

INSTITUTIONAL INVESTOR STUDY REPORT
OF THE
SECURITIES AND EXCHANGE COMMISSION
SUMMARY VOLUME

COMMUNICATION

FROM

THE SECURITIES AND EXCHANGE
COMMISSION

CONSISTING OF

LETTER OF TRANSMITTAL OF MARCH 10, 1971, FROM THE SECURITIES AND EXCHANGE COMMISSION, LETTER OF THE STUDY ADVISORY COMMITTEE TO THE COMMISSION, AND A SUMMARY OF EACH CHAPTER OF THE INSTITUTIONAL INVESTOR STUDY REPORT, BEING A STUDY AND INVESTIGATION OF THE PURCHASE, SALE AND HOLDING OF SECURITIES BY INSTITUTIONAL INVESTORS OF ALL TYPES, PURSUANT TO SECTION 19(e) OF THE SECURITIES EXCHANGE ACT OF 1934 (PUBLIC LAW 90-438, 91-410).



MARCH 10, 1971.—Referred to the Committee on Interstate and Foreign
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LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 10, 1971.

The President of the Senate.

The Speaker of the House of Representatives.

SIR: We have the honor to transmit the Institutional Investor Study Report. The Report is submitted pursuant to Section 19(e) of the Securities Exchange Act of 1934 (Public Laws 90-438, 91-410), which directs the Commission to conduct an economic study of institutional investors and their effects on the securities markets, the interests of the issuers of securities, and the public interest.

A

The Congressional joint resolution authorizing the Study directed the Commission "to make a study and investigation of the purchase, sale and holding of securities by institutional investors of all types * * * in order to determine the effect of such purchases, sales and holdings upon the maintenance of fair and orderly securities markets * * * the stability of such markets * * * the interests of the issuers * * * and upon the interests of the public * * *"

The legislative background of the Act makes clear that the Congress sought an economic study rather than an enforcement oriented investigatory proceeding. Accordingly, the Study was designed to provide a basis for understanding the underlying economic trends evidenced by growing participation by institutions in equity investment and their impacts on both securities markets and corporate issuers. As the Commission had not previously undertaken studies of this type, the Study was directed and staffed by professional economists and other personnel who, with few exceptions, were drawn from outside its regular staff. The Study also benefited from the views of a panel of knowledgeable persons having backgrounds in government and the financial community who, in accordance with the authorizing legislation, formed its Advisory Committee.

The Study's basic task was to collect fundamental economic data in an area where large informational gaps have existed. To do this, data were developed and analyzed relating to the number, types, size, growth and distribution of assets in accounts managed by the many varieties of institutions, as well as other types of data not heretofore collected about trading activity, market impacts and effects upon portfolio companies. The Study's data were obtained primarily from detailed questionnaires, supplemented by interviews. Sizable data files were developed and analyzed from responses to 200 separate versions

of 54 basic questionnaires which, in turn, were distributed to as many as 14 respondent types, several of which contained 1,000 or more firms.

The magnitude of the project is immediately apparent from an inspection of the Report itself, including supplements. The Report, of course, represents only a distillate. The size and scope of the data collection effort may be appreciated by examining Supplementary Volume II which describes the Study's questionnaires. The large data collection, editing and processing efforts undertaken by the Study could not have been accomplished in so short a period of time without heavy reliance on electronic data processing techniques and capacity.

As a result of the time involved in collecting, editing, processing and analyzing the data, drafts of important sections, and indeed of some chapters, were not completed and therefore were not available for review by the Commission and the Advisory Committee until late in 1970. Final versions of each of the Study's substantive analytical chapters were completed only during the final weeks of 1970. The Commission has required additional time since the Report was completed to review and consider its contents and formulate initial conclusions and recommendations. In submitting its Report and initial recommendations the Commission is affording others an opportunity to review and comment upon the Report and to determine their own conduct in light of its content and findings. As the Commission, other governmental units and the financial community continue to review the Report and to analyze further the wealth of data collected by the Study, we anticipate that it will serve as a basis for further conclusions and additional recommendations not only by the Commission but also by other governmental, and self-regulatory, bodies.

B

The Study's contributions are numerous and varied. In some areas its analyses establish the existence of, or suggest a spectrum of possible solutions for, structural and regulatory problems. In other areas the analyses tend to dispel previously expressed concerns over suspected problems or to identify problems not previously appreciated. In still other areas, of course, definitive analyses could not be conducted, or the results of such limited analyses as could be undertaken within available time, resource and data limitations proved to be inconclusive. Even in the last of these instances, however, the Study did in certain cases develop and test methodology whose application to improved data or related problems in the future may be of value to the Commission and to others.

The Commission's initial conclusions and recommendations regarding problems analyzed by the Study may be grouped according to the degree of their specificity into three general categories, as follows:

1. Areas where specific sets of conclusions and recommendations can be and are presented. These include recommendations regarding offshore funds, standards for measuring and disclosing portfolio volatility, and appropriate measures of investment performance for the purpose of calculating incentive fees. Conversely, in other areas the Study is able to rule out for the present certain types of recommendations, such as generalized restrictions on the

volume of institutional trading or the size of institutional transactions;

2. Areas, such as those dealing with securities market structure, where the basic ingredients of possible long-range solutions are suggested, but whose eventual content and form must be developed over time; and

3. Areas where only the problem itself can be identified, and then only in the broadest of terms; for example, questions regarding the impact of institutional investors on the distribution of corporate power.

Policy considerations in some areas are affected importantly by actions in other areas. The most fundamental and pervasive problems considered by the Study often defy simple compartmentalization. For example, incentives for the responsible exercise by institutions of their franchise as shareholders (considered in Part Four of the Study) are affected by the liquidity of secondary trading markets (considered in Part Three) and by competitive pressures on institutional investors to achieve superior investment "performance" (considered in Part Two). Similarly, incentives toward the bundling of certain services or toward the integration of firms in formerly distinct lines of business (considered in Part Two) often are affected by regulatory actions in totally different areas, such as the level and structure of brokerage commission rates (considered in Part Three). To comprehend many of these a reading of the entire Report, rather than isolated sections, will be necessary. Even then, a considerable spectrum of possible solutions may remain. Economic analyses can and ordinarily do narrow but not eliminate the range of policy options available.

The Study has been conducted during a period of rapid and deep-seated changes both in the character of institutional investing and in the structure of the nation's securities markets. As will be apparent from the recurrent references to brokerage commission rates below and throughout the body of the Report, the Commission regards non-competitive, fixed minimum commission rates on securities transactions of institutional size as the source of a number of difficulties in the development of institutional investing and the trading markets for equity securities. The clear conclusion from the Study Report is that competitive brokerage rates should be required at least on such transactions.

Under date of February 10, 1971, in conjunction with the pending commission rate structure proceeding, we advised the New York Stock Exchange that

The Commission believes the Exchange should take immediate action to implement, by April 1, 1971, the Commission's finding that fixed minimum commissions on institutional size orders are neither necessary nor appropriate.¹

We have thus taken initial steps to require competitive rates—on at least that portion of institutional transactions in excess of \$500,000—which we believe will have ameliorating effects on future developments in a number of the areas studied. Assuming that the step called for is timely implemented by the Exchange, the Commission's subsequent steps in this and related areas must necessarily be guided to a considerable extent by its experience with the initial step. The Study provides

¹ Securities Exchange Act Release No. 9079. Among other things we have also requested the Exchange, by June 30, 1971, to present "a plan for reasonable economic access to the New York Stock Exchange for nonmember broker-dealers." Letter of October 22, 1970, Securities Exchange Act Release No. 9007.

an analysis of interrelationships between various aspects of institutional investment and the structure of the securities markets and a basis for evaluating many of the issues and actions that necessarily will result from both initial and subsequent regulatory actions in these and related areas. In this situation we believe the sound regulatory course is to proceed with caution on any further concrete recommendations concerning the structure of the securities markets.

In directing the Commission to undertake the Institutional Investor Study, the Congress necessarily required the examination of areas and activities which could have significant effects upon the markets and individual corporate issuers, but which traditionally have come under the primary jurisdiction of other regulatory bodies. Although our recommendations relate principally to those areas in which the Commission has statutory jurisdiction, the Study's analyses may prove useful to those who are concerned with other aspects of institutional investment or with the activities of the institutions examined. The Commission has not, however, consulted with other regulatory bodies on policy issues arising from its analyses or initial recommendations. The views set forth below are those of the Commission. We do intend in the coming months to discuss with other regulatory agencies aspects of the Report that relate to financial institutions under their jurisdiction.

In order to place its economic and other analyses in perspective and to afford insight into the existing pattern of governmental regulation, the Study contains summary discussions of applicable laws and rules. While an attempt has been made to indicate accurately the actual and potential impact of the legal provisions discussed—and to set forth such provisions in accurate summary form—the summaries do not purport to contain a comprehensive exposition of the laws involved, nor are they intended to indicate the applicability of such laws to any particular factual circumstances. In addition, it should be recognized that the summaries include some discussions of legal matters outside the Commission's particular expertise and regulatory oversight.

With these considerations and qualifications in mind, the Commission's initial conclusions and recommendations are set forth below, organized to the extent possible around the major analytic areas covered by the Study. These are Part One: *Background Studies of Institutional Investors and Corporate Stock*; Part Two: *Institutions as Investment Managers*; Part Three: *Impacts of Institutional Investing on Securities Markets*; and Part Four: *Impacts of Institutional Investors on Corporate Issuers*.

C

Part One (Chapters I–III) *Background Studies of Institutional Investors and Corporate Stock*:

Initial Conclusions and Recommendations

The Commission contracted with the National Bureau of Economic Research, a pioneer in the development of flow of funds statistics and the system of national accounts, to prepare for the Study a *Background Report on Institutional Investors and Corporate Stock* (transmitted in its entirety as Supplementary Volume I of the Report). The substantive analyses contained in the full NBER Report

and summarized in chapters II and III of the Study Report were designed to place in historical perspective later detailed studies in Part Two of the recent behavior of financial institutions as equity investors. An important result of these analyses is to allay fears expressed in many quarters of imminent domination by institutional investors of ownership of the nation's industry—without ruling out such a longer-term eventuality. Institutions as a group have increased their share of outstanding equity securities, partly through the relative growth of institutions more heavily dependent on the equity markets and partly from shifts toward increased equity investment by other types of institutions. However, the increase has been relatively slow-paced over time.

Institutions as a group—excluding endowments, foundations, investment counselling accounts and various minor types of institutionally managed portfolios for which data are not available prior to 1952—increased their share of total stock outstanding from less than 7 percent to approximately 19 percent between the turn of the century and 1952 (chapter II). A more comprehensive definition of financial institutions places estimates of institutional holdings at approximately 24 percent of outstanding corporate stock in 1952, a figure that increased to 26 percent by 1958 where, with some fluctuations, it remained throughout the following decade (chapter III). Individual holdings, net of institutional and foreign, amounted to 71.7 percent of all outstanding equity securities (including stock in closely held corporations) in 1958 and 71.8 percent a decade later, in 1968.

Institutional holdings, however, have not been distributed uniformly across all types of equity securities, but tend to be concentrated in the shares of larger, publicly traded corporations. The extent of this concentration is analyzed in chapters IX and XV of the Study Report. In this area the pace of institutionalization has continued even during the decade of the 1960's. Three successive Census of Share-ownership surveys conducted by the New York Stock Exchange of the ownership of securities listed on that Exchange show that from 1962 to 1965 and 1970, institutional holdings increased from 31.1 percent to 35.5 percent and 39.4 percent, respectively.

Analyses in the NBER Report summarized in chapters II and III indicate that institutional investors have been net purchasers on a cash basis of corporate stock from individuals over most of the post-war period, including the decade of the 1960's. Reconciliation of this fact with the fact noted earlier that institutions did not perceptibly increase their share of the value of all equity securities during the last decade, suggests that institutional investors have concentrated their purchases and holdings in the more stable securities of larger corporations while individual investors sought and obtained the higher returns available on somewhat riskier securities during the generally rising markets of the last 20 years.

As indicated in the NBER Report, during this period the rate at which corporate assets were valued and earnings capitalized generally increased and a significant portion of returns to equity investors over the period was accounted for by these increases. Should returns over the next few decades be less than those since 1950, more rapid future increases in the fraction of institutionally held corporate shares could be expected.

The NBER Report also points out that individual investors have become increasingly conscious of the "performance" of their investments, demonstrating a willingness to shift their savings out of certain types of the more conservative institutions into potentially more profitable—and consequently more risky—investment media. Financial managers of such institutions, confronted with increased mobility of funds, became more performance conscious themselves in order to retain or redirect the savings flows.

IMPROVED REPORTING

The past and likely future growth of institutional investors in the equity markets makes the collection of timely information about institutional holdings and activity in securities essential for an agency responsible for the administration of the federal securities laws. Difficulties encountered by the Commission, the Federal Reserve Board and the National Bureau of Economic Research in the development of aggregate data for the Study on institutional holdings and net purchases of corporate shares over the post-war period point up strongly the need for improvements in the collection of information about institutional investors and their activities in the equity markets.

The appendix to chapter I of the Report discloses significant shortcomings in existing patterns of institutional reporting. The scope of information reported often is limited, particularly with respect to holdings of and transactions in the securities of specific companies; information often is supplied to more than one agency, resulting in unnecessary and costly duplicative efforts; and in some cases data is supplied only on a voluntary or confidential basis, limiting both the comprehensiveness and usefulness of the data supplied. Furthermore, the burdens of disclosure fall unevenly on institutional respondents. Extensive reports currently are provided by registered investment companies and most large insurance companies; banks, investment advisers and self-administered foundations, endowments and employee benefit funds, however, do not now for the most part provide information on holdings and trading in particular securities to any public agency. Gaps in information about the activities of such major classes of institutional investors in the securities markets provided a primary reason for the conduct of the Institutional Investor Study.

The importance of a regularized, uniform and comprehensive, scheme of institutional reporting cannot be minimized in light of the demonstrated growth of institutional investment and its impacts on the structure of securities markets, corporate issuers and individual investors. An effective program of government regulation of institutional investors and the securities markets must emanate from empirical analyses of institutional behavior, weighed on the scales of competing policy considerations. The Study represented an attempt to gather relevant data for such analyses on a one-time basis. However valuable that data may be and whatever conclusions it may suggest at the present time, the course of future developments cannot be accurately gauged nor can reasoned regulatory policies be plotted without a continuing flow of such information.

The Commission believes that gaps in information about the purchase, sale and holdings of securities by major classes of institutional

investors should be eliminated, and recommends that the Securities Exchange Act of 1934 be amended to provide the Commission with general authority to require reports and disclosures of such holdings and transactions from all types of institutional investors. Such authorization would permit the Commission, by rules adopted in conformity with the Administrative Procedure Act, to obtain continuing data for public disclosure and for the production of statistical data or aggregates, to the extent that it deems such data necessary or appropriate.

The Commission is cognizant of the need to balance the benefits of increased disclosures against the burdens imposed by such reporting on respondents. These considerations have long been recognized and reflected in the Commission's administration of disclosure requirements regarding corporate issuers under the federal securities laws. Thus, upon passage of enabling legislation, the Commission would consult with other regulatory bodies and interested persons on the form, frequency and content of reports to be required, and arrangements by which all affected regulatory bodies can share the data reported.

It is anticipated that disclosure would encompass only securities beneficially owned by institutional investors or for which institutions provide investment management. Such disclosures would include information regarding the fraction of shares held over which institutional respondents have differing degrees of investment and voting authority. Should this recommendation be adopted by the Congress, the Commission would reconsider its recommendations with respect to amendments to existing reporting provisions of the Securities Exchange Act, discussed in Part Four below.

ECONOMIC RESEARCH CAPABILITY

Experience with the Institutional Investor Study reinforces the conclusion reached by the Special Study of Securities Markets in 1963 that studies of this kind should not be, simply, "once-in-a-generation affairs, but should be a major part of the Commission's regular and continuous activities."² Special studies are disruptive of the ongoing activities of the host agency, are expensive in terms of the time, energy and money required to create quickly not only the professional staff but also all parts of the infrastructure of personnel, facilities and data required for a major research undertaking. If the Commission is to be fully cognizant of the economic implications of developments in the securities markets under its jurisdiction, including those that result from its own actions, a substantially larger internal economic research capability, fully staffed and supported, is required. Such needs will be especially acute if, in addition to existing statistical programs and analysis of presently available data, there are expanded reports by institutional investors to be processed and analyzed in a manner that contributes significantly to the Commission's policy deliberations. The Commission intends to seek the budgetary and personnel resources needed to obtain the required expansion of its economic research capability.

In addition, a great deal of worthwhile research by outside economists, financial analysts and others into basic economic developments

² *Securities and Exchange Commission, Report of the Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at XIV (1963-1964).

in the equity markets could be stimulated by enabling the Commission to facilitate the distribution of non-confidential, machine processable information collected routinely during the course of its administration of the various securities statutes. This information, although publicly available in theory, has not been accessible in usable form in the past to persons outside the Commission. In an effort to stimulate needed outside research in the area of its statutory responsibilities, the Commission is reviewing administrative and budgetary barriers to the more effective dissemination of this growing and increasingly important body of information. Such efforts are necessary if the Commission is to adapt its traditional information gathering and dissemination functions to modern technological methods and capabilities.

Part Two (Chapters IV-IX) *Institutions as Investment Managers* :

Initial Conclusions and Recommendations

The "institutions" portion of the Study was designed with two primary objectives in mind. The first was, simply, fact finding. The Study was to collect data never before available on the size and activity of institutional investors and the equity oriented portfolios under their management. The second, however, was to focus attention and analyses on two fundamental forces believed to be at work during the last half of the 1960's, whose effects were to change in important ways both the character of institutional investing and its effects on the economy. These were:

(1) The rapid growth of relatively exotic, aggressively managed investment vehicles—such as the more speculative types of registered investment companies, hedge funds and offshore funds—and the increased willingness by most major classes of institutional investors as well, to adopt more aggressive investment strategies and trading practices in search of investment "performance," and

(2) An accelerating trend toward the combination of firms in formerly distinct areas—such as brokerage, investment management and insurance—into integrated, multi-purpose enterprises.

INVESTMENT RISK, DISCLOSURE

Competitive pressures on portfolio managers for improved investment performance are examined most closely in chapter IV, which deals with investment advisory and mutual fund complexes. They are also dealt with in other chapters of Part Two, which examine other types of managerial complexes and major types of institutional portfolios.

Different classes of institutional investors formerly competed with one another for the saver's dollar only weakly. Bank trust departments, insurance companies and investment companies each offered relatively distinct types of financial services aimed at largely non-overlapping classes of customers and markets. Shifts toward increased equity investment by most major types of institutions, however, have tended to erode traditional differences between their respec-

five markets and heighten the degree of competition not only within but also across institutional categories for the management of various types of portfolios. Competition for the management of pension funds has become especially intense during the last decade as has competition for the management of educational endowments and other forms of pooled investment vehicles. Performance consciousness by the managers, sponsors and increasingly, the beneficiaries of many types of professionally managed portfolios is an expectable consequence of an increasingly competitive environment. Although the search for investment performance ordinarily is associated with hedge funds, offshore funds and relatively speculative types of mutual funds, the Study's Report makes it apparent that performance consciousness has spread far beyond exotic portfolios and portions of the investment company industry into most major types of institutional managers and competitively managed portfolios.

One disquieting result of these pressures has been to provide an incentive for investment managers to assume higher and higher levels of investment risk in many of the competitively managed portfolios under their administration, a result that often is not apparent to the portfolios' sponsors or beneficial owners. In the past, most persons or firms have tended to equate "performance" with "price action" without adjusting in any way for the risk borne by the portfolio. The Study utilized econometric techniques to measure portfolio volatility, which often is interpreted as a proxy for the degree of investment risk displayed by managed portfolios, and to adjust total return on such portfolios (price appreciation plus distributions) so that the portions of the return attributable to general market movements and to the portfolio's particular volatility can be separately identified. The incentive for institutional managers to assume higher levels of investment risk exists whether or not the manager is compensated on a "performance" or "incentive fee" basis, although its severity is aggravated by the manner in which existing incentive fee contracts typically are constructed.

