FINANCIAL MARKETS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL MARKETS

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-THIRD CONGRESS

FIRST SESSION

ON

THE IMPACT OF INSTITUTIONAL INVESTORS IN THE STOCK MARKET

JULY 24, 25, AND 26; SEPTEMBER 24, 25, 27, AND 28, 1973

PART 2 OF 2 PARTS

(September 24, 25, 27, and 28)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

22-727O WASHINGTON : 1973

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $2.05

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
WALTER F. MONDALE, Minnesota
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas

WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming
ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware

MICHAEL STERN, *Staff Director*

SUBCOMMITTEE ON FINANCIAL MARKETS

LLOYD BENTSEN, Texas, *Chairman*

HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
RUSSELL B. LONG, Louisiana, ex officio

WALLACE F. BENNETT, Utah
WILLIAM V. ROTH, Jr., Delaware

ROBERT A. BEST, *Professional Staff*

CONTENTS

Part 2

PUBLIC WITNESSES

Page

American Bankers Association, Chalkley J., Hambleton, president-elect, trust division, and president, Harris Trust & Savings Bank, accompanied by:
William W. Graulty, executive vice president, Connecticut Bank & Trust Co.; Paul J. Collins, senior vice president, First National City Bank; and Robert L. Bevan, assistant Federal legislative counsel, ABA 160
Bankers Trust Co., Quintin U. Ford, senior vice president, accompanied by:
James T. Byrne, Jr., assistant general counsel, Bankers Trust Co 114
Bostioan, David B., Jr 167
Chase Investors Management Corp., James M. Lane, president, accompanied by:
Richard A. Stark 100
Coleman, Ralph P. Jr., president, Over-The-Counter Securities Fund, Inc 146
Corcoran, Thomas G 207
Ford Foundation, Roger G. Kennedy, vice president, financial affairs 136
Ford, Quintin U., senior vice president, Bankers Trust Co., accompanied by:
James T. Byrne, Jr., assistant general counsel, Bankers Trust Co 114
General Electric Co., Edward H. Malone, vice president, trust operations 126
Hambleton, Chalkley J., president-elect, trust division, American Bankers Association and president, Harris Trust & Savings Bank, accompanied by:
William W. Graulty, executive vice president, Connecticut Bank & Trust Co.; Paul J. Collins, senior vice president, First National City Bank; and Robert L. Bevan, assistant Federal legislative counsel, ABA 160
Kahn, Harry, Neuberger and Berman 236
Kelso, Louis O., Esq., general counsel, Bangert & Co., Inc 13, 56
Kennedy, Roger G., vice president, financial affairs, Ford Foundation 136
Lane, James M., president, Chase Investors Management Corp, accompanied by:
Richard A. Stark 100
Malone, Edward H., vice president, trust operations, General Electric Co 126
Musgrove, Dr. Richard A., professor, Harvard University 28, 94
Over-The-Counter Securities Fund, Inc., Ralph P. Coleman, Jr., president. 146
Ture, Dr. Norman B., president, Norman B. Ture, Inc 18, 87

COMMUNICATIONS

American Council on Capital Gains and Estate Taxation, George Kline Smith 249
American Insurance Association, Walter D. Vinyard, Jr., counsel 253
Bucher, Jeffrey M., member, Board of Governors, Federal Reserve System. 259
Federal Reserve System, Jeffrey M. Bucher, member, Board of Governors 259
Price Waterhouse & Co., B. Kenneth Sanden 254
Racz, Andrew G 264
Sanden, B. Kenneth, Price Waterhouse & Co 254
Smith, George Kline, representing the American Council on Capital Gains and Estate Taxation 249

	Page
Steiner, Rouse & Co., Inc., Leon J. Weil, chairman of the executive committee	252
Vinyard, Walter D., Jr., counsel, American Insurance Association	253
Weil, Leon J., chairman of the executive committee, Steiner, Rouse & Co., Inc	252

ADDITIONAL INFORMATION

Articles:	
Can U.S. Industry Find the Money It Needs?	2
The Institutional Investor—Who Needs Him?	154
Playing With Investment Fire	155
Institutional Investing Dangers—III	158
The De-Institutionalisation of the Stock Market in American Society	167
Heard On the Street	205
Vanishing Individual Investors	251
Questions by Senator Bentsen submitted to:	
Kelso, Louis O., general counsel, Bangert & Co., Inc	48
Musgrove, Dr. Richard A., professor, Harvard University	43
Ture, Dr. Norman B., president, Norman B. Ture, Inc	45

FINANCIAL MARKETS

MONDAY, SEPTEMBER 24, 1973

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE OF FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:07 a.m., in room 2221, Dirksen Senate Office Building, Senator Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senators Bentsen, Byrd, Jr., of Virginia, Bennett, and Roth, Jr.

Senator BENTSEN. Would Mr. Kelso, Dr. Ture, and Dr. Musgrave please come forward and we will try to do this in a panel, gentlemen, if we may.

The committee will come to order. This week we will continue our inquiry concerning the condition of the U.S. equity markets and the role the institutional investors are playing in this market.

I like to think that these subcommittee hearings have already had some impact. I know that the institutional investor study by the SEC came out in 1971 but it was not until the start of these hearings that the SEC began to seriously consider proposing disclosure legislation for large institutions. I think that disclosure would be of great help to the smaller investor by providing him with a greater degree of confidence. In addition, disclosure will give us a better insight into the impact of the institutions on the market.

I heard some analysts say that they have seen a modest change in the direction of investment by some of the major institutions into lower tier stocks. The opinion has been hazarded that these hearings and the information developed by this subcommittee have had some influence in that direction. I like to think that this is the case. And I think it is something that is healthy for the overall equity market.

Good morning, Senator Bennett.

So I believe our first hearings were valuable in helping to identify the problem.

The testimony gave us considerable concern. One of the most disturbing aspects is the decline in the number of individual investors. For the first time since 1952 when they started keeping a record of the number of individual investors we are seeing a decline in that number and that decline is alarming because these individual investors, with their judgments, with their variety of opinions and decisions, really contributed to a free marketplace. Millions of individuals investing their savings have given our market vitality and they have provided the needed reservoirs of capital.

Now, while individual investment has declined there has been a growth of institutional business. That in turn has not been sufficient

to set off the loss from individual investors. The volume is down and we read of brokerage houses that are in financial trouble today. Underwritings of new issues have dropped off alarmingly and public offerings of new companies are nonexistent. Without access to equity financing, I don't know where they are going to raise capital unless they try to raise it through borrowings and if you go to an institution with a low multiple and try to raise it through borrowings, you find first that you are going to probably pay points over prime. I heard of one case the other day that paid five points on front. And then the lenders will often say, "and by the way, we would like some free warrants collateral to add up to 10 percent of equity" and then, of course, they say we certainly want a compensating balance.

So what does your true yield finally end up as being and where do you find investments today that give you that kind of return? And when we realize that it costs $25,000 in new capital to create just one new job in manufacturing, where are all these new jobs going to come from that a growing population needs in this country of ours? Are they destined only to be created by the major corporations who might have sufficient cash flow to do that or might be selling at a high multiple where they can afford to go to the market? Does it mean that the small company with a low multiple that has reasonable prospects of growth, that it can't go to the equity market, that it is selling five times earnings and that means it needs something that gives them a 40 percent return before taxes, and they have a difficult time in borrowing, does it mean that they finally are merged taken over? Is that the end result? If it is, that is of great concern to me as chairman of this subcommittee and I know to all members of this committee.

The other thing that was brought to our attention was the trend where the institutions today on the New York Stock Exchange have 70 percent of the volume but 10 years ago they had 35 percent of the volume and if you extrapolate that kind of a trend curve, it means finally they could have all of the market and we would have a situation like Germany where today I understand that German banks control about 60 percent of industry. You have one bank over there whose trust department has more than 25 percent of over 120 nonfinancial corporations. The largest bank's trust department in Germany owns more than 25 percent of the largest shipping concerns.

The current issue of Business Week carries an article entitled "Can U.S. Industry Find the Money It Needs?" I think that article expresses very well some of the concerns of this committee and I request the consent of the committee that it be printed in the hearings.

Senator BENNETT. I think it should be, certainly.

[The document referred to follows. Oral testimony continues on page 12.]

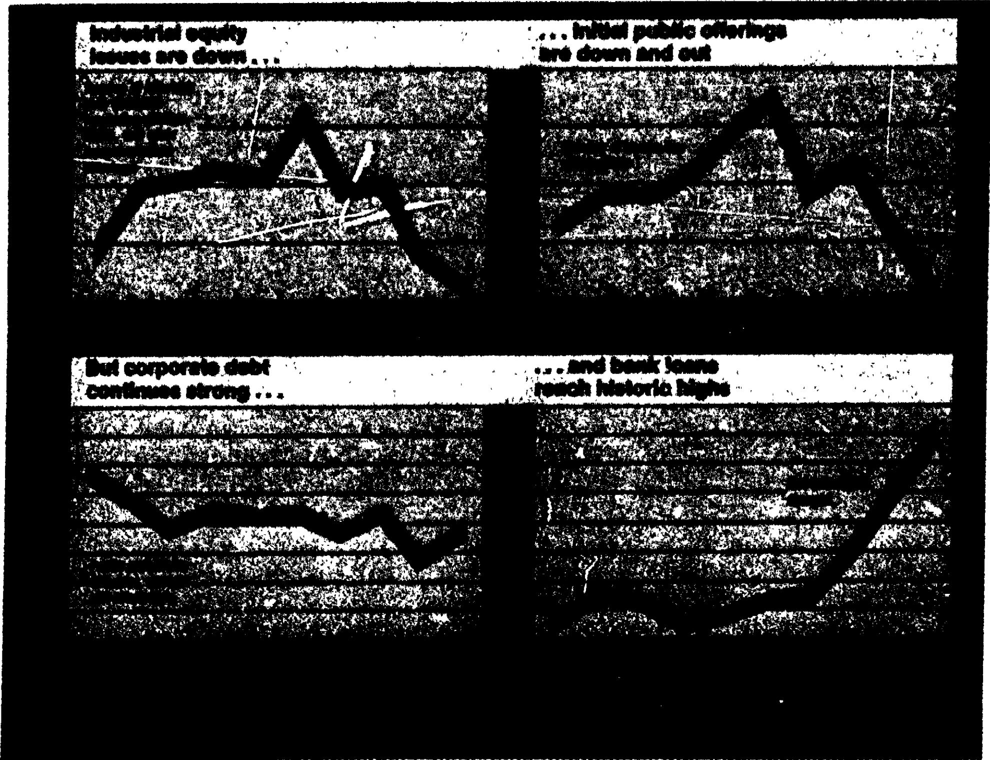
[From Business Week, Nov. 22, 1973]

CAN U.S. INDUSTRY FIND THE MONEY IT NEEDS?

"A great deal of American capitalism will be dead," warns Senator Lloyd M. Bentsen, Jr. (D-Tex.), if institutional concentration in a few "religion" stocks eliminates the ability of U.S. markets to provide capital for thousands of other corporations.

As Bentsen's subcommittee on financial markets resumes hearings next week, it is clear that his concern is well founded. Institutional dominance of trading has combined with historically high interest rates to drive most individual investors out of the marketplace. Institutional concentration in a tiny handful of high-

priced, high-visibility securities has driven most stocks down to historically low p/e ratios. Unable to raise new equity, companies are contracting ever-increasing interest costs that cut down their existing equity's attractiveness. Except for the benefit of a few famous institutional favorites, the equity markets have ceased to fulfill their primary purpose. Stock issues have effectively ceased. In just the first six months of 1973, more than 300 offerings were withdrawn as unsalable. The stream of equity capital to U.S. industry has run dry.



In the view of James M. Roche, until recently chief executive of General Motors Corp., such a situation could scarcely have come about at a less appropriate point in time. "In the next few years," he stated recently, "the American economy faces an unprecedented need for capital." The domestic oil industry, according to the economists at Chase Manhattan, will require some $200-billion by 1985. Power utilities will want about $70-billion in outside capital in just the next five years. Just one company, American Telephone & Telegraph Co., will, according to executive vice-president and treasurer John J. Scanlon, need $40-billion to $50-billion for itself and its subsidiaries in the next decade. And Stewart S. Cort, chairman of Bethlehem Steel Corp., says his industry needs $3-billion to $4-billion a year between now and 1980 to replace obsolete facilities, install pollution control equipment, and expand capacity by the additional 20-million to 25-million tons it expects to need.

"Our competitive free enterprise system," Roche emphasizes, "has succeeded in large part because of the success of our capital-raising mechanism." When this mechanism falters, as it is faltering today, it rapidly affects thousands of American companies. They drop into debt. They cut back. They get taken over—sometimes by companies whose institutional sponsorship has provided or preserved a higher p/e multiple, and sometimes by foreigners.

THE DANGERS OF EQUITY SHORTAGE

If the short-term effect of the equity shortage is painful for individual American corporations, the long-term effect on the American economy could be agonizing.

This is why some thoughtful securities industry leaders see the Bentsen committee as among the most significant on Capitol Hill today. Whereas other important—and more celebrated—Congressional committees are considering problems vital to the securities industry, Bentsen is examining questions vital to all industry. Among them: the possibility he raises that "the current two-tier market system may be stimulating the takeover of U.S. companies by foreign

entities," and "the effect of institutional investors on the ability of new or small and medium-size firms to acquire the capital they need to survive and compete with U.S. corporate giants and foreign producers."

Institutional dominance of the markets has, of course, impaired the equity-raising ability of many U.S. corporate giants too, unless they're lucky enough to be numbered among the institutions' "sacred cows." Donald T. Regan, chairman of Merrill Lynch, Pierce, Fenner & Smith, has noted that "it's just as essential, from an economic viewpoint, that an established corporation should be able to raise capital as that capital should be available to emerging companies." Other early witnesses before Bentsen's committee, which first met for three days in July, left no doubt of the urgency or the global nature of the problem. C. V. Wood, Jr., chairman of the Committee of Publicly Owned Companies (BW–June 2), asked: "Can small and medium-sized—and even a large number of very big companies—survive? Can they have access to equity capital?" Wood's group now claims as members nearly 600 corporations, and he testified, "They feel keenly that they are being starved out of the capital markets."

Among his preliminary ideas, Bentsen told Business Week, he is leaning toward limitations on institutional holdings. Such legislation could have two highly desirable effects. On the one hand, a reduction of institutional concentration in a few stocks would eventually spread an enormous amount of wealth among hundreds of others. The top 10 U.S. banks alone have concentrated about $27-billion in just 10 sacred cows. This huge equity represents 3% of the value of all 2,700 stocks listed on both New York and American stock exchanges. At the same time, limitations on institutional concentration would do much to eliminate the violent sell-offs in fallen institutional favorites—the plunge by Levitz Furniture Corp. from $60 to $6 being a prime example—that have done so much to destroy individual investors' confidence in the market.

A restoration of such confidence, it is clear today, is essential if the market is to recommence its function as a provider of equity capital, a function it has ceased to perform (tables). Merrill Lynch's Regan, the first witness before Bentsen's committee, testified that the value of new industrial equity issues had tumbled from $4.8-billion in the first half of 1972 to $1.2-billion in the first half of 1973. And James W. Davant, chairman of Paine, Webber, Jackson & Curtis, says: "Whatever the situation in the first six months, you can bet it's a lot worse in the last three."

