

## Chapter VI

### INSURANCE COMPANIES

#### A. LIFE INSURANCE

##### 1. COVERAGE AND FOCUS

The analyses of life insurance companies focused upon life insurers in their capacity as investment managers. In so doing the chapter has documented the competitive pressures and opportunities which have produced a greater emphasis upon the industry's investment-management function and has analyzed the evolution of life insurers as investment managers in four parts. First, changes in the structure of the industry and in the growth rates of various lines of business were described with emphasis upon the expansion of insurers' activities through affiliates and the development of equity based products designed for sale to individuals. Second, the chapter documented the responses of life companies during the late 1950's and the 1960's to the declining share of pension-benefit plan assets managed by insurers and provided measures of the joint success achieved by these responses in returning life insurers to a more competitive position in this portion of their business. Among the several responses was the creation of special separate investment accounts tailored to serve, in particular, the equity investment needs of pension-benefit plans. The development, growth, and characteristics of separate accounts were analyzed in a third major section of this study.

Finally, the analysis concluded with an examination of life insurers' investment organization, management practices, and policies.

##### 2. DEVELOPMENT OF INDIVIDUAL EQUITY BASED PRODUCTS

###### A. INDUSTRY STRUCTURE AND RECENT DEVELOPMENTS

At the end of 1969, there were over 1,800 legal reserve life insurance companies operating in the United States with total assets of \$197 billion. In addition, Canadian life insurers, several of which are included in the Study samples of life companies, held \$15.8 billion. By number, over 91 percent of life insurers are organized as stock companies. However, the 156 mutual companies account for better than two-thirds of industry assets.

The insurance industry is relatively highly concentrated; a smaller number of firms account for a higher proportion of industry assets under management than is true for bank trust departments or the investment advisory industry. Fifty percent of industry assets are held by only seven insurers. Separate account assets and group annuity reserves are even more concentrated. However, concentration in the industry has been slowly declining for many years with the entry of new firms and the higher growth rates achieved by younger firms.

In recent years, life companies have found that the environment in which they function has become more intensely competitive due to (1) the aggressive competition of bank trust departments, and recently, investment advisory complexes, for management of pension-benefit plan assets; (2) mutual funds encouraging individuals to save through mutual fund shares rather than cash value insurance; (3) other financial institutions developing full financial service packages, including insurance; and (4) industrial and conglomerate corporations invading the insurance business. Insurers have responded to these pressures by (1) expanding and diversifying their activities through subsidiaries and via the creation of holding companies; (2) offering group and individual variable annuity products; (3) entering the mutual fund business; (4) preparing the way for variable life insurance; (5) developing equity funding arrangements and modern flexible contracts for pension-benefit plans, including offering administrative and investment services to pension-benefit plans without insurer assumption of mortality and morbidity risks; and (6) building up their investment skills, concentrating more effort on the management of invested assets, and in particular, increasing their activity in various types of equity investments.

#### B. FINANCIAL INTEGRATION

Stock and mutual insurers have expanded their activities through the creation of subsidiaries. In most instances these subsidiaries are engaged in businesses reasonably ancillary to the insurance business, including investment management. However, those stock companies which are interested in making full use of existing capital, increasing their means of raising funds, and diversifying widely have created upstream holding companies to accomplish these objectives. The acquisition or creation of noninsurance affiliates accelerated rapidly during 1968-69. In fact, over three-quarters of the noninsurance affiliations reported by the Study's sample of life insurers as of the end of 1969, had been consummated during those two years.

Not surprisingly, State insurance regulators have viewed this proliferation of noninsurance activities with concern, particularly where control of insurers by noninsurance enterprises results. At the heart of this concern is the fear that extensive conflicts of interest are being created between controlling persons and policyholders and other shareholders of the insurers involved.

#### C. INDIVIDUAL EQUITY BASED PRODUCTS

Life insurers' decisions to offer mutual fund shares or variable annuities, or both, dramatically changed industry marketing strategies by introducing substantial customer participation in equity investment risks. As a result, some insurers are offering financial services which they recognize may compete with, rather than complement, the sale of insurance products. Most life insurers having made the decision to offer individual equity based products have chosen between mutual funds and variable annuities as the initial product, although virtually simultaneous introduction of both products has occurred.

Most respondent companies indicated that in deciding to enter the mutual fund field, three considerations were highly important: (1) de-

veloping a financial package more salable than traditional products in an inflationary environment, (2) increasing agents' income, and (3) increasing sales of individual insurance policies. In addition, exactly half of the 26 respondent companies which were offering fund shares regarded mutual funds as one step in the desired direction of creating a diversified financial institution.

Variable annuities are preferred over mutual funds by some insurers because they are viewed as a traditional product in modified form. The essence of a variable annuity based on investment performance of an equity portfolio is that the annuitant assumes the investment risk. Individual variable annuities are securities which must be registered under the Securities Act of 1933 and the separate account used as a funding medium is an investment company required to register under the Investment Company Act of 1940. The Commission has provided insurers offering variable annuities under tax qualified pension-benefit plans substantial exemptions under these acts. The recently enacted Investment Company Amendments Act of 1970 provides statutory exemptions. Variable annuities and separate accounts are also regulated under state insurance law.

For several reasons, including the time and resources required to retrain insurance agents, neither mutual funds founded by life insurers nor variable annuity policies have as yet made much of an impact. Sales of both these products are also undoubtedly affected by agents' compensation scales on various products. Differences in compensation appear to induce many agents to continue to concentrate their efforts on life insurance products, rather than on mutual funds or individual (fixed or variable) annuities, except in specialized markets where tax considerations significantly affect buyers' purchase decisions.

Variable life insurance, defined to mean insurance contracts in which benefits vary with the investment performance of a separate account, are not being sold by any of the respondent U.S. insurers. Such policies are sold in Canada, England and Holland, and U.S. companies have been actively preparing to offer variable contracts by examining questions of actuarial design, working to obtain State authorization to offer such products and discussing the applicability of the federal securities laws to such products with the commission. The potential impact of variable life insurance appears to be much greater than that of variable annuities, and unlike insurers' entry into mutual funds, will directly affect the pace of insurance company investment in equities.

### 3. LIFE INSURANCE COMPANIES AS FUNDING AGENTS FOR EMPLOYEE PENSION-BENEFIT PLANS: THE GROUP ANNUITY BUSINESS

#### A. LIFE INSURERS AND THE COMPETITION FOR MANAGEMENT OF PENSION-BENEFIT PLAN ASSETS

In the early World War II period, at the point when collective-bargaining agreements began to play a major role in pension-benefit plan design, private pension-benefit plan funding was split about equally between insured contracts and various noninsured trustee arrangements. Insurers subsequently fell behind noninsured funding media (primarily bank trust departments) in the competition for

management of pension-benefit plan assets. In response to the deterioration in their competitive position insurers increased the flexibility of contracts and broadened the investment services offered so that, by the latter half of the 1960's, they had substantially improved their competitive position.

Insurers' competitive problems in this area were caused by (1) their inability to offer investment management, and particularly equity investment management, tailored to the needs of employers funding pension-benefit plans, (2) inflexibilities in group annuity contracts, (3) their inability to credit a competitive rate of investment return to pension-benefit plan customers, and (4) tax inequities. The development of separate investment accounts, more flexible deposit administration contracts, the investment year method of crediting investment return to contract holders and amendments to the tax statutes have removed these disabilities.

Insurers generally feel that they have regained a competitive posture in the business of managing pension-benefit plan assets. They regard their ability to offer a package of actuarial, administrative, and investment services as the most important competitive advantage they hold over banks and other noninsurance funding media which do not offer actuarial services in particular. Also of considerable importance is insurers ability to offer investment, mortality, and other guarantees. Insurers find their greatest competitive disadvantage results from banks' ability to develop close relationships with employers through their commercial banking business. The competitive environment also is significantly affected by banks' ability to establish closer relationships than insurers with pension consulting firms.

One possible index of the current intensity of competition for management of pension-benefit plan assets is the incidence of split funding, the allocation of a plan's assets among more than one investment manager. However, the desire to obtain aggressive competitive asset management is not the only reason employers choose to adopt split-funding. In fact, some split funding between insurers and banks exists because group annuity contractual restrictions prohibited employers from fully terminating their insured contracts during the 1950's when many employers were shifting their plan funding from insurers to bank trust departments. Nevertheless, knowledge of the frequency of split funding and insurers' consciousness of the fact of split funding is of assistance in understanding the nature of competition for pension-benefit plan asset management.

On the whole, replies to Study questionnaires suggest a high degree of consciousness on the part of insurers of split funding. Twenty-five percent of the plans reported on by the respondent insurers were known by them to be split funded. As expected, the percentage is highest for the largest respondents, and declines with respondents' size. The responses also show that where a plan is split funded, nearly 60 percent of the time a bank is the competing funding agent, while other insurance companies are the other managers most of the rest of the time.

## B. GROWTH AND CHANGE IN THE GROUP ANNUITY BUSINESS

The most dramatic change in the composition of group annuity contracts, evident during the period 1950 to 1969, is the increase in the more flexible deposit administration contracts at the expense of deferred annuities. This shift is especially pronounced since 1965. The growth in deposit administration contracts occurred both as a result of substantial shifts in reserves from existing deferred annuity contracts and from the attraction of new deposit administration customers.

The concentration of business among a few large companies is greater in the group annuity line than in other lines of business in the life insurance industry. However, some modest dilution of concentration appears to be occurring.

## C. CHANGES IN FUNDING MEDIA : THE DEVELOPMENT AND USE OF SEPARATE ACCOUNTS

Separate accounts were developed initially for the purpose of providing a funding vehicle for pension-benefit plans funded by cost-conscious employers. Favorable investment results can substantially reduce the cost to employers of providing retirement benefits to employees. Separate accounts also are used to fund group and variable annuities, but variable benefits have not proved to be popular with most employers.

During the four years 1966-69, the proportion of group deferred annuity and deposit administration contract reserves funded in separate accounts grew from about 1 percent to 11 percent. By yearend 1969, the largest insurers in the group annuity business reported that cases accounting for over half of their group annuity reserves were making some use of separate account funding. However, only 14 percent of the number of outstanding group annuity contracts issued by these companies were taking advantage of the availability of separate accounts, indicating a much higher incidence of separate account use among the larger customers.

## D. NEW BUSINESS AND TERMINATED BUSINESS

Growth of an insurer's group annuity business occurs both through growth of reserves in existing contracts and from newly acquired business net of terminated business. Although the primary source of growth for the industry as a whole derives from existing business, net new business makes a substantial contribution in some companies and analysis of the characteristics of new customers and terminating customers provides some clues to the trends in the demand for various insurer services.

The Study found that most new cases have first been brought to the issuing insurer's attention by the insurer's representatives or by consulting actuaries. Banks, investment advisers or other noninsurance financial institutions seldom are sources of pension business to insurers.

The majority of new group annuity cases acquired by respondent companies during 1968-69 represented newly created pension-benefit

plans. About 23 percent of the new cases in terms of estimated contributions (8 percent of the number of new cases) were removed from banks or other noninsurance funding agents.

The frequency of separate account funding in new cases is of particular interest since the availability of equity funding through separate accounts has been presumed to be of major significance in determining the ability of insurance companies to compete for pension business. The Study found that a significantly higher proportion of new customers as compared to existing cases, appear to make use of separate account funding. The larger cases appear more likely to make use of separate accounts than the smaller ones.

The primary reason pension plans terminated their contractual relationship with the responding insurers, or significantly reduced their contributions, was to shift assets to another funding agent, usually a trustee bank. This shifting among funding agents accounted for 50 percent of the number of cases lost or reduced, and 80 percent of the estimated loss in contributions, indicating that the loss of larger plans must usually have been due to the desire to employ another funding agent.

#### 4. SEPARATE ACCOUNTS: DEVELOPMENT, GROWTH, CHARACTERISTICS AND MANAGEMENT FEES

The Study collected information on nearly 200 separate accounts in existence as of yearend 1969. These included accounts holding 94 percent of the \$3.6 billion in separate accounts in U.S. insurers plus \$215 million in separate account assets of Canadian insurers. Separate accounts can be distinguished according to (1) whether or not the account is registered with the Commission under the Investment Company Act of 1940, and (2) whether the account commingles the assets of a number of contract holders or is established solely for a single customer. All registered accounts are commingled accounts. Nearly half the sample accounts (with one-third of the reported assets) are single client accounts, about 60 percent of which were established in 1968-69.

All registered accounts are relatively small, most having assets of less than \$10 million at the end of 1969, reflecting that the registered accounts are relatively new and primarily serve to fund contracts sold directly to individuals. In the nonregistered commingled account category, 54 of 70 accounts had assets of less than \$25 million each, but five accounts, each with over \$100 million in assets, contained about two-thirds of all nonregistered commingled account assets. Of these five large accounts, four were established in 1962 and the fifth in 1963. Most single client accounts are relatively small; accounts of less than \$25 million make up 78 percent of single client accounts and contain 40 percent of assets in this account category. Nearly 98 percent of the assets in sampled separate accounts represent interests of tax qualified pension-benefit plans.

Most separate accounts have been established to provide equity funding through investment in common stocks. However, 25 of the 166 sampled unregistered accounts were intended to invest primarily in debt securities (eight accounts), mortgage loans (two) or in a mix of debt instruments and equity securities (15).

Among accounts with a common stock orientation, larger accounts, older accounts and commingled accounts tend to have higher proportions of their assets invested in common stock than do other accounts.

Insurers have in recent years been issuing contracts in which the investment features are much more significant than had previously been the case, and under which assets can be much more freely transferred to other funding agents. The investment and transferability features are often especially prominent in contracts which include the utilization of separate accounts as funding media. In some separate accounts this flexibility has been accompanied by dilution of insurers' responsibility to select investments and brokers, as funding employers, have retained some discretion in these decisions for themselves or for an investment adviser.

In nearly all cases investment management fees charged to separate accounts are based upon the net asset value of the account or upon each contract holder's interest in the account. In commingled accounts the fee rate is most commonly stated as a flat percentage of the account's assets. Where a schedule is used, as is the case for about one-third of the unregistered commingled accounts, the charge is usually levied against each participating contract holder separately. Graduated rate schedules are the norm for single customer accounts.

Multivariate regression analysis revealed that the size of a separate account and the size of the managing insurer jointly have a significantly negative impact upon investment management fee rates—fee rates are significantly lower for large accounts and accounts managed by larger insurers. Thus, at least to some extent, economies realized from account size and insurer size are passed on to customers. The results also indicate that when account size and other variables are given, commingled accounts pay higher fee rates than single client accounts. However, contrary to expectations, this analysis showed no observable tendency for registered accounts to charge higher fees once their size, commingled status and other characteristics are taken into account. The results of this analysis also suggest that fee rates had an upward time trend over the 1966–69 period.

## 5. PORTFOLIO MANAGEMENT: INVESTMENT ORGANIZATION, TECHNIQUES, POLICIES AND RESULTS

### A. PORTFOLIOS MANAGED

Investment personnel of life insurance companies are responsible, together with supervisory investment committees and the companies' boards of directors, for management of the insurers' assets including separate account as well as general account assets. The 63 companies responding to the Study's life insurance intrinsics questionnaire held over \$160 billion in general account assets at the end of 1969. The investment personnel in these companies also managed \$3.3 billion of separate account assets. In addition, the same investment personnel managed \$5.3 billion in property and liability insurer assets, the bulk (\$4.5 billion) accounted for by three large insurance complexes, and \$192 million in affiliated life insurance company assets. However, only

a relatively small portion of the mutual fund assets reported by the responding companies are managed by the same personnel that manage the insurers' own assets.

#### B. ORGANIZATION FOR INVESTMENT DECISIONMAKING

The ultimate power and responsibility for investment policy and practice resides in each insurer's board of directors. However, the effective policy body is usually a subcommittee of the board and is generally composed largely of outside directors, but may include two or three of the company's top officer-directors. This committee, most commonly known as the finance committee or the executive committee, sets the insurer's investment policy guidelines.

The committee exercises control over equity security selection and trading decisions through review of the trades and frequently through the use of one or more approved lists. With rare exceptions, respondents indicated that the finance committee does not direct the means by which trades are executed, including markets and brokers utilized.

#### C. EQUITY INVESTMENT DECISIONS

##### (1) *Statutory investment restrictions*

Insurance company equity investments are severely restricted by State insurance laws, and among the States New York has occupied an especially influential and restrictive position. The statutes governing insurer investments impose quantitative limits affecting both total investment in equities and investment in shares of any single issuer or on any parcel of property. The statutes also constrain insurers as to the characteristics of permissible equity investments. New York companies are limited to common stock investments not exceeding the lesser of 10 percent of assets or 100 percent of surplus. This limitation is, of course, confined to general account investments. In addition to specifically eligible investments, most States have a statutory "leeway" or "basket" clause which permits insurers to make investments not otherwise qualifying for insurers' portfolios.

Separate accounts are, of course, free of the aggregate limits on the proportion of portfolio assets which may be held in common stocks. In many States, including New York, any qualitative restrictions on the type of common shares which are eligible for life insurers' portfolios are applicable to separate accounts. However, such restrictions are normally offset by a relatively generous leeway clause.

##### (2) *Equity security investment personnel and procedures*

A full-scale securities investment operation utilizes a number of skilled personnel including portfolio managers, security analysts, professional traders and economic researchers, as well as various support personnel and the supervisory services of some of the highest ranking officers in the company. Among the larger companies the most significant increase in personnel between 1964 and 1969 occurred in equity security portfolio managers, analysts and traders. This increase was more modest for the smaller companies.

Of the several basic ways in which institutional investors can obtain information and recommendations which influence decisions regard-



ing which equity securities to buy or sell, in-house analysis of financial statements is rated most important by companies in all size groups. For smaller companies, information and recommendations purchased from broker-dealers via commissions ranks next in importance. For the largest 10 companies information purchased with commissions from brokerage houses and direct contact with issuers were ranked as about equally significant.

#### D. PORTFOLIO COMPOSITION OF GENERAL ACCOUNTS

Although most separate accounts created by life insurance companies have been intended primarily for investment in equity securities, life insurance general account investments have been constrained by tradition, their fixed dollar liabilities and the type of statutory restrictions summarized above, to a primary emphasis upon fixed income obligations. However, the movement of assets into separate equity accounts has been accompanied in recent years by various forms of equity participation obtained with general account investments in directly placed corporate debt securities and mortgage loans.

Total industry general account assets grew from \$149 billion as of year end 1964 to nearly \$194 billion at the end of 1969. Corporate debt securities and mortgage loans continued to account for about three-quarters of general account assets during this period, although the distribution of mortgage loans held shifted markedly away from single family home mortgage loans to loans on apartments and commercial properties. Policy loans increased proportionately more than any other asset category, from 4.8 percent of assets in 1964 to 7.1 percent in 1969. This policy loan experience contributed significantly to a very tight cash flow situation for many companies and in some cases retarded planned increases in common stock investments. Common stocks, which unlike other insurance company investments are reported at market value, increased from 3.6 percent of general account assets in 1964 to 3.9 percent in 1969.

Restricted common stock issues held in general accounts of respondent companies amounted to just 2.2 percent of common equities reported. Common stocks listed on the New York Exchange account for 96.5 percent of the five largest insurers general account common stock holdings at the end of 1969. The remaining companies as a group have about three-quarters of their common stock holdings in stocks listed on the NYSE. NYSE listed stocks make up about three-quarters of the value of all common shares outstanding. Approximately half of the non-NYSE stocks excluding bank and insurance stocks, consist of stocks which are listed on the American Stock Exchange, solely on regional exchanges or are unlisted.

During recent years life companies have been successful in obtaining additional compensation on directly placed corporate debt obligations and on mortgage loans secured by apartments, or commercial business or other nonresidential properties. This additional compensation can take many forms including common stock, real property, instruments convertible into common stock, warrants, various options to purchase equity securities or real property, provisions for sharing in the income or capital gains realized by the borrower and interest in residual values.

It appears that insurers' taste for equity kickers on debt instruments has been stimulated and that they will continue to negotiate hard for such provisions even as interest rates decline from the historic high levels reached in 1968-1970. Some respondents indicated that as interest rates ease, the desire for equity provisions may induce them into investing in lower quality debt instruments.

#### E. TRADING IN COMMON EQUITIES

##### (1) *Separate account turnover and activity rates*

As life companies have increased their holdings of common equity securities in recent years, they have also increased their trading activity in these securities. Common equity turnover rates<sup>1</sup> for separate accounts increased substantially during the period 1965-1969 inclusive, with the most dramatic increase occurring in 1968. This timing lags behind the increased turnover for mutual funds by about 2 years, but is roughly in line with that of bank managed corporate pension funds and property and liability insurers.

In general, activity rates<sup>2</sup> also increased over the same period, but the overall percentage increase is smaller than that observed for turnover rates and this pattern is not ubiquitous as was true for turnover rates. Thus, for example, there is no particular trend in activity rates for nonregistered commingled accounts, or for the oldest accounts or for the largest accounts.

The Study finds that the increase in turnover rates during the 1965-1969 period occurred over a wide variety of accounts and is not due to changing mixes of account characteristics. Indeed, most account and insurer characteristics do not contribute much to an explanation of the variations in turnover rates among accounts.

##### (2) *Separate account investment performance, volatility and turnover*

The Study collected data on separate accounts which permitted computation of rates of return for 80 of the reporting accounts.

Each of these account's volatility also was calculated. An account's volatility is a measure of the sensitivity of the market value of the account's assets to movements in general market prices of the same types of assets. Since most separate accounts are primarily equity accounts the market standard employed was the Standard & Poor's 500 Stock Index. Use of the volatility concept made it possible to segregate that portion of an account's return resulting from portfolio management from that portion which simply reflects movements in the general level of stock prices. This was done by comparing the return on an account to the return realized by a standard, unmanaged account of the same volatility.

During the period covered (the latter part of the 1960's), relatively low volatility accounts performed somewhat worse than hypothetical unmanaged portfolios while higher volatility accounts performed somewhat better. This pattern is similar to that observed for accounts managed by other institutions.

<sup>1</sup> Defined as the lesser of acquisitions and dispositions of common equity securities during a calendar year divided by the average market value of beginning year and end year holdings.

<sup>2</sup> Defined as the average value of acquisitions plus dispositions during the year divided by the same average holdings used in calculating turnover rates.

Of primary interest, however, was not the excess return attributable to management *per se*, but the relation between this performance measure and account characteristics such as turnover, the total value of account common stock holdings and the asset size of the insurer which manages the account. Although a significant negative relation is found between performance and turnover for mutual funds and bank collective funds, no significant relation between these two variables appears to exist for separate accounts. Thus, although the Study does not find turnover to be negatively related to investment performance for separate accounts during the latter half of the 1960's neither is there any evidence that higher turnover is associated with better performance.

### (3) *General account turnover and activity rates*

For the five year period 1965-69, there was also a year-to-year increase in turnover rates for general accounts as a group; the increase, however, was much more modest than that recorded by separate accounts. The largest increase occurred in 1968, as it did with separate accounts. General account activity rates increased in about the same proportion as turnover rates over the period. Although general account activity rates for insurers reporting on both general and separate accounts increased from 10.6 to 19.5 percent between 1965 and 1969, these insurers' activity rates as a whole (for general and separate accounts combined) increased from 11.4 to 27.3 percent during the period. This difference is explained by the growth of, and higher activity rates generated by, separate accounts.

Turnover rates for general account equity securities are less than those for equity holdings in separate accounts for at least two reasons: (1) contractholders in separate accounts are primarily cost-conscious employers who seek relatively aggressive investment management in the hope of obtaining substantial investment returns, and (2) while most separate accounts are free from income and capital gains taxation, insurers do incur taxes upon gains made from security sales in the general account. Questionnaire responses indicate that capital gains tax consequences have some effect upon general account security sales.

## F. CONFLICTS IN THE TREATMENT OF VARIOUS ACCOUNTS

### (1) *The problem*

The proliferation of investment accounts managed by some life insurance companies' investment personnel raises questions as to how conflicts among differing interests are and should be handled in the management of multiple accounts. Several groups of interests may be involved and affected by investment decisions, including the interests of stockholders of the insurance company, the management of the insurance company and the various groups of shareholders, policyholders or contractholders which have participating interests in the various accounts. Stockholders are, of course, absent from the group of parties involved in decisions made by mutual insurers. The Study focused upon two specific types of allocation problems that arise in the management of multiple accounts; namely, (1) where more than one account is engaged in a program of purchasing or selling the same security, and (2) allotments of new equity issues among various accounts under management.