The Commission concludes that improved disclosure of investment returns, portfolio volatility, and short-term trading (that tends to accompany high volatility portfolios) is needed from the managers of most types of professionally managed portfolios. One method of measuring portfolio volatility is developed in chapter IV of the Report; it is anticipated that other measures can and will be developed in the future to accomplish this purpose. Such disclosures would not only better inform portfolio beneficiaries of the risks to which they may be subjected, but also can moderate existing pressures on portfolio managers to assume more aggressive investment postures than otherwise would be warranted by the investment objectives of the accounts under management.

The Commission believes that disclosure of investment returns, portfolio volatility and short-term trading is both practicable and desirable for many types of competitively managed institutional portfolios at the present time. In the case of funds required to register under the Investment Company Act, such disclosure can be achieved within existing statutory authority through prospectuses and periodic reports. The Commission believes that it would also be desirable for

such disclosures to be made for other classes of professionally managed portfolios and will consult with other regulatory bodies toward this end.

PERFORMANCE FEES

In addition to disclosure of investment returns, volatility and short-term trading, which the Commission considers desirable whether or not managers are compensated on an incentive fee basis, the Commission believes that when incentive fees are present a second step is necessary to reduce disparities between the interests of portfolio managers and beneficial owners. In general, an "incentive" or "performance fee" (as used here) is compensation to a portfolio manager that varies according to investment results rather than solely the amount of assets under management. The second step is to structure penalties for sub-standard investment performance that are symmetrical with rewards for superior performance in order to deter the assumption of excessive risk in managed portfolios. It should be noted that in the Investment Advisers Act of 1940, Congress in effect had prohibited the use of any performance fees by registered investment advisers except for the fees charged to registered investment companies by their advisers. In the Investment Company Amendments Act of 1970 Congress required that any performance fees charged to registered investment companies be symmetrical as outlined above and then authorized the use of such performance fees for other accounts (but not most qualified employee benefit plans) where the assets under management exceed \$1 million.

Although the Commission believes that symmetry in the calculation of performance fees is desirable and important for any portfolio managed on an incentive fee basis, it does not now request legislation extending coverage of these provisions to types of institutional portfolios or managers not covered by the Investment Company Amendments Act of 1970. Should competitive pressures not lead after a reasonable period of time to the more general adoption of symmetrical compensation bases for other classes of institutional portfolios utilizing such fees, the Commission will review its determination not to seek such legislation.

When an adviser is compensated on the basis of total return or return relative to an index having a lower volatility than the portfolio itself, an incentive is created for the manager to assume greater risk. Thus, when incentive fees are present, a third step appears desirable to eliminate as fully as possible the realization of compensation by investment managers based in part on risk borne by portfolio beneficiaries. To accomplish this end the Commission intends to give serious and prompt consideration to requiring that incentive fees be based only on volatility adjusted investment returns. Incentive compensation would thus be permitted only on that portion of total investment return that is in excess of what general market movements affecting securities displaying equivalent volatility would produce on an unmanaged basis. Technical methods for basing incentive fees on such risk or volatility adjusted returns were adopted for analytic purposes by the Study. Although the techniques employed are of relatively recent origin, it appears that measures of risk adjusted investment "performance" such as employed in the Study are feasible. Their use, as well as other

methods for accomplishing this end that may be developed, can provide appropriate and unbiased methods of calculating managerial compensation that would discourage the assumption of excessive risk in managed portfolios, permit superior advisers to obtain additional compensation and permit the profitable operation of smaller economic units not having access to large and efficient sales organizations.

The Commission now has authority under the Investment Advisers Act of 1940 as amended by the Investment Company Amendments Act of 1970 to determine an appropriate index or other measure of investment performance for incentive compensation purposes that reflects the degree of volatility displayed by managed portfolios. As experience is gained with volatility adjusted incentive fees authorized for the expanded types of accounts permitted under the Investment Company Amendments Act of 1970, the Commission will also review the desirability of requesting legislation to extend such provisions to other types of institutional managers and portfolios utilizing incentive fees.

HEDGE FUNDS

The Study examined the activities of hedge funds. These investment vehicles generally are organized as limited partnerships having fewer than 100 partners. With the exception of survey material gathered for the Study and more detailed information assembled by the Commission's regular staff, there has been a dearth of hard information about both individual hedge funds and hedge funds as a group.

The Study found hedge funds to be volatile investment vehicles. Many are highly leveraged; short selling and other speculative techniques play an important part in their market strategy. During the period studied, hedge funds as a group were actively engaged in the new issue market and turned over their portfolios at extremely high rates.

Often the hedge funds' managing partners have other significant advisory functions, such as the management of registered investment companies. In most instances the compensation arrangements provided by unregistered hedge funds are far more favorable to the investment manager per dollar of assets managed than the compensation provided for similar services by registered investment companies or other classes of accounts within an advisory complex. Here, as in other situations where differing compensation arrangements exist, there are potentially serious conflicts of interest.

Although hedge funds bear attributes of investment companies and their general partners perform many of the same functions as investment advisers, neither the funds nor their general partners ordinarily are registered under either the Investment Company Act or the Investment Advisers Act of 1940. The hedge funds' activities might also be construed to bring them within the statutory definition of "dealer" contained in the Securities Exchange Act of 1934.

As a result of the Study's review of hedge funds' operations, it now appears practicable to clarify the applicability to hedge funds of registration requirements under one or more of the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934, and to formulate any necessary rules regarding such funds under the appropriate securities laws. The Commission

does not believe that new legislation is required and will take the steps necessary to accomplish this purpose.

OFFSHORE FUNDS

The Study also examined a relatively new and dramatic type of institutional investor, the offshore fund. The capital inflow of such funds has aided the United States' balance of payments and stimulated new sources of equity capital in the countries in which they are sold. At the same time, their operations raise substantial questions of investor protection. In many cases sales practices have been aggressive and disclosures inadequate. Independently audited reports of operations often are not available, and the structure and operation of many offshore funds should be strengthened to provide greater protections against possible overreaching of investors by fund managers. These and other factors have led some countries where shares of the funds are sold to enact legislation designed to regulate—or even eliminate—the activities of offshore funds.

In the present climate of concern fostered by the well publicized difficulties experienced by certain offshore funds and their sponsors, the Commission believes that foreign investor confidence in offshore funds that invest in American securities could be bolstered significantly if they were to become subject to Commission regulation under the federal securities laws. Offshore funds currently receive treatment under the Internal Revenue Code which provides them with competitive advantages over domestic, registered investment companies seeking to sell in offshore markets. Equalization of these advantages would enable U.S. registered investment companies to compete more effectively with unregulated offshore funds. The net result would be beneficial both to foreign investor protection and the United States securities markets, as well as to the United States balance of payments.

One means of accomplishing this goal would be to establish entities through which nonresident foreign investors could receive the same tax advantages by investing in domestic registered funds as they currently obtain through the purchase of shares in an offshore fund. This might be done through the creation of Foreign Portfolio Sales Corporations which would be used as vehicles to distribute to foreign investors shares of funds registered under United States law. The sponsors of a registered fund could establish such a sales corporation, sell its shares of the U.S. registered investment company without additional layering of sales charges or management fees. Similar arrangements—unit investment trusts—frequently are employed in the United States for the sale of mutual funds.

Foreign Portfolio Sales Corporations would be based in the United States and required to register with the Commission as registered investment companies. As such, they would be subject to Commission regulatory and disclosure requirements and Federal Reserve margin requirements. If such companies were free of United States capital gains taxes and if foreign investors in them were free of United States estate taxes, comparability would be achieved. Taxes on dividends and interest paid by Foreign Portfolio Sales Corporations still would be withheld and any related management company or investment adviser

owned by United States persons could be fully subject to United States taxes.

Alternatively, a separate registered investment company could be created and designed to appeal specifically to foreign investors. Because such an investment company would be managed exclusively for nonresident foreign investors, and its shares offered only to such investors the fund and its investors would be granted the tax treatment described above. Moreover, it would appear appropriate to exempt purchases of foreign securities by such a company from the Interest Equalization Tax.

Whichever investment vehicle is chosen, sales promotion would, of course, remain outside the United States. As is the current practice for most offshore funds, initial purchasers or agents would be required to sign a statement that they are not U.S. persons and were not acquiring the securities for distribution to U.S. persons. In addition, securities could be redeemable by the company if acquired at a later date by Americans.

The Commission recommends that a high level governmental task force be organized to explore and develop the possibility of the establishment and regulation of Foreign Portfolio Sales Corporations as well as registered offshore investment companies. We would expect such a task force to consider appropriate tax treatment for such funds and nonresident foreign investors, and methods of gathering data with respect to foreign institutional investors in order to facilitate further study of developments in this area.

The rapidly growing internationalization of the securities markets indicates the need for national regulatory agencies such as the Commission to participate in the international development of common elements of securities regulation. Efforts by international organizations to identify international regulatory norms and establish acceptable international standards governing mutual fund operations should be encouraged, and the Commission will accelerate its own efforts towards this end.

FINANCIAL INTEGRATION

The second major area of concern reflected in the Study's treatment of institutional investors and the portfolios under their management, is an accelerating trend during the last half of the 1960's toward the integration (or diversification) of formerly specialized functions into multi-purpose financial service organizations. The integration of such functions creates both regulatory and competitive problems. Regulatory problems result from the potential conflicts created by such combinations between financial managers and their various classes of clients; competitive problems result from barriers to the separate provision of specialized products or services. Ultimately, certain types of combinations among financial institutions may have important implications for concentration of power in the American economy.

Incentives for the integration of financial services derive from both economic and regulatory sources: economies of scale, including economies derived from the combination into larger units of joint products or services, diversification and judgments regarding the profitability of entering new and unrelated areas all are economic

in origin; regulatory incentives for the combination of separable products or services ordinarily can be traced either to direct regulatory limitations on the provision of specialized products or services unless provided in combination with others, or to indirect inducements toward that end resulting from the maintenance of regulated prices at non-competitive levels or prohibitions on the charging of direct rates or fees for certain services.

To the extent that integration is induced by economic incentives, and especially by economies obtained through the provision of joint products or services, decisions to limit such combinations should be made only reluctantly by regulatory or other public authorities, and then only on the basis of demonstrated regulatory necessity. The Commission also believes, however, that integration should not be artificially induced or compelled by governmental action in the absence of overriding regulatory objectives. Thus, direct limitations on the granting of corporate trust powers only to firms that also offer commercial banking services, and actions by regulatory authorities to permit the maintenance of noncompetitive rates or prices on various types of financial services should be reviewed, and justified only on the basis of compelling regulatory needs. The Study's analyses indicate that banks enjoy important competitive advantages over other types of investment managers derived both from their possession of corporate trust powers and from the indirect compensation (permitting them to charge lower direct advisory fees) that they obtain from the link between trust and commercial operations.

An important stimulus to the recent wave of combinations between equity management and brokerage functions, however, is the fixed, minimum brokerage commission. Efforts to maintain brokerage commissions at noncompetitive levels for large, primarily institutional investors, have had profound effects on the structure of the nation's securities markets, discussed in Part Three. They also have conferred important competitive advantages, again reflected in part in lower direct fees, on institutional managers who are either directly affiliated with brokerage firms or who benefit from well developed reciprocal practices involving the use of brokerage to purchase a number of other services provided by the brokerage industry.

The Commission does not presume to speak with authority on the desirability of, or regulatory purposes served by, regulated rates or prices in areas beyond its statutory jurisdiction. Having completed extensive reviews of the economic and regulatory effects of fixed minimum brokerage commissions, however, the Commission has concluded that such rates cannot be justified on orders above \$500,000 in value and will review the desirability of requiring competitive rates on smaller institutional-size transactions as experience is gained with competitive rates on larger transactions.

MANAGEMENT FEES

Actions by regulatory authorities that result in the unbundling of certain services currently provided in combination with others under an umbrella of regulated rates or prices can have a variety of beneficial results. One is to remove artificial barriers to competition in the separate provision of specialized functions or services; another is to

bring into the open for evaluation by portfolio beneficiaries, regulatory authorities and institutional managers themselves both the services obtained and the prices paid for many of the services currently obtained by institutional managers and paid for indirectly, through reciprocity. It is entirely possible that some of these services would not, in fact, survive public disclosure and the market test of separate pricing. To the extent that this occurs, the full cost to portfolio beneficiaries of management services would be reduced. At the same time it should be recognized that many of the services currently provided and paid for indirectly, in combination with brokerage or other services, may be of considerable value to portfolio beneficiaries, may be obtained more economically by institutional managers from external than from internal sources and would, therefore, survive both disclosure and economic tests.

Current levels of direct fees charged by investment managers for their services have developed over time in cognizance of a manager's ability to obtain external services on a reciprocal basis. This ability is especially important for the smallest types of institutional managers whose internal staffs often are minimal and whose reliance on "The Street" for research and other services traditionally obtained through reciprocity has been greatest. To preserve the ability of specialized firms to offer legitimate services to institutional customers and the ability of institutional managers to obtain these services externally, in an economical manner, it may be necessary for such firms to adjust direct charges to clients or to change contracting arrangements between themselves, their clients and external suppliers of research or other financial services.

MUTUAL FUND DISTRIBUTION

One area within the Commission's traditional jurisdiction in which competitive brokerage commissions are likely to have a direct and substantial impact is the distribution of mutual fund shares. A combination of circumstances—including existing levels of direct sales charges, retail price maintenance on such charges, noncompetitive brokerage commission rates and restrictions on the use of advertising and other mass merchandising techniques—have intersected to create and perpetuate a relatively expensive distribution system for investment company shares. Fixed minimum brokerage commissions allocated to support fund sales have provided an important source of income for the distribution of mutual fund shares. As we have noted, the Commission believes that fixed rates on orders above a given size can no longer be justified. To the extent that this action eliminates a significant source of revenue to the distributors of fund shares, it can be expected to lead to one or more of three possible results: increased direct sales charges or payments to fund sellers, reductions in the extent of the distribution system for fund shares, or the development of lower cost distribution systems for the industry. The latter result is to be desired and the Commission expects that as part of the study of mutual fund distribution now being conducted by the National Association of Securities Dealers pursuant to Section 22(b) of the Investment Company Act of 1940, the NASD survey will focus not only on costs inherent in existing methods of fund distribution, but also on ways in which

these costs can be reduced and savings passed on to fund purchasers. In addition, the Commission will consider the feasibility of achieving this result in connection with its own pending study of the impact of eliminating Section 22(d)—the so-called retail price maintenance provision—from the Investment Company Act of 1940.

INSTITUTIONAL MEMBERSHIP

The Commission expects that its recent decision on competitive rates on large orders will have the effect of reducing artificial inducements to the combination of management and brokerage functions, and that this in turn will tend to reduce but not eliminate economic pressures toward institutional membership on stock exchanges. Further actions to increase the fraction of institutional transactions subject to competitive rates, of course, could be expected to further reduce such pressures. The Commission realizes, however, that issues relating to institutional membership are at least partially separable from questions regarding the level and structure of brokerage commissions and would not be disposed of entirely even by fully competitive rates on all securities transactions.

The essential problem faced by the Commission at this juncture is whether to deal with institutional membership now as a combination of problems involving both commission rates and the integration of management and brokerage functions, or to reserve judgment on this important issue pending additional steps by the various exchanges to eliminate fixed minimum commissions on orders of institutional size.

The Commission realizes that combinations of management and brokerage functions once made cannot be easily reversed. It also realizes that desires to maintain viable competition in the provision of specialized financial services, to avoid undue concentrations of economic power and to abate potential conflicts and regulatory problems inherent in combinations of management and brokerage functions may militate against the removal of remaining barriers to membership by institutions on national securities exchanges. Certainly those fiduciaries who feel their long-term interests lie in the effective management of their clients' funds, unencumbered by either the diversions or potential conflicts incident to simultaneous operation of brokerage activities, should not be forced to apply for membership in order to meet what they may feel are shorter term obligations to avoid excessive transaction charges.

At the same time, the Commission cannot ignore indefinitely the asymmetry that results from some persons who manage institutional portfolios at the same time belonging to major exchanges while others so engaged are prohibited from belonging. Institutions affiliated with exchange members enjoy important competitive advantages over other institutions by virtue of this fact. Elimination of remaining barriers to such membership might provide additional incentives for securities exchanges to move more rapidly toward the rationalization of brokerage commission rates. The Commission believes that the Study's admittedly limited analyses of regulatory problems resulting from the combination of management and brokerage functions, as well as the accumulation of its experience to date with existing combinations of these functions by members of major exchanges, has not revealed

unique, additional regulatory problems whose severity justifies sweeping prohibitions of such combinations.

The Commission will withhold its final determination regarding the desirability or necessity of prohibiting membership by otherwise qualified institutional investors on national securities exchanges, pending actions by the exchanges to eliminate artificial inducements to such membership by compliance with the clear intention of the Commission's recent releases regarding the abolition of noncompetitive fixed commissions on orders of institutional size.

Part Three (Chapters X–XIII) *Impacts of Institutional Investing on Securities Markets:*

Initial Conclusions and Recommendations

Part Three of the Study was designed to assess the impact of institutional investing upon the stability of prices in the secondary equity markets, upon the structure of those markets and upon the securities industry that services the markets.

STABILITY OF PRICES

The preponderance of data collected by the Study on monthly net institutional trading imbalances, on institutional position changes, on block trades and on day-to-day price changes analyzed in chapters X, XI and XII indicate that institutional trading in the aggregate is related to or coincident with relatively few of the large price changes that occur in the securities markets. For example, although price changes in excess of 3 percent occurred more often on days when block trades took place during the 15 months studied (July 1968 to September 1969), block trades in stocks listed on the New York Stock Exchange occurred on only 9 percent of the stock days in which prices changed relative to the market by such an amount. In addition, analyses performed on monthly net institutional trading imbalances over a 20 month period (January 1968 to September 1969) indicate that most monthly stock price changes (relative to the market) were unrelated to aggregate institutional trading imbalances in the particular stock over the time span. Other analyses of random large position changes by institutions indicate that, even on an inter-day basis, institutional trading appeared to offset price movements about as frequently as it appeared to contribute to them. Furthermore, from the data on market makers it appears that during stock months in which institutions were more active, large close-to-close price changes were less frequent.

The Study could not and did not individually examine institutional transactions. Consequently, the data collected by the Study do not negate the possibility that one or more institutions trading at particular times in particular securities did impair price stability or otherwise act in a manner contrary to the public interest. This limitation does not, however, put in question the validity of the important finding that institutional trading overall has not impaired price stability in the markets. Thus, the Study has not discovered any basis in terms of price stability for imposing generalized limitations on the volume of institutional trading or on the size of institutional transactions.

MARKET STRUCTURE

It is clear that the securities markets are changing in rapid and significant ways. There are a number of reasons for these changes; among the most important are the greatly increased volume of trading by institutions, the negotiated nature of many institutional transactions, the fixed minimum commission rates that stock exchanges impose on such transactions and technological advances in communications and data processing. The evolution of the securities markets has been, and many continue to be, affected and distorted by barriers to competition. Among the most significant of these are minimum commission rates and rules that insulate markets, market makers and broker-dealers from each other. The combination of fixed minimum commission rates and barriers to access have tended to cause institutions to choose market places, in part at least, for the purpose of reducing the commission they pay or taking advantage of opportunities to purchase various services with "soft" commission dollars by means of reciprocal practices. These appear to be the most important explanations for the accelerating growth of institutional trading on the regional stock exchanges and in the third market. Because the assembly of many block trades takes place primarily over the upstairs communications systems of broker-dealers rather than on the floor of any stock exchange, such transactions can be executed wherever the participants select, and markets have therefore been selected on the basis of these considerations.

The fixed minimum stock exchange commission on large orders has led to the growth of complex reciprocal relationships between, on the one hand, institutions (particularly mutual fund managers and banks) and, on the other, broker-dealers. This has had the effect of making commission rates for institutions negotiable but limiting the extent to which the ultimate investor rather than the money manager has benefited from such negotiation. As noted earlier, these relationships tend to aggravate potential conflicts of interest, to be anticompetitive in nature and to impede the development of a central market system for securities trading. Elimination of fixed commission rates for institutional size transactions should go some distance toward dealing with these problems. The Commission will closely observe the extent to which competitive commission rates lead toward these results.

The Study has found that all types of market makers tend to stabilize prices by trading to offset temporary imbalances in supply and demand. In view of the size and "lumpiness" of institutional transactions it becomes increasingly important that all market makers be encouraged and strengthened in the performance of their dealer function. The Study has also found, however, that a market maker's willingness to offset temporary imbalances depends in large part upon the volume of trading to which it is exposed. This function, of course, is impeded if the market maker's opportunity to participate in the total volume of trading is limited by rules which artificially restrict its exposure to that volume.