Last year Davant's firm brought to market eight companies offering stock to the public for the first time; this year, there was one. "The use of equity financings for emerging companies," says Davant, "has not just diminished; it's ceased." The figures bear him out. In July and August last year, according to *New Issue Outlook*, there were 78 new issues; in July and August this year, 7.

THE TREMORS ARE INDUSTRY-WIDE

The result is grim for literally thousands of companies, large and small, established as well as emerging. The problems of Reliance Steel & Aluminum Co. (box) are typical of those plaguing medium-sized corporations in the sort of basic industries in which sophisticated financial institutions have lost interest. So are those of Franzia Winery, Stouffer Foods, and American Metal Climax.

Franzia, California's fifth-largest winery, has increased sales from $16-million two years ago to an estimated $30-million in fiscal 1973. Earnings, too, are expected to double the 1971 figure of $542,000. But when Franzia planned an equity offering to help finance 1973 capital expenditures of $3-million, "the market was a disaster," and the issue was abandoned. In its place came an acquisition offer from bibulous Coca Cola Bottling Co. of New York (BW July 7), which also took over Mogen David wines in 1970. Like that institutional darling and more famous relative, "Coke" of Atlanta, Coca Cola of New York has managed to maintain the reasonably high multiple essential to takeovers.

Stouffer Foods also was taken over when a public share offering was seen as unlikely to produce a satisfactory price for its owners, Litton Industries. In its place, Litton accepted a bid from Switzerland's Nestlé, and ownership of the familiar household brand passed into foreign hands. So did much of the aluminum business of America Metal Climax, the fourth-largest U.S. fabricator of aluminum. Eager to expand capacity, but strapped for equity and burdened with a debt that had tripled since 1967, Amax (BW–Aug. 25) sold a half-interest in its aluminum operations to Japan's Mitsui for $125-million.

While a handful of banks (such as California's Security National) and famous retailers (such as Gimbel's) are among the U.S. corporations whose control has passed to foreigners since the establishment of the two-tier market, power over

even more of them seems rapidly to be passing to creditors—particularly to bankers.

Reginald Jones, chairman of General Electric Co., recently fretted that the volume of corporate long-term debt issues had virtually "exploded," with debt-to-equity ratios for the S&P Industrials leaping from 26% to 41% in just 10 years. And Thomas I. Unterberg of Unterberg, Towbin, a New York investment firm with a respected record in the underwriting of smaller companies, answers the question of what happens to such companies when they cannot raise equity cash: "They merge. They reduce expansion. They pay the banks 1½% over prime, plus 20% compensating balances. They go out of business."

The list of companies forced by the two-tier market to cut back on expansion or fall back on their bankers would stretch from coast to coast—and from Florida to Minnesota.

In Miami last month, diversified Pershing Industries withdrew an offering of 200,000 shares at $7 a share and, says President Maurice Revitz: "This has caused us to approach any sort of expansion with a lot more caution." To acquire additional cars for Pershing's leasing division, he would have to pay "2% to 2½% over prime, which means the customer would pay $30 to $40 a month more for his car."

In Minneapolis, Wilson Learning Laboratories, manufacturers of video educational programs, had seen sales soar 90% last year and was seeking $1-million in equity to finance further expansion. Instead, they were obliged to turn to banks—"a hard route," says founder and chairman Larry Wilson, "because you never get as much money as you really need." Wilson emphasizes that "not getting the money from the stock offering has hurt. We are running from month to month, project to project—with a real cash flow crunch."

Among the young, thriving electronics companies in the San Francisco peninsula's "silicon valley," Advanced Memory Systems withdrew a 460,000 share offering in May, and added $2.5-million to its $6.5-million in short-term bank borrowings. Said a spokesman: "It would have been nice to sell those additional shares, rather than borrow more from the bank with interest rates so high."

In Fayetteville, N.C., the building business of American Classic Industries dropped a series of expansion and development projects when its public offering was withdrawn. Says Barry Barnard, vice-president for finance: "We've leveraged ourselves a little more highly than before. We are pretty much trapped between high interest rates and not being able to go public.

A bottling firm in Baltimore withdrew an offering of common stock intended to replace high-cost indebtedness. Instead, worries its treasurer, "our interest cost is bearing on our earnings." His lament points up a problem like an exposed nerve in tooth cavity—a cavity which, left unfilled, could rapidly deteriorate into the general decay of profitability. As C. V. Wood told the Bentsen committee: "When we can't raise [equity] money for expansion, replacement of facilities, or pollution control, we have to go to the banks and saddle our companies with very high interest rates and fixed charges." Salomon Bros.' chief economist, Henry Kaufman, recently noted that bank loans to business had expanded, in the first seven months of this year, nearly four times as fast as even in 1969. The result of consistent debt financing, as GE's Jones makes clear, is to "exacerbate the compression of profit margins." Jones quotes statistics showing that in the early 1950s, nonfinancial corporations earned a pretax 23% on total capital. "Ten years ago it had dropped to about 18%, and in 1971 it was down to 13%."

LITTLE ROOM FOR OPTIMISM

With short-term interest rates at their historic highs, and long-term rates nearing them, there is no reason to suppose that this situation has improved since 1971. Nor are there grounds for optimism that it will—miraculously or otherwise—get better in the foreseeable future. In 1946, AAA bonds yielded an average 2.5%, but those days are gone forever. With an "inflation expectations component" (BW–Sept. 8) of 4% to 5% to be added to the "real" rate of interest of another 4% to 5% that is normal for a period of economic expansion, the cost of servicing debt can only bear down more heavily on corporate profits. Economist Kaufman warns that "Many corporations face refinancing requirements. There's $37.9-billion in corporate bonds maturing by 1985 that needs to be refunded."

In debt financing, as Paine Webber's Davant points out, "The government pays half." Interest, for corporations as for individuals, is deductible dollar for dollar against taxes, so its net effect on the earnings per share of most companies is only 50% of its actual cost. Furthermore, Davant says, "companies that borrow are expecting their return on new investment will be higher than their normal return."

Take a steel company with $1-billion in debt outstanding and a return on investment of 8%. Suppose it borrows an additional $100-million. At 10%, its interest cost is $10-million. If it can make 12%-half as much again as its normal return—it can add $1-million post-tax to earnings. But if the economy goes into a recession, or even just a dip, and return on the new investment drops to the level of the old, it represents a drain of $1-million on post-tax earnings. Unfortunately, in practice, corporate results frequently fail to live up to corporate expectations. Speaking of the performance of the S&P Industrials in the five years from 1966–71, GE's Jones notes that "many a company didn't earn the equivalent of interest charges on newly added funds."

David Healy, vice-president and director of research at Drexel, Burnham, who has specialized in analysis of the steel industry, notes that steel's earnings coverage (of interest costs) got "really bad" at the beginning of this decade "because of deteriorating profits and increasing debt."

This combination, it should be noted, is what pushed the Penn Central into bankruptcy. On the eve of its collapse, moreover, the Penn Central was planning a further massive increase in its debt burden. But if added debt financing is undesirable for the majority of U.S. companies—and all evidence suggests that most of them should be decreasing rather than increasing their borrowings—where is the capital they need to come from?

This is the central problem confronting Bentsen and his committee, and it is a vital as well as a thorny one. Unless corporations can obtain large infusions of equity, they will be obliged either to stop expanding, or to expand via debt. In taking on more debt, at inevitably high interest cost, they increase what Healy calls the reverse leverage on their equity. Their expansion reduces, rather than improves, their per-share earnings—as does the necessity of refinancing old debt on which interest costs represented substantially less of an earnings drain. The "embedded" cost on AT&T's total debt has risen 1.15% since the beginning of this decade. This, Scanlon notes wryly, "costs us $250-million extra a year."

THREE SOURCES OF EQUITY CAPITAL

The high cost of new debt will trap most corporations in a tightening noose from which they can escape only by selling off operations or going out of business—unless they can obtain equity, and obtain it soon. Apart from retained earnings, there are for U.S. corporations today essentially three sources of equity capital for plant and equipment: institutional investors, individual investors, and venture capitalists.

Of these, the richest and the most reluctant are the institutions. Largely because of the banks' traditional policy of concealing the scope and size of their holdings, there is much confusion as to exactly how much of American industry they now effectively control. It is a common practice of bankers to pooh-pooh the notion that institutions now dominate the markets. Thus Samuel R. Callaway, executive vice-president of Morgan Guaranty, cites SEC figures showing that, at the end of 1972, individuals owned 63% of all equities, and claimed this as "impressive evidence that the individual is not out of the market." SEC figures cited by another banker (C. Roderick O'Neil, executive vice-president of Manufacturers Hanover) show however, that individual ownership at the end of 1971 had been 66.8%. The rapid decline, 3.8% in one year, appears to indicate that the individual is quitting the market in a hurry. In terms of dollars, the 3.8% shift means that individuals own some $40-billion less of the equity of U.S. corporations, and institutions own some $40-billion more—in one single year.

Furthermore, such figures do not by any means tell the whole story of the new institutional dominance. This was well illustrated when James J. Needham, chairman of the New York Stock Exchange, told the Bentsen committee that institutions owned approximately 30% of Big Board-listed equities by the end of 1972. But he emphasized that this figure specifically excluded the banks' personal trust holdings. He said that were these and other smaller institutional groups to be included, the figure would probably total 45%. Figures released last week by the FDIC reveal that just 300 U.S. banks control trust assets of $365-billion. Institutional holdings of equities now total half a trillion dollars, give or take a billion or two.

By restricting their sponsorship to what Needham calls an "ever-narrowing circle" of investments, the institutions have created a self-perpetuating downward spiral for other stocks. According to the Economic Report of the President for 1973, individuals have been selling more of their holdings of equities than they have bought since 1962—and the stocks they have been selling have been those not favored by the institutions. Since the institutions control the pension money

that provides virtually the only fresh flow of funds into the market, there has been no way for these stocks to go but down. The result, as expressed in Securities Industry Assn. (SIA) testimony before Bentsen: "When the valuation mechanism is distorted, the whole capital formation process—and the nation—suffers."

HERD PSYCHOLOGY AND STARVATION

While one product of the institutional philosophy of concentration (less politely known as "herd psychology") is equity undernourishment for nonglamour companies of any size, another is equity starvation for small and emerging companies of almost every type. Few big banks—and the top 20 U.S. banks control 48% of all America's trust and pension assets—will consider investments in companies capitalized at less than $5-million. Chalkley J. Hambleton, president of the Harris Trust & Savings Bank in Chicago, a forward-looking bank that is the nation's 12th largest in terms of trust assets, says that $5-million worth of stock in the hands of the public is the smallest situation in which Harris Trust would invest—"but we would much prefer a minimum of $50-million."

Morgan Guaranty is unquestionably the most progressive of the really big banks in its seeking out of smaller companies as potential investments: Whereas First National City Bank and Bankers Trust are invested in about 400 companies each, and Manufacturers Hanover in around 250, Morgan is invested in 569. Callaway told the Bentsen committee that the bank had established two funds: one specializing in "smaller companies, defined as those with market capitalizations of up to $100-million," and another specializing in "small to medium companies," which Morgan defines as from $100-million to $500-million. Although the bank invests, through these funds, in some 268 companies, Callaway allows that they do not represent a very large proportion of Morgan's equity investments. Of the bank's $21.4-billion in common stocks, well over $19-billion is in the shares of "larger" companies, those with capitalizations of more than $500-million. Moreover, Callaway says that "while I'm sure we have invested in companies with capitalizations of as little as $5-million, we'd have to be really interested to do so."

If institutions are limiting themselves to corporations worth $5-million—or, as in most cases, a great deal more—it is evident that equity capital for emerging companies is going to have to come from somewhere else. The same is true of nonglamour companies—that overwhelming majority of small, medium, and large companies whose industries just do not interest the institutions. The major potential source, because of his propensity to save 6% to 8% ($50-billion a year) of his disposable income, is the individual investor.

Just as Bentsen's prime concern in establishing his committee was the new institutional dominance of the markets, so one of his primary objectives is to bring the individual investor back. Several witnesses, however, raised questions about his absence. Morgan Guaranty's Callaway, as noted, questioned whether the individual had ever gone. And Merrill Lynch's Regan suggested that he might be coming back already. Regan pointed to the fact that Merrill Lynch is opening new accounts at "the highest rate in our history"—a sentiment echoed by Paine Webber's Davant and (with some exceptions) by brokers all over the U.S., in a survey conducted by Business Week.

One explanation was provided by Stan West, research director of the New York Stock Exchange: "Given the well-publicized problems of the Street, a lot of shareholders may be switching to well-capitalized firms as a matter of self-protection. These people show up as new accounts at Merrill Lynch, even though they're not new shareowners. And when a firm like Reynolds takes over Courts in Atlanta, the people that go with Courts' registered representatives to Reynolds won't show up as new account openings. But, if Courts' R.R.s take them to Robinson-Humphrey [another Atlanta firm], they'll show up as new."

Just as consolidations produce new accounts for some firms without actually bringing new investors into the market, so do liquidations. The 48,000 investors who had accounts at Weis Securities will show up as new accounts somewhere, even if all they do is liquidate what is left of their holdings.

WHERE IS THE INDIVIDUAL?

In any case, however many accounts are opened, individual business in the equities market is off sharply. Through Aug. 10, business on the Amex—which is dominated more than 70% by individuals' trading—was off 32%, in relation to the same period last year; business on the Big Board—which is dominated to about the same extent by institutions—was by contrast off only 7%. If the individual was indeed coming back, he was doing so very slowly.

Furthermore, Business Week's survey showed that many erstwhile investors had grave doubts about coming back to the market at all:

Gary A. Daum, administrative vice-president of General Nutrition Corp., a Pittsburgh food supplements retailer, says: "I'm a gambler by instinct, and I still have a yearning to play the market. But not now. There's too much risk involved, because the worth of a company no longer determines the value of its stock. Stocks move to the pressures of big investors."

Other investors find the interest rates on fixed income securities too tempting for equities to appear attractive. Says Barry E. Tague, an investor who is vice-chairman of the Philadelphia-Baltimore-Washington Stock Exchange: "It's that time now when you should be content with 9% on your money, and go fishing for a while."

And others, of course, are indeed girding their loins and preparing to reenter the fray. For example, David W. Eaton, a Los Angeles management consultant, is anxious to get back—despite punishing losses in 1968–69: "I bought companies at $35 that are going for 7¢," he says.

It is perhaps investors like Fred Torres, general sales manager of Cleveland's Woodhill Chemical Co., who represent the biggest challenge to the Bentsen committee. Torres says he has "definitely lost confidence in the stock market," and he has cut his investments to perhaps 20% of what they were a few years ago. For one thing, he has bought a house. For another, he has put some of the money into bonds. And he has been "shaken by what has been happening to the brokerage industry." Torres had money in an account with Dempsey-Tegeler, another brokerage firm that went under, and he says "I almost never did get that thing straightened out."

If many people feel as do Torres and most of the ex-investors in Business Week's sample, Bentsen faces a severe struggle to get them back in the equity market.