(2) *Allocation policies and practices*

When more than one account is buying or selling the same security over a period of time, allocations among accounts may be quite important if the trades are placed on the basis of information, or if the act of trading itself has price impacts, since early trades in purchase or sale programs are more likely to receive better prices. Just one-half of the Study's respondents stated that they had no policy as to allocation of purchase or sale transactions among various accounts. This lack of a policy was explained in some instances by the fact that only one account (the general account) was being managed, or that separate accounts were relatively new, or that the accounts were sufficiently small and/or only stocks with a large floating supply were held or purchased so that any purchase or sale decision could always be completed in a single day.

Most of the largest companies reported that they had a policy of trying to allocate each day's trades in the most equitable way possible, generally in proportion to the size of each account's order or its position to be liquidated.

However, 11 respondents reported that some sort of conscious priority was established, with small accounts, registered accounts, separate accounts, or "performance-minded" portfolios receiving priority.

The Study also computed average prices received by three classes of insurer accounts whenever at least two of those classes of accounts within a reporting insurer purchased (sold) the same stock issue in the same month. This was done for about 800 stocks over 21 months, January 1968 to September 1969. An analysis of these data, which reflect the limited experience life insurers have had managing multiple accounts, provides no evidence that insurers consistently favor general account, single client separate account or commingled separate account portfolios in allocating acquisitions or dispositions of securities where the same security is bought (sold) for more than one of these classes of accounts in the same month.

Another means of giving preferential treatment to particular types of accounts is through the allocation of limited quantities of economically attractive securities, such as new common stock issues. Substantial numbers of new issues rose from their initial offering prices in after market trading during the 1960's. Consequently, acquisition of shares in the initial offering frequently proved to be quite profitable. Ten companies replied that some sort of preferential treatment existed as a manner of policy—most often favoring small separate accounts.

The Study's analysis of new issue activity collected detailed information on purchases of 84 new equity security issues during the 18 months beginning with January 1968. Of the \$58.6 million of these issues purchased at offering by institutional investors, \$3.7 million were purchased by 15 life insurance companies. Most of these companies were relatively small and apparently managed only one or two accounts. Nearly all of the purchases of these new issues which were allocated to nonregistered separate accounts, investment companies and accounts of affiliated life or property and liability insurers, were made by just six insurers.

For these six insurers, investment companies received the largest share of new issues relative to the size of their total common stock

holdings; each type of separate account (registered, nonregistered, commingled and single client) also received disproportionately large shares, while general accounts and accounts managed for affiliated insurers received small allotments relative to the value of their common stock holdings.

*(3) Concluding comments on preferential treatment problems*

The statistical tests used to detect the existence of preferential treatment among accounts are meant to be suggestive only. The study considers the question of equitable treatment of accounts to be important and believes that effort needs to be applied in developing standards of fairness.

Finally, the discussion of conflict problems which arise when multiple accounts are managed is not intended to suggest that insurers should resist the trend toward account proliferation. Serious conflict questions can also exist in the management of large commingled accounts containing interests of a variety of customers with varying investment needs. Where there are no clear differences in investment objectives, commingled accounts may facilitate fair treatment. But where clear differences exist, segregation of customers with relatively homogenous investment requirements can be a more effective means of serving customers' investment objectives and has the further advantage of bringing questions of priorities into the open.

## B. PROPERTY-LIABILITY INSURANCE

### 1. PROPERTY-LIABILITY INSURANCE IN THE STUDY

P-L insurance may be thought of as a second and much smaller part, as measured by aggregate assets, of a brother-sister team with life insurance. However, with respect to investment in the securities markets it is significant to note that almost all P-L investment assets are in marketable securities, while very substantial life assets are in privately placed issues and mortgages.

The P-L insurance industry was included in this Study for the following reasons:

1. To complement the study of life insurance investment;
2. P-L companies rank as the fourth largest institutional holder of common stock with approximately \$11.7 billion in publicly traded shares on December 31, 1969;
3. To explore the reported recent increase in P-L common stock activity rate;<sup>3</sup>
4. To provide consolidated asset holdings data for a significant part of the P-L industry;
5. To examine the organization and composition of P-L insurance groups<sup>4</sup> and their degree of financial integration; and

<sup>3</sup> The common stock activity rate is currently defined as the average of purchases and sales divided by the average market value of stock holdings at the beginning and end of the period, stated at an annual rate. Common stock activity rates are published quarterly in the Statistical Bulletin, U.S. Securities and Exchange Commission, April, June, September, and December issues.

<sup>4</sup> A P-L insurance "group," formerly referred to as a "fleet," is defined herein as including any company writing property-liability insurance that directly or indirectly controls, is controlled by, or is under common control with another property-liability insurance company, whether by reason of common management, ownership, or otherwise.

6. To examine the securities investment operations of P-L groups. The Study collected information from the 25 largest groups (20 stock groups and five groups headed by mutual companies). Together these groups wrote approximately 58 percent of the total industry net premiums in 1969.

## 2. STRUCTURE OF THE INDUSTRY AND REGULATION

### A. STRUCTURE

The P-L insurance industry is relatively diffuse. Approximately 3,000 separately chartered companies or organizations underwrite P-L risks in the United States. Essentially all relatively large P-L companies are affiliated with at least one other P-L insurance company. These affiliated companies are under common control and are referred to as insurance groups. There are approximately 350 insurance groups, made up of 900 of the 3,000 P-L companies. Large P-L groups are the most significant factors in the industry, with the 50 largest groups writing approximately 74 percent of industry premiums in 1969. That there is relatively great diffusion among P-L groups is evident, since the largest group in volume of net premiums written had only 5.9 percent of the U.S. market in 1969.

The stock company is the most significant form of legal organization for private P-L insurers, as measured by the 68 percent of total industry net premiums written by stock companies in 1969. There are approximately 820 stock companies writing P-L insurance in the United States.

Second in importance to stock companies as measured by assets employed as well as net premiums written are P-L insurers organized as mutual corporations. The nearly 2,200 mutual companies wrote over 27 percent of the total industry net P-L premiums in 1969.<sup>5</sup> The mutual company feature of returning to policyholder-owners, in the form of a dividend, the margin in excess of the cost of operations, and the absence of equity investor-owners to provide additional capital, are perhaps the two most significant differences between stock and mutual companies and their operations as insurers and as investors. These differences limit the amount of policyholders surplus. Since State P-L investment regulations (and company policy) indirectly base the allowable amount of common stock investment on the amount of policyholders surplus, these differences effectively limit the amount of common stock investment and the attendant opportunity for portfolio appreciation for mutual companies.

Insurance groups, in addition to having common control and management, typically enter into an insurance pooling agreement that allocates net premiums written by the entire group to each affiliated company on a pro rata basis. To a large extent only the legal entity distinction exists among a group's several companies. Stock groups are more prevalent, and typically include more companies than are found in mutual groups, because common stock ownership is a convenient and logical means of effecting control. Affiliation among mutual companies is more cumbersome.

<sup>5</sup> *Bests Aggregates and Averages: Property-Liability 1970* (A. M. Best Co.)

Although accurate consolidated asset figures for P-L groups and for the total P-L industry are nonexistent, the volume of net premiums written is a satisfactory proxy for relative asset size and reflects the degree of concentration in the P-L industry.<sup>6</sup> While net premiums written indicate the volume of insurance retained by an insurer, gross premiums from direct business written reflect the direct public market activity of an insurance company or group. Direct premium data available by lines, groups and States for 1969 show the concentration and dispersion in the P-L industry.

On the basis of the volume of direct premiums written, automobile lines account for approximately 46.2 percent of all P-L premiums. This of course explains the considerable attention paid by the industry, governments and the public to regulation and ratemaking in automobile insurance. Workmen's compensation follows with 11.8 percent, but none of the other 19 individual lines accounts for as much as 10 percent of the industry. When all P-L lines are combined the dispersion in the industry is indicated most clearly since the largest P-L group in terms of direct premiums written (State Farm) accounts for approximately 6 percent of the industry, the second largest (All-state) accounts for 5 percent and the next three groups 4 percent each. The 10 largest groups combined had 38 percent of the industry direct premiums in 1969.

#### B. REGULATION

Property liability insurance companies are subject to regulation primarily by the States rather than by the Federal Government. The primary objective of State regulation is protection of policyholders, although revenue production through taxation is also a major consideration. Toward these objectives State regulation enters all phases of the insurance business including restricting investment, conducting periodic financial examinations, approving policies and rates and licensing companies, agents and brokers.

A major force for uniformity of regulation among the several States is the National Association of Insurance Commissioners (NAIC). This organization is a significant factor in insurance regulation through its standing committees, studies of special problems, standardization of reports and preparation of model laws. In spite of this effort the laws of the States differ in many respects, though this lack of uniformity is tempered in practice for the large insurers doing business in the major States by the New York insurance law requirement that foreign (non-New York domiciled) insurers substantially comply with the New York requirements for domestic insurers. Because few States are more restrictive than New York and because most large companies and groups do business there, the New York standards amount to national ones for most purposes.

Entry into the P-L business is controlled by New York insurance law<sup>7</sup> primarily (1) by requiring a minimum amount of capital and surplus for each specified line of insurance a company intends to write, (2) by specifying liquid, fixed income investments in which the minimum capital funds may be legally invested, and (3) by re-

<sup>6</sup> Net premiums written are defined as gross premiums from direct business written, plus reinsurance assumed from other writers, less reinsurance ceded to other companies.

<sup>7</sup> New York insurance law is used for illustrative purposes.

quiring that the company be licensed by the State insurance department to conduct a specified insurance business. Similar requirements including reporting as well as licensing are imposed by each State in which the company does business.

In general P-L companies are permitted relatively great latitude in the amount of investment in different types of affiliated (subsidiary) companies as well as in the amount and type of regular portfolio investment. With regard to portfolio investment in nonaffiliated companies, regulation is effected primarily through the minimum capital investment requirements described above and an additional required investment in specified categories of qualified assets until the combined total exceeds 50 percent of unearned premium and loss reserves. Aside from the concentration limitation mentioned below, the remainder of a P-L company's investments are essentially unrestricted. New York insurance law limits the total investment in any one institution, except classes of governmental obligations eligible for minimum capital investment, to a maximum of 10 percent of the investing insurer's admitted assets, unless the investment qualifies (a) as an investment in another insurer or (b) as an investment in a subsidiary company doing a specified financial or insurance related business. As to investment in another insurer, New York specifies that the total direct investment together with indirect investment through intermediate subsidiaries must not exceed the greater of (a) 35 percent of surplus to policyholders of the acquiring insurer, or (b) 50 percent of the acquirer's surplus over and above its liabilities and capital. This is not particularly restrictive, as evidenced by the widespread development of groups of affiliated insurance companies. Furthermore, the existence in an insurance group of a noninsurance holding company at the top of the ownership chain allows essentially unrestricted affiliation between insurance companies.

In addition to investment in other insurers as above, New York allows a domestic P-L company to invest in or acquire one or more solvent corporations engaged in any of the following businesses after it has satisfied its minimum capital and reserve investment requirement:

- (a) Insurance agent;
- (b) Securities broker or dealer investing or trading for its parent or any affiliate;
- (c) Management, sales or other service to any investment company subject to the Investment Company Act of 1940, as amended;
- (d) Investment adviser;
- (e) Insurance related functions including actuarial, loss prevention, safety engineering, data processing, et cetera;
- (f) Pension fund administrator;
- (g) Ownership and management of assets which the parent could itself own and manage;
- (h) Administrative agent for government instrumentality performing an insurance function;
- (i) Financing insurance premiums;
- (j) Any other business activity reasonably ancillary to an insurance business;
- (k) A holding company owning businesses specified above in (a) through (j) and/or other insurers;



The organization of noninsurance holding companies by insurers, the acquisition of insurance groups by noninsurance companies and the distribution to them of significant amounts of assets from insurance subsidiaries triggered studies of holding companies by the NAIC and the New York Insurance Department. Regulatory legislation in several States including New York soon followed. Additions to the insurance law in New York (1) provide stringent tests and limits on the amount of dividends that can be distributed and (2) require registration with the superintendent of noninsurance holding companies that control (that is, own 10 percent or more of the voting securities of) domestic insurers. Certain transactions between domestic insurers and noninsurance holding companies now require advance notice to, and approval by, the Superintendent of insurance. Significantly, approval in advance is required for anyone other than an authorized insurer seeking to acquire control of any domestic insurer. The fragmentation of regulation among the several States is awkward in many respects, but it is also well entrenched. Despite this fact, Federal involvement in the property-liability insurance business by way of studies and legislation is evident. For example, problems involving automobile insurance and high risk areas are widespread and are receiving national attention.

#### C. PROPERTY-LIABILITY GROUPS AND COMPLEXES

The 25 P-L insurance groups covered in the Study have followed the industry practice of adding companies. Groups add new P-L companies for the purpose of entering new territories, taking on new insurance lines, writing specialized contracts, or simply taking advantage of state laws favoring domestic corporations. From yearend 1964 through yearend 1969 these 25 P-L groups increased from 125 to 155 P-L companies. This net increase of 30 companies resulted largely from acquisitions of companies or from combinations with other P-L groups. Relatively few new companies were chartered by these 25 groups during this five-year period.

P-L insurance groups have not remained exclusively in the property-liability insurance business. The movement to multiple line contracts, multiple line companies and multiple line groups has in most cases also included entering the life insurance field. Those groups writing health insurance and having life insurance affiliates are referred to as "all-lines" insurance groups. This affiliation with life insurance companies is particularly prevalent among the 25 large P-L groups studied. All but three of these groups have at least one active life insurance company as an affiliate. Four P-L groups with very large life insurance affiliates—Travelers, Aetna Life and Casualty, CNA (Continental Assurance) and Connecticut General—are at least as well known for their life business as for their P-L business.

While insurance holding companies are now subject to some regulation under insurance laws, they are not subject to regulation of their investments in the manner that insurance companies are regulated. Consequently, one avenue to corporate affiliation (control) of other noninsurance enterprises is to have a noninsurance holding company be the parent company.

The noninsurance affiliations of large P-L insurance groups to date are almost exclusively with financial service enterprises. The most noteworthy exception is Allstate's affiliation as a subsidiary of its founder, Sears, Roebuck and Co., the Nation's largest retailer. Several other groups have been acquired by conglomerate corporations having important noninsurance business.

The complexes composed of the 25 P-L groups and their affiliated financial and nonfinancial enterprises had consolidated assets of \$62.764 billion at December 31, 1969. The assets of the 25 P-L insurance groups themselves range from \$690 million to \$9.172 billion and 17 had assets in excess of \$1 billion. Of the total amount \$30.767 billion are in the consolidated assets of the 155 P-L companies and their subsidiaries that comprise the study sample.

The financial affiliates of the large P-L groups include finance companies (present in 15 groups), investment advisory firms (12 groups), securities broker-dealers (10 groups) and real estate management or advisory firms (nine groups). At least two other P-L groups have acquired securities broker-dealer firms during the first half of 1970 to continue this trend. Ten of the P-L group complexes were already active in the investment company business at the end of 1969. Their affiliated investment advisers managed \$2.364 billion of mutual fund assets at that date and were not included in the previous asset total for complexes. In addition three other complexes have entered the mutual fund business or had taken preliminary steps to do so during the first six-months of 1970.

### 3. BEHAVIOR AS PORTFOLIO MANAGERS

#### A. ORGANIZATION AND PROCEDURE IN INVESTMENT DEPARTMENTS

In the insurance industry investment considerations and operations traditionally have been considered to be essentially separate from, if not secondary to, the insurance underwriting side of the business. The 25 large P-L insurance groups are serviced for the most part by one investment department<sup>8</sup> per group. With one exception the 25 P-L groups provide their own internal investment management for their significant companies. Factors that bear importantly on the role of P-L insurance groups in the securities markets are the operational relationships between these investment departments and their higher authority and any changes in these relationships in recent years.

Even though the several boards of directors in each group studied retain ultimate authority and responsibility, in every instance the insurance companies of the group have delegated responsibility for determining and implementing operational investment policy to a subordinate committee of directors, usually called the finance, executive or investment committee. The finance committee typically consists of five to eight directors and most often includes the board

<sup>8</sup> Investment department\* means that division or group of persons within the P-L insurance group or an affiliated entity which makes day-to-day purchase, sale, or hold decisions for the securities portfolio, even though some other person or group has ultimate responsibility over the investments of each company. For example, if a committee of investment officers makes only portfolio recommendations and these recommendations are seldom, if ever, overruled by a group with ultimate authority, the committee of investment officers and its staff is the investment department for the purposes of the study. This department will not necessarily be the same as any department in a group that may be called the "Investment Department."

chairman, the top one or two operating officers, the top financial officer and several outside directors.

The finance committee typically establishes investment policy and guidelines for the operations of the investment department. In general the investment policy guidelines established by a finance committee are quite different for fixed income securities and common stock. However, dollar amount or percentage of assets limits on the amount invested per issuer are used in many groups for most securities. The maximum discretionary limit reported for an equity security is \$10 million per issuer, although many groups did not indicate that any specific dollar limits existed.

Subject to these discretionary constraints per issuer, the investment department is usually at liberty to buy and sell most fixed income securities without securing specific committee authorization. The sale of common stock, with one exception, is also permitted without specific authorization. In contrast, purchases of common stock are normally permitted only with advance authorization unless the issue is on the approved list. In many instances the approved list includes those issues currently held in the portfolio, thereby allowing the investment department flexibility to add to existing positions of issues that do not exceed the maximum amount permitted.

Additions to an approved list or the authorization of a transaction requires in most groups, a majority vote by the finance committee. Though procedures for approval and authorization appear formidable, conservative and formal, there are modifying provisions in many P-L group's investment policy. At least 10 groups indicated that approval of a transaction by as few as two committee members is sufficient when necessary. Recent changes in investment department procedures reported by some groups indicate a gradual shift toward increased investment flexibility in the P-L industry.

Changes in the number of persons in various investment department employment categories between 1964 and 1969 give some indication of the relative significance of these positions today versus five years ago. The most significant relative change is the great increase in emphasis on professional traders. This is particularly true of equities traders, whose numbers increased fourfold in this five-year period, compared to an increase of 48 percent in total investment department personnel. Also of interest is the relatively great increase in account supervisors, portfolio managers and investment research staff for equities compared to the increases in those categories for bonds. This increased emphasis on investment in equities presumably means common stock investment since preferred stock investment is relatively small and is often associated with fixed income investment.

The 25 P-L group investment departments were asked to rank several external sources of securities research and information, indicating their importance in making purchase or sale decisions. "Financial statements of issuers" is ranked as the top source of information by 88 percent of the respondents. The only other category that scored consistently high was "Information from broker-dealers purchased with commission dollars."

## B. INVESTMENT POLICY AND PRACTICE

Part of the lore of the P-L insurance industry is that historically investment relationships have existed between (a) the volume of net premiums written in various lines of insurance and (b) liquidity requirements, portfolio composition and management. Given its own experience about volume of premiums and lines of business each of the 25 groups was asked, in the context of consideration of its relative reserves (liabilities) and surplus (capital in excess of liabilities), to describe what investment consideration, if any, is given to absolute and relative liquidity needs in determining portfolio composition. Cash plus traditional high quality, short-term liquid investments were to be contrasted to common stock investments. In addition, they were asked to describe the impact their particular groups' distribution of premiums by classes of lines had on the types of securities held in their portfolio.

Nearly all of the 25 P-L groups agree that diversification across insurance lines plus reinsurance has virtually eliminated consideration of insurance lines in portfolio management. At the same time there is some difference of opinion about the impact of premium volume, reserves, and surplus on portfolio composition. Obviously even those groups that disclaim any consideration of premium volume still maintain some pool of liquid, short-term securities to meet contingencies. Most significantly, however, there is evidence of some reevaluation among P-L groups of the role played by common stocks in building surplus and maintaining a satisfactory reserve to surplus ratio.

The 25 P-L groups were asked, in the context of current Federal income tax provisions, to describe the impact of underwriting profits and losses on portfolio composition and on investment management for income, realized and unrealized gains. The purpose of these questions was to ascertain the continuing impact of underwriting experience and tax law on the selection of different types of investment and on investment activity. The responses indicate that P-L insurance groups in general respond to some degree to prolonged statutory underwriting losses by reducing or halting further purchases of tax-exempt bonds. In light of the statutory underwriting losses experience recently, given the IRS provision exempting interest from municipal bonds from Federal income taxes, and given the related higher pretax yield available on taxable bond issues, P-L insurance groups are acting in a rational economic manner only if they exercise the option to divert investment funds into higher net yield (taxable) bonds. In contrast, P-L companies that are affiliated with profitable noninsurance operations may continue to favor tax-exempt investments.

Until recently, the traditional separation of the insurance underwriting functions from the investment function has excluded essentially all investment return from direct consideration in ratemaking. Whether prospective changes in regulatory consideration of investment income in ratemaking will affect investment policy or behavior is subject to conjecture at this time. The inclusion of, for example, the investment income associated with the investment of funds equivalent to P-L

liabilities would offset some underwriting losses and expenses. Concurrently insurance rates and premium income would change but in directions and in amounts that defy forecasting. Presumably these resultant changes would reduce statutory underwriting losses since P-L companies cannot survive prolonged losses. To the extent that overall profits change, the relative use of taxable and tax-exempt securities would also change. To the extent that statutory accounting does not adequately reflect actual underwriting experience the likely impact of including investment income in ratemaking is disguised further.

Most groups also reported that underwriting losses increased flexibility in managing the equity portfolio by permitting them to take capital gains which are offset by underwriting losses, thereby avoiding or minimizing current taxes.

Although most large P-L insurance groups measure investment performance, many of them use rudimentary methods that provide only crude indicators of portfolio appreciation and measurements are made relatively infrequently. Only a very few groups produce a measure that apparently could be used to indicate the performance of the investment department itself. Based on this information there is little evidence that these large P-L groups are performance oriented at this time. There is, however, some indication that they are moving toward more appropriate performance measurement. One group specifically reported that they were now using the Bank Administration Institute's time-weighted method of measuring performance. Two other groups said they currently were changing their internal valuation and reporting system to allow them to produce a time-weighted measure on a frequent basis.

The degree of involvement of P-L groups in the venture capital market is restricted by the traditional focus on liquidity in P-L investments. This emphasis on marketability has led P-L groups to invest almost exclusively in publicly traded issues. Private placements to large, well-established companies are insignificant. Only in a few P-L groups, particularly those with large life insurance assets to invest, do the investment departments have the experience and expertise necessary for involvement in private placements of any type. A few groups indicated a developing interest in venture capital investments, but in general there does not appear to be a significant movement in this direction among P-L groups.

Data collected by the Study permitted the first uniform consolidation of P-L insurance group assets for a significant part of the industry. The 25 P-L groups in the study had consolidated assets of \$30.77 billion at December 31, 1969. By comparison it was determined that the Commission has made satisfactory approximations in estimating P-L industry assets for its reports and for activity rate computations.

The consolidation of assets also produced accurate common stock holdings data that distinguished between investment in affiliated companies and other portfolio common stock. After eliminating investment in all affiliated companies, the total common stock investment of the 25 P-L groups was \$8.445 billion at the end of 1969. Of this dollar amount, 86.7 percent of the common stock was listed on the NYSE, indicating the preference of P-L groups for stocks of that type.

Categories of assets in which the 25 P-L groups had significant investment were common stock (33.66 percent), State and local governments (28.35 percent), nongovernment long-term debt (8.49 percent), and U.S. Governments (7.53 percent). Common stock investment was significantly more important in stock groups than in mutual groups, with 38.61 percent and 11.57 percent of assets, respectively.

Other data collected allowed the Study to compute the first accurate common stock activity and turnover rates for P-L groups by eliminating intragroup transactions. The annual activity rates for 1965 through 1969 from study data increased from 6.5 to 22 percent. This confirmed the significant increase in activity revealed in the Commission's published data, but the published figures consistently overstated the activity rate by one to four percentage points. In spite of the marked increase over this period, the correct P-L activity rates still are less than one-half of the rates reported for investment companies.

Overall, the Study concludes that P-L insurance groups have not exhibited unusual investment developments nor have they had a significant impact on the securities markets during the period studied. Although the investment activities of P-L companies are regulated by the several States in which they operate, internal insurance company and group policies tend to control regular portfolio investments. Investment regulation does limit investment in noninsurance activities by P-L companies but the unregulated holding company has been used effectively to permit unrestricted investment in these areas. Several large P-L groups were acquired by noninsurance holding companies during 1968-69, but market conditions and new State regulations affecting the acquisition of P-L companies apparently have stemmed this development.

