STATEMENT OF THE NEW YORK STOCK EXCHANGE, INC.
BEFORE THE FINANCIAL MARKETS SUBCOMMITTEE
OF THE SENATE FINANCE COMMITTEE
ON S.2842 -- THE STOCKHOLDERS INVESTMENT ACT
FEBRUARY 6, 1974

My name is James J. Needham. I am Chairman of the Board of Directors and Chief Executive Officer of the New York Stock Exchange, Inc. With me today are Donald L. Calvin, Vice President, and Dr. William C. Freund, Vice President and Chief Economist of the Exchange.

Since we have already filed a detailed statement for the record, I will limit my comments to a brief summary of that statement in order to have time to respond to your questions.

In brief, our comments deal with three areas --

- the limitations imposed in the Bill on stock holdings of pension funds;
- the proposed revisions in the capital gains tax; and
- a new proposal directed at permitting broker-dealers to improve their ability to serve investors through the adoption of tax stabilization reserves, comparable to those presently available to other financial intermediaries.

All of these proposals have a common objective -- and that is, to strengthen and improve individual investor confidence in our securities markets.

This Subcommittee -- and especially its Chairman -- was one of the first to recognize the necessity for Congressional action to broaden individual investor participation in our securities markets. This can only be done if investors have confidence in our system.

Only through imaginative and constructive action -- such as proposed in S.2842 -- can the demands on the U.S. corporate securities markets, and the Nation's capital markets in general, be met.

As you know, we are facing unprecedented demands for capital to finance industrial modernization and expansion, to meet the housing requirements of our growing population, to clean the environment and to supply the energy we need.

Of special concern in properly allocating the necessarily limited supply of capital to all those diverse needs, is the distorting effects of government borrowing on the capital markets. The Federal, state and local share of all debt and equity securities issued has edged past the sixty per-cent mark -- with the Federal government and its agencies by far the Nation's biggest borrowers. Moreover, they enjoy special privileges which are not available to private corporations and individuals. If for no other reason than to keep our capital markets from being overwhelmed by Federal demands, return to a more responsible balanced government fiscal policy is essential.

Testimony before this Subcommittee last July made clear the growing concern of individual investors about institutional dominance of our securities markets. S.2842 focuses on this concern and proposes restrictions on the stock holdings of pension funds which are, as a group, the largest of the institutional investors whose activities are being challenged.

In our earlier appearance before this Subcommittee, we pointed out the lack of existing data on the extent and nature of institutional securities holdings. Absent such data, it is difficult to assess the impact of the proposals in the Bill. Accordingly, we would like to see the Congress enact reporting requirements for institutional investors, either as a part of this legislation or in a separate bill along the lines proposed by Senator Harrison Williams, Jr.

We have, however, prepared a research paper analyzing the pros and cons of the restrictions proposed in S.2842. This research paper is attached to our full statement as Appendix I. On balance, it appears that the pros of the proposal outweigh the cons. However, for the reasons I have indicated, we are not in a position at this time to offer a final evaluation or comments. Accordingly, while we cannot support the proposed restrictions, neither would we object to their enactment.

More important, in our opinion, are the revisions proposed in S.2842 in the capital gains tax area, aimed at providing needed incentives to individuals to invest in all types of capital assets.

As mentioned in our last appearance before the Subcommittee, we had commissioned the well-known public opinion research firm, Oliver Quayle and Company, to conduct a study of the impact of capital gains taxation on individual investor behavior.

This study, which I would like to offer for the hearing record, was based on personal interviews with individual investors. Their actual 1972 portfolios and investment decisions were reviewed and probed.

In large part as a result of the Quayle study, the major planks in the New York Stock Exchange's capital gains tax program are: 1) immediate return to the 25% maximum alternative rate on all long-term gains that prevailed prior to 1970 and 2) retention of the six-month holding period for long-term gains.

Comments on Capital Gains Tax Proposals in S.2842

At the same time, we do support the basic graduated capital gains tax plan in S.2842 which would raise the capital gains exclusion rate to 80% over a 15-year period. This proposal recognizes and seeks to offset the fundamental capital gains tax problem: That individual investors can be easily "locked into" or hold assets over unnecessarily and inappropriately long periods of time because of the burden of the tax on realized gains.

It is also gratifying to see a proposal which works toward mitigating the effect of inflation on the investment dollar. Ideally, perhaps, the proceeds of an asset sale should first be deflated by a price index, so that only the <u>real</u> appreciation in the value of the holding is taxed. While short of that ideal, a graduated capital gains tax gives some recognition to the realities of inflation.

However, it seems to us that two additional provisions in the Bill's tax package will diminish the effectiveness of the exclusion rate plan as a stimulus to new investment and investment turnover. I am referring to the proposed repeal of the present 25% alternative capital gains tax rate, and the proposed extension of the minimum capital gains holding period from six to 12 months.

If the alternative tax is repealed, the first $50,000 of net long-term capital gains, now taxed at 25%, could be taxed initially at rates as high as 35% under the proposed graduated exclusion rate plan. An individual investor in the 70% income tax bracket would, in fact, have to hold onto his assets for seven years in order to obtain the tax treatment he now receives on the first $50,000 of gains after six months. An investor in the 60% tax bracket would have to hold assets four years to match the rate he now receives after six months.