How U.S. Industry's cash needs soar

	Planned capital expenditures 1973 (billions of dollars)	Projected capital expenditures 1985 (billions of dollars)
Selected manufacturing groups		
Steel	$2.0	$4.5
Machinery	4.1	9.6
Electrical machinery	2.7	7.7
Instruments	0.9	4.2
Chemicals	4.5	8.9
Paper & pulp	1.9	6.3
Rubber & plastics	1.6	4.0
Petroleum	5.7	12.6
Food & beverages	3.0	7.5
Selected non-manufacturing groups		
Airlines	$2.7	$15.2
Communications	13.9	37.1
Electric utilities	17.0	41.1
All business (including other industry groups not shown above)	$106.0	$233.0

Data: McGraw-Hill

One additional difficulty in doing so is noted by former SEC chairman G. Bradford Cook. He feels that, in these days of increased Social Security and improved pension possibilities, many of the sort of people who once invested in the stock market to build up a nest egg no longer do so. Instead, feeling that their nest egg needs will be taken care of, and disillusioned by market gyrations and manipulations, they look to other outlets for spare money and savings. Among the most important, Cook suggests, may be second homes.

The present prospects for raising large amounts of fresh equity capital from these investors appear bleak. Indeed, these prospects appear downright forbidding when the third basic source of equity is also considered—for the venture capitalists are not able to provide more than a tiny percentage of what is needed.

No exact figure exists on how much the equity venture capitalists do provide, but the generally accepted figure is $100-million a year.

Obviously, this is a drop in the bucket of equity capital that U.S. companies require. Obviously, too, although some venture capitalists are now taking advantage of low p/e multiples to move in on relatively large businesses, they only invest. in principle, in a rather restrictive type of company: the type that can provide them, as Leroy W. Sinclair of Technimetrics says, "with at least 40% on their investment, compounded annually."

"STARTUP CAPITAL IS TIGHT"

Venture capitalists are now able to make investments on terms that attract them, says Stanley M. Rubel, who runs his own venture capital consulting firm in Chicago, "because a lot of companies are desperate for capital." Despite this demand, and despite the fact that as much money is available for venturing as ever, an anomalous situation has developed. "Startup capital is tight," Rubel says. "More venture capital money is flowing into secondary financing, because venture capitalists are waiting to see how companies perform before they invest."

This impression is confirmed by venture capitalists themselves—such as Edgar F. Heizer, of Chicago's Heizer Co. Because of low multiples in the stock market, he says "startup investors don't see their stock being tradeable for five or six years, and they're backing off from startup investing."

The multiples that venturists are looking for moreover are clearly very different from those being paid these days on most emerging companies. It is evident, too, that while there is equity ready, waiting, and to spare for a new Polaroid, an Itek, or a Digital Equipment, venture capitalists are not going to solve the equity problems of stodgier, more basic, less spectacular companies.

Here, in fact, is one of the most exasperating examples of the waste that is a byproduct of the two-tier market. Venture capitalists have plenty of money available for the right deal. Indeed, they are scrambling over each other to get into the deals that offer some prospect of venture capital-sized returns. In the same way among the few established companies that qualify for institutional interest, there is no practical limit on the amount of equity available. This is, says Paine Webber's Davant, an effect of the institutionalization of savings. Says Davant: "Where decisions are made by a handful of money managers, instead of by a large number of individuals, only the institutional darlings are able to sell equity."

An excellent example is Digital Equipment. A "religion" stock as far as institutions are concerned, it recently sold 750,000 shares to bring in some $66-million. Digital's p/e was then 40, and it is interesting to note the primary object of its offering: the repayment of Digital's bank debt. By paying off the debt with capital obtained at 40 times its earnings, the company would be able to improve these earnings still further, thus, conceivably, justifying the institutions' putting an even loftier multiple on its stock.

THE EUROPEAN PATTERN

Digital Equipment illustrates another problem put by C. V. Wood to the Bentsen committee: "Will America follow the pattern of Europe—where the economy is controlled by a few great banking houses?" While the concept is utterly foreign to the U.S., it no longer appears altogether implausible. The economist Richard Scott-Ram says: "Unless we can get the stock market back on course, many companies won't be able to raise equity capital. The banks are going to be called on to provide most financing—just as they do in Germany."

As part of the "Universalbank" or total financial services concept that characterizes the German banking system, the banks there function as the only underwriters. They are heavy purchasers of the issues they sell, with the result that

they maintain absolute authority over a large part of German industry. Bentsen says some observers estimate that 60% of German business is now effectively controlled by banks.

Woodrow Wilson noted in 1911 that, "The great monopoly in this country is the monopoly of money." The investment policies of banks are now preventing most companies from raising equity capital and obliging them to come back to their bankers for borrowings. One of Miami's leading bank officials says frankly that the kind of companies that generally go to the public for risk capital, and are currently stymied, now have to pay 2% to 2½% above prime for expansion money—plus compensating balances. At that rate, companies are effectively paying 14% to 16%.

Although few companies relish the idea of paying this sort of short-term interest cost, they may find the thought of locking themselves into today's levels of long-term interest rates even more distasteful. Economist Paul Markowski, a vice-president of Laidlaw-Coggeshall, reckons that any company with a credit rating lower than BAA would have to pay 10% or more on long-term money today. This means in effect, that smaller companies, and those of medium or lower quality, have nowhere to turn but their banks. The reason is that public marketing of debt at 10½%, as the Penn Central discovered three years ago, is just not feasible.

As for private placements, volume in the first half of this year soared to an all-time high, with lenders expanding from the traditional small band of huge "life" companies to include more than a thousand varied institutions; among them are savings and loans, insurance companies of all sorts and sizes, and pension plans. However, the "letter stock" fiascos of 1969–70 have dulled institutional taste for private equity deals, and—with the exception of some convertible preferred—private placements now consist almost entirely of debt. In any case, as Markowski observes, smaller and non-blue chip companies find it extremely difficult to tap the institutions in the private market—"unless they're willing to give up control."

INTERNAL SOURCES ARE DRYING UP

This points up the crucial problem that is about to confront the management of almost every U.S. company outside the institutions' "favorite 50"—if indeed it is not already staring them in the face.

Corporate capital expenditures are now running at around $100-billion a year. Between now and 1985 (box), they are expected to total well over a trillion dollars. In the last two years, corporations have been able to rely more heavily than usual on retained earnings, partly because profits have been so high, partly because—owing to dividend restrictions—they have been limited in the amount they could pay out to stockholders. Now this situation has changed in two key ways. First, shareholders are allowed higher dividends, and indications from Wall Street are that they are going to demand them. Second, as Salomon Bros.' Kaufman points out: "Corporate profits are going to come down, and internal cash generation is going to slow." For equity capital, in other words, corporations must look much more to external sources.

When they do, their welcome is likely to be more frigid than many of them would imagine in nightmares. Jim Davant stresses that many of the hundreds of equity offerings that have been withdrawn this year could have been sold—"if the managements had been willing to accept 5 or 10 times earnings, where they had been expecting 15." Economists confirm such gloomy predictions. Kaufman says: "It's a question of price. If companies have the earnings, they can probably get the equity money—if they're willing to pay the price." Scott-Ram feels most companies will be forced to sell equity at eight or nine times earnings, or less.

The question immediately arises, is this worth it? A. Gary Shilling, the chief economist of investment bankers White, Weld, points out that, already, the height of some companies' debt-equity ratios may force them to sell equity "at multiples they won't like." The electric utilities, says AT&T's Scanlon "are being obliged to sell equity at or below book value. They don't want to erode any further the interest coverage on their debt."

But for thousands of campanies selling "below book," this option is hardly practicable. Tom Killefer, vice-president for finance at Chrysler Corp., whose stock is selling at $24 against a book value of nearly $50, says: "We just couldn't do an issue of equity in these circumstances. It doesn't make sense, and the stockholders would never tolerate the dilution." Chrysler, happily can finance expansion internally: but what happens to a less fortunate company—such as a steelmaker with less cash flow and a lower rate of return? "You have a heart-breaking decision," Killefer suggests, "You pay the money, or you put off your plans."

W. B. Boyer, chairman of Republic Steel Corp., leaves little doubt of what his company's answer would be. "We're not interested in maintaining a share of industry," Boyer says. "We're interested in profits. If that means we have to contract the company, we'll do it."

QUESTIONS AND ANSWERS

Unless Bentsen and his committee can come up with some solutions to U.S. corporations' capital crunch, it is clear that choices and prospects for many of these companies are less than brilliant. Like Republic, they can cut down or cut back. They can go deeper into debt. They can, if their earnings are presently high enough, raise equity capital by selling stock at ridiculously low multiples—a process eventually as harmful, since it cuts down earnings per share, as an excessive reliance on debt.

1. By placing limits on the dominance of institutions

Almost everyone who has examined the question feels that some sort of action is essential. The exchanges agree. The SIA agrees. Don Regan agrees. Wood agrees, vehemently. Even some institutions agree by implication—since they say they self-impose certain limits, in theory, already.

Bentsen favors formalizing such limitations, to the extent of setting a limit on how much of a company any one institution can hold. He also favors the bill recently introduced by Senator Harrison A. Williams (D-N.J.), under which, institutions would be obliged to stop concealing their holdings and their trading through prompt, regular disclosure of both.

The advantages of such measures are evident. Surveys by the NYSE, and SIA, and Arthur D. Little, Inc., all reveal one fundamental reason for the individual's absence from the market. As GM's Roche puts it: "More than seven out of 10 believe the market is manipulated."

2. By encouraging both institutions and individuals to invest in "noninstitutional" stocks

Regan, who would like to see institutions make public all their transactions monthly or even weekly, says: "I can see no logical objection to the point that the new power of institutions puts on them a new responsibility to disclose quickly." Were they to do so, and were each institution to be limited to, say, 3% of any company, the benefits to the market would certainly be at least twofold.

First, there would be a steady inflow of institutional cash into the stocks of hundreds of sound corporations that, despite steady and even startling earnings growth, have not benefited from this inflow, simply because they were not numbered among the institutions' favored few. Second, the fact that this process was taking place, and that because of disclosure it was seen to be taking place, would also encourage individuals to invest again. Some authorities, such as Charles F. O'Hay, senior vice-president and director of research at the Provident National Bank in Philadelphia, believe that the mere existence of the Bentsen committee and its leanings are exerting a healthy effect on securities prices. In the last few weeks, hundreds of low p/e stocks have advanced while a series of "superglamors" such as IBM, Avon, Merck, and Polaroid have hit or approached new 1973 lows. This at least suggests that the movement is under way.

Regan would also like to see a greater effort by the banks to assist the development of emerging companies. "They're the ones that can afford it," he says with emphasis.

But whatever the banks can be encouraged to do, the main burden of financing emerging companies with equity will still fall on the individual. Nashville broker J. C. Bradford says: "The institutions always want the hot issues but are usually unwilling to buy the ordinary ones. I'd say 90% of an average issue goes to our retail customers." The Philadelphia firm of Suplee-Mosley, Inc., is typical of the underwriters who normally bring half a dozen new companies public each year, and who depend on the individual investor to do so. "This year," says Senior Vice-President William Z. Suplee III, "we'll be lucky to do one."

3. By increasing the market participation of individuals

Bentsen is leaning toward some sort of relief on tax treatment of gains—and everyone concerned with the health of the equity-raising markets seems to agree that it is essential. GE's Jones admits that this may be contrary to "the rhetoric of loopholes" but stresses: "Our present tax structure has a vigorous bias against private saving and capital attraction." Equity would seem to demand some adjustment. Morgan Guaranty's Callaway makes the point that taxes put the individual

investor at a considerable disadvantage in competition with the institutions, and Bentsen notes that the "indirect tax subsidy" from the Treasury to private pensions alone is estimated at $3-billion to $4-billion a year. Even on long-term capital gains, the SIA points out, the individual can wind up losing very nearly half of any profit when state and city taxes, and a basic federal tax rate, which now reaches 36½%, are factored into the whole equation.

Regan proposes replacing this with a sliding scale to provide a taxbite graduated according to the length of time an asset is held. His range: 30% after six months, descending to 10% after five to seven years. He makes the point that a large factor in most assets' appreciation is inflation, and he does not see why investors should be taxed on this unwanted ingredient of their profit.

SIA Chairman John C. Whitehead also proposes a sliding scale and demonstrates that the present level of capital gains taxation is actually keeping large amounts of revenue from the government. At least $200-billion of capital gains are "locked in," Whitehead explains. If just half of these were unlocked, and if they were taxed at 20%, they would produce a bonus of $20-billion for the Treasury. The market can also benefit: By their nature, holdings of high-flyers such as IBM and Xerox account for a preponderance of locked-in gains; were these gains to be unleashed, economists believe, a hefty proportion would gravitate into "value" securities with lower multiples.

In the view of Regan, Whitehead, and the NYSE's Needham, equity would seem to call for some revision of the tax treatment of losses, particularly if individuals are to invest again in the relatively high-risk situations represented by most emerging companies. Regan and Whitehead suggest, simply, that the tax treatment of losses should match that of gains. Needham proposes raising investors' deduction from its present $1,000 to $5,000. He also favors treating brokerage commissions as "investment expenses," deductible against ordinary income. Bentsen says he is "very sympathetic" to that idea.

4. By making foreigners and their surplus dollars more welcome

"Foreigners," says Merrill Lynch's Regan, "find it difficult to understand why we seem to want to make it hard for them to invest in our securities." One particular bugbear is the tax (generally 30%) the U.S. withholds from dividends and interest due foreign investors. Regan told the Bentsen committee that Merrill Lynch could sell an estimate 15% to 30% more U.S. common stock abroad if withhodling were ended. He said: "There is lots of money out there looking for a happy home."

Indeed there is. John Scanlon spent last week with AT&T Chairman John D. deButts talking with investors in London, Paris, Zurich, Geneva, and Amsterdam. Says Scanlon: "There are those vast pools of dollars accumulated abroad, maybe $100-billion. I think it would be good to eliminate this [withholding tax] deterrent."

If foreigners can be encouraged to increase their investment, if individual U.S. investors' confidence can be repaired, much of the erstwhile robust health of America's capital-raising process may be restored. Most important, as Whitehead told the Bentsen committee: "Distortions caused by institutional dominance must be corrected if national markets are again to do their job of allocating resources, and attracting new capital to risk situations popular and unpopular, large and small."

Bentsen recently told Business Week: "We don't want a situation in this country like you have in Germany." As he said in the Senate: "Mr. President, unless changes are made in the current investment picture, I am concerned we will see many of our companies acquired by foreign interests, while those which retain U.S. ownership will be subject to the control of a few institutions."

Senator BENTSEN. Gentlemen, you are here because you share this concern about the equity market and what we should do for the future. I know there are committees on the Hill that invite people to testify who only reflect the opinion of the chairman. At least I have heard that. That is not the case here. We have men of varying opinions and that is what we want. We want your contribution as to how we can try to resolve this problem. If it were an easy one it would have been resolved a long time ago but we are going to dig at it. We want responsible legislation that will stand the test of time. We don't believe we can come up with a total panacea either.

Senator Bennett?

Senator BENNETT. I just would like to associate myself with the statement you have made. I think you have outlined the problem in a very real and practical sense. The thing we need in this kind of a situation is a practical and not a theoretical solution. I hope we can contribute to that kind of a solution. I am delighted that these gentlemen are here today. I will be very interested in what they have to say.

Senator BENTSEN. Gentlemen, we are very pleased to have Mr. Kelso, the general counsel of Bangert and Co., Inc., Dr. Norman B. Ture, an economic consultant, and Dr. Richard Musgrave, professor of economics, Faculty of Arts and Sciences and Law School, Harvard University. This is a very distinguished panel indeed.