The data collected by the Study indicate that New York Stock Exchange specialists, who are exposed to the greatest volume of trading, presently offset temporary imbalances to a much greater absolute extent than other market makers. The data also indicate that despite

self-regulation, there are substantial differences among New York Stock Exchange specialists in the extent to which they participate in their markets in depth, with specialists who do not so participate nevertheless earning high returns on their capital.

Institutional investors and individual investors tend to trade in different ways and by the use of different procedures. This raises a question regarding the degree to which markets used by institutional investors and by individual investors could or should be separated. Without expressing a definite conclusion on this question, it should be noted that institutional investors and individual investors presently trade with each other either indirectly through the intermediation of dealers or, to a lesser extent, directly through the matching of orders by brokers. Any effort to eliminate trading between these two investor groups would require a rather drastic change in the pattern of trading for both of them. For example, as shown in chapter X, in the average stock month in which major institutions traded stocks listed on the New York Stock Exchange, at least two-thirds of this trading was with dealers, smaller institutions or individual investors. Even respecting a typical block trade of \$1 million or more on the New York Stock Exchange, it appears that almost 30 percent of the shares eventually found new owners, largely individual investors, through the regular round lot market on the floor of that Exchange. Any attempt to deprive individual investors of the opportunity to participate directly or indirectly in trades with institutions would deprive them of the advantageous discounts and premiums which often result from such trading.

There are, however, as the Study has found, certain questions and difficulties with respect to the interaction of large and small orders in the same market. Examples are the prices at which some limit, stop and odd lot orders triggered by block trades are executed, and the price effects in the aftermarket of inventory positions acquired by market makers in block trades and disposed of in small lots. These questions require and will receive the attention of the Commission.

As pointed out above, the markets are changing, and the question is therefore presented as to the extent to which regulatory authorities, including the Commission, should attempt to direct and structure the future development of the markets. We believe that because of modern communication and data processing facilities it is possible to preserve geographically separated trading markets while at the same time tying them together on a national basis. We also are satisfied that the Commission and other regulatory authorities should endeavor to prevent the evolution of the market place from being distorted by unnecessary restraints on competition. We do not believe, however, that it is either feasible or desirable for the Commission or any other agency of the government to predetermine and require a particular structure, and still less to specify now particular procedures for the markets of the future. It is better to observe and, if necessary, to modify the structure which evolves through the ingenuity and response of the marketplace to the extent changes occur that appear inconsistent with the public interest. Nevertheless, to guide the industry in this evolutionary process certain goals and principles may be stated. In stating these we do not mean to endorse them as absolutes. Further study

is required to determine their technical and practical feasibility and their consistency with each other as well as with other accepted goals and principles. Nevertheless, on the basis of the Study and our general experience, these goals and principles appear to us to be both worthwhile and important.

A major goal and ideal of the securities markets and the securities industry has been the creation of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime. This goal has not as yet been attained. Recent developments appear to make it possible to accomplish this purpose, while at the same time other developments create difficulties in doing so.

Until comparatively recently there were serious technological limitations on creating a system where all interests of investors could be represented in a central market. This is no longer the case. Recent advances in communications and electronic data processing make such representation technically feasible if the necessary systems are developed and used. While the creation of this capability is a development of major importance, this is not to say that markets operated unsatisfactorily in the past. The major markets in the United States have been stronger than any in the world. The capability for a central market system having within it a sustained capacity for innovation can assist in a successful adjustment to changing conditions. In light of the rise of institutional investment and the resulting increase in large so-called "block" securities transactions, certain practices such as fixed non-competitive commission rates and barriers to market access have tended to work against the development of a central market and to foster the use of competing markets. These often compete imperfectly, as where they seek to attract business on the basis of relative willingness to facilitate reciprocal practices, some of which are described in chapter XIII. Under a more competitive regime such markets can function in a much more useful way.

Aside from technological problems and competitive barriers, there have been two principal obstacles to the development of a strong central market system. These are, first, the fact that there has been no market which was strong enough and liquid enough to serve as a major central market for the entire United States. Institutional investment and the resulting strains which it has thrown upon the market mechanism have aggravated this difficulty. A second and related obstacle has been the fact that prior efforts to develop a central market have included the creation of a certain amount of monopoly power, particularly with respect to the dealer function. This has been accompanied by certain restraints on competition. There has been an effort to control potential abuses of such monopoly power by regulation. Such efforts are necessary but have not been wholly successful, primarily because regulation is more effective in prohibiting misconduct than it is in motivating and causing regulated persons to take affirmative action and to assume risks in order to create and perfect a central market.

It will not be easy to overcome these obstacles but we believe it can be done and that certain guiding principles can be used for this pur-

pose. It may or may not be possible for the central market to be largely an auction market, although the values of the agency auction market must be preserved. Under present conditions it appears that such a market will also require strong dealers. These may perform the traditional function of offsetting temporary imbalances in supply or demand or they may have a more limited function such as block positioning. To provide for dealer functions, all responsible market makers should have access to the central market. In this connection it should be noted that, given present technology, it is neither necessary nor desirable that all such dealers be present in any one geographical location, since any such requirement would among other things prevent the regional exchanges from having the meaningful role in the market system which they could have.

The participation of competing dealers in the central market will also reduce the element of monopoly power which has accompanied past efforts to establish a central market and will make it possible for potential abuses of such monopoly power to be controlled not only by regulation but to an increasing degree by competition. An essential characteristic of such a system would be the prompt reporting of all securities trades to the public on a comparable basis.

In summary, our objective is to see a strong central market system created to which all investors have access, in which, all qualified broker-dealers and existing market institutions may participate in accordance with their respective capabilities, and which is controlled not only by appropriate regulation but also by the forces of competition. We propose, in consultation with all interested persons, to seek the furtherance of these general objectives as we perform our reviewing function over proposed changes in market structure.

Part Four (Chapter XIV-XV) *Impacts of Institutional Investors on Corporate Issuers:*

Initial Conclusions and Recommendations

Part Four analyzes certain aspects of the impact of institutional investors on portfolio companies. For the purposes of this Study, a portfolio company is one whose equity securities are held by institutions or held for the benefit of persons whose investments are managed by institutions. The part contains two chapters: one deals with institutional participation in primary equity financing; the other deals more broadly with institutional-corporate relationships.

Chapter XIV is essentially an economic and statistical analysis of the extent of institutional participation in corporate financing through purchases of equity securities from issuers. This kind of participation is to be distinguished from institutional participation in the secondary markets—the subject of Part Three of the Study. Direct purchases of equity securities from corporate issuers (or from underwriters of the new issues) provide the companies involved with additional capital and are thus of particular economic significance. While institutional purchases of outstanding equity securities in the secondary markets tend to involve securities of larger companies, institutional participation in purchases of the new issues studied here tended to involve financing for smaller enterprises.

The analyses in chapter XIV, while adding light to the role of institutions in new financing, do not at this time demonstrate a need for wide-reaching legislative action. While there may be particular problems regarding certain types of institutional participation in first time new issues, it does not appear that institutions as a group have been receiving significant preferential treatment in the primary equity market for such issues or that their participation in that market has been so limited as to cause concern regarding a scarcity of access to capital by newer, smaller enterprises. Subject to compliance with the investment objectives of the institution, institutional financial managers should be able to determine whether to purchase securities directly from the issuer or in the secondary markets. While there is continuing concern that such purchases should reflect investing rather than merely trading decisions and that they conform to the interests and objectives of institutional beneficiaries, it does not appear feasible to devise an all-encompassing regulatory approach that will ensure that result with absolute precision. At the same time, the Commission will continue to evaluate problems created by the new issue market, including substantial price rises in the aftermarket which have frequently resulted in large gains to institutions and other investors who dispose of new issues within a short time after purchase.

RESTRICTED SECURITIES

As noted in the chapter, institutional participation in non-public offerings is a significant factor in enabling companies, particularly smaller, less well established companies, to secure financing. However, securities purchased in such offerings ordinarily cannot be resold without registration under the Securities Act of 1933. Accordingly, these securities are ordinarily not equal in value to securities of the same class which are freely tradable. This fact has two important consequences for corporate issuers of restricted securities and for the institutions which purchase them.

First, restricted securities generally are issued at a substantial discount from the market value of freely tradable securities—the average discount for the 278 private placements examined by the Study was about 23 percent, although variation in practice was considerable. Some portion of these discounts represent an additional cost to corporate issuers of obtaining financing through the sale of equity securities in private placements.

Second, it is often difficult for institutional holders of restricted equity securities to place an appropriate valuation upon them. Valuation has important impacts on the investment performance of institutional financial managers and may also affect the computation of advisory fees based upon the value of investment assets under management. Difficulties are exacerbated in the case of open-end investment companies which are required to sell and redeem their own securities at net asset value and whose portfolios, accordingly, are expected to be comprised of securities which can be both accurately valued and which are sufficiently liquid to meet redemptions.

The Study's findings indicate that institutions have used a variety of methods to value restricted securities. The diversity of methods uti-

lized, at the least, makes investor comparison of various alternative investment media offered by different types of institutions—and by different institutions within each type—more difficult to the extent that restricted equity securities are included in one or more of the institutional portfolios compared. In general, however, the portfolio proportions of such securities have not been large.

The Commission has recognized that valuation of restricted securities by institutions and their managers raises difficult questions for which there is at present no simple or mechanical solution. During the past several years, the Commission has focused on the problem of valuing restricted securities held by registered investment companies. Several releases have been issued which call attention to the problem and suggest appropriate considerations to be taken into account.³ In those releases the Commission pointed out that the Investment Company Act of 1940 requires restricted securities to be carried at “fair value as determined in good faith by the [company’s] board of directors”; and that, as a general principle, the current fair value would appear to be the amount which the owner might reasonably expect to receive for such securities upon their resale. The discussion set forth in these releases as to methods of valuation of restricted securities is, in the Commission’s view, equally applicable, under authority of the antifraud provision of the Investment Advisers Act of 1940, to an investment adviser (as defined in that Act) irrespective of whether or not it is required to register as an adviser. Further, the Commission believes that other persons acting as trustees or managing agents with respect to portfolios of equity securities (including securities with equity features) should consider the principles enunciated in these releases when valuing securities in good faith at fair value.

As has been previously observed, some portion of the costs of obtaining financing through the sale of securities in private placements reflects the restrictions on resale of these securities without registration under the Securities Act of 1933. As a result of recommendations of the Commission’s disclosure policy study (*The Wheat Report*, April 14, 1969), the costs in time and money of the registration process would be somewhat reduced for certain classes of issuers, primarily those which have a class of equity securities registered under the Securities Exchange Act of 1934. Moreover, the circumstances under which purchasers of restricted securities may resell such securities would be more clearly defined. *The Wheat Report* recommended improvements in the disclosures provided by the continuous reporting process under the Securities Exchange Act of 1934 and the enhancement of the degree of coordination between the disclosure under that Act and the disclosure required under the Securities Act of 1933.

The Commission has implemented those recommendations through (1) adoption of a new quarterly financial report and amendments to reporting forms under the Securities Exchange Act designed to provide on an annual basis, information which will furnish a reasonably complete and up-to-date statement of the business and operations of registered companies; (2) adoption of a new short form for registration under the Securities Act of 1933 and the amendment of another short

³ See Investment Company Act Release Nos. 5847 (October 21, 1969), 6026 (April 13, 1970), 6121 (July 20, 1970) and 6295 (December 23, 1970).

form to broaden its availability; and (3) proposals to adopt rules relating to the resale of unregistered securities pursuant to conditions designed to protect public investors as well as replace subjective with objective standards for interpretation of the registration provisions of the Securities Act of 1933.

To the extent that institutional purchasers may avail themselves by contractual right or otherwise of the new short forms for registration of securities under the Securities Act of 1933 or may take advantage of rules relating to objective standards for interpretation of the registration requirements of that Act, the cost to issuers of obtaining financing through the sale of restricted securities may be reduced. In addition, the improved reporting requirements recommended in *The Wheat Report* and adopted by the Commission may, to some extent, provide information which will serve as a basis for more adequate consideration of the fair value to be placed on restricted securities by institutional holders.

Chapter XV indicates that (1) limited numbers of institutions, particularly banks, have the potential economic power, were they to act together, to exercise control or influence over a number of portfolio companies, particularly large companies, and (2) except in the case of transfers of corporate control, where the expectation of benefits to institutions or their managers is relatively clear, institutions generally report that they do not participate in corporate policy, decision making or other corporate affairs, preferring instead to dispose of their holdings in a company if its management pursues policies with which they disagree. There are two important qualifications to these findings.

First, it is rare that a single institution will have holdings in a company large enough to give it a position of clear economic power over the company. Therefore, influence over the portfolio company will depend upon either (1) the existence of other types of relationships, such as creditor relationships, or (2) the aggregation of institutional power emanating from concerted action by a group of institutions. It often is difficult to ascertain whether institutional power is enhanced or limited by the existence of business and other relationships aside from shareownership. At the same time, the Study found relatively little evidence of concerted action to influence corporate management except in its case studies on transfers of control. Concerted action, of course, requires an accommodation of interests among the institutions participating in a joint endeavor and may, therefore, not enhance the economic power of any one institution.

Second, where institutions are able to perceive relatively clear and substantial benefits—or the alleviation of difficult problems they may face—through participation in corporate affairs, their influence and participation may be both substantial and critical. This is so in the case of transfers of control, where institutions can benefit from market action. It may also occur where institutions are “locked in” to stock holdings because they are restricted, are too large to be disposed of through ordinary market mechanisms or would generate unfavorable tax consequences if sold.

A fundamental question confronting institutional, corporate and governmental policy-makers is whether the existence and use of the potential economic power held by institutions can be reconciled with

the obligations of institutional financial managers to their own beneficiaries and with the rights and interests of other investors in portfolio companies. This question is not susceptible of a simple response because the possible uses or misuses of institutional economic power do not remain static.

There are, nevertheless, two conclusions that flow initially from the chapter's findings. The first is that questions of institutional influence over portfolio companies cannot be assessed intelligently without adequate information about the continuing growth and management of institutional stock holdings. The second is that institutions or their managers, by reason of their ability to influence the outcome of efforts to transfer corporate control, appear in a number of cases to receive preferential treatment as compared with individual investors. This preferential treatment appears to have taken two principal forms. First, the acquiring company may afford special treatment to institutions in the form of premium prices, guaranteed profits and other incentives in order to attract their support. Second, institutions may receive nonpublic advance information concerning takeover efforts which may be utilized in purchasing securities either of the target company or the acquiring company with a view to profiting from the market impact of the takeover effort once its existence is publicly disclosed.

In view of these conclusions, the Commission believes that additional disclosure requirements with respect to institutional equity holdings and management, as suggested in our comments in connection with Part One, are warranted, and additional regulatory requirements dealing with transfers of corporate control as indicated below.

DISCLOSURE OF HOLDINGS

The potential or actual impact of institutions on portfolio companies cannot be assessed by institutional beneficiaries, corporate investors or government policymakers without full and fair disclosure of institutional equity holdings and management policies. The federal securities laws have consistently recognized the special status of corporate "insiders" and "affiliates"—persons having special access to the centers of corporate authority or the power, actual or presumed, to influence the exercise of that authority. Thus, the securities laws and Commission rules require disclosure of large share holdings and relationships between affected companies and large shareholders.

In practice, however, many large institutional share holdings are excluded from disclosure under existing law; Sections 13(d) and 16(a) of the Securities Exchange Act of 1934 require the disclosure only of large holdings of shares which are *beneficially owned*. As the Study found, institutions frequently hold and manage large amounts of a company's shares, but do not themselves have beneficial ownership of such shares. The limitation of disclosure to beneficial ownership means that the holdings of a complex of institutions or accounts under common management by a single financial manager are not aggregated in determining whether there must be any disclosure, except to the extent that the complex constitutes a group of persons within the meaning of Section 13(d) or 14(d). The Study found that it is common, for ex-

ample, for a group of investment companies or other types of accounts under common management to invest, on occasion virtually simultaneously, in the same securities. Under existing laws, even if the aggregate holdings of these accounts exceed 10 percent, no disclosure would be required under Section 16(a); disclosure under Sections 13(d) or 14(d), which under recent amendments is at the 5 percent level, would be conditioned upon a finding that members of the complex alone or with other institutions or complexes constitute a "group" for the purposes of those sections.

Because not all situations can be reached through interpretation of the "group" concept in Section 13(d), the Commission believes that it would be appropriate to amend the Securities Exchange Act of 1934 to the extent necessary to require disclosure of holdings of equity securities in excess of 5 percent of the outstanding issue, whether under investment management or beneficially owned. Thus, the test of reportable holdings and transactions would include *either beneficial ownership of or investment management* over the securities in question. A bank trust department, for example, would report the number of shares which it managed (not including those for which it provided solely custodial services), aggregating shares held in various investment or trust accounts. An investment adviser would report the shares held by various investment companies and counselling accounts managed by the same adviser. Disclosure should further be broadened to require an indication of the voting authority of the shares under management, whether sole, partial or none.

In connection with this proposal to expand shareholder reporting provisions of the Securities Exchange Act, it should be recognized that certain other modifications of existing requirements under Sections 13(d) or 16(a) would appear to be in order. Section 13(d) was enacted in the context of transfers of corporate control and it consequently provides for disclosures concerning such matters as the investor's plans for the portfolio company and its sources of financing which may not be appropriate in the context of an institutional holding where no takeover is contemplated. Similarly, a purpose of Section 16(a) was to provide information concerning possible liabilities under Section 16(b) and consequently, fairly prompt reports of any change, no matter how small, in a holding are required. This might well not be needed in the present context. The choice of Section 13(d) or Section 16(a) or a new section as a vehicle for the type of disclosure here proposed would depend upon whether it was concluded that disclosure of information in addition to the mere existence of the holding and the identity of the institution is needed. General rule-making authority such as requested in connection with Part One above would be the preferable and most flexible and comprehensive approach.

The Commission does not at this time recommend that Section 16(b), dealing with the recovery of short-swing profits, should be modified in any way.

DISCLOSURE OF POLICIES TOWARD CORPORATE MANAGEMENT

While it does not appear appropriate for the Commission to attempt to advise institutions how or whether to become involved in the

affairs of portfolio companies, it would be desirable for both portfolio companies and institutional beneficiaries, including investment company shareholders, to be informed of the policies of the institutional financial manager on such matters. Presently, most investment companies disclaim in their statement of policy that it is their intention to become involved in management of portfolio companies. Consideration should be given to requiring all institutions to state their policies on involvement in corporate affairs and with more specificity than now required of investment companies, including: their procedures for considering proxy materials, any general policy regarding supporting management, any general policy of abstaining from voting, any general policy on voting for or against (or not voting on) certain types of proposals, any general policy of participating or not participating in corporate transfer situations, and any policies regarding other business relationships, personnel relationships and informal participation or consultation with portfolio companies in corporate affairs.

This type of public disclosure would focus the obligation of institutions to act in the interests of their beneficiaries and lead to their setting up procedures for systematic attention to questions of stockholder voting. As a number of institutions responding to the Study's questionnaires indicated, the beneficiary should be able to choose the institutional manager whose policies on investment management appear to him most appropriate. The only way in which this can be done is to give beneficiaries full information about the policies followed, including policies regarding relationships with portfolio companies. The public nature of such information would also serve to inform corporate management and other shareholders of any general policies of the institution.

Because the Commission believes such disclosure should be generally applicable to all institutions, it wishes to consult with other regulatory agencies to develop guidelines for disclosure to portfolio beneficiaries, portfolio companies and regulatory agencies of policies pursued by institutional managers regarding relationships with actual or potential portfolio companies. This may lead to legislative proposals. In the meantime the Commission will also proceed with drafting of rules for comment with respect to investment companies for which its present legislative authority is adequate.

INSTITUTIONAL INVOLVEMENT IN CORPORATE TAKEOVERS

The takeover area is one where the need for additional regulation is indicated by the Study's findings. Some institutions have received both preferential economic benefits and preferential informational benefits in connection with transfer efforts. As to the receipt of preferential economic benefits—such as premium prices or other special inducements—the Commission believes that regulatory action is appropriate to prevent powerful institutions from being treated more favorably than individual investors. (The Commission has already taken some steps in this area by promulgating Rule 10b-13.)