The diversification of P-L groups together with the peculiarities of statutory financial reporting requirements for P-L companies have contributed to a credibility gap in the P-L financial reports which are required by every State in which an insurance company operates. Among the accounting shortcomings in this reporting is the failure to determine underwriting results in a meaningful manner, the absence of market valuations for all securities investments, and the absence of consolidated financial statements for P-L groups. Improvements in some of these areas of reporting are forthcoming.

## Chapter VII

### OFFSHORE FUNDS

An offshore fund is an investment company incorporated in a foreign country, the shares of which are generally sold to persons who are residents of foreign countries other than the fund's country of domicile. Although offshore fund shares usually are not offered for sale to Americans, they are often organized and managed by Americans and, typically, they invest all or a substantial portion of their portfolios in U.S. equity securities.

Basically, offshore funds are structured in this manner so as to minimize U.S. and foreign income taxes and to secure maximum freedom from regulation, exchange controls and other restraints. Because offshore funds are not registered under the Investment Company Act of 1940 and their shares are not registered under the Securities Act of 1933, their shares may not be publicly offered in the United States.

Offshore funds have, within the space of five years, become a significant vehicle for foreign investment in U.S. securities. The reported value of offshore fund holdings of U.S. equities held by U.S. custodians alone increased from about \$896 million in December 1967 to \$2.35 billion in December 1969, before declining slightly to \$2.12 billion in February 1970. During the calendar year 1969, net reported purchases of U.S. equities by offshore funds totaled \$534 million or about 35 percent of total net foreign purchases for the entire year.

In many respects, this development has been beneficial. Offshore funds have made a contribution to U.S. balance-of-payments receipts.

Furthermore, although offshore funds do not pay capital gains tax, they have become a source of U.S. income tax revenue by reason of taxes withheld at the source on dividend and interest income paid to them. It is impossible to calculate the amount of such withholding tax on dividends and interest (at a 30 percent rate, subject to treaty reduction) paid by offshore funds as a group. However, on U.S. securities holdings (bonds and stocks) of about \$3 billion, it would have been substantial, even allowing for heavy investment in low-yield stocks. Also, a number of persons in the United States have benefited financially from doing business with or for offshore funds, including brokers and bank custodians and transfer agents. To the extent that this has occurred, U.S. income taxes paid by such persons have been higher.

Offshore funds have also produced undeniable benefits outside the United States. In some cases, sales organizations connected with offshore funds have been able to tap new sources of capital for equity investment in the countries in which they operate. In addition, as successful competitors for savers' and investors' cash, offshore funds

have caused foreign financial institutions to reexamine their own attractiveness and responsiveness to the needs of their domestic savers.

At the same time, however, the development of offshore funds as a significant vehicle for foreign investment in U.S. equities has not been without its problems.

By U.S. standards, the quality of disclosure provided to prospective foreign investors in offshore funds has not always been adequate—in some cases it has been very poor and possibly misleading. On occasion sales practices have been hyperaggressive and sales and management charges have been excessive. Furthermore, there is no standard for providing investors in such funds with reliable, independently audited reports of operations. In addition, generally operating in a minimal regulatory environment, offshore funds offer little reliable protection against possible overreaching by the organizers and operators of such funds.

Many U.S. fund managers have elected to enter foreign markets through an offshore rather than an existing U.S. registered fund. For those managers this too is not without problems, even where foreign restrictions present no insurmountable barriers.

Managers of U.S. registered investment companies are fiduciaries. Management of offshore funds, however, tends to subject those fiduciaries to heightened conflicts of interest. For example, while every manager of more than one portfolio is presented with the difficult problem of allocation of portfolio decisions, the problem can be considerably aggravated where the manager also advises an offshore fund from which he may realize a fee for a maximization of portfolio performance substantially higher than that paid by the U.S. registered company. As explained in section G.1.a. of this chapter, the Investment Company Amendments Act of 1970 attempts to deal with this problem.

Still another problem presented by offshore funds lies in their possible impact both on the market for particular U.S. securities and on the marketplace itself. The activity of offshore funds in particular securities could have a significant impact on the market for particularly volatile securities.

In another area, available data indicates that certain types of offshore funds have experienced an extremely high velocity of portfolio turnover compared to the portfolio turnover rates of other investment vehicles, including even other offshore funds. While many funds have not been subjected to such trading, the potential is present in all offshore funds due to the absence of any limiting regulation and the absence of any capital gains tax or limit comparable to that provided by subchapter M of the Internal Revenue Code with respect to U.S. regulated investment companies.

The development of offshore funds as a significant investment vehicle in U.S. equities raises other potential difficulties. Such companies may be utilized as a means of acquiring control over specific U.S. companies contrary to existing laws or otherwise detrimental to U.S. national interests. For example, one offshore fund was alleged in October 1970 to hold approximately 28 percent of the stock of a U.S. company subject to the Shipping Act of 1916 which limits foreign ownership in such companies to a maximum of 25 percent.<sup>1</sup>

<sup>1</sup> Wall Street Journal, eastern edition, Oct. 1, 1970, p. 29.



Another difficult question presented by the proliferation of offshore funds arises from the way their management companies are sometimes structured. In some cases, the fund is managed by an offshore management company in part or wholly owned by the U.S. promoters of the fund. The offshore management company contracts with a domestic investment advisory corporation for portfolio management. Fees retained by the offshore management company and not paid to the domestic adviser for advice present an issue as to whether such fees are or should be subject to U.S. income taxes.<sup>2</sup>

Recently, several offshore funds have suffered financial reversals. In some part, this may be attributable to the fact that the management of these funds engaged in business conduct and financial transactions which would be prohibited if they were subject to the Investment Company Act.

For example, many if not most of the recently disclosed self-dealing transactions engaged in by the management of one large offshore mutual fund complex would be unlawful if the investment companies were registered under the Investment Company Act. In another recent instance, a real estate investment trust which sold redeemable securities encountered liquidity problems, and has had to stop sales and redemptions. If the company had been organized and operated from the United States, this could not have happened because the Federal securities laws would prohibit such a trust from selling securities under the representation that they were fully redeemable at net asset value at the option of the holder. It is somewhat ironic that the managements and promoters of these offshore funds would not sell to Americans because they believed that it was advantageous to avoid registration and regulation by the Commission under the Federal securities laws.

While these experiences may not have significantly affected foreign investor confidence in the U.S. securities markets, they are commonly regarded as having caused a general loss of confidence by foreign investors in offshore mutual funds. By implication this loss of confidence may have been extended to all foreign funds, including perhaps even U.S. registered investment companies' sales abroad.

As a consequence, to the extent foreign sales of U.S. funds have been adversely affected, the U.S. balance of payments and capital market may have been denied a positive cash flow. (The same statement is applicable with respect to any country in which investments might otherwise have been made.) Furthermore, to the extent that the recent, well publicized difficulties of offshore funds have engendered net redemptions by shareholders and have led to the net sale of U.S. securities by the funds, the United States is detrimentally affected by an outflow of foreign capital in the balance of payments and by selling pressure on individual securities.

For the Study, a special questionnaire had to be devised and extensive cooperation solicited from the U.S. securities industry. This did not always yield results because principal books, records, prospectuses, and portfolio data are generally kept outside the United States. Nor can the Commission always seek information abroad without opening itself to criticism for supposed unwarranted extension of sovereignty and conflicts of jurisdiction with laws of other countries.

<sup>2</sup> In this connection, it should be noted that the 1964 report of the Presidential task force (Fowler Report) stressed even then that "no tax concessions to U.S. corporations or individuals are recommended."

With respect to the U.S. tax laws, in order to attract foreign investment in U.S. securities, the Foreign Investors Tax Act of 1966 provided certain tax advantages to foreign investors. Offshore funds, like other foreign investors, are exempt from the U.S. capital gains tax. As already noted, this can affect the degree of trading activity.

Offshore funds can also diversify their portfolios beyond U.S. securities by purchasing foreign securities without payment of the interest equalization tax ("IET"). The exemption from the IET for such funds exists so long as they are able to avoid becoming classified as a U.S. person under the terms of the Internal Revenue Code. In contrast, a U.S. domiciled mutual fund (considered to be a U.S. person), is required to pay the IET if it purchases foreign securities for its portfolio and is subject to the constraints on such investments under the voluntary foreign credit restraint program administered by the Federal Reserve System.

The Foreign Investors Tax Act also provided estate tax relief to foreign investors. It reduced the estate tax with respect to those foreign investors who directly acquire U.S. securities. However, a foreign person who invests directly in an offshore fund is not subject to U.S. estate tax because he does not invest directly in U.S. securities. He also avoids costs of probate. Thus, a U.S. domiciled, registered, mutual fund is at somewhat of a disadvantage in directly seeking business of foreign private investors. Even those wealthy foreign investors who apparently prefer to purchase funds registered with the Commission because of the regulatory protections afforded, are now encouraged to do so only through foreign financial intermediaries so as to eliminate the estate tax problem.

Recognizing this disadvantage of the registered U.S. fund, in order to gain or recapture this business, many of the U.S. financial industry who might otherwise have operated more directly with U.S. registered funds, have set up offshore funds to attract and service foreign clients. Of course, the greater investment flexibility and possibility of higher fees and profits in the atmosphere of minimum regulation may have also played a role.

The Foreign Investors Tax Act of 1966 was designed to implement the recommendations of the Fowler task force appointed by President Kennedy to develop programs to encourage foreign purchases of U.S. securities. Toward this end, perhaps the most significant change in the Internal Revenue Code made by the FITA (at least with respect to offshore funds), was the provision for the operation of a discretionary trading account by a U.S. agent for foreign investors without subjecting the foreign investors to graduated U.S. income taxes or U.S. capital gains taxes. This change in the Internal Revenue Code helped foster the growth in the number of offshore funds as a vehicle for foreign participation in the U.S. securities markets. Conceivably, such participation would continue to occur if foreign investor interest in the U.S. securities markets is appropriately stimulated and, in addition to the exemption from capital gains tax, U.S. estate taxes on the estates of foreign investors continue to be minimized.

What this suggests is the consideration of various means of encouraging foreign investment directly in shares of U.S. registered investment companies. This is the simplest and most direct approach to increasing foreign investor interest in U.S. securities through the in-

vestment company vehicle. Furthermore, foreign investor participation through existing regulated investment company channels would not present the very difficult problem of the added conflict of interest which is inherent in every case of an offshore fund managed by an investment adviser who also manages other investment vehicles which, unlike the offshore fund, are subject to Commission regulation.

It is conceivable that registered investment companies, regardless of the methods considered to enhance their attractiveness to foreign investors, will not be deemed to be an adequate substitute for separate investment companies designed expressly for, and sold exclusively to, foreign investors. To date, such vehicles have been molded into the form of offshore funds.

From the investor's point of view, however, it is clear that the offshore fund, and its propensity for minimal regulations, has not been the ideal vehicle for participation in the U.S. securities markets. The Study has also found that from the point of view of the investment adviser and the promoters of such vehicles, offshore funds have not been without their difficulties. These often include delays in communication, language difficulties, the uncertain quality of foreign audits, high fees charged by oligopolistic service industries in some offshore domiciles, questions of political stability, and the level of competence of foreign staff personnel. As a consequence, some investment advisers connected with offshore funds have expressed an interest in coming back "on shore" if this could be accomplished without sacrificing the benefits enjoyed by their foreign shareholders; that is, if foreign investors in such funds could continue to enjoy the existing benefits of the Foreign Investors Tax Act, including exemption from capital gains tax as well as freedom from U.S. estate tax, and perhaps also anonymity and bearer certificates where desired.

#### *The need for accepted international standards*

The rapid recent growth of offshore funds demonstrates an increasing awareness on the part of foreign investors throughout the world of the merits of equity based investment. In an era of growing internationalization of capital movements and the emergence of transnational business corporations, this awareness and desire for equity investment is not restrained by national boundaries.

As a general proposition, this development should be looked upon favorably by the countries affected. Movements of capital between countries should not be restricted unnecessarily. Accordingly, national regulatory agencies should endeavor to show flexibility in their treatment of foreign funds selling in their markets, provided that the degree of investor protection afforded by the country of origin is generally comparable to that given by their own. Requirements for investor protection should serve to facilitate, rather than impede, the free flow of capital between countries.

To aid the development of such a flexible approach, it would be desirable for most major countries to agree on a minimum norm that could be used as a model or guide, although each country would have the right to impose more restrictive, but nondiscriminatory requirements if it wished.

Work at trying to identify common elements in national regulations is under way at the Organization for Economic Cooperation and De-

velopment in Paris in the Working Group on Standard Rules for the Operations of Institutions for Collective Investment. Representatives of the Commission and the Treasury Department make up the U.S. delegation to meetings of this group.

While it appears appropriate for the Commission to examine the applicability of Section 7(d) of the Investment Company Act to offshore funds which use the U.S. mail or other means or instrumentalities of interstate commerce in connection with the offer or sale of their shares, a system of international uniform standards for investor protection might serve to facilitate the administration of that section. This approach presupposes far greater contact between the Commission and other national regulatory agencies than has been the case to date.

## Chapter VIII

### PENSION—BENEFIT PLANS, FOUNDATIONS, AND EDUCATIONAL ENDOWMENTS

Chapter VIII considers certain institutional portfolio groups which are among the major clients of the institutional investment managers covered in the preceding chapters. In addition, the chapter examines self-managed portfolios and their investment departments as institutional managers. The portfolio groups examined include noninsured corporate and multiemployer pension-benefit plans, State and local government retirement systems, educational endowments, and private foundations. Insured accounts are examined in chapter VI.

The Study concentrated its data collection and analytical efforts for this chapter upon samples of each portfolio type chosen to maximize coverage of assets while minimizing the number of individual respondents. The largest members of each portfolio group, then, are the subjects of this chapter.

Noninsured corporate pension-benefit plans is a category consisting primarily of pension plans and profitsharing plans and to a much lesser extent savings and thrift plans and stock and bond purchase plans. An element common to the members of the category is that benefits in some form are received at or after retirement, or other termination of employment. The principal difference between pension plans and profit-sharing plans lies in the nature of the employer's contributions. In the typical pension plan, employer contributions are made periodically at such times and in such amounts as are determined actuarially to be adequate to provide the benefits conferred by the plan as they become payable. In the case of the typical profit-sharing plan, by contrast, the employer contributes amounts out of profits from time to time and the plan contains a formula permitting calculation of the employee's interests in the fund and the benefits to be paid to participants who qualify.

Both types of plans may provide for employee as well as employer contributions; occasionally, employee contributions may be required. In a fairly high percentage of the larger plans, about 50 percent, employees may, prior to retirement, acquire vested rights to receive benefits at or after retirement; in others, continued service until retirement will be a condition precedent to the receipt of benefits. Some plans may provide death benefits to named beneficiaries of participants. Some may provide disability benefits.

To an increasing extent pension plans may provide for variable benefits with the amount of benefit based either on the investment results of a fund or separate account, or upon some general index such as the cost-of-living index. These kinds of benefits stem from efforts to offset the effects of inflation on fixed-dollar benefits provided in the older, traditional plans.

If a pension-benefit plan is funded through the medium of a trust, the trust is entitled to tax exemption under the Internal Revenue

Code provided that certain qualifying standards are met. In general, to qualify, the plan which is the subject of the trust must be in writing, must not discriminate in favor of certain classes of employees, must cover certain percentages of employees, must provide for the vesting of benefits upon termination of the plan, and must be used solely to benefit employees or their beneficiaries. If a plan qualifies, contributions to the trust by the employer will be deductible by the employer, contributions as well as the income and capital gains of the trust will not be taxed to the trust, and beneficiaries will not be taxed until benefits are received, sometimes at the more favorable capital gains rates. By far the greater number of pension-benefit plans do seek and attain qualified status; all of the plans in the Study's samples were qualified.

Beyond the qualification provisions of the tax law, another important part of the legal environment of pension-benefit plans is the Federal Welfare and Pension Plans Disclosure Act. In general, it requires plans covering more than 25 employees to file a descriptive statement with the Department of Labor as well as an annual report supplying information on the financial status and the investments of the plan. The plan's administrator is required to deliver upon request in writing to participants or beneficiaries a copy of the description of the plan and "an adequate summary of the latest annual report." In addition, copies of the description of the plan and the latest annual report are to be made available for inspection by participants or beneficiaries "in the principal office of the plan."

Recent sessions of the Congress have seen a number of bills introduced which would upgrade the quality of the reports required by the Act. A listing of securities by issue showing both current value and aggregate cost would be required under one bill. In addition, some of the bills would establish stricter standards of fiduciary responsibility on the part of persons who administer plans, provide for minimum vesting and funding standards, insurance, and portability of benefits from one employer to another.

During the period of time covered by the study and up to the passage of the Investment Company Amendments Act of 1970,<sup>1</sup> the Federal securities laws also were of major importance for pension-benefit plans. Amendments contained in the Investment Company Amendments Act have the effect of reducing substantially the impact of the securities laws on these plans.

Although interests of participants in plans meet the definition of "security" under the Securities Act of 1933, prior to passage of the Investment Company Amendments Act, the Commission generally did not require plans to register under the Securities Act. If, however, amounts exceeding employer contributions were invested in the securities of the employer, registration was required. This position has, in effect, been codified by the Act. Former section 3(c)(13) of the Investment Company Act of 1940 exempted from that Act trusts funding qualified plans; however, separate accounts maintained by insurance companies funding qualified plans were not similarly exempted. In this area, the Commission required registration under both the Securities Act and the Investment Company Act except to the extent exemptions were made available by rules 3c-3 and 6e-1 under the Investment Company Act and rule 156 under the Securities Act.

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<sup>1</sup> Public Law No. 91-547 (Dec. 14, 1970).

The Investment Company Amendments Act exempts interests or participation in trusts and insurance company separate accounts funding qualified plans from the registration provisions of the Securities Act and the Securities Exchange Act of 1934 and from the registration and regulatory provisions of the Investment Company Act with two exceptions. Interests or participation in trusts and separate accounts funding H.R. 10 plans must be registered under the Securities Act, and interests or participations in single trusts or separate accounts funding the plans of a single employer under which an amount in excess of the employer's contribution is allocated to the purchase of securities of the employer must be registered under the Securities Act. For these purposes, securities of affiliated companies are considered securities of the employer, but interests or participations in trusts or separate accounts themselves are excluded from the class of employer's securities.<sup>2</sup>

In addition to the Federal laws and regulations discussed above, pension-benefit plans and their trusts also are subject to State laws in regard to such matters as responsibilities of trustees and investment of assets.

Multiemployer pension-benefit plans generally are subject to all of the above legal provisions and must in addition comply with the provisions of the Taft-Hartley Act regarding joint union-employer boards of trustees for pension and welfare funds. State and local government retirement systems are expressly exempted from the Welfare and Pension Plans Disclosure Act and, except to the extent that nongovernmental agencies enter the picture, from most provisions of the securities acts. For these systems, the major factors in the legal environment are local and State laws establishing and regulating the individual system. Because these systems are already tax exempt as State agencies or instrumentalities, qualification under the Internal Revenue Code is far less important than for private employers' plans, although some State and local systems do qualify.

Both educational endowments and foundations, the other major portfolio types examined in this chapter, generally are tax exempt under the Internal Revenue Code, provided that they do not engage in prohibited transactions as set forth in section 503(c). The Tax Reform Act of 1969, which was not in effect during the period covered by the study's data collection, imposes a tax on foundations.

One striking aspect of these institutional portfolios is their large size and concentration. In the area of corporate pension-benefit plans, for example, the combined plans in the Study's sample for the firm having the greatest amount of pension-benefit plan assets, contained over \$5.6 billion in total assets or about 5.5 percent of the estimated total assets of all corporate plans. The plans of the nine firms having the largest pension-benefit plan assets had \$24.7 billion, about 24 percent of the assets of all corporate plans. In terms of common stock holdings, the comparable figures were for one firm's plans, the largest in terms of common stock holdings—\$2.4 billion—and for the nine largest firms' plans, \$16 billion.

Similar figures are observed for State and local government retirement systems. The largest system in terms of total assets within the

<sup>2</sup> See sec. B.8.c of this chapter for a more complete discussion of the Investment Company Amendments Act.

Study's sample held \$3.8 billion, or about 7.8 percent of the assets of all systems, while the largest 11 held \$20.1 billion or about 41 percent of the assets of all systems. The largest system in terms of common stock holdings held \$4 billion, about 8.7 percent of all systems' holdings of common stock, and the top 11 held \$2.5 billion, about 55 percent of all systems' holdings.

There was an observed tendency among all the portfolio groups studied, including educational endowments and foundations, to seek diversity of management; in the area of corporate pension-benefit plans, however, bank management predominated. Indeed, four banks managed 37 percent of all noninsured accounts covered by the study. Self-management and investment adviser management in particular appeared to be increasing. Within the bank managed plans, there was also a tendency to split the plan among more than one manager. This chapter did not develop data on insured plans. However, chapter VI discusses competition by insurance companies for the management of employee-benefit funds.

Those ultimately responsible for the disposition of the assets of portfolios within the groups studied evidenced to some extent an interest in the investment return of their accounts. This was less evident among the State and local government retirement systems as a whole; a substantial number of these systems, however, are severely restricted in terms of their ability to invest in equity securities. Among those systems having substantial equity investments, the same interest in investment results, as evidenced by frequent measurement of the account's return and use of outside agents for evaluation was observed.

The fact that many portfolios within these groups have changed or added new managers within the past five years also is evidence of an interest in and a desire for increased investment return.

With the notable exception of foundations, all portfolio groups observed experienced growth over the period from yearend 1964 to yearend 1969 in terms of both common stock holdings and total assets, with common stock growing faster than total assets for all groups (foundations declined less in terms of common stocks than total assets). These figures reflect growth attributable to both new contributions and investment return. The fastest growing group in terms of common stock was State and local government retirement systems which grew 266.4 percent over the five year period, from \$763.5 million to \$2.797 billion. Next was multiemployer pension-benefit plans with a growth rate of 94.5 percent over the five year period. Corporate plans' stock increased at a 53.6 percent rate, while educational endowments grew at a more modest 27.7 percent over the period. The leader in terms of total asset growth was multiemployer plans with 64.6 percent, followed by State and local government plans with 61.4 percent, corporate plans with 31.2 percent and endowments with 19.4 percent from the yearend 1964 to yearend 1969. Foundations in the sample declined 7.3 percent in total assets and 7.0 percent in the magnitude of their common stock portfolios over the period.

Another consistent pattern across these portfolio groups over the five year observation period was a growth in common stock turnover and activity rates. Corporate plans went from an annual common stock turnover rate of 7.5 percent in 1965 to a rate of 17.2 percent in 1969, with the largest jump (from 8.2 to 13.3 percent) occurring between 1966 and 1967. State and local government retirement systems



went from 3.0 percent in 1965 to 11.7 percent in 1969 with the largest jump (4.2 to 11.7 percent) occurring between 1968 and 1969. Multi-employer plans went from 5.1 percent in 1965 to 8.7 percent in 1968 and jumped to 14.4 percent during 1969. Educational endowments started at 7.1 percent in 1965 and went to 20.2 percent in 1969. The biggest jump for endowments was from 7.8 percent in 1967 to 19.1 percent during 1968. Foundations started at 3.6 percent in 1965 and rose fairly gradually to 5.2 percent during 1969.<sup>3</sup>

All types of portfolios held by far the majority of their common stock assets in New York Stock Exchange listed securities. State and local government systems were the most NYSE-oriented, holding 96.8 percent of their stock in these securities. This should be compared with the ratio of the market value of NYSE-listed equities to the market value of available equities of about 75 percent. Foundations, the group which held the smallest percentage of NYSE-listed stock, 77.3 percent, were still slightly above this rate.

There were few observed differences between portfolio accounts of the same type across different types of managers. For all groups except foundations, investment adviser managed accounts had the highest turnover rates, followed by bank managed and self-managed accounts. Again, except for foundations, investment adviser managed accounts had the lowest percentage of common stock held in NYSE-listed securities. For corporate and multiemployer pension-benefit plans and foundations, investment adviser managed accounts had the highest percentages of total assets in common stock and were a close second in endowment accounts to bank managed. Among State and local government retirement systems, however, self-managed accounts had the highest ratio of common stock to total assets.