Now, I think it might be helpful if each of you would take about 20 minutes and then we can just open up to discussion.

STATEMENTS OF LOUIS O. KELSO, ESQ., GENERAL COUNSEL, BANGERT & CO., INC.; DR. NORMAN B. TURE, NORMAN B. TURE, INC., ECONOMIC CONSULTANTS; DR. RICHARD A. MUSGRAVE, PROFESSOR OF ECONOMICS, FACULTY OF ARTS AND SCIENCES AND LAW SCHOOL, HARVARD UNIVERSITY

STATEMENT OF LOUIS O. KELSO

Mr. KELSO. I would be pleased to start, Mr. Chairman.

I am Louis O. Kelso. May I say that Mr. Norman Kurland, who collaborated in the preparation of the paper that we have submitted, is also present in the room today.

I would like to begin, Mr. Chairman, by discussing a technique of finance which Bangert & Co. is pioneering. The activities of Bangert & Co., Investment Bankers, are explained more fully in our written submission. I think it will have completed between 40 and 50 financings this year using this technique. The reason for emphasizing it is that it is so little known I can't really talk about its implications unless it is understood.

If I may do so, I would like to have the committee turn to the paper which we have presented and let me make a few comments on what is described there as Model I or "Conventional Corporate Finance." (Page 71 herein.)

I want to compare this in a moment with the technique of finance which we call Employee Stock Ownership Financing.

Model I is based on some simple assumptions, namely these: that a corporation, a business corporation or perhaps a trade or finance corporation, has determined that it can sell an additional output of its product or services, and that to do so it needs some capital, the usual problem. It needs new plants or new machinery or perhaps rolling stock or whatever its business requires. And it has done its feasibility study.

There is a logic, of course, to corporate finance and that is the logic of investing in things that will pay for themselves. That is perhaps the highest single responsibility of business management: to make sure that the things it invests in will pay for themselves within a reasonable period of time. Normally, 3 to 5 years is a rule of thumb.

22-737 O - 73 - pt. 2 -- 2

It may take longer in certain industries. It may take longer under certain economic conditions. But in any event, in this example, we assume the feasibility study is completed and that it demonstrates that the proposed expansion will pay for itself within an acceptable period of time.

Model I represents certain of the techniques for accomplishing this financing transaction that are conventional today and have been in the past. One of the most frequently used methods, of course, is that the corporation goes to a lender. The lender may be a bank, an insurance company, or, in a rare instance, a pension trust. The feasibility study is presented to the lender, discussed, maybe adjusted, but eventually, let's say, the lender approves and the loan is made.

The corporation gives back its promise to pay. It then takes the cash and buys its incremental new equipment, puts it into its working capital, or whatever the business requires.

The lines at the bottom of the corporation symbol represent the stockholder base, the owners, the men who own the title deed, as it were, to the corporation's assets.

Now, there are other ways to accomplish that conventional financing step. The corporation can earn profits, withhold the "wages of capital" from the owners of capital—the stockholders—and accumulate enough of those earnings after paying its corporate income taxes usually both State and Federal aggregating substantially above 50 percent normally, and take the remainder to buy the tools that it needs.

It also has access, of course, to accelerated depreciation which is a technique provided by the tax law to help finance the growth of business. Similarly, investment credit. Similarly, if it is a natural resource industry, to depletion allowances.

If you put all of these techniques together, they really fall into two essential classes: financing growth out of current cash flow or financing growth out of borrowings, repaid out of cash flow.

Over the last 15 years, and I have left out one technique which I will mention in a moment, these techniques in the aggregate account for the financing of about 98 percent of new capital formation. Now, it is important to note that in none of these techniques is any stock issued. In none of these techniques is a single new stockholder created. Not one.

This, by the way, is the reason that notwithstanding the quantitative studies about their being 32 formerly and now 31.5 million shareholders in the U.S. economy, the qualitative studies all show exactly the same thing. They are cited in our paper. Namely, that 5 percent of the households and individuals own all the equity capital.

The amount that is owned outside is negligible. That is to say, the income significance of it is negligible.

If you called a capital-owning family a family that derives one-half its income, its spendable income, from capital sources, you are talking about one-half of 1 percent of the consumer units, the households and individuals, in the United States.

Now, there is one other technique of finance that I have mentioned. That is the sale of stock to the public for cash. On the average over the past decade and a half this method accounts for about 2 percent

of new capital formation. In many years it is actually negative. That is to say, corporations buy back more of their stock than the aggregate of new stock issued. This has been true of about 7 of the past 15 years.

The sale of new stock to the public similarly does not create any new shareholders. The reason is that the purchase of stock is a cash transaction and very, very precious few people have the money to buy stock over and above their consumer demands, their rising consumer costs, their rising taxes, and their reasonable rising expectations.

Now, what you have here is a rather frightening realization that we finance our economic growth—and it runs up to well over $100 billion per year in the U.S. economy today—in ways that build the *ownership* of the incremental productive power, represented by the gigantic new capital formation that takes place each year, into a stationary—and even shrinking—stockholder base.

Now, if it were just a question of some people being too rich and some people not being rich enough and had no functional significance that would be one thing. But the fact of the matter is that in the U.S. economy and in all economies around the world, the input mix into the economy, if you functionally divide it simply into inputs made by people and by nonpeople, or by people and by things, or by labor and by capital—I am here speaking of physical input sources—we are simply building a time bomb into the U.S. economy and the fuse on that time bomb today is burned almost to the end.

Technology is rapidly changing that input, mix, shifting the burden of production off the human factor and onto the nonhuman factor. If at the same time we finance our growth in ways that confine and even shrink that ownership base, then we are bringing about a gigantic mismatch between the possession of unsatisfied needs and wants and the possession of sufficient economic productive power to enable people to be self-sufficient in meeting their own needs and wants.

Now, let me mention just a couple of more implications of conventional finance and then I would like to turn to the alternative that Bangert & Co. has developed, is using, and that I think has got to become enormously important in the near future for the very reasons that underlie these hearings.

In conventional finance, represented by model I, the labor force of those corporations that use its methods is put in a very difficult position. The workers' living costs being inflated, their taxes are progressively raised, and their expectations go up because we advertise and educate, and because our mass production economy assumes mass consumption. And yet, when you take a mature worker, by which I mean a man or woman who has learned to perform his or her job about as well as that person can, there is no way acceptable to labor to make that individual any more productive as a worker. In some industries, the tool and die industry for example that may take a decade or a decade and a half, but I understand that one major hamburger chain considers that it takes 30 minutes to teach a counterman all he needs to know to perform his job competently

So the point I am trying to make is this. You can raise the productivity, the productivitiness, the inherent productivitiness of a worker only up to the point where he really knows his job. Beyond that

there is no way on God's green earth to raise his productivitiness except to make his work longer or harder, and if you do either of those, the trade unions will say you are engaged in a speedup, and the philosophers will say the purpose of industrialization is not to make us all work harder, but rather to spare us from oppressive toil.

Now, thus, the labor force under model I financing is put in a position where it must literally take the monetary system into its own hands. How does it do that? It does it by demanding more and more pay for less and less work. This is not pay for production. It is welfare or charity disguised as pay for production. It is the monetization of welfare. It is outtake not based on input.

Therein lies the thrust of inflation, and I am not blaming labor. No one should assume that I am criticizing labor. I am saying that our conventional techniques of finance put labor in this hopeless, helpless position. There is but one way to raise the productiveness of a mature worker and that is to build the ownership of capital into him, using the logic that business has always used, namely, put him in a position where he has access to credit, to buy capital on terms where it will pay for itself.

Let me point out that in model I the logic of corporate finance from the standpoint of the stockholder is simply this. The stockholder through his corporation has access to nonrecourse credit which is used to buy new tools which increase the productive power behind his stock.

Now, if I may, please, ask you to turn to page 73 of our written testimony where you will find a diagram labeled "Model II" representing employee stock ownership financing.

The object of model II financing is to put employees (to whatever degree management and, if a labor union is involved, labor may decide) in the same position that the stockholder has traditionally been under conventional financing techniques without taking any property away from existing stockholders. The objective of employee stock ownership financing is not to impair the property of existing stockholders in any sense of the word. We cannot build a private property society on the destruction of private property. Rather, the purpose of employee stock ownership financing is to plan the growth, some of the incredible growth of the future, the literally trillions of dollars of new capital formation that we must put into energy development, new towns, rapid transit, improved housing, new factories, new farms, and what have you, so a major portion of the ownership of that newly formed capital will be built into the labor force whose inputs are indispensable to bringing it about, and yet do it in ways that do not diminish the workers take-home pay.

Model II is based on the same assumptions as to facts as model I but here we have plugged into the financing structure a traditional deferred compensation trust used in a very unconventional but nevertheless legal manner approved by the Internal Revenue Service and well substantiated with various tax rulings and statutory provisions. The ideal trust is a stock bonus trust. It is possible within limits also to use profit sharing trusts. In fact, it is also possible to use so-called money purchase pension trusts.

Here the lender makes his loan to the trust, not directly to the corporation. The trust turns around and invests in the corporation. The corporation sells newly-issued stock at its market value on the

day the transaction happens. The trust gives back its note to the lender. This puts the cash, of course, in the corporation, which is then able to buy its new tools, its new plants or factories, And the corporation gives its guaranty to the lender to the effect that each year it will make a payment into the trust of an amount sufficient to amortize the current installment of debt of the trust.

Now, let me compare the two models. When the financing transaction is complete under model II, you have built the ownership of a million dollars worth of capital into the labor force of the company without taking anything out of the workers packets or pay checks. In model II the retirement income provisions of the corporation literally become costless. Why? Because the cost of the capital in model II is about the same as the cost in model I.

The reasons for that are the following: firstly, the payments by the corporation into the trust are deductible from corporate income tax so that it finances its growth on pretax dollars rather than after tax dollars.

Secondly, building of a capital estates in the workers for use after retirement is actually an aspect or function of the financing process itself.

Now, this needs to be compared with and distinguished from the typical case of the institutional investor today that uses the vast stream of pension and profitsharing retirement funds to go out and put demand pressure on the market prices for outstanding pieces of paper, outstanding securities, and simply bids up the price of those securities. In other words, employee stock ownership plan financing, used on a large scale, is capable of harnessing the growth of broad capital ownership in the labor force with financing the growth of the corporate sector.

It is rather frightening when you realize that the vast amount of funds poured into the pension trusts and profit sharing trusts of the United States are simply invested in a game of churning around the ownership of outstanding securities. The conventional investment of retirement funds does not create any new productive capital. It creates jobs for a lot of speculators and croupiers in the stock market casino but it does not finance new capital formation and it does not create new owners but merely defers income to post-retirement years, whereas employee stock ownership plan financing does.

Now, the implications for motivation are rather obvious. I think the American economic dream is the dream of accumulating over a reasonable working lifetime enough productive capital to have economic security, to have a secure source of capital and income, whether one is ill or aged or technologically unemployed. Employee stock ownership plan financing is the means of building the American economic dream into men and women who are just as certainly deprived of it today as if it never existed.

In terms of inflation, which is one of our most serious problems, I believe that this is the only technique by which we can turn around inflation. Again, the labor force under conventional financing is absolutely forced to take the monetary system into its hands. It must demand more and more pay for less and less productive input. In so doing, it generates inflation as sure as tomorrow's sunrise. We have gradually priced ourselves out of all kinds of markets that

are being taken over by foreigners. Under employee stock ownership plan financing, the labor force is gradually put in the position where if it demands more and more pay for less and less work, it is cutting its own throat. In other words, it can't really afford to do that.

Finally, I think the last observation I should make here is simply this. The question of the adequacy of the funding for the enormous growth of the future has been raised in this committee. If you will look at our model II diagram in our statement and under the box labeled "Lender" sketch in a little box there entitled "Federal Reserve," and draw a line from the lender down to the Federal Reserve System representing the discounting of the financing paper, and a line back from the Federal Reserve System representing the payment of cash by the Federal Reserve to the lender, then you have a technique for doing almost the opposite of what we are doing today. Today we monetize welfare by acceding to demands for more and more pay in return for less and less work. This is why you have to arbitrarily increase the money supply year in and year out. But employee stock ownership plan financing, with provisions for Federal Reserve discount, is a technique for monetizing tools, monetizing the nonhuman factor of production. As it pays for itself, the credit is totally reversed, but the tools go on producing indefinitely thereafter because their productive power is preserved by depreciation procedures that set aside out of gross income sufficient funds to restore it. Thus employee stock ownership plan financing, with provisions for Federal Reserve System discounting of financing paper will be a powerful deflationary force in the economy.

There is lots more to be said and we have tried to cover it very fully in our paper. I must not take the time of my colleagues on the panel, but I appreciate having a chance to make these comments.

Senator BENTSEN. Thank you very much.

Your full statement will be placed in the record.

Senator BENTSEN. If it is all right, Senator Byrd and Senator Bennett, we will let all three witnesses testify and then ask questions.

You may proceed.

STATEMENT OF DR. NORMAN B. TURE

Mr. TURE. Thank you, Mr. Chairman.

May I take the liberty of commending the subcommittee on this investigation.

Senator BENNETT. Will you identify yourself.

Mr. TURE. I am Norman Ture, President of Norman B. Ture, Inc., consulting economists in Washington, D.C.

The performance of the major U.S. financial markets this year has been a source of widespread concern and bewilderment, and I commend the committee for undertaking this activity and hope that it will shed some light and offer a basis for some constructive changes.

Against the background of vigorous economic expansion in 1972 and early 1973, as measured by indicators of real—as opposed to monetary—aggregates, the principal indicators of financial market activity appear to have been much more closely in line with a stagnant economy, if not, indeed, one in resession. Aside from a fillip in late 1972 and early 1973, the New York Stock Exchange composit index shows at best no trend in common stock prices, and in all probability

a downtrend. The price-earnings ratios of all but a relative handful of stocks have been astonishingly low throughout the year. Transaction volume has been so limited as to push many brokerage firms to—or over—the brink. There are numerous indications, moreover, that institutions have accounted for a very substantial part of total volume, while individual savers-investors appear largely to have withdrawn from the stock market.

There is a common and readily understandable proclivity to insist on simple answers to complex questions. In the case of the financial markets, it is tempting to identify one or a few factors as the source of its puzzling behavior. The true explanation, however, is probably as complex as that for any current economic phenomenon. I hasten, therefore, to disabuse this subcommittee of any idea that my discussion and recommendations are submitted as exhausting either the causes of the financial markets' present conditions or exhausting recommendations for dealing with these factors.

The current concern about the financial markets should stem from recognition of the fundamental role those markets play in the U.S. economy. However recondite or esoteric the operations of the stock market to the man in the street—Main Street, not Wall Street—or even to the economist, it is obvious that no advanced and diversified economy depending largely on private enterprises for the conduct of business in free markets could function efficiently without a well developed capital market. When evidence that the capital market is not doing its job effectively begins to accumulate the occasion for concern far transcends the effects on the immediate capital market participants; it extends to the entire economy, public and private sectors alike. Surely we do not need a repetition of the great market crash of 1929 to have its lessons well in mind.

Before proceeding, perhaps it would be advisable to review the fuctions of financial markets in order to be clear about the context of the discussion to follow.