The problem of preferential informational benefits is more difficult. The Study found that in some cases companies and broker-dealers intending to make or induce a takeover bid privately advised certain in-

stitutions of this fact, enabling such institutions to make purchases of the target company shares in anticipation of the market impact of a subsequent public announcement of the bid. While there may be some similarities between the nondisclosure of information regarding an intention to make a takeover bid for another company and the nondisclosure of material information about a company's business affairs, the two situations involve somewhat different considerations and different underlying principles. With respect to the latter, material undisclosed corporate information, the relevant principle has been developed as an interpretation of Rule 10b-5 and other antifraud provisions. Persons who have acquired material undisclosed information about a company by reason of their relationship with that company (and usually for a corporate purpose) may not utilize this information for their own benefit either by trading themselves or by giving the information to favored investors in order that the investors may use it in their trading.

With respect, however, to passing on information about a prospective takeover effort to favored institutions, the persons who do so usually are the persons who plan the takeovers and ordinarily have no relationship to the target company, nor do they usually have any fiduciary duty to that company or its shareholders. This difference in relationships does not necessarily mean that such passing on of information concerning takeovers should be permitted, but it may well mean that if such activities are to be prohibited, this should be done by a rule specifically directed to that situation rather than by an expanded interpretation of Rule 10b-5 resting on a somewhat different theory than that underlying that rule as to the obligations and duties of those who receive material undisclosed information.

There are also practical differences. Where trading by insiders or by their tippees on material undisclosed corporate information is prohibited, the corporation and its insiders have a choice either to make the information public or else, if the business interests of the corporation require a postponement of public disclosure, to refrain from trading and keep the information entirely secret. In the case of a prospective takeover, a requirement of immediate public disclosure as soon as the effort is contemplated would be likely to abort the takeover. This consideration was recognized by the Congress in the Williams Act (Section 13(d)) which postpones public disclosure of a takeover until the persons planning the takeover have either acquired over 5 percent of the target company's shares or make a tender offer for more than that amount. A person planning a takeover usually cannot, however, keep his plans completely secret. He may, for example, have to consult commercial banks or investment bankers with respect to financing for the effort, and if he is proceeding responsibly he will wish to obtain as much information as he can from bankers or otherwise as to whether the proposed target is a desirable acquisition and, if so, how high a price can properly be offered. Thus the persons planning a takeover do not have the same option of public disclosure or complete secrecy as is available in the case of undisclosed corporate information.

The Commission will, accordingly, consider the possibility of developing appropriate rules to deal with misuse in the market of undisclosed information concerning corporate takeovers. It presumably will

be necessary in such rules to distinguish between persons who receive information on this subject for a legitimate purpose related to the proposed takeover and those who are given a "tip" for some other purpose. It may also be necessary to distinguish between, on the one hand, persons who in fact are part of the group attempting the takeover, who should be permitted to communicate among themselves and to purchase shares of the target company subject to the requirements of the Williams Act and, on the other hand, those who are not part of the group but who are given the information for other purposes.

D

The Institutional Investor Study, with its heavy emphasis on the application of quantitative, mathematical techniques to the analysis of economic and regulatory problems, has carried the Commission into new and often unfamiliar territory. No member of the Commission is a professional economist and, as indicated in our recommendations for Part One, the size of the Commission's regular economic staff is relatively small. As a result, the Study's special staff necessarily operated with a great deal of professional autonomy.

The Commission, of course, has reviewed the Study's Report from its own perspective as a regulatory body. The resulting product, therefore, represents a unique and, we believe, a constructive blend of the disciplines and the perspectives of the professional economists and the regulatory agency that collaborated in its development. While the Commission's ability to review in the time available certain of the more technical aspects of the Study's quantitative analyses may be limited, and further external review of the data and analyses may be desirable, we are confident that the Report constitutes a valuable contribution to our understanding of this important and rapidly changing sector of the nation's capital markets.

The Commission is deeply indebted to Donald Farrar, the Study's Director, Lawrence Jones and Seymour Smidt, the Study's Associate Directors, Donald Feuerstein and James Halpern, its Chief Counsels, Keith Johnson, the Study's Assistant Director, and their staff of economists, attorneys, computer specialists and support personnel. They brought to the work not only talent but devotion. They made possible the conduct of a large undertaking on a comparatively short time schedule. We also are grateful for the contributions of many persons in the regular divisions and offices of the Commission. In addition, the Commission wishes to express its appreciation to the Advisory Committee,⁴ members of the financial community, the self-regulatory agencies, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Bureau of Economic Research and the numerous private institutions and firms who gave so generously of their time and resources in assisting the Study in this important effort.

During the coming months the Commission will proceed along the lines indicated in this letter. We have not attempted to state conclusions and recommendations here as to relatively minor matters or details that follow from the initial conclusions and recommendations

⁴ A copy of the letter dated March 1, 1971 of the Advisory Committee to the Commission is attached to this letter of transmittal.

stated above. The Commission will submit specific proposed legislative language to carry out those initial recommendations that require legislation. As the Commission gives further consideration to the results of the Study and such supplementary and additional inquiries and analyses as we determine to conduct, we expect to reach additional conclusions and may make additional recommendations in further communications to the Congress.

By direction of the Commission:

RICHARD B. SMITH, *Commissioner*.

ADVISORY COMMITTEE TO THE INSTITUTIONAL INVESTOR STUDY

MARCH 1, 1971.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

DEAR SIRs: The Joint Resolution of Congress dated July 29, 1968 which authorized the Institutional Investor Study provided that "The Commission shall also consult with an advisory committee which it shall establish for the purpose of advising and consulting with the Commission on a regular basis on matters coming within the purview of such Study."

The Commission appointed the members of the Advisory Committee on January 21, 1969 and the Committee held its first meeting with the Commission on March 27, 1969. Subsequently, alternate members were selected in order to provide continuity as well as a broader base of experience for the Commission and its staff to draw upon.

The Committee met monthly and, in the later stages of the Study, more frequently with the Study's special staff and Commissioner Smith in Washington. During the early months the Committee discussed with the staff the question of appropriate areas for the Study's inquiries and participated in the review of various drafts of the Study outline.

Subsequently, the Committee advised on the composition of an extensive series of questionnaires used to gather the data which provided the basis for many of the Study's findings. At the request of the staff, separate industry technical committees were formed and met frequently with staff members to assist in making the questionnaires clear and precise and in avoiding excessive burdens on respondents.

Many Committee members then assisted in urging the thousands of institutional investors and broker-dealers who were questioned to respond promptly and completely to the questionnaires. Respondents did cooperate, providing the staff with data representing the equivalent of more than 800,000 IBM cards. Throughout this period the Committee also assisted the Study staff, who had been chosen largely from the academic community, in arranging interviews with a broad cross-section of the industry leaders.

As chapter drafts began to emerge from the Study staff, the Committee organized itself into sub-committees of two or three members to advise individual chapter authors. During the final weeks of preparation and review these sub-committees met with members of the Commission, as well as with the Study staff, to discuss the content of the individual chapters.

Finally, during the week of February 15, 1971, the Committee was given the opportunity to review and comment to the Commission on a tentative draft of the Commission's letter of transmittal of the report to Congress.

Unfortunately, the time pressures on the staff, the Commission and the Committee were very great. It was not possible for the full Committee, or in some cases the assigned sub-committee, to study the final text of most chapters before the deadline for comment. Because of the time-consuming process of gathering, collating, and analyzing the vast amounts of statistical data, there has also been relatively little time for assessing the nature and extent of problems or considering solutions.

Under the circumstances, although the sub-committees are believed to have been helpful in avoiding inaccuracies and misinterpretations, the Committee members cannot now either accept or reject all the descriptions, statements and inferences set forth in the Study. Although most members would probably find themselves in agreement with many of the major findings, some or all might disagree with certain inferences and conclusions drawn from the data.

The Study has represented an interesting and useful approach involving interaction among a regulatory agency, a research team drawn largely from the academic community and an outside advisory group experienced in the areas being studied. There is no question that the Study had been a very worthwhile undertaking. A great void of statistical data has previously existed in areas to which the Study addressed itself. New data now are available to support further study and policy recommendations.

The Committee wishes to emphasize its conviction that time is now required to analyze fully the extensive data produced by the Study, to appraise its findings properly and judiciously and to give considered judgment to possible courses of action.

The Committee particularly supports what it understands to be the Commission's view that it should be empowered to require institutional investors to submit significant information on their holdings and transactions in securities over which they have investment authority on a regular, continuing basis, with due regard, of course, to duplication and burden. Such information will make possible the continuing identification of potential problems and the analysis of possible solutions.

The Advisory Committee would like to make it clear that, while its advice was freely sought and freely given, the Study was a Securities and Exchange Commission study and the final report is a Commission report and does not bear the Advisory Committee's unqualified stamp of approval. This is not to say that the Committee disapproves of the report. Any study of this magnitude cannot be either approved or disapproved as a whole.

We are grateful for the opportunity to have assisted the Commission in the Study so far, and we look forward to participating in the future. The Committee is pleased to have been asked by the Commission to continue in existence and to be available to offer its advice as further policy recommendations are considered in the months ahead.

Very truly yours,

JOHN C. WHITEHEAD, *Chairman*,
(For the committee).

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National Association of Securities
Dealers, Inc.,
Washington, D.C.

Mr. John Donovan,
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Goodbody & Co., Inc.,
New York, New York.

Mr. Wilbur J. Strauss,
Vice President in Charge of Equity In-
vestment Activities,
The Equitable Life Assurance Society
of the United States,
New York, New York.

Mr. Alexander Tomlinson,
Partner, Morgan Stanley & Company,
New York, New York.

Executive Assistant :
Mr. William T. Dailey, Jr.,
Goldman, Sachs & Co.,
New York, New York.

*Resigned in January 1971 upon his appointment as Chairman of Securities Investor Protection Corp.

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INSTITUTIONAL INVESTOR STUDY
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Chapter I

BACKGROUND, SCOPE, AND DESIGN OF THE STUDY

1. BASIC STRUCTURE

A study of institutional investors not limited to a single class of institution, a single type of portfolio or a relatively narrow set of public policy issues must recognize and deal with interrelationships among competing types of institutions, with important customers and suppliers and with the markets in which both institutions and individuals operate. Otherwise, such a study would be too narrowly confined to provide a basis for understanding the more fundamental economic developments raising policy issues before regulatory and legislative bodies.

Balance, of course, is required. Greater extensiveness or comprehensiveness can be obtained within given resource limitations only at the cost of lessened depth in some of the areas covered. As the current study's legislative background indicates, all initial pressures were toward greater coverage and comprehensiveness. Conscious decisions by the Study were necessary, therefore, to focus attention primarily on equity rather than debt markets and on the larger types of institutional investors such as banks, insurance companies and investment advisers rather than on smaller, but occasionally more colorful types of funds. Some relaxation in these self-imposed restrictions was, of course, possible. Institutional activity as holders of debt securities is considered at least tangentially, and both hedge funds and offshore funds do receive separate treatment. By far the greater portion of the Study's resources remains concentrated, however, on the role of the largest types of financial institutions as equity investors.

Given these basic limitations, an attempt was made to design as comprehensive a study as possible of institutional investors and their impacts on securities markets and corporate issuers. Toward this end a number of alternative conceptual structures could be envisioned. One could, for example, focus on institutions and treat savings flows channeled through institutional hands as the raw material out of which transactions are translated into market impacts, and holdings into a basis for influence or control over portfolio companies. Alternately, one could focus on the savings-investment process. The process begins with savers as sources of capital and ultimate holders of wealth and ends with portfolio companies as appliers of this capital and operators of the resulting physical assets. In between, institutional investors act as agents for the holding and management of intermediate (financial) assets, providing diversification and certain legal and administrative services, while markets serve as the place where assets are valued, trading is facilitated and capital is allocated (ultimately) among alternative uses through the pricing mechanism.

Neither of these perspectives is entirely without merit. Both emphasize the primary importance not of the institutions or markets themselves, but their impacts on the manner in which savings are mobilized, applied and controlled in a highly developed and increasingly institutionalized market economy. Each is comprehensive in that it covers each of the links between institutional investors and households, secondary markets, primary markets and corporate issuers.

In a practical sense either can be decomposed into four major sectors for separate, analytic treatment:

Aggregate analyses of national savings and wealth, highlighting flows of funds to and through the financial sector and its component institutional categories.

Analyses of institutional investors themselves, emphasizing their role and behavior as managers of large, equity oriented portfolios.

Analyses of institutional trading and its impacts on the nation's securities markets and securities industry.

Analyses of direct impacts by institutional investors on corporate issuers, as sources of new equity financing, and as large and influential shareholders.

Each of these major areas can, of course, be further broken down into specific research objectives. The chapters of the Study follow this pattern.

2. DETAILED STUDY DESIGN

PART ONE: BACKGROUND, STUDIES OF INSTITUTIONAL INVESTORS AND CORPORATE STOCK (CHS. II, III)

An attempt is made to place in historical perspective later detailed studies of the recent behavior of financial institutions as equity investors. Long-term trends in the savings behavior and asset holding preferences of households, growth in the financial sector as a whole, growth in the size and portfolio composition of major types of institutional investors, as well as trends in the financing patterns of non-financial corporations, all are traced in varying degrees of detail back to the turn of the century and before.

Substantial improvements in the sectorization of national accounts are provided for the period following 1952, permitting more detailed analyses of factors that affect the supply and demand for corporate securities, and relationships between the market value of these securities and that of underlying physical assets.

Chapter II considers long-term trends from the turn of the century until 1952; chapter III continues and expands upon these themes through the richer body of data available for the period 1952 to 1968.

PART TWO: INSTITUTIONS AS INVESTMENT MANAGERS (CHS. IV-IX)

This portion of the Study begins with an effort to distinguish between institutional investors or institutional managers and the funds they administer. This distinction, which seldom has been recognized in the past, is maintained throughout. Thus, investment advisers, bank trust departments and insurance companies are considered as major classes of institutional managers, while mutual funds, personal

trust funds, personal agency or counseling accounts, employee-benefit funds, college endowments and foundations are considered as accounts or portfolio types to be managed. Primary focus is on institutional managers and the aggregates of funds under their management, although separate chapters also deal with certain of the portfolio types managed and with characteristics of portfolio holdings across managerial and account categories.

An attempt is made to obtain uniformity of treatment across chapters for such basic elements of information as the size distribution of firms within institutional categories, the number, size, types, growth and distribution of assets in accounts managed by each institutional type, as well as fees charged and portfolio turnover for the various types of accounts and managers studied. Surveys of legal, regulatory or tax considerations that affect the growth and operation of financial institutions and portfolio types also are provided when such factors appear to be of special importance.

The effect on behavior as portfolio managers of affiliations between specific types of financial institutions and other types of firms also is examined; thus, relationships between bank trust and commercial operations, insurance company separate accounts and general accounts, and affiliations by investment advisers with various types of financial institutions and securities firms are examined.

Chapters IV through VI consider the major types of institutional managers, investment advisers, bank trust departments and insurance companies, respectively. Chapter VII examines offshore funds and chapter VIII looks at major types of institutional portfolios, while chapter IX focuses its attention on the distribution of portfolio holdings across major categories of institutional managers and portfolios.

PART THREE: IMPACTS OF INSTITUTIONAL INVESTING ON SECURITIES MARKETS (CHS. X-XIII)

This portion of the Study attempts to determine the impact on price volatility, market structure and the securities industry of absolute increases in the total volume of institutional trading and changes in its character during recent years. It contains four chapters.

Chapter X deals with two major topics: the extent and price impacts of net trading imbalances (sometimes referred to as parallel trading) among institutional investors as a group, and the volume, characteristics, and price impacts of institutional position changes over periods of up to 3 months in duration.

Chapter XI studies the growth of block trading over time, its mechanics on various exchanges, and in the over-the-counter market, its price impacts and day-to-day variations in its frequency. Particular emphasis is placed on dealer participation by New York Stock Exchange specialists, block positioning firms, and third market makers, as well as public participation in blocks traded.

Chapter XII examines the effects of institutional trading on the market making function, by relating the volume and composition of both total and institutional trading to dealer inventories, price volatility, and the profitability of market making. Economic incentives by New York Stock Exchange specialists to assume or refrain from assuming the large positions resulting from institutional activity are analyzed in some depth.

Chapter XIII considers the impact of institutional trading on the securities industry. It examines the services offered to banks, investment advisers, insurance companies, and other institutional investors by securities firms and the manner in which business is allocated to these firms by the various types of institutions. The period following 1968 is examined to assess the impact on both institutions and broker-dealers of recent changes in commission rates and Exchange rules. Differences in the profitability of securities firms serving institutional investors and the general public, as well as incentives for the integration of brokerage and management functions, are examined.

PART FOUR: IMPACTS OF INSTITUTIONAL INVESTORS ON CORPORATE ISSUERS
(CHS. XIV, XV)

This portion of the Study deals with two avenues through which institutional investors may have direct impacts on the companies whose shares they hold. The first is through participation in new issues of the companies' securities, the second is through the role of institutional investors as large and influential shareholders in portfolio companies. Each is treated in a separate chapter.

Chapter XIV considers institutional participation in the financing of corporations through direct participation in first public offerings by new issuers and through private placements of corporate securities. The amounts of such securities purchased, the characteristics of issuing corporations and the circumstances under which purchases take place all are examined; analyses also are conducted of the types of accounts for which new issues are purchased, their holding periods and rates of return.

Chapter XV considers the legal and regulatory environment governing relationships between institutional investors and portfolio companies, the extent to which the shares of particular companies are concentrated in the largest institutional portfolios, the nature and extent of institutional participation in corporate affairs through voting, consultation and personnel ties, the extent to which institutions are linked to portfolio companies through other business relationships and the role of financial institutions in transfers of corporate control.

Chapter II

DEVELOPMENT OF FINANCIAL INSTITUTIONS AS INVESTORS IN CORPORATE STOCK UP TO THE POST-WAR PERIOD

1. INTRODUCTION

This chapter and the one which follows are summaries of the much more extensive treatment of this material contained in The National Bureau of Economic Research's *Institutional Investors and Corporate Stock: A Background Report* (R. W. Goldsmith et. al., 1970). This document, hereafter cited as *NBER Report*, was prepared for the Institutional Investor Study and is printed as *Supplementary Volume I* of the Study. It provides the statistical background necessary for assessing the role of both corporate stock and of institutional investors in the American economy since the mid-19th century. New estimates are presented of the value of several classes of assets and of the portfolios of several categories of institutions, and an attempt is made econometrically to relate relative yields and general indications of economic activity to decisions by corporations to issue securities, decisions by households to purchase these securities directly or through intermediaries, and decisions by financial institutions to purchase stock and other assets.

The statistical improvements and the bulk of the analysis pertain to the period 1952 through 1968 covered in chapter III of the Study. This period is characterized by a much richer data base than is the period which precedes it. Although flow of funds estimates exist for the entire post-World War II period, the quality of the data before 1952 is inferior to that after 1952. Furthermore, the inclusion of the 1946-51 years of demobilization, of post-war adjustment, and then of renewed warfare in Korea introduces some distortions which make analysis more difficult. The *NBER Report* does, however, assemble some historical data from previous Bureau studies in order to place more recent events in a longer time perspective. The remainder of this chapter is devoted to a summary of this historical material. Chapter III examines the years since 1952 in more detail and recapitulates the general findings and conclusions of the *NBER Report*.

2. THE GROWTH OF NATIONAL ASSETS SINCE 1900

In 1900 the United States had tangible assets valued at \$88 billion; by 1968 the value of land, buildings, and equipment was estimated at \$3,140 billion. A portion of this growth in the value of assets is, of course, attributable to the increased prices of all types of wealth, particularly the price of land. Another portion of this growth is the replacement value of physical assets required merely to keep pace with

increases in population; simply to keep each member of the labor force endowed with as much capital in 1968 as in 1900 would have required considerable investment. Most of the total increase in the value of tangibles, however, has made the nation's per capita endowment of real capital much larger than it was in the earlier years of American economic history and thus, directly or indirectly, has contributed to increases in income and output per capita experienced during the century.