Analyses were performed to measure the effect of various account characteristics on the common stock turnover rate for corporate plans. Other factors being equal, accounts having higher fee rates and accounts managed by investment advisers tended to have higher turnover rates, while older accounts and accounts holding greater numbers of issues tended to have lower turnover rates.

Similar analyses were performed to test the effect of various account characteristics on the fee rates charged corporate plans' accounts. These analyses show that the value of assets in the account is the major factor in the fee rate with larger accounts having substantially lower fee rates. Older accounts, accounts holding greater numbers of issues, accounts with higher turnover rates and accounts managed by investment advisers tend to have higher fee rates.

Self-management of portfolio assets was examined in some detail. There were not enough multiemployer plans in the sample to permit meaningful comparisons. Within and among the other portfolio types, however, it is possible to make some comparisons.

The investment departments of all internally managed portfolios reported that the "Fundamental" approach followed by the "Economic Outlook" approach dominated the departments' approach to securities evaluation. Few reported attaching much weight to the "Technical" approach.

When the importance of outside sources of information was in-

<sup>3</sup> These figures all are dollar-weighted averages; in the case of foundations, however, they do not include several large foundations which did no trading.

quired into, again, there was a high degree of consistency across self-managed portfolio groups. All but State and local government systems reported heavy reliance upon financial statements of issuers, with second place going to information received from broker-dealers for commission dollars. Direct contact with issuers was generally last in importance. Foundations' departments, while favoring financial statements of issuers first, preferred direct contact over information from broker-dealers. State and local government systems' departments favored advice from investment advisers over financial statements or other forms of direct information.

Most departments which manage more than one account had some awareness of potential conflicts among accounts when it came to buying or selling programs or when only a limited number of attractive securities are available. Few, however, had well-defined policies regarding how to resolve such potential conflicts.

For the most part internal management was chosen, where it was not required by law or the governing instruments of the portfolio, in the belief that it would be more economical. While there do appear to be consistent differences between self-managed accounts and other accounts, the data reported in this chapter do not permit firm conclusions as to the relative benefit afforded by the choice.

Recent legislative activity in the areas covered by this section of the study focus their attention on retirement plans. At present these plans are subject to a bewildering array of legal requirements and prohibitions at both the Federal and State levels. Securities laws, tax laws, the Federal disclosure statute, State trust or insurance law, labor law for union-employer administered trusts and the State statutes establishing public systems all apply in varying degrees. Despite the multiplicity of applicable laws and regulations and the costs associated with their compliance and administration, calls for more comprehensive Federal legislation during recent sessions of the Congress evidence concern on the part of their sponsors that existing regulatory schemes lack the consistency needed to insure the further growth and extension of pension coverage on the one hand, while providing acceptable degrees of security regarding anticipated benefits on the other, at acceptable cost to plan sponsors, beneficiaries and the public.

Any attempt to meet these goals must face the problem that efforts to increase the security of benefits will increase costs and may, to some extent, deter employers from establishing retirement plans or increasing the dollar amount of benefits under existing plans. The solution may lie in judgment that security of anticipated benefits outweighs the loss of potential increases in benefit levels that may never be realized by many participants.

The recent call of the President's Task Force on the Aging for the establishment of a Federal Pension Commission was rooted in part in the belief that "the rights of 40 million Americans who are covered by a pension plan are equally as vital as the more substantially protected rights of the 20 million American shareholders." This same theme has been sounded in recent legislative efforts which seek mandatory vesting, fuller funding and reinsurance of pension programs, as well as the provision of information to ultimate beneficiaries that more closely approximates that given to savers through other investment media.

Full exploration of these approaches may be anticipated in the near future.

## Chapter IX

### DISTRIBUTION AND CHARACTERISTICS OF HOLDINGS IN INSTITUTIONAL PORTFOLIOS

Prior to this Study, various attempts had been made to ascertain some of the characteristics of institutional portfolio composition. But most prior analyses have been limited in scope and relatively little detailed data on the composition of institutional common stock-holdings have been collected.

#### 1. DISTRIBUTIONS OF STOCKHOLDINGS IN INSTITUTIONAL EQUITY PORTFOLIOS

An analysis was made of the portfolio common stocks held in 1969 by over 200 of the largest financial institutions (representing 70 percent of all institutional holdings of common stock). The analysis focused on 800 common stocks listed on either the New York or American stock exchanges or nationally traded over the counter and various subsamples of those stocks.

The analysis disclosed that the aggregate portfolios of the big institutions tended to be concentrated in a comparatively small number of stocks having large market values.

While a relatively few stocks dominated the equity assets of institutional portfolios regardless of size, the total number of stocks in a portfolio was not the same for all sizes of portfolios. The Study found that the total number of stocks in a portfolio increased as the value of the portfolio increased, with an average aggregate portfolio size of \$616 million spread over 121 stocks, increasing by one stock for each additional \$16 million of portfolio assets.

The analysis demonstrated that while the total number of stocks in a portfolio increased with the market value of the portfolio, the minimum number of stocks needed to constitute 50 percent of the market value was independent of institutional type as measured either by the total number of stocks or by market value of the portfolio.

Another dimension of portfolio concentration is how often each portfolio invests a significant portion of its funds in a particular stock. The Study found that significant portions of all institutional portfolios were invested in a relatively small number of stocks of the same large, well-known companies.

To determine the extent of this concentration, the Study ranked each institutional portfolio's List A common stockholdings in descending order of their market values (in the portfolios). The smallest number of (the larger) holdings required to account for at least 50 percent of the portfolio's value then was counted and summed across the portfolios studied to arrive at the number of "significant" positions available in the top 50 percent of the portfolios.

This count shows 1,968 positions in the top 50 percent for all 213 institutions studied. At least half of these positions were filled by 12 different stocks, while all 1,968 positions were filled by 232 of the total of nearly 800 stocks in the List A sample. Between six and 24 stocks accounted for half the positions available in each institutional type. They were generally the same companies for each type. The popularity concentration was greatest among bank trust departments and least among large registered investment company complexes.

Establishing that institutions hold significant portions of their portfolios in the same small number of stocks does not necessarily mean that institutions are overly concentrated in these stocks. To determine whether institutional portfolios are, in fact, heavily concentrated in the stocks, the Study determined whether institutions held more or less of a particular stock than is explained by the stock's total market value.

The proportion of the holdings of a particular common stock in the aggregate of all portfolios (institutional and individual) is the ratio of the value of that stock to the total market value of all stocks of any subset, such as the Study's random List Z. This is the "market ratio." Similarly, the proportion of the holdings of any portfolio in a particular stock is the ratio of the market value of the holdings in that stock to the market value of the entire portfolio. This is the "portfolio ratio."

If institutions hold particular stocks in proportion to their market values, the market ratio and the portfolio ratio would be equal. By dividing the portfolio ratio by the market ratio, it is possible to derive a third ratio, the "concentration index," which indicates whether institutions hold particular stocks more or less than in proportion to their total market values.

Using this analysis, the Study found that institutions generally preferred the securities of larger companies to those of smaller firms. The Study found that the larger the firm, the more likely it was to have a higher concentration index in institutional portfolios. The general public, therefore, must hold a less than proportionate share of these larger firms. This finding was also true for each type of institution analyzed separately. The stock of all large companies, however, was not held in disproportionately large amounts by institutional investors. The securities of nine of the 35 companies with a market value of \$1 billion or more on September 30, 1969, in the Study's random sample were held in disproportionately small amounts by institutional investors.

No single reason can explain this phenomenon of institutional concentration in the stocks of companies having the largest market value. Administrative cost considerations may lead institutions to seek portfolio liquidity through a strategy of concentration in a few large market value stocks rather than dispersion among a larger number of smaller companies. The widespread view that larger companies have achieved greater stability in their earnings and, thus, may constitute less risky investments also may account for observed institutional preferences for the stocks issued by these companies. Some portfolio managers also have indicated that they feel "locked in" to securities whose prices have increased considerably because of a reluctance on the part of their clients or directors to expose themselves to sizable, taxable capital gains. In addition, there are several institu-

tional factors which may reinforce tendencies for institutions to concentrate their holdings in relatively few large market value stocks. Some corporations have large individual or family holdings which appear as personal trusts managed by banks and investment advisers. Also, corporate profit-sharing plans, particularly self-administered plans, tend to invest predominantly in the stock of the sponsoring corporation.

The Study also found that the institutions surveyed managed, on the average, more than 36 percent of the outstanding shares of the 27 largest companies listed on the New York Stock Exchange. Aggregate institutional management ranged from a low of 10.2 percent to a high of 54.2 percent. In every instance, the institutions surveyed held a higher percentage of the stocks of these 27 companies than were publicly traded on the New York Stock Exchange during 1968. Thus, institutional holdings ranged from a low of 102 percent of 1968 New York Stock Exchange volume to a high of more than 2,000 percent of that volume. Stocks with relatively low-market values turned over a greater proportion of their shares than did stocks with relatively large market values. One implication of these observations is that the relatively large market value of the stocks in which institutions concentrate their holdings may overstate somewhat the liquidity of these portfolio positions.

## 2. CHARACTERISTICS OF COMMON STOCKS IN INSTITUTIONAL PORTFOLIOS

Institutional portfolio concentration also may be explained by factors important to security analysts in evaluating common stocks. The following common stock characteristics were examined: debt-equity ratio, dividend payout ratio, growth of sales per share, return on book value, nondiversifiable investment risk, market value of equity, and growth in price per share. The Study found that all the above factors taken together add very little to an explanation of aggregate institutional common stock portfolio concentration than that provided by larger market value alone.

In distinguishing among institutional common stock portfolio preferences, institutional portfolios were examined in terms of a group or profile of six characteristics—dividend payout ratio, return on book value, debt-equity ratio, growth of firm, size of firm and nondiversifiable investment risk. The portfolio preferences of each institutional type were compared with each of the remaining institutional types.

Most comparisons between the different institutional types evidenced that these different institutional types generally have common stock portfolios with differing characteristics. While there is generally a difference in the characteristics of the common stock portfolios of most institutional types, only three characteristics—return on book value, nondiversifiable investment risk and asset size—showed a pattern of significant differences between institutional types. The single characteristic studied which most often shows a statistically significant difference between pairs of institutional types is the asset size of the portfolio company.

### 3. PORTFOLIO CHARACTERISTICS OF COMMON STOCKS IN PORTFOLIOS OF PARTICULAR INSTITUTIONAL ACCOUNTS

Analysis of the sample of common stock portfolios for the same types of accounts showed some variance depending on the type of institutional manager. Evidence was found that the portfolio characteristics of employee-benefit accounts differed systematically depending on whether these accounts were managed by bank trust departments or investment advisers or were self-administered. Thus, for example, self-administered employee-benefit plan portfolios held stocks with higher dividend payout ratios and higher debt-equity ratios than those held by employee-benefit plans managed by bank trust departments. Conversely, the employee-benefit plans managed by bank trust departments held stocks of companies with greater sales growth than did the employee-benefit plans that were self-administered. The same analysis also was performed for foundation and educational endowment accounts with similar results.

Analysis was also performed on different accounts managed by the same institution. This took the form of a comparison of all accounts managed by bank trust departments and four particular account types—personal trust accounts, employee-benefit plans, foundation and educational endowments and pooled employee-benefit plans. The six portfolio characteristics examined were dividend payout ratio, return on book value, debt-equity ratio, growth of sales, asset size and nondiversifiable investment risk. This analysis disclosed that the portfolios of different types of accounts managed by the same manager—bank trust departments—tended to have different characteristics, with personal trust and employee-benefit accounts having systematically higher dividend payout ratios and firm sizes, employee-benefit accounts having higher debt-equity ratios and personal trust accounts having higher degrees of market volatility or nondiversifiable investment risk than other types of bank-managed accounts.

## INTRODUCTION TO PART THREE: IMPACTS OF INSTITUTIONAL INVESTING ON SECURITIES MARKETS

### A. THE ISSUES INVOLVED

As described in Part One (I. III, NBER Report), the proportion of all outstanding stock held by institutions has not increased drastically during the last decade and still is somewhat less than 30 percent of the total. The dramatic increase in institutional turnover of equity portfolios in that period, however, which is detailed in Part Two (IV-IX), transformed those institutions into a major, if not the dominant factor in the equity markets. For example, during 1960 individual investors accounted for approximately 60 percent of the public dollar volume of trading on the New York Stock Exchange while institutions and nonmember broker-dealers accounted for 40 percent. By 1969 those proportions were more than reversed, with institutions and nonmember broker-dealers accounting for approximately 62 percent of public volume and individual investors accounting for the remaining 38 percent.<sup>1</sup> This shift has significantly changed the character of trading in the equity markets. Part Three (X-XIII) examines the adaptations of the securities industry and markets to these developments.

Institutional orders to purchase or sell equity securities tend to be larger than those of individual investors, and there are fewer of them. Thus, there are often not enough such orders to come to the markets in a continuous flow. This characteristic of institutional trading has led to the creation of new trading mechanisms. In addition, many institutional investors have not been willing to accept the usual level and structure of charges by the securities industry for handling trading in equities.

These basic differences between the trading of institutional investors and individual investors have impacted significantly on the markets. This part of the Study deals with four basic aspects of the consequences of institutional trading: (1) the impact on the prices of securities, (2) the impact on the structure of the markets, (3) the impact on the market-making function and (4) the impact on broker-dealer firms generally. It attempts to assess the implications of these impacts for the markets, for the institutions that use them and for the individual investors with whom the markets are shared.

### B. THE SCOPE OF THE PART

As indicated, this part deals primarily with equity securities. The Study's resources did not allow general coverage of both the debt and the equity markets, and the greater part of the Commission's attention has traditionally been in the latter area. Two other limitations to the scope of the part should also be noted. As a matter of organization of

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<sup>1</sup> New York Stock Exchange, Public Transactions Study, 1970.

the report, for the most part only the secondary markets for equities are discussed in Part Three. Aspects of the primary markets—in particular those aspects involving venture capital investments, restricted securities and first public offerings—are covered in chapter XIV of Part Four. As a further matter of resource allocation, Part Three deals primarily with common stock listed on the New York or American Stock Exchanges. The Study decided not to collect transaction data about preferred stocks (straight or convertible), and time and data problems did not permit analysis of transaction data that it did collect about unlisted common stocks.

One general exception to the above limitations should be noted. In collecting aggregate data about the securities industry, as distinguished from particular transactions, the study covered all securities and all markets in one of two data sets<sup>2</sup> and all corporate securities and all secondary markets in the other.<sup>3</sup> In analyzing this data the Study attempted to concentrate on subsets that would correspond in coverage as nearly as possible to the transaction data.

#### C. STRUCTURE OF PART THREE

The markets portion of the Study is comprised of four chapters.

Chapter X deals in general with institutional trading and analyzes its characteristics and price impacts. In particular, the first half of the chapter deals intensively with the aggregate effect of institutional trading, especially the net imbalances in that trading as between buying and selling. The second half takes a somewhat more microscopic approach and analyzes a sample of particular position changes by particular institutions. The chapter as a whole is designed to provide new insights into the impacts of institutional trading on securities prices and its potential interrelationships with trading by individual investors.

One of the most dramatic consequences of institutional trading in equity securities has been the growth of block trading. Consequently, an entire chapter has been devoted to this subject. Chapter XI deals with a number of different aspects of block trading, including positioning, in stocks listed on the New York Stock Exchange. One aspect is a description of the different markets in which such trading takes place. The mechanics of that trading in each market is also described. Another aspect involves analysis of factors that influence the choice of markets for particular block trades and the typical reasons why a particular market is selected. Finally, to carry the analysis of chapter X one step further, the price impacts of samples of particular block trades are analyzed in considerable depth.

The price impacts of institutional trading depend considerably on the functioning of the market-making mechanisms. This is the subject of chapter XII, which describes the activities of stock exchange specialists, registered third market-makers and member block positioners. In addition to aggregate analyses of block positioning, particular emphasis is placed upon New York Stock Exchange specialists, to determine the extent to which they reduce avoidable temporary price fluctuations in their stocks by offsetting temporary imbalances in trading

<sup>2</sup> Questionnaire I-7, ch. XIII and Supplementary Volume II.

<sup>3</sup> Questionnaire I-61, ch. XIII and Supplementary Volume II.



volume. Finally, their economic incentives to engage in this activity are explored in some detail.

Chapter XIII analyzes aggregate data about the securities industry. The magnitude of institutional payments of brokerage commissions to the industry is described both for the industry as a whole and for different types of firms. The services being provided by the industry to institutions and the reasons for the selection of particular types of firms are analyzed. Extensive consideration is given to the profitability of this business vis-a-vis that of individual investors and the substantial changes that have taken place in the industry as the result of that difference. Finally, the extent of institutional affiliation with broker-dealers is explored.

#### D. THE DATA BASE

An attempt was made to create as varied a data base as possible, over different time frames, for this part of the Study. The analysis of net institutional trading imbalances used monthly trading data and monthly prices. For particular position changes, individual transactions and both daily and intraday prices were used. Block trades were analyzed on the basis of individual transactions and both daily and intraday prices. The market-making studies utilized daily position changes, daily prices and monthly income data.

Varied data sources also were used for the study of the securities industry. Various sets of data were annual, semiannual and/or monthly. The data were collected not only from broker-dealers but also from their institutional customers. In some cases data collected from different sources were combined for analysis.

## Chapter X

### CHARACTERISTICS AND PRICE IMPACTS OF INSTITUTIONAL TRADING IMBALANCES AND POSITION CHANGES

Prior to this Study, one view of institutional trading in common stocks was that institutions already traded largely among themselves and could be segregated into their own market entirely separate from the regular auction market for individual investors. Another and directly inconsistent view was that institutions tend to predominate on one side of the market in a particular stock at a particular time and could not continue their existing trading patterns if they attempted to trade solely among themselves. The latter view, that large net trading imbalances exist among institutions, has been explained by various hypotheses:

- (1) Institutions pattern their trading after that of certain "leader" institutions;
- (2) Institutions receive their outside research from the same broker-dealers;
- (3) Institutions' internal staffs of professional analysts have the same data available to them and interpret it in the same way at approximately the same time; and
- (4) The reduction in the number of investment decisionmakers and the concomitant substantial increase in the number of shares governed by these decisions have made trading volume more "lumpy."

#### 1. EXTENT OF NET INSTITUTIONAL TRADING IMBALANCES

An analysis was made of monthly purchases and sales of 563 common stocks by more than 230 financial institutions (representing about 70 percent of all institutional holdings of common stock) from January 1, 1968, to September 30, 1969. The analysis disclosed the existence of substantial net trading imbalances for all institutions as a group, for banks alone as a group, for registered investment companies alone as a group and for banks and registered investment companies as a combined group.

For the 27 largest NYSE stocks, out of a reported average monthly institutional trading volume in all markets of almost \$35.5 million per stock, nearly \$9 million (25 percent of the trading of all respondent institutions) was not offset by other respondent institutions. Similarly, for all other NYSE stocks a reported average monthly institutional volume in all markets of almost \$3.3 million per stock resulted in nearly \$1.2 million (more than 33 percent of the trading of all respondent institutions) that was not offset. Finally, for all AMEX

stocks, out of a reported average monthly institutional volume in all markets of some \$350,000 per stock, nearly \$220,000 (63 percent of the trading of all respondent institutions) was not offset. These imbalances tended to persist, with some reduction in magnitude, for at least one additional month. Average monthly imbalances in the three lists of stocks (representing trading in all markets) were, respectively, 18, 18 and 10 percent as large as total reported NYSE or AMEX trading volume in those stocks.

In every month there was some reported institutional trading in each of the 27 largest NYSE stocks. For the other NYSE stocks and the AMEX stocks there was no reported institutional trading in 14 and 55 percent, respectively, of the stock months. If these "zero stock months" are excluded, average reported monthly institutional volume for the NYSE stocks amounted to nearly \$3.8 million, and average monthly volume that was not offset ("dollar net imbalance") amounted to \$1.4 million (64 percent of total reported institutional volume and 22 percent as large as total reported NYSE volume). Comparative figures for AMEX stocks are a little less than \$780,000 in total reported institutional volume and a dollar net imbalance of \$480,000 (84 percent of total reported institutional volume and 21 percent as large as total reported AMEX volume).

There was no stock month in which reported institutional volume in the 27 largest NYSE stocks not offset by other reported institutional volume was more than 90 percent of total reported institutional volume. In other NYSE stocks and AMEX stocks, however, this did occur, respectively, in 40 and 70 percent of the stock months during which some institutional trading was reported. Particularly in these stocks the larger percentage imbalances tended to occur in stock months with low total reported institutional volume.

The figures on net institutional trading imbalances set forth above were designed to measure the extent to which the major institutions surveyed could trade directly with each other, rather than with smaller institutions not in the sample, individual investors and/or market makers. Because a monthly unit of observation was used, they probably overstate the extent to which such direct institutional trading does or could take place. Even on the basis of these figures, however, it is apparent that institutions cannot trade directly and solely among themselves without substantial changes both in the volume of their trading and in their trading patterns. Moreover, on a monthly basis the dollar amounts of these net trading imbalances appear too large to expect market makers alone to bridge the time gaps between institutional orders by inventorying the stock. It does not seem feasible to segregate institutions into a separate trading market wholly apart from other investors.

Similar figures on the number of institutions buying and selling in each stock month, rather than the dollar volume of trading on each side, indicate that at least on a monthly basis large numbers of institutions do not tend to "gang up" on one side of the market in a particular stock month. When there are very large percentage imbalances measured by the number of institutions, they seem to arise merely because there are few institutions trading. Indeed, a visual examination of the data indicated that the two measures of institutional trading

imbalances tended to run in opposite directions: When there was net institutional selling, more institutions would be buying than selling and vice versa.

Because of the current interest in hedge funds, a separate analysis of their trading was made. In those months in which hedge funds traded, their average gross volume in the random NYSE stocks was about \$360,000, as against \$6.9 million for the other institutions that traded in those stock months. Their average dollar net imbalance in those stocks was about \$310,000, as against \$2.4 million for all other institutions that traded in those stock months. Although hedge fund trading was almost completely on one side of the market in any given stock month (often because only one hedge fund traded), this imbalance had little effect on the net trading imbalance for all institutions. In almost one-half of those stock months, the hedge funds actually reduced the net trading imbalances for all institutions. Although hedge funds engage in substantially more in-and-out trading during a given month than any other type of institution and may well have significant market impacts over a shorter period of time, their contribution to the monthly net trading imbalance of all institutions is not significant.

## 2. PRICE IMPACTS OF NET INSTITUTIONAL TRADING IMBALANCES

Net institutional selling is systematically associated with price decreases, and net institutional buying is systematically associated with price increases. The magnitude of the imbalance, whether measured in absolute dollar amounts or as a percentage of total reported institutional trading, is directly related to the magnitude of the price change in that month.

In the largest NYSE stocks the average price decline was 1.49 percent when the percentage net imbalance was 20 to 80 percent on the sell side, and the average price rise was 0.90 percent when the percentage net imbalance was 20 to 80 percent on the buy side. In the random NYSE stocks the average price decline was 1.21 percent when the percentage net imbalance was 80 to 100 percent on the sell side, and the average price rise was 1.59 percent when the percentage net imbalance was 80 to 100 percent on the buy side. In the random AMEX stocks the respective figures were a price decline of 3.43 percent and a price rise of 5.15 percent.

If there was net selling in 1 month and adjustments were made for the imbalance in the next month, the price tended to rise in the next month. If there was net buying in the first month and the same adjustments were made, the price tended to fall in the next month. The indicated price reversal in the second month was more than one-half of the price change during the first month for the largest and random NYSE stocks and one-fourth to one-third of the previous price change for the random AMEX stocks.

Price reversals such as these usually represent the liquidity costs of large selling or buying pressures on the market rather than permanent adjustments to news or other fundamental factors. To the extent that the price changes represent such liquidity costs, they could be expected to be substantially greater on a day-to-day basis.

The net trading imbalances of registered investment companies are more typical of the net trading imbalances of all institutions than are those of banks. Similarly, the percentage net imbalances of registered investment companies correlate more closely with monthly price changes than do the percentage net imbalances of banks. Apparently, registered investment companies tend to be price aggressive—that is, their net trading imbalances tend to contribute to price changes in the same direction. Banks, on the other hand, tend to be price neutral: Their net trading imbalances tend to be in the opposite direction to the price change as frequently as they are in the same direction. In the former situation they trade passively in response to the price change and offset the trading imbalances of the registered investment companies or other investors.