First of all, financial markets provide valuations. When these markets operate efficiently, they provide objective and impersonal information about the capitalized values of the expected earnings of a huge number of business entities. This information is a summary or consensus of the varying assessments by the market participants of what future earnings are likely to be, what risks are associated with those future earnings, what costs will be incurred to realize them, and finally, how much those future earnings are worth today. Moreover, the information about any one company and its valuation takes into account the corresponding information and valuation of all others. For any one company, therefore, an efficiently operating financial market's valuation reflects its worth relative to that of all other companies.

For companies that are guided in their activities by the objective of maximizing their profits and the net worth of their shareholders, as in my judgment they properly should be, the valuations provided by financial markets are essential. They are assessments by the market participants of how well such companies have performed and of how well they are expected to perform in the future. Changes in those valuations are cues to margement with respect to virtually every aspect of their conduct of business. And they are important inputs in the determination of the cost to the company of using capital serv-

ices, hence of company investment decisions, even if capital outlays are largely internally financed.

A corollary function of financial markets is to facilitate the efficient allocation of saving. In brief, the condition for efficient allocation of saving is that at the margin the present value of the future income contributed by every dollar of saving is the same (when adjustment is made for differences in risk). In an efficiently operating financial market, information about company performance and prospects is quickly translated into valuation of the equity interest in companies, and changes in these relative valuatlns are cues to savers-investors as to changes in the composition of their investments which they can make in order to maximize the future income they can realize from their saving.

Moreover, the aggregate of all such market information provides savers-investors with the essential information about the relative cost of saving—how much current income otherwise available for consumption is required to buy a given amount of future income. Clearly, this information is a basic determinant of the allocation of income as between consuption and saving.

It is evident, I trust, that these functions of financial markets are not peripheral but are basic to the efficient operation and progress of a free-market economy. Impediments to effective performance by financial markets, therefore, also prevent the most efficient allocation and use of the economy's resources, which means that the economy as a whole is deprived of valuable output which it otherwise would enjoy. By the same token, the amount of saving and investment which the economy as a whole undertakes is likely to be less than it would be if financial markets were free of serious impediments, the consequence is slower growth of production capability and output, to the cost of all of us.

Efficient financial markets, therefore, are an important concern for all of us, not only those who are active participants at any time. If those markets cannot do their job properly, the working American is likely to find himself working with fewer, older, less efficient tools than otherwise. His productivity, hence his real earnings, will be less than otherwise. And he is more likely to be exposed to job displacement by foreign competition. Finally, those markets will afford him less assistance in putting his savings to their most productive use in his efforts to save for retirement or the proverbial "rainy day."

This subcommittee, I am sure, has heard and will continue to receive a substantial amount of testimony pertaining to deficiencies in our financial markets and to the factors responsible for them. Rather than attempt to go over that ground again, I should like to focus on one aspect, the inadequacy of individual investor participation, and to offer some suggestions to increase that participation.

One of the basic conditions for efficient operation of any market is that its structure is highly competitive. In turn, satisfying this condition in the general case requires a sufficient number of buyers and sellers so that the actions of no one can significantly affect the price(s) of the product(s) traded in that market. While economic theory affords no basis for determination of the minimum number of buyers and sellers required for effective competition, it does support the generalization that reducing the number of market participants tends

to increase the obstacles to competition. When the number of buyers and sellers is very large, of course, even a substantial variation in that number is likely to have little impact on the effectiveness of competition. But as the number of participants decreases, their influence on market outcomes increases, and market results tend to become more dispersed, less of a measure of consensus of participants, less meaningful as measures of relative values, and therefore less effective in allocating resources. Thinning out market participation, accordingly, is likely to result in a loss of efficiency by the market in the performance of its functions.

It is, of course, no news to the members of this subcommittee that thin participation has been the rule rather than the exception in the operations of the U.S. financial markets for some time past. Volume of transactions is, to be sure, only a proxy for the number of buyers and sellers, but in the case of the securities markets, there is other evidence to support the inference that the downtrend in volume during the past 18 months has been associated with a downtrend in the number of buyers and sellers. In the month of August this year, for example, average daily volume on the New York Stock Exchange was only 11.8 million, lower by far than any other month in 1972 and 1973. The average daily volume through the first 8 months of this year has been about 14.9 million shares, compared with 16.5 million for the whole of 1972. And except for January and July, the average daily volume each month this year has been lower than that in the corresponding months of 1972.

These volume data, while not themselves establishing a reduction in individual investor's participation in the market, are nevertheless highly indicative. They strongly suggest that the 800,000 decline in the number of shareholders in the United States recently reported by the NYSE has continued through 1973. Continuation of this decline will inevitably be associated with reduction in the number of buyers and sellers and with increased concentration of volume in the very large institutional market participants. The implications of this development for the efficiency of the market has already been noted.

What accounts for the inadequate participation of individual savers-investors? Obviously a great many factors, which have been explored before this subcommittee in its earlier hearings, contribute to the reluctance of individuals to hold directly equity interests in U.S. corporations and to manage these interests actively. In my judgment, the thrust of tax policy in the United States is one of these factors.

Generally overlooked in the periodic furor over tax reform is that taxation in the United States, particularly at the Federal level, is heavily biased against private saving. The demonstration of this bias on analytical grounds has been made by numerous economists at one time or another, and I don't think it would be appropriate to burden the subcommittee at this time with an elaborate exposition of this analysis. If I may, however, I should like to call the subcommittee's attention to my testimony on February 5 of this year, to the Committee on Ways and Means in the House of Representatives. This testimony was addressed explicitly and at length to various basic elements of the Federal tax system and their disproportionately heavy weight on saving as compared with consumption. If I may,

I should also like to take the liberty of referring the subcommittee to the publication by the NAM early this year of my study of "Tax Policy, Capital Formation, and Productivity," in which I have attempted to demonstrate not only the existing tax bias against saving and capital formation but also the adverse consequences of that bias for the rate of advance of labor's productivity and real earnings.

On this occasion, I'd like to concentrate on the Federal tax treatment on capital gains and losses. Surely it is not to be taken as exclusively the major element of tax bias against saving but I think it is most proximate to the problem which the subcommittee has before it. As this subcommittee is well aware, the differential between the taxes imposed on capital gains and on ordinary income is one of the principal targets of the standard list of tax reform proposals. This differential is alleged to be one of the principal "loopholes," primarily availed of by upper income individuals. In principle, it is argued, capital gains are in no significant way different from ordinary income, and, it is claimed, they should be similarly taxes. And so on.

In fact, however, when the present tax treatment of capital gains is viewed against the standard of equal treatment of consumption and saving uses of income, it turns out not to be a "loophole" but an additional tax burden on saving—a negative loophole, if you will. Perhaps an extended example will help to make this clear.

Suppose, for the moment, a tax-free economy. Individuals in that society are continuously making choices between the use of their current income for consumption or for buying additional income in the future, i.e., saving. The amount of future income which any given amount of saving buys depends on the contribution at the margin of the additional capital in which the savings are invested. The cost of any given amount of future income is the amount of current consumption which must be foregone by the saving needed to acquire it. Many considerations, of course, enter into individuals' consumption-saving decisions, but given these considerations, those decisions depend on the relative cost of saving and consumption.

As an example, suppose that in this hypothetical tax-free economy a person might be able to buy some given quantity of consumption goods for $1,000 or he might use the same $1,000 instead to buy common stock in a company earning, say, $120 per share, when the market rate of interest is 12 percent. Now suppose an income tax is levied; for ease of illustration, suppose the tax rate is 50 percent. With the tax, the cost of the same amount of consumption goods goes up 100 percent in the sense that it now takes $2,000 of pretax income to buy the same $1,000 of consumption goods. But the cost of saving goes up much more. To have $120 per year of additional income, one has to receive $240 of pretax income. But with no change in the market rate of interest, one must now buy $2,000 worth of the stock to get $240 pretax per year.[1] And to have $2,000 with which to buy the stock, $4,000 of pretax income is needed. The 50 percent income tax, thus, has doubled the cost of consumption, but it has quadrupled the cost of saving. Thus, the tax had doubled the cost of saving relative to the cost of consumption.

The effect of the tax on the total volume of private saving, depends on how responsive people are in their consumption-saving choices to changes in the relative cost of saving. Some economists assume that

[1] Assuming no income tax is separately levied on the corporation income.

this response is zero, that personal saving decisions are unaffected by changes in the real rate of return on their saving. I find this assumption untenable on analytical grounds and unverified by actual experience. Rather, it seems to me, an increase in the real cost of saving relative to the cost of consumption will reduce the proportion of income used for saving.

To return to our example. Suppose the corporation whose stock the individual purchases uses the proceeds of the stock sale to buy a $1,000 machine. Suppose, to simplify the example, the machine is expected to last forever. To warrant the investment of $1,000 in the machine if there were no tax, the machine would have to add $120 per year to the company's net revenues. But if an income tax, applicable to both the corporation and the individual at a marginal tax rate of, say, 50 percent, were imposed, the machine would no longer earn $120 per year, after taxes. The corporation income tax itself would reduce the aftertax earnings to $60 per year. And if the corporation were to distribute the aftertax cash flow to the shareholder, he would net only $30 per year on his $1,000 saving.

If before the tax was imposed he required $120 per year to induce him to give up $1,000 of current consumption, he will hardly be likely to settle for $30. Clearly, he will reduce his saving-investing. So will others like him.

Collaterally, the corporation is hardly likely to invest $1,000 in a machine that returns only $60 per year after tax. With no change in the market rate of discount of future earnings, $60 per year is worth $500, not $1,000. If the company's objective is to maximize its profits and the net worth of its shareholders, the aftertax earnings of the machine will have to increase to $120 per year; pretax earnings, then, will have to go up to $240 per year to justify the investment, if earnings are retained. And if earnings are distributed to the shareholders, pretax earnings would have to increase still further—to about $480 per year.

Obviously, a great many capital outlays which would contribute enough to the corporation's net revenues to warrant their undertaking in the absence of the tax become unprofitable and are foregone when the tax is imposed. The reduction in saving and capital formation resulting from the tax will continue until the stock of capital falls relative to the amount of labor services used in production sufficiently to generate the required pretax and aftertax earnings.

Now, to complete the example, suppose that after the adjustments in saving and investment are completed, the corporation retains its aftertax earnings, buys another machine, which will also add $240 per year pretax to its earnings, hence $120 per year aftertax. The market value of the shareholder's stock in the company, of course, will go up if the market is operating efficiently. Instead of $120 per year, per share, the earnings now have gone up to $240 and therefore a share is going to increase in value from $1,000 to $2,000.

Now, this increase in value is exactly equal to the present or discounted value of the additional $120 per year of aftertax earnings when they are discounted at the market rate of interest of 12 percent. Recall that every dollar of the corporation's earnings on the original machinery, that it owned, out of which it accumulated the $1,000 to buy the new machine, was taxed as it was earned and every dollar of the earnings of the new machine will also be taxed as it is earned.

If the shareholder decides to sell his share of stock in the corporation, he will realize a capital gain of $1,000. Under the present tax treatment of capital gains he will pay additional tax of $250 on this realized capital gain. This additional tax is properly viewed as a surcharge on the tax already paid on the prior year's earnings on his initial investment, or equivalently as a surcharge on the tax that will be paid over the succeeding years on the new machine's earnings. In either case the same future earnings stream will be taxed twice, once at 50 percent rate as the earnings are realized each year, and again at 25 percent in our example on the capitalized value of that future income stream.

The present tax treatment of capital gains, therefore, when evaluated against the standard of equal proportionate taxation of consumption and saving uses of income, emerges not as a loophole but as an additional, heavy burden on saving. Coming as it does on top of the disproportionately heavy individual and corporate income tax load on saving, the taxation of capital gains significantly increases the relative cost of saving.

But this is not the sole effect of capital gains taxation. The tax is imposed on gains not as they accrue but only when they are realized by sale or exchange of the assets. The occasion for the tax, then, is not merely the increase in value but the transfer of the asset as well. Taxing capital gains not only increases the relative cost of saving but it also increases the cost of changing the composition of the assets one owns. The interaction of these two effects of capital gains taxation is to increase the difference between the expected returns on alternative investments required to make a shift in asset holdings worthwhile.

Unless it could be established that people are utterly unresponsive to changes in transaction costs, an obviously untenable assumption, taxing capital gains must reduce the frequency of transfers and impede prompt changes in the composition of assets in response to changes in their relative values. In turn, this clearly impedes the efficient functioning of the financial markets in providing valuations of alternative uses of saving and in allocating saving optimally.

The present tax treatment of capital losses further burdens private saving and impedes prompt change in the composition of asset holdings. Under present law, capital losses are offset against capital gains and up to $1,000 of ordinary income. Any losses not so offset may be carried forward for an unlimited number of years, but in the case of individuals, no carryback to earlier taxable years is allowed. Since capital gains are fully subject to the additional tax in the year they are realized, the tax cushion against losses may very well be less than the additional tax burden on gains.[1] The risk of investment is increased. In addition, where losses have accrued on an investment, the limitation on their deductibility tends to deter liquidation of that investment and its replacement by other assets. Loss treatment, therefore, accentuates the bias against saving and shifts in asset holdings imposed by the taxation of capital gains.

I must concede it is extremely difficult to measure the weight of these tax impediments to efficient performance of the capital market, but there can be little doubt that they are significant. There are a number of studies which show that the average length of time stocks

[1] In such cases, the mean value of the probability distribution of the after-tax outcomes of any given investment is reduced. The investment, then, is not only less productive but also riskier.

are held is astonishingly long. And unless one attributes these very long holding periods to irrationality on the part of savers-investors, the tax treatment of gains and losses must be held largely accountable for the immobilization of huge amounts of past saving. It must, therefore, be viewed as a serious impediment to financial market efficiency.

This is not to say that taxation alone accounts for the declining role of individual investors in our security markets or even that those tax considerations are primarily responsible for the security market conditions now causing so much concern. Nor do I mean to suggest that changes in the tax law to ease the existing burden on saving and on transactions will, of themselves, reverse the trends in the securities markets with which this subcommittee is concerned. But surely appropriate changes in the tax law will make an important contribution to a higher rate of private saving, to greater participation by individuals in the financial markets, and to more efficient functioning of those markets.

If I may, I would like to take a few minutes to offer some suggestions for changes in the tax law.

Any discussion aimed at changes in the tax treatment of capital gains and losses in the interests of mitigating the existing tax bias against saving and the ready transferability of assets faces a huge barrier of conventional wisdom which argues instead for even heavier tax burdens on capital gains. That argument is oriented primarily to so-called equity considerations. It is predicated on a concept of income deemed to be needed if the principal purpose of taxation is to equalize economic status, without regard to the impact of implementing that income concept on the neutrality of taxation with respect to the consumption-saving choice. That income concept insists that capital gains are in nowise different from any other kind of income for purposes of measuring economic status of various individuals, and that taxing capital gains less heavily than other income defeats the purpose of progressive taxation. The conventional wisdom is clearly based on highly circular reasoning. But it has so broadly permeated the policy forum that any proposal to alter the tax treatment of capital gains and losses in the interests of neutrality—equal treatment of saving and consumption—is more often than not received as special pleading for "fat cats".