Capital accumulation was dependent, to some extent at least, on the particular set of financial institutions, arrangements, and instruments which existed. Over the same time period the stock of financial assets has grown from \$59 billion to \$3,900 billion; thus, in 1900 the value of the paper claims on the nation's stock of real assets amounted to only 65 percent of the value of real assets. By 1968, however, the economy had issued paper worth more than 130 percent of the value of its underlying tangibles. This reflects both the growth of external financing and the role of financial institutions as intermediaries between savers and the accumulators of tangible assets.

It is useful to consider briefly some of the links between the nation's so-called paper and real economies, using the financial history of the United States before 1952 as illustrative material. The data presented, while too fragmentary to permit conclusions as to causation about the role of the financial system in the economic growth of the country, do reflect the fact that shifts in the composition of wealth (occurring both through price movements and through changes in the commitment of new investment funds) have been accommodated by the set of instruments and institutions which developed simultaneously during the period. For example the rise in residential relative to nonresidential construction in the private sector was facilitated by the growth in savings and loan associations. The steady decline in the debt of nonfinancial sectors and the increased share of the debt and equity issues of financial institutions indicate that intermediation was increasing, thus implying higher rates of capital formation and growth than would have been available in their absence.

3. INSTITUTIONS AND THE STOCK MARKET, 1860-1952

In the first half of this century, the issuance of equity securities was never a major source of financing or even a major source of external financing for U.S. corporations. New issues constitute a small fraction of the amount outstanding in any year; thus the role of institutions or individuals in the equity financing of corporate business is more likely to take the form of participation in the secondary market. Trading in existing securities does permit investors to change the composition of their portfolios so as to be able to acquire new issues in excess of their inflows of new money. The valuations placed on the corporation's earnings by the securities markets also determine the terms on which corporations can issue new shares or add to the equity of existing shareowners by retaining earnings. In order to assess the impact of institutional shareholdings on the market for stocks and on the savings and investment decisions of the economy as a whole, one must look at their role both in terms of outstanding securities and in terms of purchases of net new issues.

A comparison of institutional net purchases and corporate net issues serves to indicate the extent to which control over outstanding shares is being passed from individuals to institutions or the reverse. Until 1945 institutions never absorbed more than 15 percent of the net issues of shares. These data have little to say about the price impact of such purchases except to indicate that the supply always was incremented by a greater amount through net new issues than was institutional demand; that there was greater institutional participation in the 1923-29 boom period, particularly among investment companies, than either before or after until 1945; and that another relatively high institutional demand occurred during the low-issue years of World War II. In the immediate post-war period, however, institutional net purchases amounted to almost 40 percent of corporate net issues; investment companies, pension funds and life insurance companies contributed to the demand in almost equal degrees. Net issues, while higher than they had been during the depression and war, were less than they had been during the 1920's.

Despite the rising share of institutional purchases in the increment to the value of corporate shares outstanding, institutional holdings per se were not so large as to give them general dominance of the secondary market. The holdings of institutions other than personal trust funds actually declined as a percentage of the value of all stock outstanding from 1860 until 1922, the rate of decrease in the early years of this century being more impressive than that for the late 19th century. Reasons for this are several in number. Commercial banks and mutual savings banks had begun to lose interest in stocks; life insurance companies were constrained by regulation of their portfolio policies; the day of the investment company was not yet at hand; and the volume of new issues was relatively large.

The stock market boom of the 1920's was accompanied by a dramatic increase in the institutional share of the market, as investment companies in particular increased their holdings. The increases of the depression and war years reflected the low volume of new issues during the period as well as a policy of acquisition on the part of property insurance companies, investment companies, and pension funds. Immediately after World War II the growth in institutional shareholdings again was considerable; it resulted from the large relative growth of institutional types with heavy commitments to stocks and from an apparent shift in the investment policies of insurance companies. The estimates for personal trust funds are of questionable reliability; if they are included, the institutional share is, of course, larger. The periods of greatest increase were the years 1880 to 1922 and the decade of the Great Depression, although the entire period showed a transfer of shareholdings from individual to institutional management.

Institutional attention, however, has not been devoted equally to all issues. Institutions in 1949 held a larger share of stocks listed on the New York Stock Exchange than they held of stock in general. This has probably been true since the 1920's, although no estimates are available to settle the issue; it was probably not the case in the 19th and early 20th centuries, since there was much institutional holding of unlisted bank stocks during this period. Some individual

issues also are more likely than others to have been held by institutions.

Thus, by 1952 institutions had already become a potentially important force in the stock market. This came about partly through the relative growth of institutions more heavily dependent on equities in their portfolio, and partly from apparent changes in the investment policies of institutions. In addition, corporations already had begun to rely less heavily on the equity market for new financing. Subsequent developments are examined in chapter III.

Chapter III

ROLE OF FINANCIAL INSTITUTIONS AS INVESTORS IN CORPORATE STOCK IN THE POST-WAR PERIOD

1. OVERVIEW, 1952-68

This chapter is a condensation of the much more extensive treatment of financial developments since 1952 contained in the *NBER Report*. After a brief overview of such structural changes as can be observed in the national and sectoral balance sheets, the chapter considers corporate financing patterns, household savings decisions, and the portfolio policies of financial institutions.

Chapter II concluded with the suggestion that by 1952 there were already under way several developments which, if they persisted, could lead to institutional dominance of the stock market through holdings, alone. Section A of chapter III is devoted to examining the role of institutions in the equity market within the broader framework of the shifts among sectors in the ownership of all tangible and financial assets. It also places new equity issues in the context of total credit flows within the economy over the period.

An examination of sectoral balance sheets, as well as of total national assets over the period, indicates that financial assets increased more rapidly than did real assets both in total and for most sectors; that financial institutions hold an increasing share of these assets, and, in particular, that they hold increasing shares of those assets whose relative importance is increasing. They have acquired the funds to do so in large measure from households which have elected to hold time deposits and claims on personal trusts and on life insurance and pension reserves. Over the same period, corporate shares replaced proprietor's equity as the major equity investment of households. Tangible assets grew more rapidly in the corporate than in the noncorporate sector, but the value of shares grew even more rapidly.

In order to discover possible links between the growth of financial institutions and the rapid appreciation in the value of corporate shares during the 1960's, it is necessary to examine transactions in real and financial assets during the period.

The shares of funds raised in credit markets accounted for by equity and by long-term debt issues has declined steadily over the post-war period. Bank loans and other short-term credit have provided an increasing share of financing. Thus the role of the commercial banking system in supplying credit has grown while that of nonbank financial institutions has been reduced, on a relative basis.

2. CORPORATE FINANCE

One of the phenomena which chapter II associated with the possible institutionalization of the stock market was the diminishing reliance of corporations on new equity issues as a source of funds. This financing behavior has apparently persisted; indeed corporate choices of financing vehicles seem relatively insensitive to interest rates and are much more influenced by the nonprice aspects of credit availability. This seems to be true for broad subsectors of the aggregate as well. Section B of this chapter is addressed to these matters.

Other channels by which the stock market might affect corporate financing decisions were hypothesized and some evidence was examined. While there are differences among broad industrial groups in the extent to which equity financing is used, the limited disaggregation employed here does not qualify the previous paragraph substantially. Dividend payout rates (as a proportion of earnings and capital consumption allowances) have changed little over quite a long period of rising stock markets. Finally, the separation of straight debt from convertibles issues provides some suggestive, although inconclusive, results.

3. HOUSEHOLD SAVINGS DECISIONS

A second tendency observed in chapter II was the more rapid growth of those institutions displaying a greater interest in equity securities, whose fortunes are thus more closely dependent on events in the stock market. Ultimately, the rate at which a financial intermediary grows depends in large part on its ability to attract funds from savers. Thus it is necessary in assessing the prospects for institutionalization of the stock market to explore the savings habits of households and to relate individual preferences for direct versus intermediated asset holdings. Short-run increases in income lead to increases in the share of income devoted by households to the acquisition of financial assets. Higher interest rates also encourage such financial saving. There also has developed a tendency for individuals to prefer indirect to direct equity holdings. Section C of this chapter discusses household saving and asset holdings. Households have substituted corporate for proprietors equity, have shifted into short-term claims, and have exhibited a preference for intermediated rather than direct holdings of long-term assets (which include equities). Nevertheless, disintermediation can occur, as it did when returns to direct ownership of debt rose relative to those available indirectly in the debt market.

Within the household sector one can observe differences in portfolio composition which are related to the age and wealth of the individual. The older and more affluent are more likely to devote a substantial fraction of their portfolio to direct stock holdings, while equity in life insurance and in pension fund reserves are more important for the younger and less well-to-do. This suggests that there are distributional aspects involved in assessing institutionalization of the stock market which are not completely captured by focusing on the share of "individuals" and "institutions" in corporate stock outstanding.

4. INSTITUTIONAL PORTFOLIOS

A third development explored in chapter II was the shift in institutional portfolio preferences toward equity holdings. This too seems to have persisted, and indeed intensified, during the late 1960's. This shift appears to have been the result, in some cases, of a belated adjustment to the fact that equity yields have been considerably higher than have debt yields during the post-war period. Section D of chapter III gives a brief introduction to these developments which are reported on extensively in Part Two of the Study.

The *NBER Report* found little in the way of econometric explanation for the observed investment policies of the financial institutions and portfolio types discussed. There does seem to have been a decline in the willingness of savers to entrust new money to the more conservative managers of long-term portfolios; furthermore, movements by households into and out of time deposits in response to yield spreads indicates that individual investors have become relatively yield conscious. These facts, joined with the relaxation of many of the restrictions on institutional portfolio composition in the early 1960's, and a growing inventiveness on the part of the financial system, created a suitable climate for the changes observed during the period since 1965. There does appear to have been a commitment on the part of most institutions to acquire stock. During the latter part of the period they were joined by heavy foreign demand. The only source of supply other than new issues, of course, was net selling by households, as foreign investors also were net purchasers of corporate stock during the period.

5. CONCLUSIONS

While the trends first discussed in chapter II did indeed persist throughout the post-war period, these forces had not, by the end of 1968 at least, succeeded in driving individual investors out of the equity market. Corporations have continued to find channels of financing other than equity issues; financial institutions have continued to acquire stock more rapidly than corporations have supplied it. Those classes of institutions and portfolios which have grown most rapidly have been those with the greatest commitment to the equity market, and over the period households have continued their shift toward intermediated rather than direct holdings of equity securities. Yet, institutions have not increased appreciably their share of stock outstanding over the period since the mid- to late-1950's.

Individuals have held around 70 percent of outstanding corporate stock since the late 1950's, even though they have been net sellers during much of that same period. These facts suggest that the securities which individuals have retained or purchased have appreciated more rapidly than have those which were held or purchased by institutions. While such an investment strategy increases vulnerability to large losses in declining markets, it also leads to better than average gains during rising markets. Thus, individual direct investors have performed better than the market as a whole and better than institutions as a group on a total return basis over the rising market that characterizes most of the period. In addition, some of these institutional portfolios represent the intermediated equity holdings of individuals

whose opportunities for direct participation in the stock market are limited by wealth, income, or other circumstances.

Finally, the market value of corporate stock was substantially lower during the decade of the 1950's than estimates of the market value of underlying real assets. By the mid-1960's, however, this differential had been eliminated and during the latter half of the decade was reversed. The legacy of low price-earnings ratios and low interest rates which persisted well into the 1960's made equity a relatively costly source of funds for corporations. These same circumstances also provided an incentive for institutional portfolio managers to avail themselves of the higher returns available in the equity market.

Rising interest rates over the last few years and the rising stock market which, for a while, accompanied these rates changed many of the price relationships to which participants in the capital markets had become accustomed. Corporations lately have begun to issue relatively more equity securities than they had over prior decades. Individuals in search of higher returns moved funds from those institutions to which they had traditionally entrusted their savings when yield differentials of sufficient size developed. Faced for the first time in many decades with disintermediation and increased mobility of investible funds by households and corporate savers alike, the managers of large institutional portfolios necessarily became more conscious of rates of return, or investment performance, than had previously been the case.

INTRODUCTION TO PART TWO: INSTITUTIONS AS INVESTMENT MANAGERS

A. INSTITUTIONAL MANAGERS AND MANAGED PORTFOLIOS

Part One (chs. II and III; NBER report) has examined long-term trends in the structure of national balance sheets and flows of funds through financial institutions. Broad changes in the composition of the financial asset holdings of major financial institutions and portfolios have been traced. Part Two (chs. IV through IX) examines in greater detail the recent organization and behavior of those institutional managers active in the equity securities market.

In performing this analysis the Study has attempted to maintain a clear distinction between the institutional managers, on the one hand, and, on the other, the institutional portfolios being managed. The principal institutional managers are studied. They are investment advisory firms (ch. IV), bank trust departments (ch. V) and insurance companies (ch. VI). Certain substantial portfolios, including some pension and profit-sharing plan assets and educational and foundation endowments, are not externally managed but rather are administered by personnel of the funding employer, or officers or affiliated persons of the educational institutions and foundations. These "self-administered" portfolios are examined in chapter VIII and compared to similar portfolios managed by bank trust departments and investment advisory firms.

Among the types of managed portfolios considered in Part Two are various commingled funds, such as mutual funds and hedge funds (ch. IV), offshore funds (ch. VII), common trust funds (ch. V), pooled employee-benefit funds (ch. V) and life insurance and property and liability insurance company investment accounts (ch. VI). Also examined are various management or advisory accounts (chs. IV and V), personal trusts (ch. V), endowments and foundations (ch. VIII), and retirement plans (ch. VIII). The distribution and characteristics of common stocks held in portfolios of institutions are considered in chapter IX.

In general, the Study selected institutional and portfolio groups for analysis because they were: (1) large holders of equity securities, (2) active traders of equity securities, or (3) had displayed the potential interest and ability to become significant factors in equity security markets. Thus, bank trust departments and investment advisory firms qualified because they constitute the largest classes of institutional asset managers investing significantly in equity securities. Among the portfolios studied, corporate pension benefit plans and investment companies are the largest investors in common stock. Offshore funds (ch. VII) and hedge funds (ch. IV) receive attention because of their propensity to trade equity securities actively. Life insurance companies and State and local government retirement systems qualify as institutions and portfolios respectively because of the magnitude of the assets under their control and their developing interest in equity security investments.¹

¹ Among managers and portfolios excluded from the Study's coverage are mutual savings banks, which have modest common stock investments, law firms, which manage or advise a substantial, but unknown, amount of funds, religious organizations and brokerage accounts where (even when transactions are discretionary or solicited) no direct compensation for investment advice is assessed.

An approximate measure of the assets and common stock which came under the Study's purview is provided in Tables 1 and 2. These Tables attempt to classify assets (and common stock) under management by both type of manager and type of portfolio. This is a difficult task because of the process of financial integration that has developed increasingly during recent years—that is, institutions moving into related activities have blurred conventional institutional category distinctions. Thus, for example, where insurance companies have acquired control of investment advisory complexes it is not obvious whether the mutual funds and other portfolios managed by the advisory complex should be regarded as managed by the insurance or by the investment advisory industry.² Identification of portfolio managers also is made difficult by the use of multiple advisers by some portfolios and the wide variance in investment responsibility and discretion granted by beneficial owners or controlling persons to some types of investment managers. These practices make some double counting of assets unavoidable.

In order to provide a measure of the problems, Tables 1 and 2 show an estimate of the total assets for which investment advisory firms provide investment advice or management and in parentheses the portion of those assets over which investment advisers have sole investment discretion. The amount of assets managed exclusively by investment advisers in each category is somewhere between the two numbers shown. A somewhat similar problem exists in bank-managed accounts; a description of the extent of banks' investment discretion is provided in chapter V for a sample of accounts from the 50 largest bank trust departments. The amounts of insurance company assets which also are counted elsewhere is believed to be relatively inconsequential.³

Assets shown in Table 1 are estimated at market value, except for the greater portion of the assets of insurance companies. Most assets managed by insurance companies, other than common stock and assets of registered investment companies, are valued at amortized cost. All common stock estimates in Table 2 are at market value.

Tables 1 and 2 necessarily make some ad hoc allocations of assets between common stock and debt securities. For example, a portion of insurer-managed assets and common stocks is allocated to the interests of employee-benefit plans. This is done by allocating insurers' general account assets to employee-benefit plans in the ratio of reserves for these plans to total insurance reserves. All such allocations are detailed in footnotes to Tables 1 and 2.

Of the \$714 billion total assets in 1969, shown in Table 1, about 44 percent are invested in common stocks. This proportion is reduced by the large fraction of insurance company general account assets held in debt securities. Excluding insurer assets, about 62 percent of the remaining assets managed by institutional types covered by the Study are invested in common stock.

² In this case the Tables allocate these portfolios to the investment advisory industry and only assets of investment companies which represent separate accounts registered under the Investment Company Act of 1940 and mutual funds created by insurers are counted as insurer managed.

³ Chapter IV provides estimates of the amount of insurer assets receiving investment advice from investment advisory firms.

B. THE INSTITUTIONS DURING THE 1960'S: THEIR ACTIVITIES AND THE ISSUES

In conducting its analyses of institutional organization and behavior the Study was particularly conscious of several frequently mentioned trends in institutional activity. These include the movement of some institutions and portfolios into equity securities, the increased emphasis on investment performance accompanied by a greater willingness to accept investment risks, and the process of financial integration (or diversification).

The movement toward equities was especially prominent, for example, in life insurance company portfolios, primarily through the development of equity separate accounts as funding media for pension-benefit plans, and in state and local government retirement system portfolios. Other types of portfolios which previously had held significant amounts of equity securities increased the proportion of their common stockholdings. Part Two of the Study describes these movements and some of the pressures and incentives responsible for the increased interest in equities.

Investment performance consciousness developed at a number of levels. In some cases it meant that beneficial owners or other controlling interests came to recognize that professional investment management offered a possibility of increasing investment return from what previously had been essentially unmanaged portfolios. In some cases, performance consciousness meant a new concern with total investment return, including realized and unrealized capital gains (losses) rather than a focus upon current income, and investment policies were changed accordingly. Financial pressures on some affected parties, such as universities and other nonprofit institutions and employers required to fund retirement benefits promised in collective-bargaining agreements, led to their exercising closer scrutiny of investment managers, shifting portfolios to other investment managers and, in some cases, splitting assets among several investment managers.

In order to appraise the investment results produced by these managers, an interest in better measures of performance evolved, and much has been accomplished technically in developing such measures. Whereas some portfolio owners and managers have simply attempted to increase investment return by increasing risk, others have been conscious of risk-return relationship and some portfolio managers are being evaluated on the basis of return adjusted for risk. Finally, performance consciousness in some cases has been identified with very active short-term trading, leveraging and speculation in equity issues of thinly capitalized enterprises.

At each of these levels of performance consciousness it appeared that an increased interest in investment return was accompanied by increases in the turnover of equity security portfolios. These turnover rate increases were significant for many types of portfolios. In Part Two, turnover rates during 1965 to 1969 are computed and analyzed for a wide variety of institutional manager and portfolio classes. For limited types of accounts it is possible to investigate the relationship between realized investment performance, volatility and turnover rates.

The process of financial integration began to have major effects upon the structure and behavior of financial institutions during the

1960's. Some institutions, such as commercial banks, have integrated numerous financial services for many years. Even banks, however, have desired to add additional services, such as commingled agency accounts, and through holding companies have established affiliations with investment advisory firms and insurance companies. Insurance companies, in addition to placing greater emphasis upon the investment management of assets generated by insurance operations, have affiliated with mutual funds and investment advisory firms. Some brokers have expanded into the investment advisory and mutual fund businesses. Part Two attempts to deal with some of the implications of these developments.

One of the effects of financial integration is that it tends to create or increase potential conflicts of interest and problems of equitable treatment when many customers' investment and other financial needs are being serviced. Potential conflict situations are created when institutions, through their asset management activities, (1) are simultaneously creditors to and shareholders in a corporation, (2) are brokers and investment advisers, (3) accept deposits and manage portfolios, or (4) offer insurance or other financial services and provide investment management.

The chapters include material bearing on these trends and issues. They explore the nature and intensity of competition among investment managers, economies of size realized at the manager or account level and the extent to which realized economies are passed on to customers, the influence of other financial services offered by institutions upon investment selections, trading decisions and the viability of competition among investment managers, and managerial policies and practices developed to deal with conflict of interest questions.