Although net institutional trading imbalances appear to have substantial market impacts, only a small fraction of all month-to-month price changes can be associated with institutional imbalances. Data on the combination of dollar net imbalance, percentage net imbalance, and total NYSE or AMEX volume explain a maximum of only 10 percent of the month-to-month price changes in the largest NYSE stocks, 12 percent in the random NYSE stocks and 28 percent in the random AMEX stocks. The bulk of month-to-month price changes arise because of imbalances in the trading of individual investors, news, or other factors.

### 3. CAUSES OF NET INSTITUTIONAL TRADING IMBALANCES

In order to determine the causes of observed net institutional trading imbalances, two mathematical models were constructed and used to simulate institutional trading. The imbalances expected from chance according to these models were then compared with the imbalances actually found in the data reported.

The first model utilized the reported number of shares purchased and sold per stock month, but the specific stock month in which each purchase or sale took place was determined by random selection. This model was constructed to ascertain the extent of net imbalances expected from the “lumpy” nature of institutional trading—that is, not only does the number of shares of a particular stock that any institution will purchase or sell vary widely from stock to stock and from month to month, but also the amounts are much greater than for an individual investor and there are fewer such stock months of trading. The model resulted in larger net trading imbalances among all respondents in all three stock groups than were actually reported. For example, in the larger NYSE stock the model resulted in dollar imbalances of \$10.0 million and a percentage net imbalance of 28.2 percent, as against \$8.8 million and 25.5 percent in the actual data. This relationship between the actual data and the model was also true within the separate groups of banks, registered investment companies, and banks and registered investment companies combined, both in the random NYSE stocks and the random AMEX stocks but not in the largest NYSE stocks.

There were indications from the comparison of the actual data with the first model that the decision of a particular institution to trade at a particular time is not completely independent from the

other institutional trading that is then taking place in that stock. This does not necessarily mean that institutions tend to be on the same side of the market. Institutions tend to be interested in and trade the same stocks at the same time, but some purchase the stocks and others sell them. Accordingly, it was necessary to construct a second model in order to take account of any such "clustering" of institutional activity.

The second model was identical to the first, except that the determination whether there was any trading by a particular institution in a particular stock month was made by reference to the actual data. The second model generally resulted in smaller net trading imbalances than the first model. Thus, the clustering of institutional activity tends to reduce the net trading imbalances that would be expected from chance.

When the results from the two models were compared with the actual data, the Study found :

With respect to the larger NYSE stocks, both banks alone and registered investment companies alone exhibited larger net trading imbalances than could be expected from chance. Within each group there may be some degree of parallel trading—that is, their net trading imbalances may arise to some extent either by design or from unplanned similarity. The amounts not explained by chance, however, were relatively small. Since banks and registered investment companies are often on opposite sides of the market, the net imbalances both for the combined group and for all respondents were actually less than could be expected from chance. Thus, in terms of total market impact on a monthly basis, parallel trading does not appear to be a factor. Rather, monthly institutional trading imbalances appear to arise because of the "lumpiness" of institutional trading.

With respect to the random NYSE stocks, banks exhibited larger net trading imbalances in the actual data than could be expected from chance. Registered investment companies exhibited less. Neither difference was very great. The combined group of banks and registered investment companies and the group of all respondents both exhibited smaller net trading imbalances than could be expected from chance when clustering was considered and greater net trading imbalances when it was not considered.

With respect to the random AMEX stocks, banks alone exhibited slightly greater net imbalances than could be expected from chance when clustering was considered and less when it was not considered. Registered investment companies alone and banks and registered investment companies together exhibited about the same as by chance when clustering was considered and somewhat less than when it was not. The group of all institutions exhibited substantially smaller net trading imbalances than could be expected from chance both with and without clustering. Here, too, there appeared to be little or no net trading imbalance remaining that might arise by design or from unplanned similarity.

Thus, at least on a monthly basis, net institutional trading imbalances appear to arise almost entirely from the "lumpiness" of institutional volume rather than from other factors. Such imbalances are accordingly inherent in the institutionalization of the equity markets. To cope with such imbalances an interchange between the trading of institutions and other investors and a strong market making mechanism seem to be necessary.

#### 4. PRICE IMPACTS OF INSTITUTIONAL POSITION CHANGES

To ascertain the price impacts of institutional position changes, the Study analyzed data on each transaction in several hundred such position changes in NYSE-listed stocks. The particular stocks and time period chosen for each institution were determined by strict rules set down by the Study, which gave the responding institutions no leeway as to which stock or time period to select.

The analyses of these position changes were designed and conducted on the assumption that a large position change by an institutional investor would typically have a definite price impact whose magnitude might depend on certain characteristics of the position change, such as whether it was a purchase or sales program, the size of the position change, the number and size of transactions used, the intensity of trading and so on. The findings are consistent with the idea that a position change by an institutional investor sometimes does have a significant price impact—or at least tends to accentuate the price impacts of trading by others. But the findings indicate that situations in which the trading of an institution may create or accentuate price movements are more or less matched in number and importance by situations in which the trading behavior of an institution *reduces* the magnitude of the price impacts of trading by others. The most striking result of the analysis is that the original assumption is factually inaccurate. In general, situations in which an institutional position change may have a price impact seem to be no more frequent than situations in which such a position change tends to offset the price impacts of trading imbalances by other market participants.

This conclusion applies generally to large and small position changes, to those conducted by banks or by investment advisers (including mutual funds) and to both purchase and sales programs. With relatively minor exceptions, it applies even after allowance is made for characteristics of the position change, such as its total size or the size of the individual transactions used, and for the market conditions under which the position change was conducted. The analyses did, however, indicate that, when institutions trade on the third market, they save, on the average, the equivalent of a full stock exchange commission. But the Study could not determine whether the third market is underutilized, in the sense that substantial savings would also be available with respect to transactions that are presently executed in other markets.

## Chapter XI

### CHARACTERISTICS AND PRICE IMPACTS OF BLOCK TRADING IN COMMON STOCK LISTED ON NYSE

One of the most dramatic impacts of institutionalization on the securities markets has been the growth of block trading. Theoretically, a block trade is a securities transaction that cannot be executed in the exchange auction market in the normal course. Since this definition is not workable for purposes of statistical analysis, data were collected in terms of the size of the transaction—10,000 shares (\$400,000 of a \$40 stock) for the New York Stock Exchange (“NYSE”) and 2,000 shares (\$80,000 of a \$40 stock) for the regional stock exchanges and the third market. In general, the data cover the full year 1968 and the first three quarters of 1969. The findings and conclusions primarily refer to that time period.

#### 1. DESCRIPTION OF BLOCK TRADING

##### A. NYSE

About 65 percent of the total volume in transactions of 10,000 or more shares involving common stocks listed on the NYSE is executed on that exchange. As an important market factor on the NYSE, block trading is a relatively recent phenomenon. From the last quarter of 1964 to the third quarter of 1970 it increased almost eleven fold in absolute magnitude, and its share of total NYSE volume septupled (from 2.1 to 14.8 percent). The number of stocks involved in NYSE block trades varies substantially from day to day.

Block trades on the NYSE usually involve numerous participants and often numerous institutional participants. There are usually fewer participants on the side that initiates the trade (“active side”) than on the other side (“passive side”). The broker-dealer primarily responsible for assembling the orders of different participants (“block trade assembler”) handles the active side and all or almost all of the passive side in about one-third of all such transactions, particularly the larger ones. In block trades of \$1 million or more the assembly process usually takes place initially over the upstairs communications network of the block trade assembler. There is some indication that the negotiation process by which smaller block trades of some size are assembled is somewhat more related to the floor of the NYSE, particularly to the specialist. The remaining description of NYSE block trades will be limited to those of \$1 million or more, unless otherwise noted. Trades of this size represent over two-thirds of the total dollar volume in all NYSE transactions of 10,000 or more shares.

The typical block trade is initiated by an institution that wishes to purchase or sell a large quantity of stock and will accept a discount



from the current market price or pay a premium in order to do so. In about three quarters of the blocks that institution is a potential seller.

The key to assembling a block trade is to find the orders on the passive side. To offset the order of the institution initiating the trade in the median block, the block trade assembler finds one institution and five to nine other parties. On the average, however, the institution accounts for only 39 percent of shares on the passive side. Other customers account for 3 percent. By further upstairs communications the block trade assembler finds other broker-dealers, primarily representing institutions, with orders for something less than an additional 14 percent of the shares. On the floor of the NYSE the block trade assembler is able to find orders for an additional 7 percent among the specialist's book, the odd lot dealers and other broker-dealers in the crowd. The specialist himself takes 14 percent. This leaves about 23 percent uncommitted, and the block trade assembler itself positions it.

In terms of the analysis in the preceding chapter, the net institutional trading imbalance is 31 percent, as compared with the average of 55 percent for institutional trading in random NYSE stocks. Because of their important role in offsetting imbalances in block trades the participation of the specialist and the block trade assembler that inventory part of the block ("block positioner") deserves special attention.

In part, the specialist's relatively low-participation rate in block trades of \$1 million or more seems to reflect his orientation to the exchange floor, away from the upstairs communications networks, where—at least initially—"the action is." On the other hand, in the smaller block trades, whose assembly is more related to the floor, the specialist's participation rate on the passive side is substantially larger while the block trade assembler's is substantially smaller. In block trades of both sizes individual specialist units vary greatly in their participation rates. Some of this participation, as well as some participation for the book, is not desired by the other parties to the trade and possibly not permitted by the rules of the NYSE. In any event, there is some indication that the positions acquired by the specialist in block trades are mainly laid off through the regular round lot market in subsequent dealer transactions.

In addition to his dealer participation (for which, unlike the block positioner, he receives no commission) the specialist receives two kinds of floor brokerage as part of the block trade. The first arises from his book's participation. Most of the time the limit orders on his book receive the benefit of the block discount or premium; sometimes they do not. Stop orders sometimes also receive disadvantageous executions. The second source of floor brokerage is payments by the block trade assembler even though it is otherwise represented at the post. In some cases these "writeouts" represent a sharing of commissions when the specialist plays an important role in the assembly process as a "finder" or a participating market-maker. In other cases, however, they cannot be explained in this manner and raise regulatory questions, particularly with respect to the independence of at least some specialists' administration of the retail market.

Positioning by the block trade assembler sometimes performs part of the market-making function when, for whatever reason, the specialist does not offset fully the public imbalance in a potential block trade.

There is, however, a wide variation in the participation rates of individual block trade assemblers. In addition to actual positions, block positioners frequently make bids or offers for the entire block early in the assembly process. Such capital commitments are substantially larger than the eventual positions and are sometimes bettered in price. Contrary to the rules of the NYSE, block trade assemblers also occasionally treat shares not committed to customers at the time of the block execution but laid off shortly thereafter as though they had never positioned them.

The combination of block positioning with investment management is troublesome. A small percentage of the customers of the block trade assembler that participate in its block trades is accounts over which it has investment discretion. A potential conflict of interest exists when a block trade assembler's discretionary accounts participate in its block trades without specific consent. Particular transactions reported to the Study appear to pose serious problems in this respect.

The block trade assembler disposes of nine-tenths of the shares positioned in transactions on the NYSE, often by using the specialist as its floor broker. The remaining shares are "laid off" on regional stock exchanges, primarily to institutions or their brokers. In all, about 70 percent of the shares positioned appears to be laid off to institutions or their brokers as a result of upstairs communications, and the remaining 30 percent appears to be laid off to the specialist or to brokers representing individuals or institutions in the regular round lot market on the NYSE floor. Thus, the block positioner is highly dependent upon efficient and inexpensive access to that market. Moreover, this dependence means that almost 30 percent of the shares in a typical block trade of \$1 million or over may eventually find new owners, largely individual investors, through that market.

Block trade assemblers would normally prefer to dispose of their block positions as quickly as possible. They are limited, however, by the ability of the regular round lot market to absorb those positions and their own ability either to find additional institutional interest that was missed in their initial search or to persuade institutions that were not originally interested. Consequently, the disposition of these positions can take more than a month. On the average, only about one-eighth of the shares is laid off on the day of the block, and less than one-half is laid off during the first week. Seven percent remains at the end of a month. Moreover, the block trade assembler will sometimes actually increase its position while it is in the process of disposition. Some of these transactions, which evidence the importance of retail market prices to the block positioner, raise serious questions under existing antimanipulative provisions of the securities laws.

The length of time that positions must be held by block trade assemblers creates considerable risk. To some extent this risk may be increased by an NYSE ruling that prohibits layoffs on the same day as the block trade except at a profit or with prior permission, although the ruling does not appear to be very strictly enforced.

In any event, on their overall layoff activities, block trade assemblers suffer average trading losses (not including commission equivalents) per block trade of about one-half of 1 percent of the amount positioned. These losses vary with the general condition of the market.

They only offset about one-fifth of the brokerage commissions on the entire trade, however, leaving a profit per block trade (before other expenses) of 2 percent of the amount positioned.

Almost as dramatic as the growth of block trading has been the decreasing concentration of the volume in NYSE-listed stocks that has resulted. Although 65 percent of the volume in transactions of 10,000 or more shares is executed on the NYSE, the 35 percent that is not is quite important. Moreover, the proportion of the block volume that is executed in other markets is more than twice the percentage for transactions of all sizes in NYSE-listed stocks and has been growing rapidly. Indeed, this growth has continued despite the abolition of customer-directed giveups and the institution of a volume discount on all stock exchanges. The reasons for this decreasing concentration of volume and its consequences deserve careful consideration.

#### B. REGIONAL EXCHANGES

Regional exchange transactions of 10,000 or more shares do not differ dramatically in size distribution from NYSE transactions in this category, nor is the average price per share substantially different.

The most frequently reported reason for institutional instructions to execute block trades in NYSE-listed securities on regional stock exchanges was the availability of a better price. Other reasons given include the later trading hours of the Pacific Coast Stock Exchange, avoidance of the New York State stock transfer tax, reduction of price impacts, avoidance of undesired participation by the NYSE specialist (and possibly public orders, also), and differences in public reporting.

There is little evidence that a better price is frequently provided by the regional specialists. They play a relatively insignificant role in offsetting any imbalances involved in the trades: They participate only on the Midwest and Pacific Coast Stock Exchanges and then only to the extent of 5 and 1 percent of the shares, respectively. Moreover, over 60 percent of the shares involved are crossed by NYSE member firms that assembled the block trades through their upstairs communications systems and could easily have been crossed on the NYSE or any other exchange where the securities are traded. The data indicate that the reasons for regional block executions must be found elsewhere.

The distribution of the total regional block volume among the various regional stock exchanges provides that answer. In 1960, when the Boston and Detroit Stock Exchanges had the most liberal giveup rules, they accounted, respectively, for 35 and 12 percent of the total regional share volume in transactions of 10,000 or more shares. Those exchanges do not allow institutional membership. In 1969, after the abolition of customer-directed giveups, their percentages dwindled, respectively, to 5 and 0. The Pacific Coast Stock Exchange, which was originally the leader with respect to institutional membership, saw its percentage increase from 27 in 1968 to 52 in 1969. The percentage of the Philadelphia-Baltimore-Washington Stock Exchange stayed fairly constant, rising only from 13 to 17.

The Midwest Stock Exchange does not fit the above pattern. Although it was not especially liberal about customer-directed giveups before 1969 and does not have any significant institutional membership today, its percentage rose from 13 in 1968 to 26 in 1969. Most of its

transactions of 10,000 or more shares are reported not to be crosses, however, and the increase may represent block trades that are assembled by its specialists as floor brokers for other member firms. Moreover, its share of regional block volume has more recently declined somewhat. At the same time, the percentage of the Philadelphia-Baltimore-Washington Stock Exchange, which is now the major regional exchange for institutional membership, has increased dramatically while that of the Pacific Coast Stock Exchange has decreased substantially.

These figures on changes in market share among the regional stock exchanges, coupled with the low participation rate for regional specialists and the high proportion of crosses (mostly by NYSE members) indicate that with the possible exception of the Midwest Stock Exchange, considerations relating to commission rates may well be the most important reason for regional execution of block trades in NYSE-listed securities. In this respect, institutional membership, which affords the institutional money manager an opportunity to reduce the commissions paid by its accounts (and thereby possibly obtain a better price) and/or to increase its own profits appears currently to be the most dynamic factor in regional execution of blocks.

#### C. THIRD MARKET

Like regional block trades, transactions of 10,000 shares or more in the third market do not differ from those on the NYSE in size distribution or in average price per share. In the period studied, however, they did differ substantially in two important respects: the complexity of their structure difficulty and the charges made for executing them.

Third market block trades were less complex in structure, although not necessarily less "difficult," than block trades of similar size executed on the NYSE. Only 20 of the 167 third market trades of 10,000 or more shares in the sample involved more than one party on either side, and only seven involved more than two parties on either side. None of the multiparty blocks involved any substantial dealer participation by the third market firm. In all third market blocks of \$1 million and over principal-at-risk transactions by third market firms accounted for about one-fourth percent of the shares (as compared to a combined total of about three-eighths for the NYSE specialist and block positioner).

To some extent these differences may arise from the reluctance of institutions to trade outside the range of high and low prices for the day on the NYSE. Almost all third market blocks trade no more than one stock exchange commission away from this range and also trade somewhat closer to the previous close than NYSE blocks. (This is also true of regional block trades.) Without the same size of discount or premium with respect to last sale that is available for NYSE block trades, it may be difficult for the third market firm to assemble the block and unattractive for it to participate itself. To the extent that this occurs, third market firms are disadvantaged rather than advantaged by not having their executions reported along with those of the NYSE.

Riskless third market block trades are sometimes confirmed on an agency basis and sometimes on a riskless-principal basis. Average agency commission rates and riskless-principal spreads for third mar-

ket block trades per 100 shares were less than one-third of the then stock exchange minimum commission rates in 1968. The commissions and spreads for block trades in the third market did not change appreciably after the NYSE instituted its volume discount but were still only slightly more than one-half of the minimum stock exchange commissions. Despite reciprocal reasons for not using the third market, banks and investment advisers (including mutual funds) are the biggest customers with respect to all third market transactions of 2,000 or more shares, the banks' accounting for 30 percent of the shares and the investment advisers for 50 percent.

All of the figures previously stated for third market block trades do not include transactions by third market firms on the NYSE or on the regional stock exchanges. There is some such trading, particularly on those regional stock exchanges to which third market firms may belong. In addition, rules of various regional exchanges are not as strict as the NYSE with respect to third market executions by member firms. Consequently, there is a significant amount of third market volume between third market firms and member firms of regional stock exchanges that do not also belong to the NYSE.

The primary reason for the execution of a transaction of 10,000 or more shares in the third market appears to be the saving in transactions charges because of the substantially smaller agency commissions and riskless-principal spreads. Other secondary reasons include the complete avoidance of public reporting, sometimes more effective execution and clearance and—in the case of the banks—an opportunity to profit by imposing a “service charge” equal to brokerage commission.

#### D. FOURTH MARKET

The fourth market, consisting of trading by institutions directly with each other and without the use of broker-dealers, is not presently significant. The reason most frequently offered by institutions for not checking other institutions is the importance of anonymity. They do not wish to expose their interest to possible competitors. Their comparable reluctance to trade directly with issuers and issuers' pension funds may arise because of existing legal uncertainty.

#### E. AUTOMATION

Three automated systems to facilitate block trading have recently begun operation. Autex, the one most extensively used during the period studied, is primarily a communications system that supplements broker-dealers' existing upstairs communication systems. Negotiation and execution must be accomplished in the usual manner. The major users of the system are third market firms. The NYSE's competing BAS, which was not used as extensively in the period studied, performs similar functions but as a practical matter necessitates the presence of two NYSE member firms in every block trade. BAS, which has recently expanded the variety of its services, also provides for the retrieval of extensive market information. Instinet, the third system, provides for negotiation and execution as well as the location of potential participants for the passive side. During the period

studied, the system was used very extensively, and a large majority of the actual trades were with third market firms. The original design of the system has apparently proved somewhat inflexible for the negotiating process, and Instinet is presently attempting to improve it. It is too early to tell whether the negotiation and execution functions can be successfully automated for block trading.

## 2. PRICE IMPACTS OF NYSE BLOCK TRADES

Block trading, of course, directly affects the participants in the blocks. Because of its possible price impact, it also affects other investors who are in the market at the time, as well as all persons who rely upon the reported prices of securities transactions. The following paragraphs describe the price impacts of NYSE block trades of \$1 million or more. The statistics set forth are the averages of the individual impacts of all blocks surveyed in that size category. Individual block impacts may be substantially larger or substantially smaller than the average. Moreover, because the blocks have been classified by tick, and the anxious party in zero-tick blocks cannot be readily identified, the statistics overstate the average impact of block trades. In any event, all block trades (10,000 or more shares, regardless of dollar value) cause no more than 9 percent of the large (3 percent or more) day-to-day price changes on the NYSE.

Minus-tick block trades (initiated by sellers) are accompanied by a price drop relative to the market of almost 1 percent in the prior 20 trading days (mostly in the preceding 3 trading days), an additional price drop of about 1 percent on the day of the block trade (as measured from the previous close to the close on the day of the block) and almost a complete return to the beginning price during the next 20 trading days if no subsequent blocks occur. The size of the decline in the closing price on the day of the block varies with the size of the block. Within the day of the block trade there is an additional price decline in the neighborhood of three-fourths of 1 percent, which is recovered before the end of the day.

The decline on the day of the block trade appears to be the liquidity cost of moving a large quantity of stock more rapidly than the regular round lot market on the floor can absorb it. The decline prior to the block may result from the "shopping" of the block during the assembly process and varies extensively from block to block. Since both declines are temporary, the institution that initiates the trade pays a price for liquidity, and the institutions and individual investors who participate on the passive side of the block seem to receive a bargain. To the extent, however, that excessive or careless shopping of the block spreads the decline over a longer period of time, or the recovery is unnecessarily prolonged, other buyers may obtain bargains at the expense of sellers.

The much smaller number of plus-tick block trades (initiated by buyers) are accompanied by a price rise relative to the market of almost 4 percent in the 20 trading days before the block (slightly over 1½ percent in the preceding 3 trading days), an additional rise of more than 1 percent on the day of the block and no subsequent price return within the next 20 trading days.

Since these price rises tend to be persistent, the block may well merely accelerate a repricing of the stock due to fundamental factors. Institutions and individual investors on the passive side of these blocks do not obtain bargains, but neither do they appear to be disadvantaged because they sell their stock at a persistent price. To the extent that the block accelerates the repricing process, it reduces the number of sellers who fail to obtain the realizable values of their securities, perhaps because of lack of knowledge or understanding of a fundamental change, and the number of buyers who benefit from this situation.

Because the block trades initiated by sellers appear to involve liquidity costs, a closer examination of the effect of participation by block trade assemblers and NYSE specialists on those costs is appropriate.

Block positioning does not appear dramatically to affect the total price impact of block trades. It does, however, substantially affect the distribution of that impact between the day of the block and the prior few days. There is evidence that block positioners shop their blocks less extensively and/or more expertly, perhaps because of their steady flow of institutional inquiries. The prior market impact of positioned blocks is only slightly more than one-third of that in blocks handled by other block trade assemblers. On the other hand, the market impact of positioned block trades on the day of the block is more than three times as great as nonpositioned blocks. The cumulative impact of the positioned block is thus about one-third greater.

Block positioning appears, however, to tend to prolong the price recovery. The block positioner in effect puts a ceiling on the price of the stock while it is disposing of its position, since any demand emerging after the block trade may be immediately filled from the block positioner's inventory. In some cases it may even drive the price lower, although the causal relationship between a further price decline and the speed of the block trade assembler's layoffs is probably mutual.

Participation in block trades by the NYSE specialist is associated with smaller price changes than is positioning by block trade assemblers. The data in this chapter are not sufficient, however, to determine which is the cause and which is the effect. That question is considered in more detail in the following chapter, as part of a broader analysis of whether the manner in which both the block trade assembler and the NYSE specialist offset imbalances minimizes avoidable temporary price impacts of block trading to the extent feasible.

## Chapter XII

### IMPACT OF INSTITUTIONAL TRADING ON THE MARKET-MAKING FUNCTION

The U.S. markets for equity securities are generally recognized as providing greater liquidity in depth than the markets of any other country. In recent years the growing importance of institutional trading has put added strains on these markets in a number of respects. Of particular relevance to this chapter are the increased demands placed on the market-making mechanisms by the relatively large transactions preferred by institutional investors.