The Quayle study found that the strongest impetus to unlocking capital gains -- and, therefore, to increasing Federal tax revenues from this source -- would be a cutback in the present maximum rates. For example, if the maximum capital gains tax rate were halved for taxpayers who are now subject to rates of up to 25%, and the maximum for individuals subject to higher rates were reduced to 25%, total capital gains realizations in 1972 would have been $16.6

billion higher and tax revenues would have been up almost $1.7 billion. That would have resulted in total capital gains of $49.2 billion and tax revenues of $5.6 billion. But data underlying the published results indicate the effect of cutting the maximum rate from 35% to 25% would, by itself, produce tax revenues of $1.8 billion, or almost one-third of the total.

The Quayle study findings also support the conclusion that a longer minimum holding period would inhibit capital gains realizations with consequent revenue losses to the Treasury. The in-depth interviews with investors revealed that they would simply defer realizations -- and, in effect, lock themselves in, whereever feasible -- in order to qualify for the more favorable tax rate.

S.2842 clearly seeks to enhance capital mobility, an important prerequisite for maximizing growth in a dynamic economy. However, we believe that eliminating the alternative capital gains tax rate and lengthening the capital gains holding period beyond the present six months would prove to be inconsistent with that objective -- that these two measures would, in fact, have just the opposite effect.

Treatment of Net Capital Losses

The Subcommittee is aware that the deduction for net capital losses has remained unchanged for over 30 years, despite the ravages of inflation. Ideally, tax treatment of capital losses should enhance both capital mobility and net new investment by encouraging individuals to liquidate investments that prove unsatisfactory.

The capital loss provisions in S.2842 are much more realistic than the present treatment of losses. However, we believe the Bill's approach is flawed in one key respect -- it would tie losses to the same sliding scale exclusion rates that apply to gains. While this approach appears to have an inherent fairness and logic, it assumes that an individual's financial position and well-being are less seriously damaged if he incurs a loss after holding a stock for, say, 15 years, than if he incurs an equivalent loss after 15 weeks. Actually, an investment loss may be more damaging to the investor whose funds have been tied up unprofitably for a longer period.

Stated somewhat differently, we fail to see the justification for penalizing an investor who failed to liquidate a poor investment quickly. We recommend, therefore, that all long-term capital losses be treated alike -- regardless of the length of time investments are held. The most effective course would be to permit full deduction of all capital losses, no matter how quickly or slowly they have been incurred. We would suggest, therefore, that S 2842 be modified at least to retain the present method of calculating the loss deduction -- that is, 50% of the total long-term loss. And, we believe it would be more in keeping with the intent of the Bill to increase the proportion of losses eligible for tax deduction to 100% by, say, 1980.

Additional NYSE Recommendations

In our testimony before this Subcommittee last July, we proposed a comprehensive series of tax recommendations aimed at stimulating individual investment activity. I have referred to several of our proposals in my comments this morning. Other measures which we believe would help achieve the objectives we share with this Subcommittee would, briefly:

One -- Allow a $1,000 capital gains tax exclusion from adjusted gross income when gains do not exceed 25% of earned income;

Two -- Raise from $1,000 to $5,000 the maximum tax deduction against ordinary income for a capital loss;

Three -- Increase from $100 to $200 the dividend exclusion from Federal income taxes;

Four -- Permit commissions paid on stock transactions to be treated as investment expenses and, thus, as deductions against ordinary income; and

Five -- Permit a $1,500 tax deduction for individuals who buy stocks as part of a personal pension plan, provided they are not covered by adequate employer-sponsored plans.

These proposals are described in greater detail in our full statement.

BROKERAGE INDUSTRY STABILIZATION RESERVE

In addition to the needed revisions in the capital gains tax and possible restrictions and/or disclosure of institutional investors' holdings, we would offer for the Subcommittee's consideration a proposed new provision which would permit broker-dealers to improve their ability to serve investors through the establishment of tax stabilization reserves comparable to those in effect for other intermediaries.

Broker-dealers operate under dual handicaps today. First, the securities business is highly cyclical and second, unlike other financial intermediaries, broker-dealers cannot establish reserves in good years to even out the financial problems of bad years.

As a result, brokerage firms historically have had great difficulty in attracting and holding adequate capital to provide essential services to investors in both good times and bad.

We have developed a proposal for your consideration to enable the industry to establish sufficient capital reserves to help offset the adverse effects of cyclical swings. Under this proposal, broker-dealers would be permitted, each year, to set aside a small portion of profits, tax-free, up to a prescribed minimum, in a loss reserve fund. The fund could be drawn upon, in bad years, to help ease the critical capital problems which, in the past, have periodically beset the industry. This proposal is discussed in our Research Report, "Stabilization Reserves -- A Route To Easing Cyclical

Problems In The Securities Industry," which we have submitted with our full statement, as Appendix II.

In closing, may I again express our appreciation to the Subcommittee for its courtesy in inviting our comments on S.2842. We believe that the Bill, together with the revisions we have suggested, can help restore investor confidence and set the stage for meeting the heavy capital demands facing this Nation in the years ahead.

That concludes my statement, Mr. Chairman. We will be happy to reply to any questions the Subcommittee may wish to ask.