Although data and information utilized in Part Two were derived from many sources, the primary source in each chapter was information obtained through the Study's questionnaires. These were of three basic types: (1) survey questionnaires, (2) institutional "intrinsic" questionnaires, and (3) portfolio or account questionnaires. Survey questionnaires were utilized to establish some knowledge of the universe of institutions or portfolios where no satisfactory information existed. Thus, one such questionnaire provided something approaching a census of investment advisory firms. Another provided a basis for sampling bank trust department accounts, and other survey questionnaires provided a census of large pension-benefit plans, state and local government retirement systems and educational endowments.

Institutional intrinsic questionnaires were sent to bank trust departments, investment advisory firms, insurance companies and some self-administered portfolios. These questionnaires elicited information on the investment organization and structure of the managers, services offered, affiliations and other data intrinsic to the institutional class. Account questionnaires produced data on individual accounts, including detailed asset composition, holdings of individual equity securities, purchases and sales of common stocks, management fees charged and other characteristics of the accounts. Some of these account samples were drawn from the groups of managers—that is, from banks, investment advisory firms and insurance companies—and some from their clients, the portfolio's beneficial owners—that is, from pension plans, universities, foundations, etc. The structure of these questionnaires assured a substantial degree of uniformity in the treatment of these data in each of the various chapters.

TABLE 1.—TOTAL ASSETS OF PORTFOLIOS CLASSIFIED BY MANAGER TYPE

[Dollars in millions—1969]

Manager class	Portfolio type								Total
	Foundation	Educational endowment	Employee benefit plans	Insurance accounts other than pensions or mutual funds	Registered investment companies	Personal trust and estates	Personal advisory accounts	Other	
Self-administered foundation.....	\$ 15,210								\$ 15,210
Self-administered educational endowment.....		\$ 4,710 (7,830)							\$ 4,710 (7,830)
Self-administered employee benefit plan.....			\$ 57,810 (73,080)						\$ 57,810 (73,080)
Property and liability insurance group.....	(⁶)	(⁶)	(⁶)	\$ 48,940	(⁶)	(⁶)	(⁶)	(⁶)	\$ 48,940
Life insurance company.....	(⁶)	(⁶)	7 47,130	\$ 149,810	⁹ 680	(⁶)	(⁶)	(⁶)	\$ 149,810
Investment adviser ¹⁰	\$ 1,420	5,660 (2,540)	19,600	4,110	63,280	(⁶)	\$ 25,650 (9,620)	14,500 (3,880)	\$ 134,230 (79,210)
Bank.....	\$ 3,650	¹² 2,430	¹³ 81,120	(⁶)	(⁶)	¹⁴ 122,180	(⁶)	¹⁵ 45,790	¹⁶ 255,170
Total.....	¹⁷ 20,280	¹⁸ 12,800	¹⁹ 205,660	202,860 (199,130)	63,960 (57,720)	¹⁴ 122,180	¹¹ 25,650 (9,620)	60,300 (49,680)	713,700 (677,080)

¹ Year-end data except for the investment adviser category which represents June 30, 1969. All assets at market value except insurance company assets most of which are valued at amortized cost. Details may not add to totals due to rounding.

² Estimated using percentages derived from the study's data on management of large foundations (see table VIII-184). The self-administered category includes foundations whose principal assets is the common stock of one firm and can be considered as requiring no investment management.

³ Residual. The two figures represent limits for the range of assets that are presumed to be self-managed. The maximum (figure in parentheses) is derived by subtracting bank-managed assets and assets over which investment advisers report discretionary authority from the estimate of all assets in the category. The minimum figure is derived using all assets of investment advisers regardless of investment discretion.

⁴ None.

⁵ Adjusted to eliminate the stockholdings of property and liability groups in affiliated insurance companies.

⁶ Not available.

⁷ Estimated by applying the proportion of insured pension reserves to total reserves (37,900/158,550) against total life insurance assets (197,208).

⁸ Residual.

⁹ Represents only assets of mutual funds (413,000) or variable annuity separate accounts (264,000) originated by insurance companies, not those management companies that have been acquired.

Approximately 8,000,000 of recently acquired investment company assets have been considered here as managed by investment advisers.

¹⁰ Numbers in parentheses are discretionary assets reported by investment advisers and can be considered the minimum of assets in each category. (See instructions for form 1-5 in supplemental volume II for the definition of discretionary assets.)

¹¹ Includes personal trusts.

¹² Estimated using a percentage derived from the study's data on bank management of large educational endowments. (See table VIII-148.)

¹³ Adjusted to take account of situations in which the bank neither has investment discretion nor gives investment advice. Fifteen percent and 8 percent reductions for employee benefit and personal trust and estate accounts, respectively. (See table V-7.)

¹⁴ Includes personal advisory accounts and some institutional agency accounts; includes some accounts where the bank neither has investment discretion nor gives investment advice.

¹⁵ Estimated using techniques described in appendix III of supplementary volume I: NEBR report.

¹⁶ Total employee benefit plans estimated as the sum of three components: (1) insured plans of all types (47,133), (2) noninsured State and local plans (51,000), and (3) noninsured corporate and multiemployer plans (107,529). The noninsured corporate and multiemployer plans figure is the SEC preliminary 1969 data for pension and profit-sharing plans (91,400, at market value) and an estimate for other types of employee benefit plans such as, thrift plans, vacation plans, etc. (16,129).

Note: This table supersedes that printed in text of chapter 6.

TABLE 2.—COMMON STOCK OF PORTFOLIOS CLASSIFIED BY MANAGER TYPE

(Millions, 1969 ¹)

Manager class	Portfolio type								Total
	Foundation	Educational endowment	Employee benefit plans	Insurance accounts other than pensions or mutual funds	Registered investment companies	Personal trust and estates	Personal advisory accounts	Other	
Self-administered foundation	² \$11, 620								² \$11, 620
Self-administered educational endowment		³ \$2, 570 (4, 550)							² 2, 570 (4, 550)
Self-administered employee benefit plan			³ \$13, 390 (20, 730)						³ 13, 390 (20, 730)
Property and liability insurance group	(⁴)	(⁴)	(⁴)	⁵ \$11, 720	(⁶)	(⁴)	(⁴)	(⁴)	⁵ 11, 720
Life insurance company	(⁴)	(⁴)	⁷ 4, 390	⁸ 5, 720	⁹ \$530	(⁴)	(⁴)	(⁴)	10, 640
Investment adviser ¹⁰	² 1, 070	3, 610	9, 940	1, 270	51, 610	(⁶)	¹¹ \$20, 200	\$7, 760	95, 470
	(1, 620)	(2, 600)	(200)	(200)	(47, 960)	(⁶)	(7, 650)	(2, 470)	(63, 580)
Bank	² 2, 600	¹² 1, 540	¹² 50, 370	(⁴)	(⁶)	¹³ \$81, 360	(⁶)	¹⁴ 29, 260	¹³ 165, 140
Total	¹⁵ 15, 290	¹⁵ 7, 720	¹⁶ 78, 100	1, 8, 710 (17, 650)	52, 140 (48, 480)	81, 360	20, 200 (7, 650)	37, 020 (31, 730)	310, 550 (287, 980)

¹ Year-end data except for the investment adviser category which represents June 30, 1969. All common stock is reported at market value. Details may not add to totals due to rounding.

² Estimated using percentages derived from the study's data on management of the common stock of large foundations (see table VIII-189). The self-administered category includes foundations whose principal holding is the common stock of one firm and can be considered as requiring no investment management.

³ Residual. The 2 figures represent limits for the range of common stock assets that are presumed to be self-managed. The maximum (figure in parentheses) is derived by subtracting bank-managed common stock and common stock over which investment advisers report discretionary authority from the estimate of all common stock in the category. The minimum figure is derived using all common stock of all investment advisers regardless of investment discretion.

⁴ None.

⁵ Adjusted to eliminate the common stockholdings of property and liability insurance groups in affiliated insurance companies.

⁶ Not available.

⁷ Estimated using 2,700,000 of common stock reported in separate accounts (primarily employee benefit plans) plus 1,690,000 estimated as general account common stock supporting general account pension plan assets. The general account common stock associated with pension plans is derived by applying the proportion of general account pension reserves to total general account reserves (34,400/155,050) to general account common stock (7,618).

⁸ Residual.

⁹ Estimated on the assumption that the common stock to total assets ratio of registered investment companies originating with investment advisers (0.78) holds for registered investment companies originated by life insurance companies. Approximately 6,000,000 of stock held in recently acquired management companies have been considered here as managed by investment advisers.

¹⁰ Numbers in parentheses are common stockholdings over which investment advisers report they have legal discretion. The instructions for form 1-5 in supplemental Vol. II defines legal discretion.

¹¹ Includes personal trusts.

¹² Estimated using a percentage derived from the study's data on management of the common stock of large educational endowments. (See table VIII-153.)

¹³ Adjusted to take account of situations in which the bank neither has investment discretion nor gives investment advice; 15 percent and 8 percent reductions for employee benefit and personal trust and estate accounts respectively. (See table V-7.)

¹⁴ Includes personal advisory accounts and some institutional agency accounts; includes some accounts where the bank neither has investment discretion nor gives investment advice.

¹⁵ Estimated using techniques described in app. III of Supplementary Vol. I: NBER report.

¹⁶ Total employee benefit plans estimated as the sum of three components: (1) insured plans of all types (4,390), (2) noninsured State and local plans (5,827) and (3) noninsured private plans (67,882). The noninsured private plans figure is the SEC preliminary 1969 data for corporate and multi-employee pension and profit sharing plans (\$7,670 at market value) and an estimate for other types of employee benefit plans (10,212).

Sources for tables 1 and 2:

1. Foundations: Supplemental Vol. I: NBER report app. III. Total assets data were extrapolated from table AIII-1, 5 and the common stock was extrapolated from table AIII-3, 8.
2. Educational endowments: Supplemental Vol. I: NBER report, app. III. Total asset and common stock data were extrapolated from table AIII-5, 13.
3. Employee benefit plans: Insured plans, *Institute of Life Insurance, Life Insurance Fact Book, 1970, 38*; noninsured State and local plans, Board of Governors of the Federal Reserve System, et al., "Financial Assets and Liabilities as of Dec. 31, 1969," "Flow of Funds," statistical release, May 15, 1970, 2; noninsured corporate plans, Securities and Exchange Commission, Office of Policy Research.
4. Property and liability insurance groups: A. M. Best Co., *Best's Aggregates and Averages—Property and Liability 1970, 1, 52, 152*.
5. Life insurance companies: *Institute of Life Insurance, Life Insurance Fact Book, 1970, 70, 84, 85*.
6. Investment advisers: Institutional Investor Study, ch. IV, table IV-1, Securities and Exchange Commission, 35th Annual Report of the Securities and Exchange Commission, 125.
7. Banks: Board of Governors of the Federal Reserve System, et al., *Trust Assets of Insured Commercial Banks, 1969, table 1, 5*.

Chapter IV

INVESTMENT ADVISORY COMPLEXES

1. THE INVESTMENT ADVISORY INDUSTRY

As of December 1970, the industry was composed of approximately 3,500 advisory firms which provide professional investment advice to a wide array of corporate, institutional, and individual clients. As of June 30, 1969, assets under advisement ("advisory assets") totaled \$130 billion, of which \$54 billion was held by registered open-end investment companies ("mutual funds"). For the purposes of this chapter, only those advisers with "investment advisory clients" have been considered. Advisers whose sole service consists of issuing written reports which are distributed to a large number of clients are excluded. Also specifically excluded were bank trust departments and insurance companies, which are considered in other chapters of the Study.

A. LEGAL AND REGULATORY PATTERN

With minor exceptions, the Investment Advisers Act of 1940 makes it unlawful for any investment adviser, unless registered with the Commission, to make use of the mails or any means or instrumentality of interstate commerce in connection with the adviser's business. Registration under the Investment Advisers Act is accomplished by filing with the Commission a form which contains certain information, primarily dealing with identification of management of the firm. Thereafter the registered investment adviser becomes subject to regulation governing his contracts, the maintenance and preservation of specified books and records and other regulatory provisions relating to the conduct of his business. The Investment Advisers Act prohibits fraudulent, deceptive and manipulative conduct, as well as misstatements or omissions of material facts in any registration application or report required to be filed with the Commission. There is no requirement in the Investment Advisers Act for the filing of financial statements or periodic or other reports with the Commission by investment advisers. Hence, the Commission normally has no information as to certain types of important data concerning the investment advisory industry.

Investment advisers which act exclusively for investment companies have been generally exempt from the Investment Advisers Act. However, these investment advisers became subject to the Act under amendments passed in 1970. They are also affected by the Investment Company Act of 1940.

B. SIZE AND GROWTH OF ASSETS

The study's data show that the largest single advisory category is registered open-end investment companies. At June 30, 1969, they represented \$54.7 billion of the \$130 billion total, or 42 percent of industry assets. Individual and personal trust accounts, while amounting to 82 percent of the number of accounts managed, represent only 20 percent of assets. Employee benefit plans, including State and local retirement systems, are the next major category and represent 15 percent of total industry assets.

The Study's data indicate a rapid rate of growth of assets under advisement in a sample of 120 advisory firms for the 5-year period 1964-69. For large firms,¹ the 5-year rate of growth of total advisory assets was 14 percent per year. For small firms, the growth rate was 19 percent per year. The fastest growing advisory account was that of nonregistered investment companies other than offshore funds; this category is comprised mostly of private investment partnerships ("hedge funds"). While all small advisory complexes² as a whole were growing at a yearly rate of 19 percent, nonregistered investment companies other than offshore funds advised in such complexes were growing at a rate of 153 percent per year.

C. CONCENTRATION OF ADVISORY ASSETS

Of the \$130 billion of total advisory assets, 24 percent were concentrated in five advisory firms. The largest 25 firms advised 60 percent of assets; the top 50 firms advised 76 percent. Assets of registered open-end investment companies were found to be the most highly concentrated type of account among advisory firms. The top five advisory firms advised 35 percent of these assets, the top 25 firms 76 percent, and the top 50 firms 90 percent of mutual fund assets.

D. ORGANIZATIONAL FORMS, AGE, AND AFFILIATIONS OF ADVISORY FIRMS

The predominant organizational form of investment advisers is the corporation (approximately 70 percent of all firms). The average age for all advisory firms in the Study's sample was 19 years. The average age for small nonfund advisory complexes was 16 years, which is substantially older than for small fund complexes which averaged 3.5 years old. This difference reflects the surge of entries into the mutual fund industry during the last half of the 1960's.

Fifty-nine percent of fund complexes and 24 percent of nonfund complexes in the Study's sample indicated affiliations with broker-dealers. Thirty percent of large fund complexes indicated life insurance affiliations, while 36 percent indicated affiliations with non-life-insurance companies. Interviews with large fund complexes indicated that this trend toward financial amalgamation had substantially accelerated in the latter half of the 1960's.

¹ In the statistical data in this chapter, an advisory firm was classified as "large" if it provided advice for more than \$100 million of advisory assets as of December 31, 1969. All other advisory firms were classified as "small."

² In the statistical data in this chapter, a "fund complex" is defined as an advisory firm where more than one-third of assets being advised as of September 30, 1969, were represented by assets of registered investment companies. All other advisory firms were classified as "nonfund complexes."

To measure the significance of these affiliations, the advisers were asked to indicate the percentage of their firm and the firm's designated affiliates' 1968 consolidated gross income that was derived from various sources. The two most significant sources of consolidated gross income were investment advisory services and broker-dealer functions (other than mutual fund distribution). For the total sample, the average proportion of 1968 consolidated gross income from advisory services was 54 percent as against 30 percent for broker-dealer functions. Small fund complexes received 62 percent of 1968 consolidated gross income from broker-dealer functions as opposed to 28 percent from advisory services. The remaining 10 percent of their 1968 consolidated gross income came from sources other than investment advisory services and broker-dealer functions.

2. CHARACTERISTICS OF ADVISORY ACCOUNTS

Data were obtained from 42,118 advisory accounts of 158 large and small advisory firms. Of the accounts in the sample, 320 were registered investment companies, 7,269 were institutional and corporate accounts, and 34,529 were individuals or personal trusts.

The average advisory account is 8.4 years old. The average registered investment company account is 14 years old, having been founded in 1956. Fifty-six percent of all registered investment company accounts were started in 1960 or later, with 34 percent having been started between 1967 and 1969. Ninety percent of nonregistered investment company accounts (for the most part offshore funds and hedge funds) were started between 1960 and 1969, in an accelerating pace toward the later years.

The average advisory account contained \$2.6 million as of September 30, 1969. The largest account category was that of registered investment companies, whose average account contained \$173.8 million of assets. The smallest account category was individual and personal trusts which contained, on the average, \$0.6 million of assets. Approximately 48 percent of all registered investment company accounts had in excess of \$50 million of assets; 9 percent had assets in excess of \$500 million.

The asset structure of the average advisory account at June 30, 1969, was composed of 8 percent cash and short-term debt securities, 10 percent nonconvertible debt and preferred stock, 4 percent convertible debt and preferred stock, 77 percent common stock, and 1 percent invested in other portfolios (such as mutual funds) advised by the adviser. Approximately two-thirds of all registered investment company accounts held more than 70 percent of assets in the form of common stock, and approximately 53 percent of all nonregistered investment company accounts held more than 80 percent of assets in the form of common stock.

The adviser was asked to indicate whether the investment objective for each advisory account was either: (1) maximal capital gain; (2) growth; (3) growth/income; or (4) income. The typical advisory account was reported to have a growth/income oriented investment objective. Registered investment companies tend to have more growth oriented objectives. Fifty-six percent of registered investment company accounts have either maximal capital gain or growth objectives.

Registered investment companies allow their advisers the greatest

degree of investment discretion, with 75 percent indicating the adviser had sole investment authority. Institutional and corporate accounts were typically advised on a nondiscretionary basis.

It appears that the adviser places account portfolio orders for virtually all registered investment company clients. For other types of accounts, the adviser typically places a lower percentage of such orders.

For the Study's sample as a whole, approximately 65 percent of brokerage business associated with advisory account securities transactions was designated by the clients or was beyond the control of the adviser due to the fact that he did not place orders for the purchase and sale of securities. For registered investment companies the situation is the reverse. In 65 percent of these cases, the adviser was free to allocate all of the brokerage business.

A. COMMON STOCK TURNOVER RATE

The turnover rate for the common stock portion of the typical advisory account was found to be 21 percent per year. This varies substantially by type of advisory account. Registered investment companies had an average turnover rate of 57 percent. The typical institutional and corporate account had a turnover rate of 23 percent while the average individual and personal trust account had a turnover rate of 20 percent.

Through the analytical tool of regression analysis, the Study was able to ascertain the effect of various factors on account turnover rates, while holding other factors constant. Thus it appeared that, other things being equal: (1) older accounts typically have lower turnover rates; (2) accounts with more aggressive investment objectives experience higher turnover; (3) accounts where the adviser has sole authority to make portfolio changes tend to turn over more rapidly than accounts for which the adviser has limited or no discretionary authority; (4) accounts of clients in high tax brackets have lower turnover rates; (5) accounts which are advised by advisory affiliates of firms doing a brokerage business tend to be turned over somewhat more rapidly than accounts advised by advisers not so affiliated; and (6) accounts advised in fund complexes tend to have substantially higher turnover rates.

3. COMPETITION FOR ACCOUNTS—NEW AND TERMINATED ACCOUNTS

The average annual rate at which advisory clients move their accounts is approximately 16 percent per year. Employee benefit accounts show a higher than average mobility rate. Most advisers profess to be unaware of the previous advisory relationships of their new accounts. A substantial proportion of advisory accounts whose previous adviser was identified came from bank advisers. Advisers also claim to be largely unaware of the advisory status of their terminated accounts. Of the accounts for which designation was made, the most prominent successor category is another investment advisory firm.

Large advisory firms are more likely to have minimum asset and minimum fee requirements for new accounts than small firms. The data indicate that fund complexes have higher minimum asset and

minimum fee requirements for their nonfund clients than do nonfund complexes.

Only approximately 2 percent of the respondents to the Study's questionnaire considered advertising to be very important in obtaining new accounts or additional moneys for existing accounts in 1964 and 1969. More than half said that it was so unimportant that it was never used. Direct mail promotional literature is less frequently used than advertising. Since these types of promotional methods are among the lowest cost promotional devices used by American business, the reasons for this lack of usage may be regulatory constraints.