Apart from block positioners, who will be considered separately, three types of market-makers are of importance. They are New York Stock Exchange ("NYSE") specialists, regional stock exchange specialists and registered third market-makers. In certain respects all three types of market-makers are similar. All three regularly hold inventories in all of the stocks in which they make markets. In active stocks, the third market dealers hold 28 percent of total dealer inventories and regional exchange specialists an additional 15 percent. All three types of market-makers tend to adjust their inventories in such a manner as to respond to the trading pressures of their customers. That is, when there is an imbalance of supply over demand, as indicated by falling prices, all three types of market-makers normally buy stock. When there is an imbalance of demand over supply, as indicated by rising prices, all three types of market-makers normally sell stock. In this very important sense all of these market-makers normally tend to behave in a stabilizing manner and thus reduce the size of the price fluctuations that would otherwise occur.

The extent to which market-makers behave in a stabilizing manner varies. All types of market-makers tend to engage in more stabilization, to provide greater liquidity in depth, in more active stocks than in less active stocks. All tend to participate in greater depth when a high proportion of the trading in stock is being done by institutions. But there are also important differences among types of market makers. The NYSE is generally still the primary market for stocks listed on that exchange, and the regional exchange specialists and registered third market-makers do not have effective access to the flow of orders on the floor of the NYSE. For this reason the summary will concentrate first on the activities of NYSE specialists, who are generally the primary source of liquidity in depth, and then on the NYSE block positioners.

Among the NYSE specialist units there are important, persistent and consistent differences in behavior that seem to reflect characteristics of the specialist unit as a firm. These differences appear most clearly when NYSE specialist units are classified by the magnitude of the average change from day to day in their closing inventories.



Depending on the magnitude of this change in high-volume stocks, the 30 NYSE specialist units studied were classified into three groups of 10 each: the high, medium and low inventory activity categories. In terms of most of the characteristics examined, there tended to be consistent relationships among these three groups. If the high activity specialists were high on some characteristic, such as the value of their average closing inventory in a stock, the low group had the lowest level and the medium group an intermediate level. To simplify the exposition when this is the case, most comparisons in this summary will deal only with the high and low NYSE specialist activity categories.

In high volume stocks the average trading account positions of the high activity NYSE specialist units are nearly seven times as great as those of the low activity specialists. (The actual amounts are \$812,250 and \$118,340.) In medium volume stocks they are four times as great. (The actual amounts are \$447,200 and \$100,740.)

The closing inventories of NYSE specialist units in each of the three activity categories tend to adjust in a stabilizing manner with respect to day-to-day price fluctuations. However, the magnitude of the average stabilizing inventory change for a given day-to-day price change was persistently greater for the more active NYSE specialist units in each category of stock.<sup>1</sup> Large day-to-day price changes occurred substantially less frequently in the stocks assigned to NYSE specialist units in the high inventory activity categories. For example, when both NYSE volume and institutional volume are high, daily price changes greater than 3 percent occur on 8 percent of the days for the high activity specialist units and on 11 percent of the days for low activity units. In those high dollar volume stocks in which institutional trading is less important, the figures for the frequency of large price changes are 10 percent of the days for high activity specialist units and 16 percent of the days for low activity units. (Eighty-five percent of the stock days on which large price changes occurred were days on which there were no block trades.) These differences occur in spite of the fact that analyses of the frequency of apparently destabilizing behavior and of the variability of the specialist unit's income tend to confirm the effectiveness of the NYSE's policy of assigning inherently more volatile stocks ("dealer stocks") to the more active specialist units. These findings substantiate the conclusion that NYSE specialist units in the high inventory activity categories do a substantially better job of stabilizing the price fluctuations in their stocks by providing greater liquidity in depth.

Another finding which substantiates this conclusion resulted from examining days on which NYSE specialists had unusually large position changes.<sup>2</sup> When the pattern of price changes in these circumstances were examined, there were systematic differences among the three NYSE specialist unit activity categories. The average decline

<sup>1</sup> The Study classified stocks into different categories that were similar with respect to dollar volume and proportion of institutional trading.

<sup>2</sup> The pattern of changes in closing prices before and after the day of the unusual position change was very similar to that observed when days were selected because a block trade was known to have taken place on that day. It appears, although it was not directly verified, that in many instances when a specialist unit was long following a large position change a block trade initiated by an anxious seller took place; and that the specialist positioned part of the stock.

from the prior day's close to the close on the day of the large position change for NYSE specialist units in the low activity category was 1.46 percent, while for NYSE specialist units in the high activity category it was only 0.35 percent. Again these differences seem to reflect the fact that NYSE specialist units in the high inventory activity category are more willing to adjust their inventory, thereby providing liquidity when required and decreasing the resulting day-to-day price changes.

The inventory change of NYSE specialist units on a given day is not always in the opposite direction to the price change on that day. On a minority of days inventory changes and price changes are in the same direction, and the former are therefore apparently destabilizing. (A detailed analysis of intraday trading would be required to determine if a specialist's behavior on any particular day was actually destabilizing.) Apparently destabilizing days occurred with about the same frequency (25 percent or less of the days with large price changes and 35 percent or less of the days with small price changes) for NYSE specialist units in both the high and low inventory activity categories. They occurred with somewhat greater frequency (up to 32 percent of the days with large price changes and 42 percent of the days with small price changes) for specialists in the medium inventory activity category.

The gross incomes and returns on investment of all three groups of NYSE specialists were examined.<sup>3</sup> The most important determinant of gross income is the dollar volume of trading in the stock. Given the dollar volume category of the stock, there were only moderate differences among the three categories of NYSE specialist in their median or average gross monthly incomes before income taxes. In high dollar volume stocks NYSE specialist units in the high activity categories had median incomes of \$22,811 per stock per month; the corresponding figure for low activity category units was \$18,207. For medium dollar volume stocks the corresponding figures for the two groups were \$7,927 and \$6,323. Each individual specialist normally handles several stocks.<sup>4</sup>

Although the specialist units did not differ greatly by activity category with respect to the level of their income in comparable stocks, there are great differences in the month-to-month variability of that income (especially in high dollar volume stocks), with NYSE specialist units in the high inventory activity category having a greater income variability. For low inventory activity NYSE specialist units in high volume stocks, gross income per stock was negative on only 13 percent of the stock months. NYSE specialist units in the high inventory activity category suffered losses on 25 percent of the months in those stocks, and their losses, when they occurred, tended to be larger. Of the stocks studied there were 42 that were in the high dollar volume category for at least 12 of the 15 months for which

<sup>3</sup> Gross income consists of floor brokerage plus trading account profits, less the expenses of clearing and transferring stock. Investment is the average market value of the closing positions in the trading accounts of the specialty stock. Except where specifically indicated, long term capital gains or losses are excluded from income and stock held in investment accounts is excluded from the investment data. Office expenses, interest, and the salaries or imputed labor income for the specialist and his staff were not deducted.

<sup>4</sup> A stock was included in the high dollar volume category for a given month if it was one of the top 20 percent of all NYSE common stock issues in terms of dollar volume in that month. Similarly stocks in the medium dollar volume category.

data were available. There were only two of the 42 for which total gross income for the 15-month period was negative. Both of those stocks were assigned to high activity specialist units.

Since NYSE specialist units in the high inventory activity category have only slightly greater incomes, and considerably larger average inventory positions than specialist units in the low inventory activity category, it follows that the gross return on investment for the high inventory activity specialists will be less. The average gross return before taxes on investment in high dollar volume stocks was 88 percent per year for high inventory activity NYSE specialist units and 191 percent per year for low inventory activity specialists.<sup>5</sup>

Data on the allocation of stocks between NYSE specialist units in the three inventory activity categories was examined for a 3-year period ending in mid-1970. The proportion of the dollar volume of trading in issues assigned to the three categories did not change in this period, even though nearly 25 percent of the dollar volume at the end of the period consisted of issues (mainly new listing) for which an explicit allocation decision was made during that time period. Thus there is no indication that the NYSE is effectively using the stock allocation process to increase the extent to which its specialist units provide liquidity in depth.

The data and analyses in this chapter indicate that there are important differences among NYSE specialist units in the extent to which they participate in depth to reduce temporary price fluctuations. The findings also raise questions as to whether existing NYSE specialist units have adequate economic incentives to participate in depth.<sup>6</sup> Those units that perform best in this respect have lower average gross rates of return and are subject to greater risk than those that perform less well. The stock allocation process is apparently not used to strengthen the economic incentives to participate in depth.

To meet the increased demands on the market-making function block positioners have supplemented the activities of the specialists.

In 1968 and 1969 there were about 25 such member firms that block positioned on a regular basis. The largest five, however, accounted for about 60 percent of the total volume and overnight positions. The total volume of block positioning is about one-fifth as great as the volume of all block trading on the NYSE. Only a very small part of the positioning is short, to facilitate block trades initiated by purchasers. The total overnight positions (long plus short) of all block positioners range from \$40 million to \$70 million. When the market turned downward in May 1969, the total overnight positions decreased substantially. It appears to have done so again in May 1970.

Block positioners lose money on their positions, if related brokerage commissions and equivalents are not considered. In 1968 those

<sup>5</sup> To avoid exaggerating the differences between the high and low inventory activity categories, two NYSE specialist units in the high inventory category who appear to be unique in that their overnight positions were from two to four times as large as those of any other units, were excluded in computing this return. These units are more likely to hold stock in their segregated investment account. If these two units are included, the gross return of 88 percent per year referred to above becomes 29 percent per year.

<sup>6</sup> Greater participation in depth would require some NYSE specialist units to use more capital, and to assume greater risks than they do at present. However, considering the average annual returns, lack of capital would not appear to be an important barrier to their taking larger inventory positions. To meet the increased demands on the market-making function, block positioners have supplemented the activities of the specialists and third market-makers. Because of resource limitations, only member firm block positioners were studied in this chapter.

losses were \$9.5 million, or 19 percent of the total average overnight positions. In the first half of 1969 the losses were \$12.9 million, or 42 percent (on an annual basis) of the average overnight positions. In the first half of 1970 they were apparently even greater. Block positioners, however, earn commission equivalents on the principal part of the block trade (the shares positioned) as well as actual commissions on the agency portion (the shares crossed). If the commission equivalents on only the principal portion are added to the trading profits or losses, the figures for all firms become a trading profit of \$19.3 million, or 37 percent, for 1968 and a loss of only \$3.6 million, or 12 percent (on an annual basis) for 1969. The commissions on the remainder of shares in positioned blocks completely offset the losses, leaving a substantial surplus. In addition an equivalent amount of block trading not involving positioning is also handled by the same firms.

Block trading originated because of the expense of other methods of distributing large institutional positions and their orientation to the individual investor, who was accounting for a shrinking percentage of total volume. Block positioning was initially devised to facilitate those block trades in which orders were found for most but not all of the passive side. More recently, initial bids or offers prior to searching extensively—or at all—for orders on the passive side has enabled block trade assemblers to put together informal syndicates of institutions on the passive side for the mammoth position changes that have developed from the growth of very large institutions. In this respect the bids and offers perform much the same function as the firm commitment underwriting in a new issue.

To date, block positioners have mostly been compensated for this activity through the commissions and commission equivalents earned on positioned blocks and on "easy" trades that subsidize their trading losses. This has had the effect of averaging over all block trades the cost (and price impact) of difficult position changes requiring extensive market-making participation. On the other hand, the fact that block positioning made block trading highly profitable even though positions were sold out at a loss may have tended to have a somewhat depressing effect on the market after the block.

Negotiated commissions on block trades may eliminate the subsidy by reducing the cost of easy trades. Consequently, the effect of increasing the commissions charged in the positioned trades must be considered. So must the ability of block positioners to reduce their trading losses or even turn them to trading profits in order to substitute for the commission subsidy.

If brokerage commissions on positioned trades increase, the method of reporting those transactions becomes particularly important. In a block that is entirely positioned, the amount of the commission does not have any economic effect on the actual proceeds of the transaction to the seller or the actual amount paid by the buyer. Its principal effect is upon the way that the trade is printed on the ticker tape, and the block positioner may be able to "negotiate" any commission that it desires. Consequently, negotiated commissions could lead to misleading reporting of block trades. On the other hand, if the block is only partially positioned, the gross purchase price and the net proceeds from the trade are determined in arm's length negotiations with the customers on both sides. As long as the per-share gross purchase price or

net proceeds of the shares positioned are the same as those of the shares crossed, discretion in reporting would be limited to the point within this range at which the trade is printed.

With respect to their trading losses, block positioners suffer from a number of weaknesses. The prompt reporting of their transactions, which alerts the public to the existence of the block trade, coupled with disclosures made to prospective institutional customers during the assembly process, tends to make their positions known. The margin requirements for those positions may inhibit the block positioners from holding them as long as trading judgment might indicate. Some persons may short against those positions in the expectation of buying the stock from the block positioner at lower prices, and there are serious questions whether the block positioner may support the market against this threat. Finally, the block positioner is removed from the regular round lot market on the floor and is therefore somewhat dependent upon the specialist in laying off its position there.

On the other hand, the existing time pressure in disposing of positions arises because the block positioner wishes to free its capital as quickly as possible in order to use it to earn additional commissions in the next block trade. If those commissions were not large enough to justify block positioning on a loss basis, block positioners might simply hold their positions longer and reduce the volume of their positioning. In blocks initiated by sellers the price usually does recover eventually, and short positioning is not very prevalent today anyway. To the extent that block positioners could make trading profits but would dispose of their positions only as quickly as the market could absorb them while still recovering rapidly from the pressures of the block trade, fewer investors in the market would be affected by the temporary price disparity.

The data collected by the Study do not indicate whether block positioners can make money trading either in their present trading posture or in a stronger one. It is doubtful that anything but experience could answer that question.

## Chapter XIII

### IMPACT OF INSTITUTIONAL TRADING ON BROKERAGE SERVICES AND THE SECURITIES INDUSTRY

#### 1. LONG-TERM IMPACT OF INSTITUTIONAL INVESTORS ON THE SECURITIES INDUSTRY

##### A. OVERALL TRENDS IN THE SECURITIES INDUSTRY

The decade of the 1960's was marked by tremendous growth in the volume of securities transactions. In 1968 the dollar volume of trading on all registered exchanges was more than three times greater than in 1960. Between 1962 and 1968 the gross income of NYSE member firms increased from \$1.5 billion to \$5.4 billion. In 1968 almost every member firm had gross income of more than \$1 million; in 1962 only two-thirds of the firms earned that much. In the same period the number of NYSE members with gross income of \$50 million and over increased from 1 to 6 percent.

The major source of NYSE member firms' income during the period was the brokerage commissions received on agency orders. Between 1962 and 1968 these commissions increased from \$0.9 billion to \$3.2 billion. In 1962 only 45 percent of the member firms had \$1 million and over in commission income but by 1968 this figure had increased to 83 percent, while the number of firms with commission income of \$25 million or more increased from less than 1 percent to 7.57 percent.

After 6 continuous years of rising volume, 1969 saw the beginning of a decline which had persisted into mid-1970. Share volume on all exchanges declined 7 percent from 1968 to 1969, and the value of shares traded on all exchanges declined 11 percent.

Commission income on NYSE transactions declined 23 percent, commission income on other exchange transactions 20 percent and on over-the-counter market transactions 13 percent. This was due in part to the decline in dollar volume and prices and in part to the volume discount. Other phases of the broker-dealer business also declined; for example, dividends and interest received declined 36 percent, profit from trading and arbitrage 31 percent, and income from the sale of mutual funds 12 percent.

##### B. GROWTH IN INSTITUTIONAL INVESTORS' PAYMENTS TO THE SECURITIES INDUSTRY

Most of the growth in the securities industry during the period 1960-69 was due to increases in securities transactions by institutional investors. Their share volume increased on the NYSE by 548 percent, compared with a 133 percent increase in individual investor volume. Institutional share volume rose from about a quarter of total 1960

NYSE public volume (excluding members' trading for their own accounts) to about a half of 1969 public volume. Banks and mutual funds alone increased their combined percentage share of NYSE public volume from 18 percent to 34 percent during this period. Moreover, since the average price of shares traded by institutions has always been higher than the average price of shares traded by individuals, the institutions accounted for an even higher proportion of the dollar volume on all exchanges.

In part reflecting the growth in the size of institutions and in part reflecting changing trading policies, the average size of institutional orders executed on the NYSE during this period also increased greatly. The average size of mutual fund orders, for instance, increased from 550 shares to 3,726 shares

#### C. IMPACT OF INCREASED INSTITUTIONAL INVESTOR BUSINESS ON SECURITIES INDUSTRY PROFITABILITY

The growth in institutional trading had a large significant effect on NYSE member firm profitability. The business of the primarily retail firms (average commission income per transaction under \$50) proved far less profitable during this period than the business of the primarily institutional firms (average commission income per transaction of \$100 and over). The 1968 median pretax profits of member firms illustrates this point. The median pretax profit was \$824,000 for all NYSE firms, \$672,000 for primarily retail firms and \$2.4 million for primarily institutional firms. While institutional firms represented only 13 percent of the firms, they accounted for 52 percent of the firms earning \$5 million and over. The 62 percent of the firms that were retail accounted for only 41 percent of the firms with pretax income of \$5 million and over. Fewer than 1 out of 10 institutional firms, but 7 out of 10 retail firms, had pretax profits under \$1 million.

These disparities in total 1968 pretax profits were due almost entirely to differences in the profitability of the security commission business. Although the primarily retail firms as a group received two-thirds of all gross security commission income, they accounted for only one-third of the pretax profits on this business. In contrast, institutional firms as a group received only 14 percent of all security commission income but accounted for 39 percent of the pretax profits of all firms. Median pretax profit margins on the security commission business itself were almost 5 percent for retail firms and 27 percent for institutional firms.

These higher 1968 profit margins for institutional firms on their security commission business occurred despite their sharing of commissions with retail firms. In large part this reflected the commission rate schedule in effect in 1968. This schedule did not recognize economies of scale in effectuating a single large order or numerous small orders for the same customer. According to a study done for the NYSE, the average cost of handling a 1,000- a 10,000- and a 100,000-share order of a \$40 stock was, respectively, 6, 42, and 377 times the 100-share commission yet the commission charged in 1968 was, respectively, 10, 100, and 1,000 times the 100-share commission.

Trading and arbitrage, underwriting and margin interest income accounted for most of the noncommission income of member firms.

The institutional firms were much more dependent on commission income as a percentage of their total income than were retail firms. Retail firms, on the other hand, derived more than 10 percent of their other income from distributing mutual fund shares and 30 percent from margin interest income (institutional firms received only minimal percentages of income from these sources). The highly profitable commission business done by institutional firms may to some extent, however, have been offset by losses suffered on other business. Nineteen percent of the institutional firms lost money on their other business compared with 4 percent of the retail firms. Institutional firms may be willing, for example, to accept the risk of losses on block positioning in order to attract profitable institutional commission business.

#### D. DISTRIBUTION OF INCREASED INSTITUTIONAL INVESTOR BUSINESS

Recognizing the profitability of institutional commission business retail firms competed for institutional customers. For most firms income per transaction increased between 1962 and 1968, with 11 firms moving to a higher category of income per transaction for every one firm moving to a lower category.

Institutions allocated the bulk of their commission business by placing agency orders with the broker-dealers of their choice. Prior to December 5, 1968, however, a further distribution of commissions was often made by directing the confirming broker-dealer to pay a portion of the full commission received (that is, to "give-up" a portion of the commission) to other broker-dealers. Between 1964 and 1968 the use of the customer-directed give-up by investment companies increased more than 700 percent. In 1968 all but nine of the 57 investment company complexes studied used the customer-directed give-up. This device was used much less frequently by other institutional investors. A willingness on the part of NYSE members to give-up to other members as much as 70 percent of the commission on a single transaction was fairly common. Some brokers, in fact, were willing to give-up 90 percent on trades that they executed but did not clear or confirm.

In 1968 three out of every five NYSE member firms received some compensation from investment companies in the form of give-ups. Investment company advisers, however, wished to route some of the give-ups to nonmembers of the NYSE, principally because a significant amount of fund sales were originated by nonmembers of that exchange. Since the rules of the NYSE did not prohibit member firms from executing orders on the regional exchanges, and since some regional exchanges not only permitted give-ups to their own members but permitted give-up distribution to members of the NASD (which has about 3,700 broker-dealer members) or foreign broker-dealers, institutional investors were able to expand their commission dollar distribution by directing broker-dealers to execute orders on those regional exchanges. Brokers worked out complex methods which allowed the institutional investor to direct give-ups to nonmembers of the NYSE even when the order was executed there. Most give-up arrangements had one common characteristic: They permitted the



institution to utilize a limited number of executing broker-dealers (lead brokers) that would give up a large portion of the commission to other broker-dealers. Thus, the number of net recipients of give-ups was about three times greater than the number of net payers.

#### E. 1968 COMMISSION RATE CHANGES

On December 5, 1968, the NYSE adopted an interim commission rate structure which incorporated a volume discount and prohibited customer-directed give-ups. The Amex and regional exchanges concurrently adopted similar provisions. The volume discount reduced commissions on all orders in excess of 1,000 shares on securities selling for less than \$90 per share. In no case was the fixed minimum commission on a single order to exceed \$100,000.

#### F. IMPACT OF 1968 COMMISSION RATE CHANGES

One of the major effects of the prohibition of customer directed give-ups was to increase the number of broker-dealers confirming institutional transactions. A number of firms that received no actual (as opposed to give-up) commissions in 1968 began to do so in 1969. Those NYSE member firms that were net payers of give-ups in 1968, as a group, received in 1969 a smaller percentage of total actual investment company commissions (67 percent in 1969, 81 percent in 1968).

Although those firms which in 1968 were net give-up payers were affected in 1969 by the volume discount to a much greater extent than those firms which were net give-up recipients in 1968, in general the give-up prohibition more than offset the volume discount's impact. The firms which were give-up payers in 1968 received \$57.1 million less in actual commissions in 1969, but because of the give-up prohibition they retained all their actual commissions whereas in 1968 they had paid out \$58.2 million in give-ups.

#### G. PROFITABILITY OF INSTITUTIONAL INVESTOR BUSINESS IN 1969-70

The profitability of NYSE member firms declined greatly in 1969. Thirty-seven percent of NYSE members lost money in 1969, while only about 3 percent had lost money in 1968. The 1969 increase in such costs as interest, clerical and administrative salaries, and office and equipment expenses, contributed to the decline in profitability in all firms.

The most profitable firms in 1969, as in 1968, were institutional firms. The retail firms were hit hardest by the volume decline. Forty-two percent showed losses in 1969 while only 18 percent of the institutional firms showed losses. The median pretax profit during this period for all firms was \$128,000, for retail firms, \$63,000, and for institutional firms, \$722,000. More than one-third of the institutional firms had a 1969 pretax profit margin on commission business in excess of 30 percent, while less than 6 percent of the retail firms had that high a profit margin.

In part the continued differences in profitability between retail and institutional firms reflects a commission rate schedule that, despite the December 5, 1968, changes, has not fully adjusted to the costs of doing

business. According to a study done for the NYSE, the cost of handling a single small order sometimes exceeded the commission rate. The cost of handling a large order still left room for a substantial profit.

## 2. ALLOCATION OF COMMISSIONS AND OVER-THE-COUNTER BUSINESS BY INSTITUTIONS

### A. COMMISSIONS PAID BY INSTITUTIONAL INVESTORS

Most commissions paid in 1968 by the institutional investors in the Study's sample were for the execution of stock exchange transactions. A lesser amount was paid for the execution of over-the-counter agency transactions.

Investment companies and bank trust departments were by far the largest source of institutional brokerage commissions. These two categories of institutional investors paid out about seven times more brokerage commissions than all other institutional investors combined (that is, the noninvestment company accounts of the largest investment advisers, life insurance companies, property and liability insurance company, and self-administered pension funds, educational endowments, and foundations). Six banks and seven investment company complexes paid out 38 percent of the total commissions reported by all the institutions studied.

Institutions tend to pay commissions to a large number of broker-dealers. The average bank in the Study's sample (the 50 largest trust departments), for instance, received confirmations from 212 broker-dealers, the average investment company complex (the 57 largest complexes) from 136 broker-dealers. Banks on the average used give-ups in 1968 to compensate an additional six broker-dealers and investment companies an additional 59 broker-dealers. The largest broker-dealer recipients of commissions from any category of institutions, on the other hand, received a high percentage of the total commission dollars paid out by that category. Fifty broker-dealers accounted for 59 percent of the commissions paid in 1958 by all of the institutions studied.

Most broker-dealers in the Study's random sample receiving institutional commissions tended to have three common characteristics: an NYSE membership, strong capitalization, and high gross income.