As an economist, I profess no expertness regarding tax equity. Both the historical record and abstract analysis strongly suggest to me that Government tax and expenditure policies and programs are ineffective in redistributing income. Indeed they are likely to be highly counterproductive. The interests of all active participants in the economy—that is, the overwhelming majority of us—rather lies in a tax system that as little as possible interferes with our private choices as to how we obtain and use our income and wealth. Such a tax system should as little as possible change the relative costs of the alternatives we face in the marketplace. And given the enormous requirements for additional capital we face in the coming years—$250 billion it has been estimated merely for environmental control measures over the next decade, environmental control capital which adds not one single dollar's worth of goods and services to the consumer's market basket—to maintain, let alone advance our productivity and living standards will require enormous increases in capital outlay, it

seems to me. Given that fact, top priority in tax policy should be given to reducing the existing heavy tax bias against saving.

The tax proposals which I am about to present are oriented toward reducing this tax bias. In my judgment, they are also likely to make the tax laws fairer. But that judgment, just as the contrary judgments of others, should be taken as expressions of preference, not as scientifically derived truth.

It follows from my earlier argument that one important revision to reduce the existing income tax bias against saving and capital asset transactions would be to eliminate capital gains and losses entirely from the income tax base. In the context of the history of the U.S. income tax, of course, this would be a drastic change. But this subcommittee surely is aware that it is not a drastic change when viewed against the tax policiés of most of the other advanced industrial nations. Only two of them, the United Kingdom and our neighbor to the north, Canada, in fact treat capital gains similarly to the way we do. In most other countries, capital gains are excluded substantially from the tax base.

A less drastic approach would be to extend the present "rollover" treatment of gains on personal residences to a larger list of capital assets—at the least to gains on corporate securities. Under this treatment, the tax on capital gains would be deferred so long as the proceeds from the sale of eligible assets were fully reinvested. The basis of the property acquired upon reinvestment would be proportionately adjusted downward by the amount of the tax-deferred gains.

This proposal would in effect tell the saver-investor that he could maintain the value of his eligible asset holdings as long as he fully reinvests the proceeds from the sale of any of these assets. This rollover treatment, therefore, would exert a powerful incentive for remaining an active investor without penalty for engaging in capital asset transactions or changes in one's portfolio.

Both of these problems, of course, encounter the objection that they would primarily benefit the affluent. As indicated, I am highly skeptical about the relevance and validity of this objection. To the extent that such measures increase saving and business investment, their principal effect is to increase the amount of capital with which labor services are used, hence to increase the rate of advance of labor's productivity and real wages. In evaluating proposals for tax changes, it is important to look beyond their initial impact on the distribution of tax liabilities and to their ultimate effects. Failure to do so is largely responsible for the existing tax bias against saving and for resistance to tax changes to reduce that bias.

But insofar as egalitarian preferences restrict the opportunities for constructive tax changes, there are a number of less drastic revisions in the tax treatment of capital gains and losses which would provide significant abatements of the existing antisaving tax bias and encouragement for individual ownership of equity interests in American business. One of these revisions would be to allow everyone a lifetime exemption of up to, say $50,000, or $100,000 of capital gains say, $50,000 or $100,000 of capital gains realized on corporate securities and perhaps other specified types of property. A variation of this approach would be to exempt up to some specific amount of capital gains per year, say $5,000, realized on corporate securities. The tax

abatement in this general approach would obviously be far more significant to persons of modest incomes than to those with very large portfolios.

A companion change would be to increase substantially the amount of capital losses which might be offset against ordinary income. The limit under present law is $1,000. This might be increased to, say, $10,000 or $20,000. Indeed, full offset of losses against ordinary income would be highly desirable and effective. This would obviously have to be associated with a more effective carryover provision. I would suggest that a 3- or 4-year carryback of losses should be added to the present carryforward provisions for losses which cannot be offset in the current taxable year.

One proposal currently receiving a great deal of attention would provide for a downward graduation of the capital gains tax rate the longer the capital assets had been held. For example, the rate applicable to gains on property held for 5 years or less might be 25 percent, that on property held as long as 10 years might be 20 percent, and so on, with a bottom rate of 10 percent, say, on property held for 20 years or longer. As noted earlier, there is a large amount of gains locked up in capital assets which have been held for extremely long periods of time. The downward graduation of rates with length of holding period would certainly result in a flood of realizations of long-held appreciated capital assets.

To the extent that accrued gains on long-held assets reflect primarily inflation, the graduated stepdown proposal would afford at least partial recognition of this fact in determining tax liability. A more direct way, of course, of dealing with this serious difficulty would be to provide an explicit inflation adjustment in determining the amount of taxable gain.

Both of these proposals would be effective, I believe, in freeing up assets which would be realized but for their illusory appreciation. Both would somewhat reduce the additional tax burden on saving. Neither, however, deals head on with the fundamental bias against saving in the present income tax and capital gain provisions. While these proposals deserve, in my judgment, serious consideration, I hope that they would be regarded as merely very modest first steps toward the more basic revisions which I suggested earlier.

In my introductory remarks, I alluded to the proclivity to look for simple answers to complex questions. Mindful of that caution, I do not offer the above suggestions for tax revisions as a panacea. Many factors other than taxes impact on the functioning of the financial markets and influence market results. But these tax changes should make a significant contribution to mitigating existing impediments to efficient operation of financial markets. Hopefully, these proposals at the least will spur a more innovative search for constructive tax reform than is usually found in the standard reform program.

Thank you.

Senator BENTSEN. Dr. Ture, that is a most interesting presentation. I think it will be helpful to our considerations.

Now, we will hear from Dr. Musgrave who does not share many of your views, as I understand it.

STATEMENT OF DR. RICHARD A. MUSGRAVE

Dr. MUSGRAVE. Mr. Chairman, gentlemen, I am Richard A. Musgrave, professor of economics at Harvard University.

The chairman indicated at the beginning that a variety of views will be heard. If my good friend, Dr. Ture, with whom I have argued this for many years, is correct, you have had an example of straight reasoning and scientifically derived truth, and you will now be exposed to an example of circular reasoning and value judgment.

The concern of this subcommittee, as the chairman has pointed out, is, one, that the stock market has been dominated increasingly by large investors, to the detriment of the individual investor; and two, that this has resulted in a "two tier" market in which small and growing firms cannot obtain capital at reasonable cost. Moreover this has lead three, to such companies being scooped up by foreign investors at bargain prices. Specifically, however, the problem before this panel is the extent to which this situation was caused by or can be remedied through tax policy, in particular the treatment of capital gains.

Since I am not an expert on the stock market and since the long run concern of your committee is with the development of an equitable and efficient tax structure, I will address myself primarily to this tax issue. However, a brief look at the broader problem is needed to set the stage. As I see it, the growing role of institutional investors is a largely inevitable development, reflecting as it does the desire of individual savers to delegate their investment management to such institutions. At the same time this development has been encouraged by tax advantages and can be retarded somewhat by their removal. The high degree of concentration in the investment business and the resulting diversion of funds toward established companies with increasing cost of financing for smaller firms on the other hand is not inevitable. At the same time it is a problem the remedy of which calls for regulatory rather than tax policy measures. A further widening of the capital gains perference in particular is not the proper remedy; and the two-tier issue now before you should not be permitted to divert the Finance Committee from the goals of tax reform, goals which I believe, to quote Dr. Ture's conventional wisdom, call for a tightening rather than a relaxation in the tax treatment of capital gains.

Let me therefore begin with a brief statement why the current capital gains preference should be curtailed and why most students of taxation are agreed that an equitable income tax calls for the taxation of capital gains as ordinary income. In principle, at least, such taxation should apply whether capital gains are realized or not. The underlying principles are these:

1. Under the income tax a person's ability to pay should be measured in terms of the accretion to his economic capacity; and this is the case independent of the sources from which the income was derived or the uses to which it was put.

2. As to sources, the tax treatment of income—as a measure of broad based taxable capacity—should not differentiate berween wage or capital income, nor should it distinguish between different types of capital income. Thus, dividend income should be treated in the same way as interest income, and capital gains should be treated in the

same way as these two. A dollar of income is a dollar and in all cases there results the same addition of the taxpayer's economic capacity. Moreover, it should make no difference whether capital gains are realized or not. If my net worth has increased by $1,000 I have become wealthier by $1,000. Whether I choose to sell and reinvest or to retain the particular asset is merely a matter of deciding how to use the gain or to arrange my investments. It should not be of concern from the tax point of view.

3. Turning to uses, the income tax should be indifferent as to whether a person decides to consume or to save, to swap investments or to maintain his portfolio unchanged. How the taxpayer uses his economic capacity is his business. The tax is to be based on his gain in capacity, that is all.

4. All this is quite straightforward. Income measured as accretion therefore calls for the inclusion of capital gains in the tax base. At the same time, I do not deny that a case can be made for other forms of taxation. In particular, a tax might be based on a person's consumption rather than his income. That is to say, saving may be excluded from the tax base and having done so, a personal and progressive rate tax (similar in form to the income tax) might be imposed on consumption expenditures only. There are some difficulties with implementing this new form of taxation but it can be done.

In my view, income is preferable to consumption as a measure of taxable capacity, since it provides a more comprehensive measure, but the consumption base is not nonsensical. However, and this is an important point, an argument for a consumption tax (an "expenditure tax") as against an income tax is not an argument for the exclusion of capital gains (or their preferential treatment) under the income tax. If the tax is to be on consumption, then all income which is not spent but saved should be excluded from the tax base, and not only capital gains. Under neither tax are there valid arguments, from the point of view of tax equity, to accord special treatment to capital gains. In other words, the case would be for substituting a progressive consumption tax for the income tax but not for exclusion of capital gains from the tax base under the income tax.

5. There has been literature over the years in which it is argued that a consumption tax is preferable to an income tax because the latter "double taxes" capital income. After the confusion which surrounds this argument is cleared away one is left with the conclusion that the income tax may be said to interfere with the choice between present and future consumption whereas the consumption tax does not, and that this interference may impose an "excess burden" as economists call it, which is avoided under the latter.[1] There are serious qualifications to this argument and its quantitative importance is questionable. But even if such a point can be made, it does not follow that the consumption tax would be preferable on balance. If the income base if preferred to consumption on equity grounds, an income tax may nevertheless be considered superior. After all, the only tax which does not disturb economic decisions is a head ta- , but few people—I think not

[1] One of these confusions relates to terminology. For purposes of economic theory economists have defined income as the present value of a future consumption stream which to the nontechnical reader suggests that there is no income without consumption. This, of course, is a nonsequitor. Using this terminology, we need merely say that capital gains give rise to a potential increase in present and future consumption and this is all that matters for our purposes. The fact that such potential increase exists means that there is a gain in economic capacity. This, however, is a fine point in economic semantics with which I hope this committee will not be bothered.

22-727 O - 73 - pt. 2 -- 3

even my good friend on the right—would argue that this tax, being totally unacceptable on equity grounds, should be preferred to all others.

Turning now to the practical importance of the capital gains problem it must be noted that it is not a minor aspect of tax reform but of fundamental and strategic importance. Such is the case for two reasons:

1. Failure to tax capital gains as ordinary income has been the dominent source of tax avoidance by high income groups. Capital gains as a percent of AGI rise from less than 1 percent for returns below $30,000 to 21 percent for returns above $100,000 and to over 40 percent for returns above $500,000. Counting capital gains fully, these shares are 2, 35, and 60 percent of AGI respectively. No wonder that for returns above $100,000 tax savings from capital gains account for about half of all savings from tax preference. [See J. A. Pechman and B. A. Okner, "Individual Tax Erosion by Income Classes," in economics of Federal Subsidy Programs, Joint Economic Committee, U.S. Congress, 1972.]

The treatment of capital gains thus accounts in large part for the fact that the effective tax rate (ratio of tax liability to AGI) hardly rises above 30 percent at the upper end of the scale.

Senator BENTSEN. Dr. Musgrave, it is not that Senator Bennett doesn't very much want to hear your testimony but he has a previous commitment at the White House and has to make that commitment.

Dr. MUSGRAVE. I understand that. Thank you very much for pointing it out.

While one may debate how high bracket rates should rise, a zero rate on unrealized gains and a 36.5 percent rate on realized gains are hardly adequate upper limits; and even if they were, there is no excuse for applying them to taxpayers with capital gains but not to those who receive them from other sources and must pay rates of up to 50 or 70 percent. Effective taxation of capital gains is essential to making progressive taxation stick and to do so in an equitable fashion.

2. Failure to tax capital gains as ordinary income is an all pervasive source of trouble in the Internal Revenue Code. Many or most of the tax shelter problems (at least the domestic ones) are linked to the capital gains and accelerated depreciation issue or, most typically to the two in combination. The only satisfactory solution to these difficulties, I believe, is through reform of capital gains treatment. Other remedies, such as limiting depreciation to the taxpayers' equity in the asset or interest deduction to interest received, are questionable in principle and only makeshift improvements. Combined with the minimum tax approach they lead us away from facing up to the need for redefining taxable income in equitable form.

3. The importance of the capital gains problem cannot be belittled by the fact that the revenue significance of moving toward full taxation is limited. About $15 billion obtainable from full taxation of gains (taxation at ordinary rates of realized gains and of accured gains at death or gift) may not be much, given a total take of $250 billion or more; although it is not chickenfeed. But revenue is not the entire story. Failure to tax capital gains equitably, means failure to tax high incomes equitably; and this in turn makes it impossible

or exceedingly difficult to collect the remaining $230 or $240 billion in an equitable fashion.

Turning not to problems of implementation, acceptance of the principle that capital gains should be taxed as ordinary income does not relieve one of facing the practical difficulties of so doing. Here as in other aspects of life, an ideal solution is not possible but a good deal can be done to improve matters.

1. Obviously, full taxation of realized gains without taxation of unrealized gains at death or gift would exert too heavy a lock-in effect. Obviously also, taxation of all current but unrealized gains on an annual accrual basis would be unmanageable. The solution, as has been pointed out many times, lies in taxation of accrued gains at death or gift, combined with periodic taxation (say every 5 years) of accrued gains on readily negotiable assets such as traded shares. Losses, in turn, would have to be recognized and treated on a symmetrical basis. In fact, it is precisely the principle of taxing unrealized gains which makes the latter possible; moreover, adequate provision for averaging would have to be made.

All of this involves difficulties but they can be overcome, indeed the new problems which arise may be small compared to those encountered in dealing with capital-gains-based taxshelters on a piecemeal basis.

2. The frequently raised objection that taxation of gains not realized by sale is unfair because the taxpayer has no cash with which to pay his tax poses a valid concern only where family farms or enterprises are involved. In these relatively small number of cases, special solutions may have to be found, just as such difficulties must be dealt with under the estate tax. For the bulk of the cases, I see no problem. If the taxpayer owes a tax debt, let him sell part of his assets to meet his obligations. This is only fair, provided that he is given sufficient time—at interest—to avoid losses through forced sale.

3. What is needed in capital gains tax reform is to face up to the problem of including unrealized gains in the base. Little is to be gained by tinkering with minor measures and some such proposals will make matters worse rather than better. Discarding the special 25-percent rate would be helpful as a tidying up operation but it would not make a great deal of difference. Inclusion of gains in the minimum tax helped a little. Lengthening the holding period for short gains or returning to the stepdown rate structure of the thirties, however, would set us on a wrong course, and I shall return to this presently.

There is little economic basis to the notion that short term speculation is wicked while long term holding of investment is virtuous. Indeed, preferential treatment of long holdings adds to the inequities which result from deferral of taxation of such gains.