4. ADVISORY FEES

This section presents an analysis of the advisory fees charged by advisers to their various types of clients. The advisory fee ratio was computed by dividing the 1969 advisory fee by the total account assets as of September 30, 1969, and expressing the result as a percentage. By dividing the total fees by the total assets for the account types, a dollar weighted average of fee ratios was obtained.

The average fee ratio for the total number of accounts was 0.46 percent of assets. On a dollar weighted basis the ratio is 0.28 percent of assets. The same ratios for registered investment companies were 0.45 percent and 0.39 percent of assets. The average advisory fee ratios for registered investment companies showed the strongest central grouping, with 54 percent of funds with fee ratios between 0.4 percent and 0.6 percent of assets. Individual and personal trust account fee ratios were also highly concentrated, with 43 percent of accounts with fee ratios between 0.4 percent and 0.6 percent of assets.

For 78 percent of all advisory accounts the adviser was compensated through an advisory fee which was based on a percentage of the assets under advisement. A further 17 percent of accounts compensated the adviser through either a flat fee which did not depend on annual variation in account size and/or activity, or a combination of a flat fee and a fee based on a percentage of assets. For registered investment companies, 73 percent of advisory contracts provided for a percentage of assets advised type of fee. A further 17 percent of registered investment companies had incentive fee arrangements, of which the majority were based on the performance of the fund relative to a market index.

With respect to the relationship of fee ratio to account size, it appears that economies of scale exist for all types of accounts, and that some savings are passed along to the investor via lower advisory fees for large accounts. The results show, however, that substantially greater reductions in fee ratios exist for individual and institutional and corporate accounts than for investment company accounts. It also appears that the average fee ratios for institutional and corporate accounts are higher than for individual and personal trust accounts.

The Study employed regression analysis to analyze the impact of certain explanatory factors on advisory fee ratios. The analysis indicated that, other things being equal: (1) the newer an account, the higher the fee ratio; (2) accounts with more frequent valuations involve a higher level of fee ratio; (3) an increase in the asset size of the account is associated with a decrease in the average fee ratio;

(4) more aggressive investment objectives are associated with higher advisory fee ratios; (5) nondiscretionary accounts have lower advisory fees ratios than accounts which are fully discretionary; (6) higher tax bracket clients are charged higher fee ratios; (7) accounts advised in a complex which is associated with a broker-dealer have lower advisory fee ratios than accounts not so advised; (8) accounts where the adviser places purchase and sell orders most or all of the time have higher advisory fee ratios; (9) accounts in which the client does not designate brokerage tend to pay higher fee ratios; (10) accounts managed in fund complexes tend to pay higher advisory fee ratios than accounts in nonfund complexes; (11) turnover of the common stock portion of the account's portfolio is associated with higher fee ratios for all classes of accounts except investment companies, for which the opposite effect is observed.

5. ECONOMIC STRUCTURE OF THE ADVISORY INDUSTRY

This section presents an analysis of the economic structure of the advisory industry. The topics for analysis include operating revenues, operating expenses, advisory personnel and the profitability of firms in the advisory industry. The respondent group is composed of a random sample of 64 large advisory firms and a random sample of 65 small firms.

Operating revenue is composed of the following items: (1) management fees from advisory accounts; (2) subscriptions and other revenue from publications; (3) commissions and give-ups by advisory client securities transactions; (4) net distribution revenue from principal underwriting functions of the adviser and affiliates; and (5) other revenue. The average large advisory firm had \$2.4 million of revenue in 1964 and \$3.2 million in 1968. In both years approximately 60 percent of total revenues were obtained from advisory fees, of which two-thirds resulted from registered investment companies. Eight percent of revenues resulted from publications. Brokerage commissions on advisory client transactions amounted to 5 percent of total revenue in 1964 and 12 percent in 1968.

For small advisory firms, the average revenues amounted to \$129,000 in fiscal 1964 and \$279,000 in 1968. Whereas 72 percent of revenue resulted from advisory fees in 1964, only 48 percent came from this source in 1968. Revenues from brokerage commissions increased substantially, from 14 percent of revenue in 1964 to 37 percent in 1968. Whereas two-thirds of the advisory fees of large firms resulted from registered investment companies, approximately 85 percent of advisory fees for small firms resulted from individual and personal trust accounts.

Twenty-four advisory firms reported receiving mutual fund underwriting revenues during 1968. Expressed as a percentage of mutual fund sales for these 24 firms during the year, net underwriting revenues averaged 1.09 percent of fund sales for the 24 firms.

For the 32 broker-dealer affiliated advisers who reported brokerage commissions on client transactions, the average unweighted percentage of total 1968 revenue represented by this source was 51 percent.

The total expense data for large advisory firms indicate that an average firm in the sample had \$1.7 million of expenses (before taxes)

in 1964, and \$2.4 million in 1968. The largest single expense category is employee compensation, which amounted to 68 percent of total expenses in 1964 and 61 percent in 1968. The total expense data for small advisory firms is similar. Employee compensation was the major expense, amounting to 69 percent of expenses in 1964 and 63 percent in 1968. The total expenses for an average small advisory firm was \$98,000 in 1964 and \$222,000 in 1968.

Regression analysis was used to examine the statistical relationship between total expenses and total advisory assets. The regression results indicated that, on average, a 1-percent increase in advisory assets during 1968 was associated with a 0.69-percent increase in expenses. Simultaneously, as the proportion of registered investment companies in the total advisory assets increased, expenses increased. A 1-percent increase in the proportion of registered investment companies was associated with a 0.0079-percent increase in total expenses.

An average large advisory firm had 76.9 full-time equivalent personnel in 1964 and 103.3 full-time equivalents in 1969, while an average small firm had 10.5 full-time equivalents in 1964 and 12.0 in 1969. The Study's data indicate that typically one-half of the employees (persons other than proprietors, partners or officers) are clerical employees.

A sample of 60 advisers for 1964 had total advisory assets of \$15.4 billion, total revenues of \$97.2 million and total expenses of \$59.7 million. The profit before Federal taxes for these firms was \$37.5 million, which was 0.23 percent of total 1964 advisory assets, and 39 percent of 1964 revenues. The profit ratios increased with the size of the investment firm. Advisers with less than \$100 million of advisory assets earned 0.148 percent of such assets; advisers with more than \$750 million of advisory assets earned 0.281 percent.

In 1968 there were 90 advisers in the sample. These firms accounted for \$40.7 billion of advisory assets, \$170.3 million of revenues, \$114.6 million of expenses and \$55.6 million of profits. The profit figure represented 0.137 percent of advisory assets or 33 percent of total advisory revenues.

For 27 advisers in 1964 and 38 advisers in 1968 with separate investment company expense data, the profit ratios were 0.36 percent of investment company assets in 1964 and 0.21 percent in 1968. These figures are based on \$9.3 billion of assets in 1964 and \$17.6 billion in 1968. These advisers also advised \$4.3 billion of other accounts in 1964 and \$10.7 billion in 1968. The profit ratios for those other advisory assets were 0.04 percent in 1964 and 0.11 percent in 1968. During each of the years the results for investment companies indicated a trend toward higher profit ratios for larger advisory complexes. This trend did not exist for other accounts advised in these complexes.

6. PERFORMANCE FEES

The use of performance fees to reward investment company advisers is now commonplace. This is a relatively recent development. Performance fees have been criticized on the grounds that they are a one-way street to higher fees, that they encourage speculation, and that they create severe conflict-of-interest problems within an advisory complex. On the other hand, performance fees have been defended on

the grounds that they allow sophisticated clients additional degrees of freedom in negotiating fee arrangements with advisers, permit superior advisers to obtain additional compensation, and permit profitable operation of smaller economic units which do not have access to large efficient sales organizations.

Performance fee arrangements typically fall into two general categories: (1) fee basis related to the performance of a market index; or (2) a fee based solely on the performance of the fund itself without reference to the performance of any index. In the latter case the advisory fee is typically based on a percentage of the net unrealized capital gains, or net realized capital gains, or dividend and interest income. As of June 30, 1969, at least 137 investment companies had performance fee arrangements in effect or proposed. Six were closed-end companies. Of the remaining 131 funds, the fees of 120 were related to the performance of market indexes. Funds are continuing to use performance-based incentive fee arrangements and the same indexes as performance standards.

The Investment Company Amendments Act of 1970,³ Public Law No. 91-547 (December 14, 1970), reflects Commission recommendations concerning performance fees growing out of numerous studies conducted by and for the Commission. The Amendments Act amends the Investment Advisers Act to require registration of investment advisers whose only clients are investment companies, and it prohibits registered advisers from charging performance fees to investment companies unless such fees increase and decrease proportionately in relation to an appropriate index of securities prices or other measure of performance as the Commission may specify. It also permits a registered investment adviser to charge any other person a performance fee, but only under specified conditions. These provisions will become effective on December 14, 1971.

Existing incentive fee arrangements provide an incentive to the adviser to invest his client's funds in securities having high volatility, even though such action may not be consistent with the investment objectives of the account. The absence of disclosure by an adviser to his clients about the volatility of portfolios under management aggravates this problem. This section suggests a possible method for measuring investment volatility and performance which would both provide a basis for such disclosure and, in addition, reduce incentives on the part of an adviser to expose his client's funds to excessive risk. The method requires as an initial step the construction of a standard portfolio having the same volatility as that displayed on the average by the fund for the period being evaluated. The fund manager would be entitled to a performance fee only if the average gross yield produced under his management, net of all expenses, exceeded the rate of return displayed by the unmanaged standard portfolio having equal volatility. Rates of return on fund shares and the comparison portfolio would be computed in identical fashion and include all distributions made on both portfolios. The incentive fee would increase and decrease proportionately for superior or inferior performance relative to the standard portfolio.³ Relatively

³ Where the possibility of negative fees exists, special considerations concerning reserves and refunding are applicable.

small or random changes in return should not trigger large, discreet changes in fee ratios. The interval of time over which performance is measured should be sufficiently long to insure that accurate measures of fund volatility and adviser performance can be obtained.

While this suggested method focuses on incentive fee arrangements between advisers and their clients, another area involves procedures used by advisers to compensate portfolio managers. If portfolio managers are compensated on an incentive basis, the considerations discussed above would be equally applicable to these arrangements.

7. ORGANIZATION OF ADVISORY FIRMS FOR INVESTMENT DECISION-MAKING

For small fund complexes the management of the advisory firm is, in effect, the portfolio manager. For large fund complexes the decision-making tends to be more decentralized. An investment committee of the senior management of the firm typically generates either an approved list of securities or general policy with respect to investment decisionmaking. The portfolio managers then, with authority ranging from complete to limited, implement policies for their mutual funds and other clients. For nonfund complexes similar differences exist between large and small firms.

Fund complexes tend, on the average, to have more than twice the number of securities analysts than nonfund complexes, but only about one-half the number of people involved in economic research. On the average, nonfund complexes tend to have 7.4 portfolio managers per firm, while fund complexes, with substantially fewer accounts, tend to have 5.8 portfolio managers per firm.

In both large fund and large nonfund complexes, portfolio managers tend to spend about 75 percent of their time in investment decisionmaking and related supervision of portfolios. The percentages are smaller for small fund and small nonfund complexes where, as might be expected, portfolio managers have a broader range of other duties. The typical analyst spends about 24 percent of his time in contact with portfolio companies. This percentage is somewhat higher for fund complexes than for nonfund complexes, 34 percent as against 20 percent.

In the case of account managers, fund complexes tend to have a higher proportion of analysts with law or advanced business degrees (51 percent) than nonfund complexes (39 percent). The same differences appear to exist for investment research analysts, where 74 percent of fund complex analysts had law or advanced degrees in business as compared to 47 percent for nonfund complex analysts.

With respect to security evaluation procedures, the fundamental approach (where emphasis is on analysis and projections of corporate earnings) is typically the most important to the average advisory firm, from complete to limited, implement policies for their mutual funds with 77 percent of the total Study sample indicating that this approach was very important and always used. Technical approaches (which rely particularly on market action as the essential factor) appear only of moderate interest with 63 percent of the total sample responding that this approach was either somewhat important but not used frequently, or not important and used only rarely.

The most important source of external information to the securities research process appears to be the financial statements of issuers

which, for all sizes and types of firms in the Study's sample, receive the highest importance ranking. Direct contact with security issuers ranks next, followed by information received from other research organizations and then information purchased from broker-dealers via commission dollars. Information purchased from other investment advisers on a contractual basis appeared to be relatively unimportant for most firms.

Seventy-eight percent of fund complexes and 62 percent of non-fund complexes own or rent an electronic computer either on an in-house or service bureau basis. Large firms tend to be more likely to use computers than small firms, 88 percent as against 47 percent. The most common function for which the computer was utilized was account administration, with 50 percent of the responding firms indicating this use. This was followed by general administration duties, with 39 percent.

8. MANAGEMENT OF SPECULATIVE FUNDS

This section provides a description of the ways in which aggressive capital gain oriented funds are managed, and examines differences in the portfolio behavior of two groups of such funds: (1) registered open end funds which indicated they could engage in certain speculative investment techniques ("registered speculative funds") and (2) unregistered private investment partnerships ("hedge funds"). Unless otherwise indicated, the data are as of December 31, 1968. On that date, the 43 registered speculative funds surveyed had total assets of approximately \$1.7 billion and were 7 percent of the 603 active open end funds registered. The 140 hedge funds surveyed had total assets of \$1.3 billion.

The registered speculative funds were smaller and more recently registered than the average mutual fund. The average size registered speculative fund was \$39 million and the median size was \$13.6 million, while the average size mutual fund was \$96 million at December 31, 1968. The average size hedge fund was \$9 million and the median size hedge fund was \$2.7 million at December 31, 1968. The average age of the mutual funds which reported to the Study was 14 years old as of September 30, 1969. More than half of the registered speculative funds, 24, were registered in the years 1966-68, and 116 of the 140 hedge funds were formed in the years 1966-68 (78 in 1968 alone).

The hedge funds had fewer participants (none had as many as 100) but they were generally persons of greater means than the shareholders of the registered speculative funds. The median number of shareholder accounts for the registered speculative funds was 3,250 and the average account size was \$3,787. The average account size for members of the Investment Company Institute ("ICI") was \$5,800 as of December 31, 1968.⁴

The 35 registered speculative funds in operation throughout 1968 enjoyed a huge net capital inflow during the year, 105 percent of their beginning of the year net assets. For all members of the ICI net capital inflow was just over 5 percent of beginning of the year net assets. For

⁴ Mutual Fund Fact Book, 1969 (ICI). At year-end 1968, the ICI represented 240 open end investment companies, with total assets of almost \$52.7 billion, or about 90 percent of the total assets of all open end investment companies on that date. Throughout this section, data published by the ICI for all 240 members in the 1969 Mutual Fund Fact Book will be referred to.

the hedge funds during 1968 net capital inflow was 9 percent of the beginning year assets of those hedge funds which were in operation throughout the year. Total hedge fund assets grew very quickly from \$333 million at yearend 1966 for the 35 hedge funds organized in 1966 or earlier to \$1.3 billion for 140 hedge funds at yearend 1968.

The largest portion of the assets of members of the ICI (84 percent) of the registered speculative funds (74 percent) and of the hedge funds (61 percent) were invested in common stocks as of December 31, 1968. Cash and cash items accounted for 6 percent of the total assets of ICI members, 9 percent of the registered speculative funds, and 10 percent of the hedge funds' total assets.

The relative total liabilities of the hedge funds (which are equal to 32 percent of total hedge funds assets) were about three times greater than the relative total liabilities of the registered speculative funds (11 percent of registered speculative funds total assets). Hedge fund borrowings were equal to 15 percent of their total assets, while borrowings were only 2 percent of the total assets of the registered speculative funds. Short positions accounted for 12 percent of the yearend total assets of hedge funds, but only 0.8 percent of the registered speculative funds' total assets. The ratios of short sales to total sales of the hedge funds were 10 times as high as those of the registered speculative funds during the first two quarters of 1968.

New York Stock Exchange listed common stocks were the largest stockholdings of the hedge funds (47 percent)⁵ and the registered speculative funds (49 percent), while NYSE listed stocks accounted for 92 percent of the common stock holdings of registered investment companies represented in Table IX-14, as of September 30, 1969.⁶

Over-the-counter stocks were the second largest of the common stockholdings of the registered speculative funds (29 percent) and of the hedge funds (26 percent). The registered speculative funds had 20 percent of their portfolios in American Stock Exchange listed stocks and the hedge funds had 25 percent as of December 31, 1968. In contrast, OTC common stocks accounted for 6 percent of the common stock portfolios of a sampling of 37 ICI members for the latter portion of 1970. The AMEX listed stocks accounted for 6 percent of the portfolios of registered investment companies as of September 30, 1969, as indicated in Table IX-14.

For 1968, the annual turnover rate of the hedge funds was 317 percent, compared with 143 percent for the registered speculative funds and 45 percent for all members of the ICI.

For fiscal years ending during 1968, the registered speculative funds had significantly higher expense ratios and advisory fees than did all members of the ICI. The expense ratios of 34 of the registered speculative funds for 1968 were 1.16 percent of their 1968 average net assets on a dollar weighted basis. Their 1968 advisory fees were 0.70 percent of their average net assets on this basis. In contrast, the ICI claimed expense ratios of 0.46 percent of average net assets and advisory fees of 0.35 percent on a weighted basis in 1968 for a sample group representing 90 percent of the assets of its members. The higher

⁵ Throughout this section the 28 largest hedge funds, with assets accounting for 82 percent of the assets of hedge funds surveyed, will be referred to. However, information on market listing was available for only 27 of the largest hedge funds.

⁶ Table IX-14 also indicates that 96 percent of the common stock portfolios of all institutions were invested in NYSE listed stocks.

expense and advisory fee ratios of the registered speculative funds may be explained to a great degree by the higher percentage of performance fees among the registered speculative funds.

By September 30, 1970, the total assets of the 28 hedge funds which were largest at December 31, 1968, were almost 70 percent less than at yearend 1968, and at least five of the 28, including the one which was previously the largest, had either been dissolved or were in the process of liquidating. The net assets of the registered speculative funds were 40 percent less on June 30, 1970, than they were as of yearend 1968.

9. SIZE, GROWTH, AND PERFORMANCE OF REGISTERED INVESTMENT COMPANIES

In this section the investment performance of a group of open end registered investment companies is examined. For each fund being evaluated, a standard portfolio having the same average market volatility is constructed for purposes of comparison, as described in section F. The difference between the rate of return realized by the fund and the rate of return realized by the standard portfolio is the basic measure of performance used in this section. Another important measure computed for each fund is the degree of diversification, defined as a percentage of variation in monthly rates of return for the fund which can be accounted for by movements in the market itself, in this case by rates of return on the Standard & Poor's 500 stock index.

The sample of mutual funds examined consists of 236 companies, of which 125 had complete investment return data over the 10-year evaluation period. As of June 1965, the total net assets of these 236 funds was \$36 billion, which represented approximately 90 percent of industry assets at that time.

Performance measures for the 10-year period 1960-69 indicate that the funds, on the average, outperformed the volatility adjusted performance standards. In a typical month during the 10-year evaluation period, the average fund had total returns 0.05 percent greater than returns on standard portfolios of equivalent volatility. During the first 5-year period the funds as a group had lower average returns than the standard portfolios. The situation is reversed during the 1965-69 period, during which the funds tended, on average, to outperform the standard portfolios. During the 1960-64 period, low volatility funds consistently outperformed standard unmanaged portfolios having equal volatilities, while higher volatility funds did not. During the period 1965-69, the reverse was true, with higher volatility funds outperforming the standard portfolios.

Diversification measures indicate that approximately 60 percent of the variation in monthly fund returns can be explained by movements in the market index (as opposed to 100 percent, by definition, for the performance standard).

The Study also examined the question of whether a significant portion of differences in risk-adjusted, market-related fund performance statistics can be explained by systematic differences in one or more of nine specified variables.⁷ In preparing the data for regression

⁷ The variable are: (1) volatility adjusted performance; (2) fund turnover; (3) total net asset value of the fund; (4) total advisory complex assets; (5) monthly cash or noncash inflows to the fund; (6) net sales of fund shares; (7) volatility of the fund relative to a market index; (8) performance fee; and (9) sales load.

analysis, two approaches were used. The first approach was to treat each fund-month observation as an independent observation. The second approach was to average the data for each fund before conducting the analysis.