Over 98 percent of the NYSE member firms in the sample received some commissions from the Study's sample of institutions. Fifty-nine percent of the NYSE firms (but only 18 percent of the nonmembers of the NYSE) received over 5 percent of their gross income in institutional commissions. Of the firms receiving more than \$1 million in institutional commissions, 92 percent were members of the NYSE; the remainder were members of the Midwest or Pacific Coast Stock Exchanges.

Fifty-five percent of the firms with less than \$100,000 total capital received no institutional commissions. On the other hand, all the firms with over \$5 million total capital received some institutional commissions and 44 percent of these firms received over \$1 million in institutional commissions. Fifty-four percent of the broker-dealers with gross income over \$5 million received at least \$500,000 in institutional commissions.

## B. OTC NET TRADES IN STOCK BY INSTITUTIONAL INVESTORS

On many occasions an institution will transact at net prices in the over-the-counter market for listed and unlisted securities with a dealer that is purchasing the stock for, or selling the stock from, its own account. The banks and investment companies accounted for most of these transactions, in fact, \$10 billion of the \$11 billion total for all institutions in the sample. The number of broker-dealers dealing at net prices with institutions is far smaller than the number acting as agents. Only the banks, the investment adviser managed investment company complexes and the other accounts managed by investment advisers averaged such OTC trades with more than 15 broker-dealers. Moreover, the business was even more highly concentrated than the commission business, with 10 broker-dealers handling more than half of the net trades reported by each type of institution. The four broker-dealers with the largest volume of these trades and two of the remaining six in the top 10 by volume made OTC markets in listed securities. For some of these firms much of their institutional OTC business was in stocks in which they did not make markets. In all, 56 percent of the total OTC net trades in both listed and unlisted stocks was done with firms that made such markets.

Almost three-quarters of the broker-dealers in the Study's random sample with more than \$10 million in institutional OTC net trades were members of the NYSE, and, like those firms receiving commission business, tended to be heavily capitalized and to have high gross incomes.

## C. CUSTOMER DESIGNATION OF BROKER-DEALERS

The manager of an account does not always trade for the account. When the manager does trade, it is not always granted the authority to choose the broker-dealer. A customer, for example, may want to reward a particular broker-dealer which may have introduced the account to the manager, which may have some affiliation with the customer (a large donor to a college whose endowment fund is the account or an investment banker for a company whose pension fund is the account) or which may have performed some service for the institution (such as pension fund performance evaluation). Where an investment adviser or bank trust department is managing individual accounts, the customer may have a relative or friend through whom he wishes account brokerage handled.

The brokerage for about one-third of the investment adviser-managed accounts and more than two-thirds of the bank-managed accounts was reported to be free of customer designation. Some accounts designate a broker-dealer but allow the bank or adviser discretion to deviate from that choice if circumstances warrant. Other accounts allow discretion as long as certain amounts of unrelated commissions are paid to the designated broker-dealer.

Eleven percent of the broker-dealers receiving bank commissions received only "free commissions" (undesigned) and an additional 23 percent received at least 80 percent of their bank commissions as

free commissions. Eighteen percent of the broker-dealers, however, received almost all of their brokerage commissions from banks solely because one or more customers had so designated.

#### D. EXECUTION AND CLEARANCE

More than one-half of the orders to purchase and sell stocks for bank trust departments and nonbank trusts and estates are for 100 shares or less. The techniques involved in the execution of these smaller orders have remained unchanged for decades. On the other hand, the orders of insurance companies, investment companies and pension funds are frequently of large size. The institutional broker-dealer receives such an order because it has developed the ability to find the other side of the transaction among institutions and other large investors.

When seeking an execution in unlisted stocks more than four-fifths of the institutional investors surveyed by the Study dealt on a principal basis directly with a marketmaker at least a majority of the time. Institutions gave better price, better market quotes and more depth as the reasons for going directly to market-makers. In some cases, though, an institution might decide to use a broker to compensate it for unrelated services or because the broker may be more familiar with the various market-makers and therefore be able to obtain a better execution. Self-administered institutions, such as endowments and pension funds, tend to deal through agents more often than institutional managers of other people's money.

Although executions in many listed securities may also be obtained net in the third market, two-fifths of the institutions surveyed did not check third market quotations, and only one-fifth checked third market quotations on a majority of their trades. Most institutions cited either inability of some third market-makers to accept large trades or importance of using the auction market for small trades for their reluctance to check third market quotations. Some institutions expressed a belief that an execution unsubstantiated by a tape print could be susceptible to criticism whereas an execution on a regulated exchange could rarely be questioned. Other institutions expressed a preference for the third market, stating that it may offer a better price (after taking commissions into account), allows direct negotiation of the price, offers a known price at which the trade will be accomplished, and offers more rapid stock delivery. Some of these institutions claimed that a large order sent to the third market will not adversely affect the exchange auction market. Some banks (one bank accounted for more than one-half of the total) have increased their own income by executing agency and custody orders in the third market at net prices and charging the account the net price plus a full or partial commission.

Only about one-fifth of the institutions surveyed "ordinarily" granted a broker-dealer discretion as to the timing of transactions to effectuate a single investment decision. Thirty percent of the institutions "occasionally" granted such discretion while almost two-fifths "never" granted it.

One-half of the institutions surveyed "always" or "ordinarily" granted discretion to choose the executing market, and an additional

quarter "occasionally" granted such discretion. It must be remembered, however, that choice of the broker-dealer may be the choice of the market. For example, when an NYSE member receives an order from an institution the institution may well contemplate an NYSE execution. Similarly, an order given to a third-market firm is expected to be executed off the exchange.

In most instances no price discretion is granted to the broker-dealer. Rather, the institution will either place a price limit on the order or request the broker-dealer to check back with the institution before execution.

Clearance and settlement is the process whereby the purchaser of a security receives the certificates and the seller receives the proceeds of the transaction. Unlike transactions of most individuals, institutional investors usually do not pay for a trade until the certificate is delivered to it or its custodian. It is consequently possible for an institution to retain the cash needed to pay for a security it has agreed to purchase (the purchase of which it immediately reflects in the institutional portfolio) for some period of time until settlement—a period that has become extended by reason of the fails problem and rejection of partial deliveries. The retained cash can in the meantime be put to double use, earning some return. Often it is the custodian of the institution's portfolio (usually a bank) to whom the institution has transmitted funds for the purchase rather than the institution itself that benefits from the arrangement. It is the broker-dealer who bears the cost of this situation since it must carry the securities until payment is received. Various proposals are now pending to facilitate the completion of deliveries of securities to institutional investors.

#### E. INSTITUTIONAL INVESTOR PAYMENTS FOR RESEARCH

The magnitude of institutional payments allocated to research is based on two factors, the amount of research needed to supplement that produced by the institution and the alternative uses to which the generated commissions may be put. Insurance companies and other self-administered institutions in the Study's sample presently have few alternative uses of commission dollars and reported often paying all or most of their commissions to firms providing them with research. Banks, on the other hand, reported allocating only 12 percent of their total "free commissions" for research (two banks accounted for more than a fourth of the total commissions paid by banks for this purpose) and investment company complexes reported allocating 23 percent of their commissions for this purpose.

In 1968, investment companies paid research commissions to an average of 88 broker-dealers while banks paid such commissions to an average of 49 broker-dealers. In dollar value, however, research commissions tended to be concentrated among a few broker-dealers. In terms of total broker-dealer gross income, banks and investment company commissions allocated for research are relatively insignificant, comprising about 1.4 percent of the total.

In the 1968 NYSE firms had research expenses of \$97 million, or 2.4 percent of total expenses. Those NYSE firms dealing primarily with institutional investors incurred greater research expenses, both

absolutely and in relation to total expenses, than did firms dealing primarily with the public. While the median research expense per retail firm was \$45,000, the median for institutional firms was \$129,000.

#### F. OTHER SERVICES OFFERED TO INSTITUTIONAL INVESTORS

In addition to execution and research, broker-dealers offer other brokerage-related services to institutional investors including portfolio valuation, custody of securities, financing of margin accounts and facilities for communication between the institution and the broker-dealer.

Many broker-dealers offer to value institutional investor portfolios as often as twice daily, and some broker-dealers also offer to measure the portfolio performance of the institution. Many broker-dealers offer direct, free wires to institutions that generate a substantial commission volume, enough to justify the cost of the wire. Most institutional investors, however, do not use the custody service of a broker-dealer, preferring instead to use bank custodians. Also, most of them do not trade through a margin account—only about 3 percent of the total trading of institutional investors was margined.

#### G. RECIPROCITY

Reciprocity (purchasing products or services from those purchasing your products and services) is a well-documented form of business behavior in the securities industry. Also well documented, however, are the economic and legal problems attending reciprocal arrangements. The ability to negotiate terms of reciprocal arrangements for many institutional investors has aspects of negotiating commission rates. However, unlike negotiated rates where negotiation could accrue benefits directly to the account managed, reciprocity often tends to benefit the manager and not the account. Absent a specific credit, the accounts benefit only to the extent that management fees and sales loads may be lower than they would be in the absence of reciprocity. Reciprocal considerations bearing on the allocation of portfolio business create a potential conflict of interest between the manager and its account in choosing a broker-dealer or market to use when executing an order. In the past, pressure for lower or negotiated commission rates has come primarily from those institutional investors who have not been able to receive the benefits of reciprocity and those self-managed institutions for which reciprocity is a cumbersome, circuitous way of recapturing part of the fixed commission. These institutions, including the insurance companies and the advisers to mutual funds sold by captive sales forces, represent a small but nevertheless significant portion of the commissions paid by institutions.

Broker-dealers strongly enhance the probability of receiving portfolio brokerage from a bank by maintaining a deposit at that bank. Eighty-seven percent of bank's free commissions were paid to depositors. Seven of the 46 banks studied paid almost 98 percent of their free commissions to depositors.

Extensive interviews with both broker-dealers and banks indicate that the relationship between depositors and commission recipients is not one of chance. The bank traders, for example, reported receiv-

ing periodic memoranda outlining the current commercial relationships with broker-dealers. Some of these memoranda simply suggested broker-dealers to be used. Others were less precatory, listing the dollar amounts of commissions to be paid to individual broker-dealers. Banks and broker-dealers sometimes met to negotiate or renegotiate the flow of deposits or commissions, reflecting the increased or decreased activity of either party.

A random sample of broker-dealers illustrated the extent of these commercial relationships. The broker-dealers in the sample averaged 11 deposit relationships with banks. Six of these accounts were "inactive" accounts having fewer than 10 transactions during a 1½-year period. Although the maintenance of an "inactive" account may have some business justification, the pervasiveness of the practice suggests that many of the accounts reflect a need to maintain the commercial relationship necessary to the receipt of commission business.

After giving priority to customer designations and research obligations, some banks systematically allocated commissions among broker-dealer depositors. The banks in the sample on the average paid out available commissions (total commissions less designated and research commissions) equal to 10.4 cents for every dollar in deposit accounts. The banks interviewed indicated that the ratio to the broker-dealer may actually run closer to 15 to 25 percent of the deposit balance because of the float in the active accounts.

Many banks, in the face of a warning by the Antitrust Division of the Department of Justice, as well as suits filed on behalf of individuals, claim to have abandoned or modified their former methods of allocation.

Most mutual fund sales in the United States are made by independent broker-dealers, not affiliated with the manager or principal underwriter of the mutual fund. Independent broker-dealers can enhance their probability of receiving mutual fund brokerage commissions by becoming sellers of the funds' shares. Some of the fund complexes studied chose, almost exclusively, to send portfolio orders to broker-dealers selling the funds' shares.

The mutual fund adviser is limited, however, in the amount of brokerage it can channel to the fund seller. The average size of the fund's portfolio order is relatively large, but (in terms of the number of sellers but not volume of sales) retailers of the funds' shares are usually small nonmember broker-dealers without the capacity to execute and clear such transactions. Thus, although most of the commission dollars generated by mutual funds are paid out to fund sellers, most fund sellers receive no portfolio brokerage from the funds they sell.

Since approximately four-fifths of total investment company transactions are on the NYSE, the NYSE members are in a position to be compensated with direct commission dollars. Transactions in NYSE-listed securities may also be directed to regional exchanges where those securities are dually traded in order to compensate regional exchange members for their selling efforts. It is difficult, however, for the investment company adviser (especially since the "give-up" prohibition of December 5, 1968) to compensate the nonmember of any exchange. The advantage held by NYSE members has increased their incentive to retail fund shares. Between 1962 and 1969 their percentage of total mutual fund sales increased from 21 to 39 percent.

Insurance companies will, in some instances, consider insurance relationships in the choice of a broker-dealer. In no case has the Study discovered brokerage allocations systematically related to insurance premiums. It is not unusual, however, for a broker-dealer to purchase insurance coverage from more than one insurer in the hope of maximizing the receipt of insurance company brokerage business. Two recent developments increase the potential for broker-dealer and insurance company reciprocity: First, insurance companies are selling mutual funds and could utilize independent broker-dealers to distribute the shares. Second, members of at least one exchange, the Midwest Stock Exchange, are now permitted to sell insurance.

### 3. AFFILIATIONS BETWEEN INSTITUTIONAL INVESTORS AND BROKER-DEALERS

#### A. TYPES OF AFFILIATIONS BETWEEN INSTITUTIONAL INVESTORS AND BROKER-DEALERS

Institutional investors, especially investment advisers with captive sales organizations and insurance companies, have in recent years affiliated through ownership with broker-dealers that execute and/or clear securities transactions. Broker-dealer affiliations of institutional investors in the past were mostly between an investment adviser to a mutual fund and the principal underwriter (distributor) of the funds' shares who was required to register as a broker-dealer. The new class of affiliates that execute and clear securities transactions are in some cases structured to do so for only the accounts managed by the institutional investor, in some cases only for others, and in some cases to do both.

#### B. THE LEGAL ENVIRONMENT

These affiliations are not prohibited by the Federal securities laws and do not appear to be prohibited by the Federal banking laws.

#### C. STOCK EXCHANGE REQUIREMENTS

Institutional membership has, however, been severely restricted by the constitutions and rules of the various exchanges. The NYSE, prior to 1970, prohibited public ownership of member firms, thus precluding the largest institutional investors from membership. The rules, however, did permit membership to privately held organizations whose primary purpose was the brokerage business. Within this framework, in 1969 almost half of the member firms received advisory fees from accounts managed by themselves or their adviser subsidiaries. These fees totaled \$44 million after offsetting, in some cases, commissions generated by the advisory account. Since early in 1970 the NYSE has permitted public ownership of its members with certain restrictions. These include a provision that the "primary purpose" of the member firm and any parent must be the brokerage business.<sup>1</sup> Since for the

<sup>1</sup> The Commission did not object to the inclusion of this requirement; however, it did indicate that it intended to review "both the appropriateness of the requirement and the suggested standards for its determination \* \* \* after we have the benefit of the exchange's study of institutional membership which we have requested to be completed no later than July 1, 1970." Securities Exchange Act Release No. 8849 (Mar. 26, 1970). The study referred to has not been completed.



purpose of determining the primary purpose advisory fees are not considered part of the brokerage business, this provision effectively precludes most institutional investors from owning more than 25 percent of the voting stock of any member.

The regional stock exchanges have been more permissive than the NYSE in permitting subsidiaries of institutional investors to join. The Philadelphia-Baltimore-Washington Stock Exchange has no provision prohibiting institutional investors or their subsidiaries from joining and many have joined. Although the Pacific Coast Stock Exchange had no prohibitions until 1965, after one large mutual fund adviser joined, it immediately passed rules against such membership. Since then these rules have frequently been changed, often under threat of antitrust suits, to permit broker-dealer subsidiaries of institutional investors desiring membership to join. The present rules, while restrictive, give to the exchange's board of governors certain exemptive powers which have facilitated membership for subsidiaries of institutional investors. The rules of the Midwest Stock Exchange specifically prohibited most institutional investors from membership, but were revised in 1970 as part of the program to implement public ownership. Unlike the NYSE, whose rules exclude from membership any broker-dealer with a parent not in the securities business, the Midwest permits such members as long as their parents agree to comply with certain reporting and other requirements. The rules of that exchange permit membership to any broker-dealer doing a "general" and "public" securities business, with more than half of the revenues derived from other than affiliates.

Institutional membership has been sought primarily by those institutional investors, such as insurance companies and advisers to investment companies sold by captive sales forces, which could not avail themselves of reciprocity with broker-dealers. The potential loss of reciprocity to banks and investment advisers because of antitrust actions could have two possible consequences. Many of these institutional investors deprived of their significant course of reciprocal income may decide to affiliate with a broker-dealer with the intent of directly receiving income from commissions paid by their customers which they have received indirectly in the past. Others may decide not to affiliate but may exert pressure on the exchanges, the Commission and others to take action to reduce commissions. The unequal membership rules of the exchanges has led to a trend toward institutional investors joining some regional exchanges and placing orders away from the primary market in New York. As long as the NYSE has a minimum commission rate which the institutional investors do not believe to be "reasonable," and as long as the NYSE prohibits these institutional investors from membership, it is probable that this trend will not only continue but will accelerate.

## INTRODUCTION TO PART FOUR: IMPACTS OF INSTITUTIONAL INVESTORS ON CORPORATE ISSUERS

Earlier parts of the Study have considered the operational characteristics of various types of financial institutions and their impacts on the securities markets. In Part Four, the Study examines relationships between institutions and the companies whose equity securities they purchase or hold.

### A. CORPORATE FINANCING

Chapter XIV focuses on purchase by institutions of equity securities from issuers in nonpublic offerings and in initial public offerings. As developed in Part Three, institutions have become a major factor in the secondary equity markets, accounting for an increasingly substantial portion of trading volume on national securities exchanges and in the third and fourth markets. Institutional participation in primary financing—that is, purchase of equity securities directly from corporate issuers (or from professional underwriters of new issues)—represents only a small percentage of total institutional holdings. However, such participation is significant because of its direct impact on the availability of external funds to corporate issuers.

Companies generally have no control over the acquisition by institutions of their securities in the secondary markets; the relationships arising out of such purchases ordinarily do not reflect any initiative on the part of the portfolio company. On the other hand, corporate issuers do have the right of initiation with respect to new issues of their securities. Companies determine in the first instance whether to issue additional securities and what kind of securities to issue. Where a nonpublic offering (or “private placement”) is contemplated, the company may, in effect, select its shareholders. By participating in such transactions, the shareholders acquire “restricted” securities that ordinarily cannot be publicly resold except by compliance with the registration requirements of the Securities Act of 1933. Although an initial public offering by a company does not afford the same opportunities to direct the placement of securities because of the customary use of a professional underwriter, there may still be some element of initiative on the part of the issuer to the extent that particular underwriters deal with certain types of investors.

Chapter XIV evaluates the extent to which institutional investors have been a significant factor in primary equity financing:

Their involvement in venture capital investments, which are of great importance to companies in the developmental stage and which, if successful, also may come to dominate the institution’s portfolio;

Their involvement in private placements, in which the institution receives unregistered, restricted securities; and

Their involvement in initial public offerings, in which the company for the first time invites general public investment.

The analysis is designed to afford insight into the nature as well as the extent of institutional participation in corporate financing. It covers the number and types of institutions that are most likely to make such investments, the size and types of companies in which institutions are most likely to make such investments, the potential rates of return obtained by institutions from such investments, and the numbers and types of broker-dealers that are most likely to serve as underwriters for first public offerings in which institutions are substantial participants. Consideration also is given to the opportunities and benefits available to institutions relative to the general investing public.

#### B. CORPORATE DECISIONMAKING AND CONTROL

Chapter XV focuses on institutions as shareholders or representatives of shareholders in publicly-held corporate enterprises. By participation in primary financings and by purchases in the secondary markets, institutions have become major holders of corporate equity securities. Their holdings, considered independently and in conjunction with any personnel or business relationships they may have with portfolio companies, create a potential element of influence or control over many issuers. The fundamental question confronting institutional, corporate, and governmental policymakers is whether the existence and use of this potential economic power can be reconciled with the obligations of institutional financial managers to their own beneficiaries and with the rights and interests of other (noninstitutional) investors.

In the first main section of chapter XV the Study surveys the way in which existing laws define or regulate the role of institutions within the structure of corporate power. The next two sections of the chapter examine, from a statistical point of view, the extent of economic power accruing to institutional investors from shareholding, personnel and business relationships with corporations. An attempt is made to portray the extent to which the largest institutions hold in their portfolios the outstanding shares of a broad sample of public companies. There also is an analysis of intercorrelations between shareholdings and certain types of personnel and business relationships linking institutions and companies.

The final two sections of the chapter examine the extent to which the large institutions surveyed have actually exercised economic power by involvement in corporate decisionmaking and in transfers of corporate control. The Study explores the reasons for such involvement, its prevalence and its impacts on the companies concerned.

#### C. SOURCE OF FINDINGS

The findings in chapter XIV are based upon extensive responses to questionnaires, fully described in the chapter. The sections in chapter XV on institutional shareholdings and on institutional personnel and business relationships also are derived from statistical questionnaires, described in the chapter.

While questionnaires were also utilized for the section on involvement in corporate decisionmaking, they proved to be unsatisfactory in many respects because of the essentially subjective nature of the information sought: The policies and views of the institutions, and instances of informal participation or consultation all are matters not the subject of ordinary records or susceptible of ready recall and verification. Therefore, reliance necessarily was placed upon interviews with institutional and corporate financial managers.

In the final section on transfers of corporate control, the Study conducted or drew on a number of case studies disclosing specific instances of institutional involvement. Since aggregate statistical data on such involvement would have been virtually impossible to obtain, the case studies provided the only feasible means of investigating, as requested by Congress, the effect of institutional investors on corporate issuers in transfers of control.

## Chapter XIV

### INSTITUTIONAL PARTICIPATION IN NEW EQUITY FINANCING

This chapter describes the significant role financial institutions of various types play in providing equity financing for corporations, particularly smaller, less established corporations. Thus, unlike the focus of Part Three of the Study on the secondary trading markets, here the focus is on the primary issue market—although attention is also paid to immediate aftermarket effects of institutional participation in this market. Institutional purchases in public offerings and private placements of both common stock and convertible debt securities are examined in the chapter.

Two factors should be recognized in connection with consideration of this chapter. First, the Study's data relate to a period of unusual market activity when all investors, including institutions, tended to make riskier investments. This was also a period of increasingly restricted credit. Second, institutional participation in direct equity financing of corporations, although important to those corporations, is not in the aggregate significant to institutions. For example, only 0.3 to 0.4 percent of gross purchases of securities by institutions are purchases of securities in first public offerings.

#### 1. VENTURE CAPITAL INVESTMENTS

The participation of financial institutions in the financing of corporations was significant in the area of venture capital investments. This is particularly important, since by definition these transactions represent investments in smaller and, perhaps more important, newer companies without the history of operations or equity base to attract other forms of capital. The Study defined a venture capital investment as the purchase of a security in a private placement from an issuing company whose average net earnings over the 2 years preceding the year of purchase did not exceed \$250,000.

Twenty-five percent of the value of venture capital transactions reported by the broker-dealers involved companies with a deficit and an additional 58 percent involved companies with earnings of between \$0 and \$100,000. The comparable figures for venture capital investments made by financial institutions were 29 percent and 51 percent, respectively. This tendency to invest in newer companies is limited, however, by the tendency of institutions to concentrate their venture capital investments in relatively few industries.

Broker-dealers in the Study's sample placed a total of \$765 million of private venture capital investments in 784 different transactions involving 638 different issuers during the period from January 1965 through September 1969. This represents the majority of venture capi-

tal investments placed by broker-dealers during this period. The broker-dealers themselves invested \$138 million of this amount; unaffiliated financial institutions, \$350 million; and private investors, \$277 million.

Obtaining venture capital often laid a foundation for ultimately obtaining public financing, generally within a relatively short time after the investment. Of the 638 issuers, 160 made their first registered public offerings of common stock subsequent to the venture capital investment, and 19 made their first offerings pursuant to an exemption from registration under Regulation A. The Study analyzed 48 of the registered public offerings and estimated the average period between the venture capital investment and the public offering to have been 11.5 months.

Presumably, the equity base provided by venture capital investments would also facilitate the obtaining of other forms of capital, such as bank loans, by such companies. However, this appears to have been an expensive source of financing for these corporations.