The crux of the problem, I repeat, is not in reforming the treatment of gains realized by sale, but in first tackling the more basic issue of taxation of gains not thus realized. A proposal for taxation at death and gift was made by President Kennedy in 1963 and repeated in the Treasury's tax reform proposals submitted to the committees of the Congress in 1969. Moreover, legislation along this line has recently been adopted in Canada. Bringing capital gains into the tax base is possible and there can be no honest to goodness tax reform without doing so.

Tax deferral and inflationary gains: In concluding this part of my discussion I shall note two further and complex aspects of the problem; that is, (1) the role of tax deferral, and (2) that of inflation.

1. Tax deferral arises because capital gains are taxed when realized rather than when they accrue. This would be the case even if taxation at death or gift was applied. The taxpayer who receives income in the form of capital gains thus enjoys a benefit of tax postponement, whereas others who receive their income as wages or dividends must pay at once. Receiving a tax postponement is valuable to the taxpayer since it is equivalent to receiving an interest free loan. Or putting it differently, postponement reduces the present value of the tax. A tax of $100 payable in 10 years, discounted at a rate of 8 percent, is similar to a present tax of $46 only, so that the taxpayer is given a tax benefit of 45 percent. This suggests that to treat capital gains wholly similar to other income, an interest charge would be needed at the time when the tax is imposed. Reducing the rate of tax with the length of the holding period, therefore, works precisely in the wrong direction, as it adds to the benefits which long holdings already have obtained from tax postponement.

2. Income as a measure of taxable capacity should be viewed in real rather than in nominal terms. Capital gains which merely reflect a rise in prices do not constitute a real gain in net worth and should not be taxed. An equitable treatment of capital gains calls thus for an inflationary adjustment. Since such an adjustment is not made, it has been suggested that the present preferential treatment may be viewed as a substitute therefor.

Regarding realized gains, we note that the rise in share prices over the years has tended to be in excess of consumer prices, suggesting an inclusion ratio of 67 percent for assets held over the period from 1947 to 1972 and a 49 percent for assets held from 1960 to 1972. More recently, of course, the picture has been reversed with share prices falling together with a rise in the general price level. It must be noted, however, that unrealized gains are not taxed at all; and since such gains are a multiple of realized gains, the conclusion remains that capital gains are typically undertaxed under present law.

This conclusion is reinforced if the deferral factor is allowed for. Thus the question arises, how to construct a system under which both the deferral inflation aspects are accounted for. In this connection I would refer the committee to a paper of a young colleague of mine at Harvard, Roger Brinner, which is going to appear in the December issue of the National Tax Journal, where this matter is examined in detail.

I now turn to the effects of fuller taxation of capital gains on the health of the economy:

(1) Preferential treatment of capital gains being a powerful factor in reducing the effectiveness of progressive taxation, fuller taxation could greatly increase progressivity over the higher income ranges, and this may or may not be desirable. However, this conclusion follows only on the premise that there would be no offsetting reduction in bracket rates. Inclusion of gains combined with a reduction in rates to a maximum of 50 percent—as now applies to earned income—would cushion the increase in progressivity, while leaving us with a substantial gain in "horizontal equity," that is to say, a substantially more equal treatment of people with equal taxable capacity or income.

(2) The argument may be made that capital income is taxed more heavily than wage income since it is not only subject to the personal income tax but also to the corporation profits tax and to property taxes. This being the case, is not the preferential treatment of capital gains a justified offset to this discrimination? My response is that preferential treatment of capital gains is not the appropriate remedy. If the tax burden on capital income is to be reduced, the proper remedy is to treat all capital income alike, and not to limit the relief to capital gains. I would thus combine full taxation of gains with integration of corporate-source income into the individual income tax, without there being an additional corporation tax. Such an approach would improve horizontal equity as well as close the loophole which the preferential treatment of capital gains now provides for high bracket taxpayers.

(3) In considering the effects of fuller capital gains taxation on the level of investment and economic growth, a distinction must be drawn once more between the overall level of capital taxation and how it is imposed. Fuller taxation of capital gains would shift a larger part of the burden to this form of capital income; but unless the overall level was increased in the process, the burden on other forms of capital income would be reduced. On balance, I see no presumption that the effect would be harmful to growth. Preferential treatment of capital gains as a whole, I think, is not an efficient way of giving tax incentives to investment. At the same time, it is a highly inequitable way. Tax policy aimed at furthering growth must be designed to accomplish this objective with the least damage to tax equity and from this point of view the capital gains preference is a very poor approach.

(4) In concluding, I return to the bearing of tax policy on financial markets and the particular concern of your committee with the growing role of institutional investors.

This growth, of course, is no recent phenomenon, but a continuation of a long-term trend, extending back to the beginning of the century. As capital markets broaden and become more complex, individual investors naturally wish to delegate their investment decisions to experts who are in a better position to make intelligent choices. This is merely a sensible division of labor. Moreover, this development reflects the changing structure of saving. As income rises, people are enabled to retire sooner, and this requires savings to be placed into forms which serve the retirement purpose, for example, savings institutions of various kinds. For this and other reasons, the growth of institutional investment management is a natural development, and I see no need for deploring it. Indeed, one would expect the needs of both savers and the capital market—though not perhaps the brokerage business—to be served better in the process.

At the same time, the case for institutional investment does not call for excessive and growing concentration in this business. Indeed, the evils of excessive concentration in this industry may well be more pernicious and the potential gains in productivity less than in other industries. The specter of Japanese-type financial concentration is indeed a frightening one. At the same time, I find it somewhat difficult to understand why the increased importance of institutional investors must lead to a two-tier market and resulting dearth of funds for small firms. Should one not expect that institutional investors, being larger in size—even without being huge—will be better able to undertake the

investment research required for detecting promising small firms than the individual investors for whom the purchase of well-known shares may well be the only feasible solution? The recent tendency for institutional investors to concentrate on a relatively small number of large glamour stocks may thus be somewhat of a fad. As time goes on, this fad will subside—and there are already indications thereof—and bubbles may arise in other sectors of the market. Nevertheless, the very existence of large portfolios may cause such bubbles to develop more easily and to interfere with an even-handed market. If so, this accentuates the overall problem posed by heavy concentration in the investment industry.

The way to deal with it, however, is not through tax adjustments or at least not primarily so. The obvious remedy is to limit the size of investment management firms and to break up the 10 or 20 largest firms that now dominate the market. Unbroken over a period of years, this should pose no great difficulty, as no physical plant or production structure is involved. If the result is insufficient and there is still a dearth of capital for small firms, a requirement to hold x percent of assets in such issues could be considered. However, the proper approach to small business relief, if it is to be granted, is to go the direct route of subsidy. Certainly, the way to help small business is not through tax relief which combines inefficient aid to small business with effective but inequitable grants to large investors.

In this connection, it is important not to be misled by a picture of the market that shows little individuals driven out of the market by huge institutions. The fact of the matter is that these institutions—which, I agree, should not be permitted to be so huge—reflect, to a substantial degree, the interests of the little individual who has placed his investment into life insurance, savings accounts, or mutuals, whereas the individual investor—through little in terms of his market share—is typically a very substantial person in the high-income brackets. While his participation in the market may be increased somewhat by reducing the taxation of realized gains, provided that the additional funds do not go into mutuals, the further deterioration in tax equity would be too high a price to pay. The structural problem with which you are concerned, therefore, is not a tax problem—except perhaps for certain measures to tighten the tax treatment of pension funds—but one of excessive size; and the proper remedy for what lies in a ceiling on the portfolio which may be managed by any one firm.

Finally, a further word about the lock-in effect of capital gains taxation. Just as an increase in the tax on realized gains, taken by itself, would increase this effect, so would a reduction reduce it. This, however, is not the only way in which to approach the problem. As I have noted before, the lock-in effect is reduced also by inclusion of unrealized gains in the tax base; and, as a matter of equitable taxation, this is the approach toward which we should move. I hope that the committee's current concern with the financial market and the two-tier problem will not lead you to lose sight of this more important and lasting objective of tax reform.

Thank you.

Senator BENTSEN. Thank you, Dr. Musgrave, for your testimony. I think that it will be helpful to us.

Can you tell me what capital gains policies are in effect in some of the developed countries of the world, such as England, Germany, and Japan?

Dr. MUSGRAVE. Well, Canada and the United Kingdom moved pretty much to the present U.S. system. Canada moved pretty much to the present U.S. system on realized gains but added taxation at death and gift of unrealized gains. There is a wide variety of the tax treatment in continental countries. On the whole, their tax treatment on capital gains is looser than ours.

On the whole it is less tight, less tight among continental countries than it is in the United States.

Senator BENTSEN. Now, you made a statement that you couldn't understand why large financial institutions wouldn't make greater investments in some of the smaller companies because these institutions would be better equipped to undertake the kind of research required to detect small promising firms than individual investors.

Well, I would agree with you but it doesn't work out that way. The testimony we have had before us from the Morgan Guaranty Trust Co. indicates that of the $21.4 billion of common stock held by Morgan, over $19 billion of it is in shares of larger companies. Now, which are those? Those are companies with capitalizations of more than $500 million.

The witness for Morgan says that:

> While I am sure we have invested in companies with capitalizations of as little as $5 million, we would have to be really interested to do so.

It is pretty obvious that they haven't done it in many instances.

Then you have to look at the practicalities of what they are faced with. They have an eight-man investment committee making these decisions for over $21.4 billion worth of stock. So as a practical matter it is a lot easier for them to limit themselves to the larger companies.

You made a comment that a capital gains tax at death would free the sale of stocks by older persons who might otherwise hold the stocks until death to avoid any capital gains tax. That might be true in some cases, but I can't help but remember an attorney friend of mine whose specialty was drafting wills. He told me that of all the clients that he drafted wills for, there were only two who prefaced their requests by saying, "When I die," while all the rest said, "If I die."

Mr. Kelso, Senator Bennett had a couple of questions he wanted me to ask you concerning your proposed plan. Does the employee have any option—as I understand it, your plan aims to encourage the ownership of corporations by the corporate employees.

Mr. KELSO. That is correct.

Senator BENTSEN. Does the employee have any option in that, or is it a compulsory thing; and in turn, if he gets out of it, can he still stay with the company?

Mr. KELSO. Senator, he has no choice. That is to say, merely by being an employee, he automatically is put in a position where, over a period of years, he accumulates in his account shares of stock in the company. It doesn't take anything out of his paycheck, and he does take it if he leaves under an investing schedule and the maxi-

mum investing schedule is 10 years. Many corporations fully vest them in 5 years.

I might add, Senator, even though employee stock ownership financing is used ultimately to finance the growth of the corporation, and to build ownership into the individual employees, it is a simple matter to thereafter achieve diversification. That is to say, the employee stock ownership trust can exchange shares in that trust with shares held by any other trust or both on the open market, for that matter, as a tax-exempt trust, and can be diversified if that is desirable. There really are—and for this reason I think that this proposal does address itself to the question of how you finance small companies.

At the end of our paper, we have a list of legislative proposals there. One of them is the development of a capital diffusion insurance corporation which would be somewhat the counterpart of the FHA in the consumer field. FHA insurance insures a lender that loans on home mortgages. Capital diffusion insurance corporation would insure a lender that loans to an employee trust for the purpose of financing growth and building ownership into employees. We think that this, together with the ability to really finance growth on credit, which I intended to point to when I suggested drawing in the Federal Reserve, the ability of the lender to discount with the Federal Reserve, really gives us open-ended power to finance the growth of our industry, completely untrammeled by ay kind of institutional limitations. In other words, the growth of the economy would be limited by purely physical things: Resources, manpower, desire of the market to consume.

Senator BENTSEN. Dr. Ture, is it your opinion that the locked-in gains of persons over age 60 would come into the marketplace if there was a stepdown in the capital-gains tax relating to the period of holding?

Dr. TURE. Senator Bentsen, certainly there would be a much stronger incentive on the part of those holders to investigate opportunities to change the composition of their portfolios. One of the things they would have to bear in mind, of course, is that if there were some large disgorging of those securities over a relatively short period of time, capital losses would start to accumulate at a pretty fair clip, and that in itself would act as a check against the liquidation of those holdings. But on the whole, it seems to me perfectly clear that you would get at least one very powerful one-shot effect in getting people to liquidate holdings that they have held for a very long period of time, not because they found them the single most attractive asset to have in their portfolios, but because they want to avoid the very substantial tax penalty on changes in their portfolio.

Now, thereafter, what the effect would be would, I think, depend on the detailed specifics of a downward graduated plan. I could very well visualize that one of the reservations about it is that downward graduation always affords an inducement to hold on a little longer instead of to liquidate or to transact in the very near term. If you are within, for example, a year's time of a 5-point cut in the rate that you will pay on gains that you will realize, you are likely to think very seriously about selling those assets today and think very seriously about the advantage of holding onto them for another year.

Senator BENTSEN. On the other hand, if it is graduated at the rate of 1 or 2 percent a year for a period of years, I assume that 1 year's

differential wouldn't make a lot of difference in an investment decision.

Dr. TURE. Well, I would suggest that the longer the time period before there is another stepdown in the rate, the less the locking-in effect of downward graduation would be. Some of the downward graduation plants, of course, I think would have a perverse effect, but those that I think are receiving considerable attention today involving 5-year stepdown periods, are not so likely to involve that perverse effect.

Senator BENTSEN. Do you think this will increase revenues collected by the Government or not?

Dr. TURE. Well, certainly with respect to that first one-shot effect, I can't help but see that there would be a very substantial revenue gain. I am not in a position to offer you any estimate for it. I am sure staff can. But to the extent that people in fact are locked in and find a very low rate available to them for liquidation of assets that they don't really want to hold any longer, of course there will be substantial revenue gain flowing into the Treasury, at least the first time around.

Senator BENTSEN. Dr. Musgrave, are there incentives for investment that you would prefer rather than lowering the capital-gains rate?

Dr. MUSGRAVE. Yes. I certainly prefer the investment credit approach. I think that it is much preferable. For one thing, it addresses itself to real investment taking place. It is not related to a particular type of financing, and it is much more acceptable from the point of view of the equity of the income tax.

If investment incentives are to be given, they should not be given in a way which introduces new inequities into the tax structure, because then they will be looked upon as devices of tax avoidance by the affluent. They have to be given in honest fashion which says, all right, we want to give investment incentives on the one side, but we do not want to use the need for giving investment incentives as a means of vitiating the taxation of the rich.

I think the investment credit is both more effective dollar for dollar as investment incentive, and it is much more acceptable on equity grounds.

Senator BENTSEN. I agree that the investment tax credit is an effective tool, but it is something that increases investment by corporations rather than adding individual investors to the marketplace. Wouldn't that be correct?

Dr. MUSGRAVE. Certainly the investment credit should be applied to partnerships and to individuals as well as to corporations.

Senator BENTSEN. If you move it to partnerships, it would be just a step away from individuals, then, wouldn't it?

Dr. MUSGRAVE. Present law permits the credit to be taken by noncorporate investors. Moreover, the individual who invests in corporate shares will benefit from the credit which is given to the corporation.

Mr. KELSO. Senator, could I address that question?

Senator BENTSEN. Yes.

Mr. KELSO. One of the most serious problems about the ownership basis is, of course, the increasably concentrated ownership of equity capital in the U.S. economy. One percent of the consumer units owns 71 percent of the equity base.