In general, the analysis showed that even jointly the variables had little ability to explain variations in fund performance. Virtually none of the variations was explained in the fund-month case, while 10 percent was explained in the fund-average regression. Nevertheless, some observations can be made.

Both performance-averaging methods indicated a significantly negative relationship between portfolio turnover and performance. The data indicate that, on the average, a 10 percentage point increase in turnover rate would have reduced fund performance in the fund-average case by approximately 0.05 percent per month and by approximately 0.02 percent in the fund-month analysis. The second observation is the lack of a significant relationship between either fund size or advisory complex size and fund performance. The remaining variables appear to have little influence on fund performance. Thus, the results suggest that funds having performance fees do not perform significantly differently from funds without such fees. Also, the results suggest that there is no appreciable difference between the performance of funds which charge sales loads and those which do not.

Mutual fund turnover statistics are next examined. It is possible here to account for a substantial portion of variations in turnover as a function of the variables used in the analysis. Approximately 40 percent of the variation in fund turnover can be explained by the variables, primarily by performance, fund sales and volatility. Fund size and complex size both are significantly and negatively related to portfolio turnover. The relationship between turnover and mutual fund sales is positive and statistically significant in all equations. The data indicate that a one percentage point increase in fund sales as a percentage of net assets is, on average, associated with a 3.5 percentage point increase in fund turnover.

10. PREFERENTIAL TREATMENT IN THE MANAGEMENT OF DIFFERENT TYPES OF ACCOUNTS—THE PROBLEM OF CONFLICTS OF INTEREST

This section discusses the stated policies of 106 investment advisers regarding allocation of purchases and sales of a particular security between accounts and regarding allocation of securities which may be unusually attractive investments at the time. The section also examines statistically the relationship between the allocation of certain new issues and the turnover rates and investment objectives of the different accounts managed by a sample of 32 advisory firms.

The 106 advisers answered a request by the Study to describe "any policy of the Investment Adviser governing the allocation of purchase or sale transactions among various client accounts where an acquisition or disposal program requires a period of days or weeks to complete; for example, in a purchase program, how is it determined which accounts will receive which day's purchases and at what price?"

Thirty-four advisers stated that they had no allocation policy. Of the remaining 72 respondents, 27 prorated the amounts actually purchased or sold during a particular period on the basis of the relative

size of the purchase or sale requests of their clients or portfolio managers or on the basis of commitments of each account. Ten advisers rotated accounts either alphabetically, by branch office, or randomly in an effort to achieve long-term equitable treatment. Twenty-four advisers, most of whom stated they intended to give fair treatment, provided no basis for such allocations.

Eleven advisers indicated that their policy was to give priority or preferential treatment to particular types of accounts. Nine of these said they gave priority in executing orders to discretionary accounts, and the other two gave preferential treatment to registered investment companies.

The same 106 investment advisers also replied to a request by the Study to "describe any policy followed by the Investment Adviser governing the allocation of limited quantities of economically attractive securities among various clients with similar investment objectives; for example, new stock issues. (A 'new stock issue' is defined as an initial offering of the stock of a company which previously had no publicly traded stock.)"

Sixty-one of the 106 respondents stated that they had no allocation policy in this area. The explanation given overwhelmingly was that these particular advisers did not purchase new or limited quantity stock issues. The remainder of the advisers responding indicated that they did have a policy with respect to the allocation of limited quantities of economically attractive securities. Eighteen said that they allocated such securities proportionately, either according to the size of the order placed or the assets of the account. Eight stated they allocated new issues and limited quantities of stock on some form of rotational basis between their accounts. Six advisers indicated that they divided new issues or limited quantities of securities equally among the accounts for which such purchases were appropriate. Seven advisers stated that they had adopted preferential policies concerning allocations of limited quantities of economically attractive securities. A few of these favored clients on a first come, first served basis, while others acknowledged a tendency to favor accounts which performed relatively poorly in the past, or accounts which were smaller. Finally, six advisers stated without explanation that they simply had a policy of allocating "on a fair and equitable basis."

The new issue data collected by the Study on the allocation of 84 new issues among 32 advisory firms was used to examine the relationship between new issue allocations and the size, turnover rates, and investment objectives of the accounts in these firms. The 32 advisers included in this analysis obtained approximately 80 percent of the total market value of the 84 new issues received by all investment advisers.

The average ratio of new issues to common stockholdings is 0.35 percent for registered investment companies; 0.23 percent for individuals and personal trusts; 1.41 percent for nonregistered investment companies; and 0.77 percent for the adviser's own portfolio.⁸

When common stockholdings are replaced by a measure of common stock turnover,⁹ the data show that registered investment companies

⁸ All figures for "adviser's own portfolio" result from only two of eight advisory firms with "own portfolio" transactions.

⁹ Common stock turnover is defined as the common stockholding as of June 30, 1969, multiplied by the average turnover rate for accounts of that type within each advisory firm.

received 0.58 percent of activity; individual and personal trust accounts 0.96 percent; nonregistered investment companies 0.46 percent; and adviser's own portfolios 12.26 percent.

The question of preferential treatment also requires consideration of account investment objectives. For some classes of accounts the investment objective may well be such that the adviser would consider allocation of relatively speculative new issues to these accounts as inappropriate. Thus, in making comparisons among allocations to various account categories, an attempt is made to adjust for differences in investment objectives.

The Study's data show that on the basis of both holdings and turnover, individuals and personal trusts, nonregistered investment companies, and the adviser's own portfolio received substantially more than their proportionate share of new issues. Nonregistered investment companies and the adviser's own portfolio had, on the average, the most aggressive investment objectives while individuals and personal trusts had investment objectives that were close to the group average.

Registered investment companies, which received 81 percent of the new issues, held 74 percent of the common stock and had 87 percent of the common stock turnover, and thus appeared to receive their proportionate share of new issues. However, the investment objectives of registered investment companies were more aggressive than those for individuals and personal trusts, which appeared to receive more than their proportionate share of new issues.

These results should be considered tentative in light of the limitations in the data used for the analysis. Moreover, interpretation of the data is complicated by the existence of two types of potential new issue allocation favoritism. One results from preferential treatment of particular types of advisory firms (such as hedge funds) by new issue underwriters. The second would result from favoritism in the allocation of new issues obtained by an advisory complex to accounts within the complex. Additional analysis would be required to separate these two factors.

Chapter V

BANK TRUST DEPARTMENTS

At the end of 1969, trust departments of commercial banks located in the United States administered \$280 billion in assets, of which \$180 billion was common stock. This common stock exceeded the sum of the common stock administered by investment advisers, insurance companies, self-administered employee benefit plans, foundations, and educational endowments.

At the same time, the 50 trust departments from which the Study collected data administered \$195 billion of assets, including \$131 billion of common stock. The 50 trust departments were the largest at the end of 1967, measured by assets administered.

1. TYPES OF ACCOUNTS AND ASSETS ADMINISTERED

Bank trust departments offer various services involving furnishing of investment advice and making investment decisions:

(a) The bank may serve as trustee, having legal title to the trust assets but with fiduciary obligations to act for the benefit of the beneficiaries in administering the trust. Typically, the beneficiaries having an interest in the income of a trust are not the same persons who have an interest in the trust's principal. Especially when banks have the responsibility to determine the amounts of income or principal (or both) to be paid to beneficiaries, banks furnish a service not customarily offered by other investment managers.

(b) The bank may serve as an agent for its customers. Unlike a trust, an agency relationship cannot be used to provide for the disposition of the customer's property after his death, since the agency relationship terminates on the death of the bank's customer. The sole service rendered for the agency accounts is giving investment advice or making investment decisions. The agency relationship usually can be terminated by the customer at any time, while the instruments governing trusts are sometimes irrevocable and sometimes do not provide for removal of the trustee.¹

(c) Banks also administer employee benefit accounts. The assets in these accounts are contributed by employers or employees (or both), for the benefit of the employees, pursuant to retirement or other employee benefit plans. A bank may act as trustee or agent in connection with these plans.²

¹ A distinction is sometimes made between accounts where a bank acts as agent for an individual (personal agency accounts) and accounts for other customers (institutional and corporate accounts). These latter customers include business corporations, foundations, educational endowments, hospitals, museums, churches, and others.

² In general, the Study does not relate to accounts where the bank does not render investment advice or make investment decisions, such as custodian, safekeeping, and escrow accounts. Nor does the Study deal with accounts where the bank acts as registrar, transfer agent, or in a similar capacity.

Of the \$195 billion of assets administered by the 50 bank trust departments, employee benefit accounts represent 41 percent; personal trust and estate accounts 40 percent; and agency accounts 19 percent. From the end of 1964 to the end of 1969, assets administered grew by approximately 50 percent. For the same period, trust department direct revenues also increased by approximately 50 percent. Employee benefit account revenues increased by 94 percent during this 5-year period; agency account revenues, 46 percent; and trust and estate account revenues, 43 percent.

The largest number of personal trust and estate accounts and the largest number of agency accounts are in the \$50,000 to \$500,000 range. Excluding the small employee benefit accounts (which are primarily H.R. 10 accounts), the greatest concentration of employee benefit accounts is between \$500,000 and \$5 million.

The banks were asked to state with respect to certain of their trust department accounts whether (a) the bank had sole investment authority; (b) the bank had to consult with other parties prior to the execution of a trade; or (c) the bank had no investment authority. The trust departments have sole investment authority over approximately 80 percent of employee benefit account assets, over less than 30 percent of assets in personal trust accounts, and over less than 10 percent of the assets in agency accounts. About 60 percent of personal trust assets and 70 percent of agency assets are in accounts in which the bank gives advice and must consult others before a transaction. It is not clear how different in actual management these are from accounts in which banks have sole investment authority. Estimates by trust officers on the frequency with which customers agree with advice given have ranged from 60 to 99 percent.

Approximately 25 percent of the total brokerage of the trust departments is paid to brokers designated by the banks' customers.

The trust departments have no voting authority, either sole or in conjunction with others, in connection with approximately 50 percent of the value of the common stock in personal agency accounts, and in connection with approximately 65 percent of the value of the common stock in the institutional and corporate agency accounts. The trust departments have sole voting authority over stock constituting approximately 75 percent of the value of the common stock held in employee benefit accounts, and have sole voting authority over approximately 55 percent of such stock in personal trust and estate accounts. The \$72 billion of common stock over which the 50 banks are estimated to have sole voting authority is 55 percent of the market value of the common stock administered by the 50 trust departments.

2. LEGAL, REGULATORY, AND TAX ENVIRONMENT

In making investment decision, trust department personnel may have to consider a number of constraints.

The statutes of some States include legal lists of permissible categories of investments for trustees. In general, legal list statutes do not apply when a bank is acting as agent, rather than trustee. Nor do the legal list restrictions apply where the instrument creating the fiduciary relationship specifies that the fiduciary shall be free to purchase securities not included in the legal list. The 50 banks are rarely restricted by legal lists.

Frequently the prudent man rule, which is embodied by statute in many States, must be considered by bank personnel when making investment decisions. Under this rule, a trustee is under a duty to make such investments as a prudent man would make of his own property having primarily in view the preservation of the estate and the amount and regularity of the income to be derived. While it is common to specify in a trust agreement or will that a fiduciary is not subject to a legal list, instruments rarely modify the prudent man rule.

There are a number of other legal and regulatory matters which affect bank trust departments. A trustee may be required by the applicable State law to send periodic reports to the beneficiaries of the trust. Regulations of the Comptroller of the Currency impose certain requirements on a national bank that the Comptroller has authorized to act in a fiduciary capacity. Such requirements concern, among other things, periodic review of account assets, bonding of officers in the trust department, and self-dealing with fiduciary accounts. Bank regulatory agencies examine trust departments periodically to determine whether there are any investments not permitted by the governing instruments.

The Federal income and estate tax laws provide tax incentives to create irrevocable rather than revocable trusts. In a random selection of personal trust accounts, the Study found that more than 70 percent of the trusts were irrevocable, because the settler had died or had chosen to make the trust irrevocable during his life. Bank trust departments benefit from the tax incentives to create irrevocable trusts, since such accounts are less likely to move to competing investment managers than revocable trusts. Even where the trustee of an irrevocable trust may be removed, the expenses involved in court proceedings, when required, may discourage the removal.

Bank trust departments also are subject to regulation concerning the pooling of investments. Although common trust and pooled employee benefit funds account for only 6 percent of the total trust department assets in the 50 banks, a substantial portion of the assets in small accounts is invested in such accounts.³ Trust departments frequently reduce fees if the customer agrees to participate in a collective investment fund. The regulations of the Comptroller of the Currency relating to collective investment funds require, among other things, that the funds be valued at least every three months and that participations may begin and terminate only as of such a valuation date. The legal status of common trust funds and pooled employee benefit funds is relatively settled, but litigation is currently pending before the Supreme Court to determine the permissibility of commingling agency accounts over which a bank has sole investment authority. Where a bank offered the public a service under which it invested participants' assets in virtually identical securities, pursuant to sole investment authority, the Commission concluded that registration was required under the Investment Company Act of 1940 and the Securities Act of 1933.

³ More than 50 percent of the assets in employee benefit accounts with assets under \$500,000 are invested in pooled employee benefit funds and over 30 percent of the assets in personal trust accounts with assets under \$100,000 are invested in common trust funds.

3. COMPETITION AND CONCENTRATION OF ASSETS

Banks compete not only among themselves but also with other money managers. Data in chapters IV, VI, and VIII indicate the extent to which investment advisers and insurance companies compete with bank trust departments for the administration of employee benefit accounts, and the extent to which investment advisers compete with trust departments for agency accounts. Banks have few corporate competitors, however, for trust and estate accounts. While some settlors choose noncorporate fiduciaries, such as attorneys, relatives, or personal friends, banks and trust companies administered 61 percent of all personal trusts submitting tax returns for the year 1962.

The largest 10 trust departments administered 37 percent of total trust department assets during 1969; the 20 largest, 51 percent; and the 50 largest, 70 percent. The 10 trust departments administering the most employee benefit account assets administered 58 percent of the industry's total for 1969 in that category, the 10 administering the most agency account assets administered 39 percent of the industry's total in that category, and the 10 administering the most personal trust and estate account assets administered 23 percent of the industry's total in that category. Concentration does not appear to have increased over the past five years. Both in terms of trust department revenues and assets administered, the 20 largest trust departments as a whole grew at virtually the same rate as the next 30.

4. OPERATIONAL FACTORS

Costs of clerical and mechanical operations, such as recording transactions, collecting and disbursing dividends and delivering and receiving securities, appear to be significant in trust department operations. These purely custodial functions account for approximately 60 percent of the expenses relating to employee benefit, agency and personal trust accounts. Research does not appear to be a large expense item to trust departments; research personnel account for less than 20 percent of total personnel expenses of the 50 trust departments studied.

There are in the 50 banks, on the average, 85 accounts per member of the professional staff (defined as all officers and employees serving trust department accounts who earn \$10,000 or more per year).

A. ACCOUNT TURNOVER AND ACTIVITY RATES

In the Study's analysis of account turnover and activity rates, the sharp increase in turnover that began in 1966 and accelerated in 1967 was apparent in all account types. In the five-year period ending in 1969, employee benefit accounts had a turnover rate more than three times that of personal accounts. Forty-four percent of personal trust and 30 percent of personal agency accounts in the Study's sample had no turnover at all during 1969. Furthermore, in that year, 8 percent of personal trust and 14 percent of personal agency accounts had turnover that was greater than zero but less than 1 percent. It appears that more than 60 percent of trust department trading in equities originates in employee benefit accounts.

B. PERFORMANCE

The Study analyzed the performance of a sample of 27 pooled employee benefit funds and 21 common trust funds managed by 41 of the 50 banks for a recent three-year period.⁴ The performance measure is based on the fund's rate of return compared to the rate of return that would be obtained from a hypothetical unmanaged portfolio having the same market volatility during the same period.⁵ During the period covered the funds with higher volatility achieved better performance. The funds tended to be relatively concentrated in the lower volatility ranges.

5. THE ASSOCIATION WITH COMMERCIAL BANKING⁶

The Study analyzed a unique characteristic of trust departments that distinguishes them from other investment managers—the combining in one corporation of trust and commercial operations.

There are several reasons why a bank's trust department may draw a portion of its customers from those who have commercial dealings with the bank.⁷

The Study's analysis showed that employee benefit accounts are the account type which is most closely associated with aggregate demand deposits in the bank. In addition, large demand deposits are more closely correlated with trust department assets than are demand deposits as a whole.

Analyzing factors affecting broker-dealers' deposits in banks, the Study developed the working hypothesis that 43 percent of brokers' deposits is attributable to the brokerage not designated by customers generated by trust departments. An increasing of \$1 in commissions paid by a trust department and received by a broker was estimated to be accompanied, on the average, by an increase of \$4.26 in the broker's deposits in the bank. The relationship found between commissions paid and brokers' deposits does not disclose who initiates the arrangement. A broker's deposits in a bank could precede commissions received or vice versa; all that can be observed in the data is that there was a statistically significant relationship.⁸

Among the securities that a bank trust department can choose to hold are stocks in companies with which the bank has commercial banking relationships. It appears that increased demand deposits by a company at a bank were, to a statistically significant degree, associated with larger holdings of the company's stock by the bank's trust department. On the other hand, loans by a bank's commercial department to a company, measured in absolute terms, did not appear to have a significant relationship to the trust department's holdings, after other factors, including demand deposits, are controlled for.⁹

⁴ The banks submitted the last three annual reports for each of the sampled accounts. The end of the last fiscal year reported varied from October 1968 through the end of 1969.

⁵ See sections F and I of chapter IV.

⁶ New York banking authorities, unlike those of some other States, refuse to charter corporations to act solely as trust companies (without a commercial banking department).

⁷ Customers may choose to transact various financial matters with the same organization because of physical convenience and because the bank may already be well acquainted with their circumstances. The bank may know who among its commercial customers are good prospects for trust department services and it may therefore have a marketing advantage with them over other types of financial managers. In addition, banks may wish to retain or improve their goodwill with commercial customers by offering investment management services to them on advantageous terms.

⁸ See also ch. XIII C.7.b.

⁹ Differences between these and similar analyses reported in ch. XV. D are discussed in the chapter.

6. COMPENSATION AND FEE RATIOS

Legal restrictions affect the compensation received by trustees. In some states a general test of reasonableness is used, while in other states statutes include specific formulas concerning trustees' compensation. In some jurisdictions the formula does not apply, however, if the governing instrument specifies other compensation.

On an aggregate basis, management and trustee fees as a percentage of assets administered by the 50 trust departments averaged 0.21 percent in 1969. The average fee rate for employee benefit accounts was 0.10 percent,¹⁰ for agency accounts 0.20 percent, and for personal trust and estate accounts 0.35 percent.¹¹

The Study analyzed the relationship between fees and the following account characteristics: (*a*) total assets in the account; (*b*) the number of stocks in the portfolio; (*c*) investment authority; (*d*) designation of brokerage; and (*e*) turnover of the equity portfolio. The analysis indicates that fee rates decrease as account assets increase; that fee rates increase as the number of stocks in the portfolio increases, holding total assets constant; that complete investment discretion appears to have the effect of increasing the fee rate; and that designation of brokerage and turnover do not have a significant effect on fee rates.

Banks receive payment for their trust and management services directly from fees charged the accounts, and indirectly from trust department accounts which have deposits in the banks' commercial departments, from the float on account transactions, and from that part of brokers' deposits in the banks which are attributable to the commissions generated by trust department accounts. Indirect revenues resulting from brokers' deposits associated with brokerage commissions paid by the trust departments were estimated to be approximately 11 percent of direct revenues received in 1969. Indirect revenues from the float and from deposits of trust department accounts for 1969 were estimated to be approximately 30 percent of direct revenues received. Expressed as a percentage of assets administered these figures are equivalent to 0.02 percent and 0.06 percent, respectively. Adding the average direct compensation and the estimates of indirect compensation gives an estimated total compensation of 0.29 percent.

The value of the cash held in custodial accounts represents a much larger percentage of direct fees, compared to other accounts. In 1969 the value of such cash amounted to 126 percent of direct fees paid by custodial accounts. It appears that customers, including investment advisers and their clients, may benefit from the cash in their custodial accounts in negotiating the fees paid for custodial services.

¹⁰ These accounts have a relatively large average size.

¹¹ These accounts sometimes involve services besides giving investment advice and making investment decisions.