Potential gains to financial institutions and others making venture capital investments were significant. Investments were made at substantial discounts, resulting in significant potential profits to the institutions involved. For the 48 offerings analyzed, the Study estimated that the average (nonannualized) percentage price change of the securities received in the private placement between the dates of the private placement and the public offering was in excess of 716 percent. (In two additional offerings the percentage changes were in excess of 10,000 percent. These observations were deleted to avoid their distorting the average.) This is not intended to represent actual gains realized by institutions in connection with venture capital investments, or to suggest that such price changes are peculiarly within the experience of institutional investors.

It is interesting to note that the placement of venture capital investments is concentrated among relatively few broker-dealers. One broker-dealer accounted for 8.9 percent of all venture capital placements; two for 16.4 percent; 10 for 57.2 percent and 25 for 72.7 percent. Ten of these 25 broker-dealers sold more than 50 percent of the value of the transactions they respectively negotiated to institutional investors.

The companies which obtained venture capital and which made their first public offerings, January 1967 through March 1970, are concentrated within relatively few industries including those industries which attracted considerable attention during the period of heavy market activity. Business services, including data processing, for example, accounted for 10.2 percent of the value of all first registered and underwritten offerings and for 28 percent of the value of all venture capital placements. The top 10 industries (out of a population of 100 industries) accounted for 57 percent of all first offerings in the period described above; these same industries accounted for 60.4 percent of the value of the venture capital placements. The industries were: (1) real estate, (2) advertising, data processing, and miscellaneous businesses, (3) engines, machinery, (4) medical services, (5) electrical machinery and products, (6) wholesale trade, (7) scientific and medical instruments, (8) food products, (9) retail restaurants, (10) retail trade—general merchandise.

## 2. RESTRICTED SECURITIES

Financial institutions also contributed significantly to the equity financing of corporations through purchase of restricted securities (securities which, generally, cannot be resold immediately by the purchaser without registration under the Securities Act of 1933). Institutions in the Study's sample representing approximately 64 percent of the assets managed by all financial institutions, invested \$3.5 billion in purchases of restricted securities (including, of course, venture capital investments) comprising common stock and debt with equity features, in the period January 1966 through June 1969. Insurance companies (with 75 percent of all insurance company assets) purchased \$1.3 billion of debt securities with equity features in private placements during that period. The Study estimates that investment advisers, with 70 percent of all assets managed by investment advisers, purchased \$516 million of equity securities in private placements during the same period. In addition, during that period bank trust departments with 69.5 percent of all bank administered assets purchased \$581 million of debt securities with equity features and \$215 million of equity securities in private placements.

Here, as with respect to venture capital investments, potential gains accruing to purchasers of restricted securities, including financial institutions, were significant. The average discount from market price of securities of the same class applied to purchases of restricted common stock was 24 percent. These discounts were generally higher for over-the-counter stocks than for listed stocks. Investment advisers generally obtained higher discounts than did banks, perhaps because investment advisers tended to purchase proportionally more of the securities of smaller, less established companies. The discounts on average were higher in periods of higher stock prices.

Purchases of restricted securities were concentrated among a relatively small number of institutions. One bank purchased 47.1 percent of all the restricted equity securities purchased by the 47 banks in the sample. Five banks in the sample purchased 77.4 percent. The comparable figures for bank purchases of equity-related debt were 35.8 percent for one bank and 79.8 percent for five banks, respectively. One investment adviser purchased 37.8 percent of all restricted equity securities purchased by the Study's sample of investment advisers and five investment advisers purchased 83.7 percent. The comparable figures for purchases by life insurance companies of equity related debt securities were 22.7 percent and 63.9 percent, respectively.

Institutional holdings of restricted securities involve smaller, less established companies than the companies whose marketable securities are held in institutional portfolios. Of the value of the purchases by banks of restricted securities of publicly held companies, 42.6 percent involved companies whose sales were less than \$20 million in the year prior to the year of the purchase. For investment advisers, the comparable figure was 31.7 percent; for life insurance companies, 21.1 percent. Banks allocated 34.8 percent of the value of their purchases of restricted securities in publicly-held companies to companies whose earnings were less than \$1 million; for investment advisers, the figure was 63.3 percent; for life insurance companies, 31.7 percent.

Although the Study draws no conclusions with respect to the methods used by financial institutions to value restricted securities, it recognizes

that this is an important question, and the data developed by the Study should be helpful in further consideration of this subject from the standpoint of compensation to institutional managers and advisers and public disclosure of portfolio practices. Institutions used a variety of methods to value their holdings of restricted securities. Banks valued their purchases of restricted common stock at the market value of similar securities at the time of purchase of the restricted securities with respect to 42.7 percent of the value of their transactions; investment advisers used this method with respect to 41.3 percent of the value of their transactions.

### 3. FIRST OFFERINGS

Financial institutions further participated in equity financing of corporations, particularly smaller corporations, through purchases of securities in first public offerings. Issuance of securities by smaller corporations (as determined by sales and net earnings) has in recent years been an important factor in absolute terms in number of offerings and in aggregate dollars raised. It has also been important in relative terms, compared to new offerings by larger more established companies; and compared to the volume of trading in the secondary markets. Institutions have played a substantial role in financing these corporations. As discussed below, however, the potential gains accruing to institutions from this role have been large.

Institutions purchased at the offering price shares valued at \$148 million, or 31 percent of a sample of 84 first offerings of common stock (generally primary offerings and sometimes primary combined with secondary offerings of common stock) valued at \$479 million. The Study's sample was taken from a list of all underwritten first offerings registered with the Commission and offered between January 1, 1968 and June 30, 1969. It should be recognized that this period was one of unusual activity in the market for first offerings which may have affected the results of the Study's analysis.

Financial institutions purchased, as with respect to their venture capital investments and purchases of restricted securities, securities in first offerings of many less established companies without significant histories of earnings. For example, they purchased 16.6 percent of the first offerings of companies with no reported sales and 35.1 percent of the offerings of companies with reported sales of \$25 million to approximately \$100 million. They purchased 23.1 percent of the offerings of companies with no reported net earnings and 32.1 percent of the offerings of companies whose reported earnings equaled \$1 million or more.

The Study's data also indicates a concentration of sales of first offerings to institutions among a relatively small group of underwriters. Five underwriters account for 14.1 percent of all institutional sales; 10 underwriters for 23.3 percent; and 32 underwriters for 50.3 percent. In most cases, these underwriters are also prominent in the retail institutional brokerage business.

Differences among institutions in regard to the extent of their purchases of first offerings is directly related to the sizes of the respective institutions. Large institutions tend to purchase more securities in



first offerings. However, the preferences of individual institutions for particular types of investments also is a factor.

The concentration among institutions in regard to the purchases of first offerings, although substantial, is less than in the concentration of institutional holdings of common stock. Where three institutions accounted for 10 percent of common stockholdings, four institutions accounted for 10 percent of all institutional purchases of first offerings. Where 25 institutions accounted for 40 percent of institutional holdings of common stock, 48 institutions accounted for 40 percent of institutional purchases of first offerings. Banks accounted for 28.1 percent of all institutional purchases; 10 banks for 11.6 percent of all institutional purchases. Investment advisers accounted for 25.8 percent of all institutional purchases; 10 investment advisers for 15.2 percent of all institutional purchases.

Based on the Study's analysis, financial institutions do not appear to have received in the aggregate a favored selection of first offerings. Taking the price change between the offering and the first market quotation as a measure of the popularity of the issue, 8.1 percent of the value of first offerings in the sample declined. Banks allocated 2.2 percent of their total expenditure on the sample of offerings to those that declined; investment advisers allocated 13.6 percent of their total expenditure to these offerings; all institutions allocated 6.6 percent of their expenditure to offerings that declined in the immediate after-market. The Study's analysis of similar data for the first week after the initial offering, the first month after the initial offering and 3 months after the offering also supports this conclusion. In addition, although limited consideration was given to the subject, the Study developed no data which would indicate that the brokerage paid by a particular institution to a particular broker-dealer is significantly related to the value of the offerings the institution purchases from the broker-dealer. Finally, individual institutions appear to have received very limited quantities of first offerings in comparison to the aggregate amount of stock offered in any particular offering.

The aggregate institutional participation in the market for first offerings is significant. Of the 1,684 first public offerings, valued at approximately \$5.7 billion, which were registered and underwritten in the period January 1967 through March 1970, the Study estimates institutional purchases of between 24.3 percent and 26.1 percent on the basis of its analysis of institutional purchases of the sample of 84 offerings. However, institutional participation in the market for public offerings is less than proportional with the participation in secondary markets. A sample of large banks, estimated to have accounted for 7.5 percent of all brokerage received by New York Stock Exchange member firms is estimated to have received 2.5 percent of all first offerings; a sample of investment advisers estimated to have paid 8.4 percent of all brokerage to NYSE member firms, is estimated to have received 2.7 percent of all first offerings. For life insurance companies the corresponding figures are 0.6 percent and 0.2 percent.

Institutional participation in the aftermarket also appears substantial. A sample of larger institutions, which purchased \$58.6 million of the \$148.3 million purchased by all institutions in the sample of 84 first offerings, purchased additional securities valued at \$30.2 million in the aftermarkets. Of the securities purchased at the offering price,

these institutions sold 8.2 percent within 1 week of the offering; an additional 10.6 percent within 2 through 4 weeks of the offering; and an additional 12.6 percent within 5 through 12 weeks of offering. The institutions realized a net gain on these sales of 30.4 percent. Institutions tended to retain the offerings that rose less in the after-market or that fell. The average unrealized gain on securities purchased in the offering and held at least 1 week was 20.3 percent; the average unrealized gain for securities held at least 4 weeks was 13.1 percent; and for at least 12 weeks, 9.9 percent. Among the classes of institutions, "other institutions," a category that includes hedge funds and holding companies, among others, held the smallest percentage of their purchases in the offering at the end of the 12th week, 21.6 percent; life insurance companies, 37.4 percent; investment advisers, 69.5 percent; banks, 84.1 percent; and broker-dealers' managed accounts, 96.0 percent.

Institutional purchases of first offerings, as those of restricted securities, including venture capital investments, were a significant source of financing for smaller companies. During the period January 1967 through March 1970, the public offering market became increasingly saturated by offerings of securities of smaller companies. The value of first offerings accounted for 16.8 percent of all registered and underwritten public offerings of common stock in 1967; they accounted for 52.8 percent of the total by the first quarter of 1970. In addition, smaller companies increasingly dominated the first offerings. In 1967, 11 percent of the companies whose shares were involved in first offerings had net earnings of less than \$100,000. By the first quarter of 1970, such companies accounted for 48.7 percent of all registered and underwritten first offerings. Only four offerings, valued at \$53 million, during the entire period, involved companies whose net earnings exceeded \$10 million. Of the companies making first registered, underwritten public offerings in the period January 1967 through March 1970, the percentages whose earnings did not exceed \$250,000 in the year prior to the offering were 39.5 percent, 57.1 percent, 65.0 percent, and 68.3 percent, respectively, for 1967, 1968, 1969 and the first quarter of 1970.

#### 4. CONCLUSIONS

Institutions are a significant factor in the primary markets for the equity financing of corporations, particularly smaller, less established companies. Institutions purchase securities of smaller companies in the primary markets to a proportionately greater extent than they do securities of issuers of this size in the secondary markets.

The potential rates of return to institutions for their participation in the primary markets for equity financing are large, although this phenomenon is not peculiar to institutional investors. Participation in the primary markets is concentrated among a relatively small number of broker-dealers and institutions and among issuers in relatively few industries. However, institutions in the aggregate, do not appear to have exerted any significant influence on the allocation of resources in the primary markets for equity capital.

## Chapter XV

# INSTITUTIONAL RELATIONSHIPS WITH PORTFOLIO COMPANIES

### 1. INTRODUCTION

The relationships between institutions and portfolio companies involve sensitive and significant questions. As pointed out in the introduction to the chapter, institutions, because of the size of their holdings, can have greater influence over portfolio companies than can the average individual investor. Questions may arise as to the impact of this influence on the management of portfolio companies, on their other shareholders and as to whether this influence would be used solely for the benefit of the institutional financial manager rather than for the benefit of investors or beneficiaries for which the institution is acting.

While a substantial number of questionnaires were utilized in connection with this chapter, the subject matter, involving as it does relationships among organizations and among people, does not (with some exceptions such as the section on concentration of stockholdings) lend itself to the same extent as prior chapters to conclusions based on intensive statistical analysis of masses of data, mostly expressed in quantitative terms.

### 2. THE LEGAL FRAMEWORK

A comprehensive analysis of the complex legal framework, State and Federal, governing the operations of publicly owned corporations and the relationships of various persons and groups having an interest in them, is beyond the scope of the Study. For the purpose of this chapter, the primary concern in this area must be the legal relationships between shareholders of publicly owned corporations and their management. At the outset it may be noted that this legal framework does not, generally speaking, differentiate between the institutional shareholder and the individual shareholder although there may be significant practical and economic differences between them. State corporation law, still the basic source of law concerning the legal relationship between shareholders and management, has in general moved in the direction of recognizing the situation which has evolved since corporations became publicly owned: the power to direct corporate affairs is largely vested in management subject only to whatever controls are imposed by reason of the existence of fiduciary duties on the part of management to shareholders and the requirement that shareholders vote both in the election of directors and certain other major issues. With the diffusion of shareownership among tens of

thousands of persons, most of whom are interested only as investors and not as owners, these requirements have not significantly diminished the powers of management.

Federal regulation, as applied to publicly owned corporations, has concerned itself primarily with providing adequate disclosure in order to permit informed investment and shareholder decisions including, more recently, decisions in connection with transfers of corporate control. It also seeks to avoid or mitigate certain conflicts of interest. Institutional investors in their role as stockholders may be subject to certain other restrictions imposed by legislative bodies or regulatory authorities but these, excepting to some extent the antitrust laws, are directed primarily to the investment policies of specific types of institutions rather than to their relationships to portfolio companies.

### 3. CONCENTRATION OF STOCKHOLDINGS

This section (unlike most of the others in this chapter) is based on an analysis of a substantial amount of statistical data. As might be expected in view of the growth of institutions and the emergence of very large institutions, the data show that the Study's sample of large institutions hold a substantial amount, approximately 30 percent, of the 800 widely held stocks included in another Study sample. These institutions, not surprisingly, do not divide their holdings more or less equally among all available stocks. On the contrary, a limited number of large institutions have very substantial holdings in a number of large publicly held companies.

The Study found that the institutions in the Study's sample held 727 of the 800 representative stocks. The sample stocks include New York Stock Exchange stocks constituting about 58 percent of the value of all such stocks, American Stock Exchange stocks constituting about 23 percent of the value of all such stocks, and over-the-counter stocks estimated to constitute about 13 percent of the value of all such stocks. Excluding the 71 smallest companies, there were 348 companies in the sample in which 10 or fewer institutions surveyed together held at least 10 percent of each such company's outstanding shares. (The data do not indicate that the same group of institutions held shares in every such company.) There were 303 companies in which five or fewer institutions held 10 percent of each company's outstanding shares. Ten or fewer institutions held at least 15 percent of the outstanding shares of 247 companies, while five or fewer institutions held 15 percent of the outstanding shares of 182 companies. Ten or fewer institutions held at least 20 percent of the outstanding shares of 159 companies, while five or fewer institutions held 20 percent of the outstanding shares of 76 companies.

Comparable data for institutional holdings coupled with sole or partial voting authority show that of the 656 largest sample companies, 10 or fewer institutions held at least 10 percent of 316 companies, 15 percent of 203 companies and 20 percent of 100 companies. Five or fewer institutions held at least 10 percent of 260 companies, 15 percent of 131 companies and 20 percent of 49 companies. In general, a larger proportion of concentrated institutional holdings were represented by investments in large companies.

The concentration analysis thus establishes that large institutions, particularly banks, have the potential economic power to exert significant influence over many companies whose securities comprise their portfolios, particularly large companies. Ordinarily, however, no individual institution would be in a position to exert this type of influence and it is necessary to aggregate the holdings of several institutions before these constitute a substantial percentage of a particular company's outstanding shares. While this statistical aggregation may disclose potential economic power in the hands of a group of institutions, it does not follow that institutions will necessarily act together or that the influence of any one institution will be augmented through concerted activities.

#### 4. PERSONNEL AND BUSINESS RELATIONSHIPS

Relationships between institutions and portfolio companies are not necessarily limited to the relationship of the institution as a shareholder. Particularly in the case of banks, other types of relationships frequently exist. On the basis of available data, the Study has limited its inquiry to personnel relationships (primarily common directorship), creditor relationships, bank depository relationships, and relationships as a manager of portfolio company employee benefit plans. It should be recognized that the number of factors that may account for the coexistence of various relationships is virtually limitless and the Study made no attempt to analyze all such factors. An effort has, however, been made to determine whether or not the presence of one or more of the specified relationships is correlated with the presence or magnitude of other specified relationships. Restricted to those factors for which data are available, the Study was able to test whether there is any systematic pattern of intercorrelation among shareholding, personnel and business ties.

Regression analysis shows that in the case of banks each of the types of relationships analyzed was more likely to occur or to occur in greater magnitude whenever another type of relationship was present. This is so even after the effects of regional proximity and institution size are controlled. The same pattern of correlation was not observed for other institutional types.

It is not, however, possible to attribute any causal relationship to the results of the regression analysis. The inability to do so in part results from the conclusion that numerous factors not susceptible to factual measurement may enter into the creation of any or all of such relationships. The data collected by the Study do show, however, that the likelihood that these functional interrelationships between banks and portfolio companies occur entirely by chance is extremely remote. As is not surprising, relationships that may exist between banks and portfolio companies are much greater than in the case of other institutions which do not offer to a company the variety of financial services which are available to a company from banks.

#### 5. INSTITUTIONAL INVOLVEMENT IN CORPORATE DECISIONMAKING

The existence of potential power on the part of institutions to influence corporate decisions by reason of their substantial shareholdings does not demonstrate that such influence is in fact exercised. Informa-

tion upon which to base a judgment as to whether or not the potential power of institutions to influence corporate decisionmaking is or is not exercised is hard to come by. The response to the Study's questionnaire shows some reluctance on the part of institutions and corporations to discuss this matter.

Such data as is available tends to show that institutions tend to vote with management on questions put to a shareholder vote and that if they lose confidence in management they tend to sell their holdings in a company rather than to attempt to control or influence management decisions. This conclusion appears attributable to two factors. First, institutions are inclined to believe that their responsibility is to make investment decisions rather than to attempt to influence management decisions. Second, while there are no statutory restrictions upon the right of institutions to attempt to influence management decisions, institutions tend to believe that an effort to do so would be inappropriate and would subject them to criticism. Over half of all institutional respondents to the Study's questionnaires did not respond to specific policy questions asking them to submit their own views about the appropriate role of institutions as shareholders.

With respect to voting, the practices of institutions vary. Thus institutions, particularly banks, which act as trustees, believe that they are under a fiduciary duty to cast an informed vote and, consequently, formal procedures, more or less elaborate, are followed in analyzing proxy statements and arriving at a decision as to which way they will vote. In the case of other institutions, these decisions tend to be made on a more informal basis. Banks also tend to vote negatively and to abstain from voting more frequently than do other institutions. Abstention from voting would ordinarily indicate lack of agreement with the particular proposal presented without demonstrating a lack of confidence in management which a negative vote might indicate.

Institutions are more likely to take a definite position on those questions which have a clear impact on their economic position and rights as shareholders. These include proposals to abolish preemptive rights, authorization of mergers, and authorization of corporate acquisitions, particularly where such acquisition involves issuance of additional securities. In general, it can be concluded that even where institutions have the potential power to influence management decisions they tend to be reluctant to exercise this power, particularly in an open and public way. While there are, no doubt, instances where institutions influence corporate decisions informally through personal consultations with management, reliable statistical evidence of the extent to which this occurs is not available.

## 6. INSTITUTIONAL INVOLVEMENT IN TRANSFERS OF CORPORATE CONTROL

During the late 1960's there was a remarkable upsurge in efforts to transfer corporate control. In some instances this involved an effort on the part of shareholders to displace corporate management, but more frequently it involved efforts on the part of one company to acquire another. In the latter case, where incumbent management had agreed to the proposed acquisition of their company, the issues presented to shareholders, institutional or otherwise, were essentially a question of how they should vote, and were generally similar to the

matters discussed in the prior section of this chapter. Quite frequently, however, the company seeking to make the acquisition was attempting to do so over the opposition of incumbent management.

Institutions with large holdings or the economic power to acquire such holdings could be and often were major forces in the determination of the outcome of such efforts. While, as noted in prior sections of this chapter, institutions are disposed to be somewhat passive in ordinary management decisions, their participation in contested takeovers was often active and crucial. This appears to result from the fact that unlike ordinary questions of corporate policy, participation in corporate takeovers afforded to the institutions involved opportunities for immediate profit from the effects upon the market of such efforts.

Again, the extent, nature and impact of institutional participation in corporate takeovers is not a matter which to any significant extent is susceptible of statistical analysis. The Study, therefore, endeavored to explore this question by case studies of particular contested takeovers. Nine such case studies were made, in each of which there was an examination of institutional participation. Summaries of these case studies are included in section F of the chapter. These summaries necessarily do not include all the details contained in the basic case studies. The summaries, together with such other statistical data as was obtainable, demonstrate, however, the significant role of institutions in determining the outcome of contested takeovers. In such situations, opportunities for obtaining substantial benefits are obtainable by institutions, including but not limited to benefits for their beneficiaries. There is also the possibility that by such participation institutions may obtain advantages not available to the individual investor. Such participation involves the possibility of conflicts of interest and of the use of information not generally available to investors which are obtainable by institutions because of the recognition by all parties to such takeovers of the economic power of institutions to influence the outcome of the contest.

Participating institutions have been involved in transfer efforts in several ways:

Institutions purchase the bidding company's shares in anticipation of a transfer bid for the target company, thereby helping to maintain or increase the price of the bidder's securities. This may be particularly important if an exchange offer is to be made.

Institutions purchase the target company's shares in anticipation of a transfer bid, with the expectation of selling or tendering those shares at a higher price after the public tender or exchange offer has been announced.

Institutions provide financial assistance to the bidding company, either directly by loans, or indirectly by private purchases of the bidding company's securities (supplying the cash necessary for initial purchases of the target's shares) or by purchases of the target company's securities under an arrangement contemplating subsequent resale to the bidding company.

Among the special inducements or benefits that institutions have received are:

Advance information that a takeover effort will be made (permitting the institution to make purchases of the bidding company or

target company securities before the market impact of a publicly announced tender offer has affected the price of the securities involved).

Most-favored shareholder provisions, under which institutions selling an initial block of the target's shares to the bidding company have the right to receive any higher price subsequently offered to all shareholders of the target company through a public tender or exchange offer.

Assurances of contingent benefits (sometimes available only if the transfer bid succeeds), such as management of the target company's investment portfolio or commercial banking arrangements with the bidding or target company.

## 7. CONCLUSIONS

1. The prevailing legal framework does not distinguish materially between institutions and other holders of corporate shares in terms of shareholder prerogatives within the structure of corporate power, although there are significant practical and economic differences between them.

2. Institutions have the potential economic power to influence many companies, particularly large companies, because of their stock holdings. Part Two of the Study demonstrates that investment assets are concentrated in relatively few institutions. These institutions in turn tend to concentrate their portfolios in relatively few stocks. Hence, it follows that institutional holdings may constitute a large percentage of the outstanding shares of certain companies. Since institutions tend to invest primarily in the securities of larger companies, concentration is most pronounced in the shares of such companies.

3. Some institutions, particularly banks, have personnel and business relationships with portfolio companies. These relationships may tend to reinforce any power conferred as a result of stock holdings. They also create potential conflicts of interest and the possibility of misuse of inside information. Although the Study can draw no general conclusions as to whether these adverse consequences actually occur or to what extent they may occur, it appears that there is a strong statistical correlation between bank stock holdings and personnel and business relationships.

4. Institutions do not generally involve themselves directly in corporate decisionmaking, but instead have a policy of liquidating their holdings where corporate policies and proposals appear inappropriate. They generally vote in favor of management proposals and only rarely report informal participation or consultation. A number of institutions have a policy of always voting with management or of refraining from participation, particularly where general corporate matters (as opposed to acquisitions) are involved. Participation is more likely to occur when the institution cannot readily liquidate its holdings in the company's shares and when the benefits of such participation are clear.

5. Some institutions have been actively and significantly involved in facilitating contested transfers of corporate control. In such cases, unlike ordinary corporate decisionmaking, the benefits to participating institutions may be more certain: in addition to trading and tendering profits, institutions may receive special inducements and benefits not made available to other shareholders of target companies.