Now, the investment credit is one of the best ways in the world to further concentrate that. That is to say, you can give them invest-

ment credit of any amount you want. All you do is strengthen and concentrate the ownership of the existing shareholders. I would submit that two bills that are cited in our paper, namely the bill S. 1370 introduced by Senators Fannin, Hansen, and Dominick on March 27 of this year, and the companion bill, H.R. 8590 introduced by Congressman Frenzel, are ideal means of encouraging incentive to investment through amplifying the use of employee stock ownership trusts.

There are a number of features to that. One is the increasing of the limits of deductibility which is the amount of financing that can be run through the trust which would accelerate the growth, the equity, both to finance business and to build ownership into employees.

Another is a provision which would make dividends deductible from the corporate income tax if paid into the trust provided the trust passes them through into the employees' pocket.

Here is a way of getting a second source of income into employees and, by the way, to broaden the idea and inculcate the idea of the importance of capital ownership which our whole economy has paid lip service to but never has really done very much about.

Finally, one of the provisions of those bills would give the employee stock ownership trust the same status as 501(c)(3) foundations.

Now, when the rich man reaches the end of the line and he clearly, as your attorney friend indicates, doesn't ever think he is going to reach it, but there is one other thing: he also thinks he is going to somehow or other take it with him when he goes. (No one has really quite made it yet; when they don't, they leave it here.) Now, the tax laws are so designed that he cannot really leave it to individuals if it is a big fortune. What does he do? He socializes it. That is to say, specifically disconnects it from people in the great general purpose foundations.

The provisions of this bill would permit a man of giant wealth, say a Henry Ford, to set up in cooperation with the Ford Motor Co. or any other corporation, for that matter, employee stock ownership trusts into which he could give his wealth the same tax advantage to himself but the difference would be that it enables the corporation to raise the incomes and economic security of employees without raising costs and, of course, to broaden the equity ownership base and reconnect the capital and rebuild the Government physical base. Bigger taxpayers, bigger incomes.

Senator BENTSEN. Thank you, Mr. Kelso.

We know that private investment in other countries is a much greater percentage of their GNP than ours and their record of productivity looks better these days when we look at Japan. Gross fixed capital formation in that country is 35 percent of its GNP compared to 25 percent in the Common Market, and less than 15 percent in this country. Of course, I know we spend a lot more proportionately on essentially nonproductive things, military at one end and welfare at the other end. Don't you think we have to encourage savings and investment in this country to a greater extent than we have today?

Dr. Ture, would you comment on that?

Dr. TURE. Yes. Let me consider those data just to make sure we have them in proper perspective.

One comment, first of all, is that it is just terribly difficult to make those comparisons. I know because I have tried on many occasions and this is an enormously frustrating statistical search.

What you will find, among other things, is that in a number of nation's national accounts—unlike those of the United States—there is a tendency to lump together both public and private capital formation, and in a number of countries, of course, a substantial amount of the investment in residential construction is undertaken under public auspices—a much, much larger——

Senator BENTSEN. Let me say that the numbers I gave you are U.S. Government estimates.

Dr. TURE. It is good to have them. I will look forward to them in the record, and I would appreciate being able to look at them.

The second reservation is the following. The effectiveness of any additional amount of capital in increasing output or productivity depends on how much capital you have in relation to labor in the first place. The United States, of course, has a much higher capital-labor ratio than any of the other countries that we are looking at. What that really means is that any additional *x* number of dollars worth of capital will add less to productivity here than it will abroad.

Now, having put that reservation in place, let me then hasten to say that I find the existing biases in our tax laws as well as in other institutional features imposed by Government, for example, in regulatory policies generally, the existing biases imposed against saving and capital formation are wholly without social purpose.

Now, I have the greatest respect and admiration for Professor Musgrave. We have been friends and professional associates for a long time and I respect his judgments about equity considerations. I don't see how I could possible gainsay his right to place very high priority on that as a guide to tax policy. So far as I am concerned, I find the matter a great deal more tenuous. I don't understand, candidly, these equity considerations, with the crystal clarity that some of my colleagues seem to, and it seems to me that vastly more important than that very will-o-the-wispy kind of policy criterion is to make sure that the economy operates efficiently. I am confident that if we are permitted to do so by the proper institutional structure that the equity problems would diminish in severity for all of us.

I think the present tax biases which initiate with taxation—the inclusion of saving in the tax base as well as the taxation of the returns on saving at the individual level, the additional tier of corporate taxation, the additional tier of capital gains taxation, the additional tier of property taxation at the State and local level, the additional tier of estate and gift taxation, and inheritance taxes at the State and local level, these amount to an enormous bias against saving and capital formation. Another associate of mine, on one occasion or another, held up a cigarette in front of an audience and said, "We tax the consumption of this vastly less than we tax saving." It is as if we treat saving as a woefully inferior good.

I don't understand what objectives of social policy are to be pursued with the present tax biases against saving and capital formation. So surely I would associate myself with the sentiment that you expressed. It would be wholly constructive, indeed, to move toward a

much more nearly neutral tax system. I am willing to take that a bit at a time. I agree with Dr. Musgrave that we really ought to take saving out of the tax base entirely but I don't think that is really a feasible suggestion at this point in time. I think it is a fairly drastic proposal, to say the least. Let's take one part of the existing tax bias against saving and modify that by eliminating capital gains from the tax base. I grant that is drastic. I think it is high time for us to think about drastic solutions to problems that are of long standing.

Senator BENTSEN. Dr. Musgrave, I am concerned about some of the major institutions getting locked in on high multiple stocks. We have seen a situation where it looks like some of them are in a position to have self-fulfilling prophecies or are manufacturing their own prophecies. We have some corporate stock down there in the mud and then other corporate stock that seems to take the approach of Jonathan Livingston Seagull, absolutely no limits.

We saw a situation where IBM took a very severe drop and the large institutions started buying again and the market recovered. We know that one particular institution has over a billion dollars a year in new income and if it served their purpose, they actually could keep up the price of stocks in their portfolios.

That sort of thing gives me some concern. Does it you?

Dr. MUSGRAVE. I share your concern with the fact that these are such huge concentrations in the investment business and I see no particular purpose, good purpose, which this serves. Economists have argued that one should hesitate to condemn large producing units such as manufacturing corporations because bigness may offer advantages in technical developments and innovations, and that these should be balanced against the more traditional case against monopolistic market shares. But these defenses of size do not apply to the financial market at all. I say if you are worried about large institutional investors, then divide them up. Set a ceiling on the portfolio which they can hold. That is the way to deal with the problem rather than to accentuate what I think are defects in the tax system.

Could I go back to the preceding question for a second?

Senator BENTSEN. Sure

Dr. MUSGRAVE. If we draw a comparison with other countries that have a much higher investment to GNP ratio, we should keep in mind that they, especially Japan, were in the process of tooling up, that they were in the process of building themselves a modern economy. Counties in that position, such as South Korea, have a growth rate of 15 percent. That rate can be maintained for a while until the economy is built up, but you can't really compare them with us.

Moreover, the matter of productivity with growth is to a considerable degree not just expanding the capital stock but introducing new technology which involves replacement investment as well as new investment. Our capital stock being very large, this is of particular importance for us.

In addition if one is worried about inadequacy of the American capital stock for the American worker, one should do something about the tax laws which encourage huge outflows of capital by American corporations which otherwise would have to be invested in the American market.

While personally I am not worried about our growth rate or our ratio of gross investment to GNP, I would urge that such measures

as are taken to increase this should be taken in a way which does not—by my value judgment—render more unequal the distribution of income and wealth.

I agree with Mr. Kelso's sentiments on that matter, but I don't see at all how his scheme will make a really significant difference in this respect. After all, from where are the additional savings which should flow into the pension funds going to be diverted? If wages are not increased, if the wage-profit share is not affected, where are the funds going to come from? I just don't see the macroeconomic consistency——

Mr. KELSO. May I respond to that?

Dr. MUSGRAVE [continuing]. Of the scheme the big burden remains on the tax system and if you use taxation to engage in growth policy you have to keep in mind the equity objective.

If one is worried about the level of saving, one might argue for replacing the income tax in part by a consumption tax. The way to do this is to place a progressive rate expenditure tax on consumption, then you retain progressivity in the system. But if you don't do it that way, if you do it by excluding capital gains from the income tax base, then the distributional aspects of the thing are totally different. And I think unacceptable.

Senator BENTSEN. Dr. Ture, would you like to respond?

Dr. TURE. If I may.

Mr. KELSO. Could I also, eventually?

Senator BENTSEN. We will try to. We are running out of time.

Dr. TURE. There are so many things to respond to I will have to economize in response.

Let me first respond to your question, if I may, sir.

I am sure that the management of a large number of these very large institutional funds are equally concerned about the problem that you mentioned and I am glad—I was delighted to hear you put it just that way because it was a much better exposition of what I was trying to get at when I was talking about efficient operation of the financial markets and the adverse impact of the thinning out of the market.

Surely if a large institutional investor decides that it might want to reduce the amount of its holdings of a particular share of stock, one of the things it has to be terribly concerned about is whether or not it can do so without really just bashing the market and it would certainly prefer to be in a situation where it would not have to be concerned about the liquidity of any particular part of its portfolio on the basis of its own actions. I don't think the solution is, as Dr. Musgrave suggests, breaking up these large institutional funds in any penal action. I think the initial impact of that would probably be catastrophic.

Rather, I think it is to find a way of diluting their influence by bringing a great many more participants into the market and therefore diffusing their concentration of ownership.

Now, I think that the existing tax impediments toward active participation by individuals as investors in the market are not inconsequential. I know there are a number of economists who say they have very little impact. In my judgment, both their analysis and the data on which they produced that analysis are wrong. I think

they have a very powerful impact, and I would suggest what is called for is a very critical examination of existing tax provisions and a very bold and general search for new ways of taxation which will in fact provide much more nearly neutral treatment as between saving and consumption.

Senator BENTSEN. Dr. Ture, thank you very much.

One of the things that concerns me, too, is the increasing debt-equity ratio that we are seeing for so many companies in the last few years and the problem, as I stated earlier at today's hearings, is that these smaller and medium-sized companies are having a great deal of difficulty raising equity capital. One thing we have to emphasize is how this relates to the employee on the assembly line who probably doesn't pay much attention to the financial pages of the newspapers. However, unless these companies can expand, they are going to find themselves merged and taken over. Sometimes some of the plants close down as a result of a merger and these employees are out of jobs. So whether or not these small- and medium-sized companies can raise money directly affects the economy of their entire area and in particular the employees that work with them.

I want to say, gentlemen, that our time has run out.

Mr. KELSO. Senator, could I just briefly comment?

Senator BENTSEN. Yes, if you would quite briefly, please.

Mr. KELSO. I will indeed.

There are two answers to Professor Musgrave's comment as to where does the money some from. One of those answers is that it would channel a large part—if employee stock ownership financing were used, it would channel a large part of the corporate retirement funds into the growth of industry itself rather than into merely bidding up the prices of outstanding securities. That doesn't create new capital formation.

Secondly, it is an old economist's tale that new capital formation can only be financed out of past savings. That is absolutely not true and it is not historically what has happened in most cases. It would be impossible to explain the growth of Japan if that were true.

New capital formation could be financed out of pure credit so that there really is no limitation—there is no such question as where does the money come from. Credit is simply the right of people to contract with each other.

Senator BENTSEN. Dr. Ture?

Dr. TURE. Well, with all due respect, I would like to say that I think there are a large number of elements in Mr. Kelso's proposal that are extremely attractive, but I think the record ought to be correct with respect to the point that was raised by Dr. Musgrave to which you have just responded.

Look at our national income accounts. The amount of gross private domestic investment is precisely equal to the amount of gross national saving and that isn't simply an accounting device. That represents a necessary equality in any economy, and I don't care what the structure of that economy is, whether it is the Japanese, Soviet, or anybody else. If you try to finance an increment of capital outlays by the creation of additional credit, either it will all be nominal, that is, just price changes and not real, or there has to be a commensurate increase in saving. If it doesn't come about, you don't get the capital.

Senator BENTSEN. Thank you, gentlemen. I have a list of questions that I would like to submit to each of you for the record, and I would appreciate very much your answers being contributed to the record.

This has been very helpful and enlightening and I will carefully review each of your testimony. Obviously, we have had a good colloquy here and I think that is a contribution.

Thank you very much.

The committee will stand adjourned until tomorrow at 10 a.m. in room 2228.

[The questions of Senator Bentsen, with replies, and the prepared statements of the preceding witnesses follow:]

QUESTIONS SUBMITTED BY SENATOR BENTSEN TO DR. MUSGRAVE

Question. How do you feel about liberalizing the decutibility of capital losses against ordinary income by increasing the maximum loss that can be deducted from $1,000 to $5,000 per year?

What about a capital loss carry-back as Mr. Ture suggested?

Answer. In principal, I favor full allowance of capital losses against other income. Just as gains should be treated as ordinary gains, so should losses be treated as ordinary losses. This involves extensive carry forward and back as well as the offsetting of losses against other forms of income. However, in a system where gains are taxed only when realized, full allowance for losses would be asymmetrical. The investor can avoid taxation of gains (by not realising) while making sure of allowance for losses (by realising). Therefore, the loss problem has to be solved in conjunction with taxation of unrealized as well as realized gains. Moreover it would not be reasonable to permit tax savings from capital losses at the full rate while capital gains are taxed at a preferential rate only. In the absence of a more complete solution, one should therefore be careful with liberalising the loss treatment. I say this with some regret because within an overall solution to the problem which provides for the taxation of unrealized gains, I am wholly in favor of full provision for loss allowance.

Question. You have mentioned the alternative of a consumption tax—I wonder if you could elaborate on its desirability or non-desirability from an economic standpoint.

Answer. The case for consumption taxes differs depending on whether reference is to the usual type of sales taxes or excises, or whether it is to a consumption tax of a personal type, i.e., based on the taxpayers annual total outlays on consumption, with progressive rates and personal exemptions, more or less similar to the approach now taken under the income tax. My reference in the statement was to the latter type of personal consumption tax. The case for such a tax may be based on: (1) the judgment that consumption is preferable as a measure of taxable capacity to income; and (2) on the proposition that the tax system should be designed to be more favorable towards saving, thus permitting a higher ratio of investment to GNP. While I think that these are arguable positions, I do not share these views.

The idea that a person should be taxed "in accordance with what he takes out of the pot" rather than in accordance with what "he puts into it" is of long standing, having been advanced, among others, by Hobbes. Nevertheless, I feel that this interpretation of saving, as a sacrifice being made to the good of society, is rather far-fetched. A person who receives income may choose to consume or to save, and at times he may choose to dissave wealth which has been accumulated in the past. In all these cases, he makes what he considers the best use of his income. I thus consider income, defined to include a person's entire accretion to his wealth, as the more meaningful and suitable basis by which to measure a person's taxable capacity.

Turning to the level of saving, the question is by how much substitution of a consumption for an income tax would increase the level of private saving; by how much such an increase would raise the rate of growth, and how important this is as a policy objective. Regarding effects on the rate saving, partial replacement of the income with a consumption tax (even at progressive rates) would undoubtedly increase the savings rate in the private sector. With personal savings now at $50 billion an increase of say $10 or $15 billion might result. This would increase private sector saving as a whole by about fifteen percent, permitting an increase in the ratio of investment to GNP from say fifteen to seventeen percent.

As a result, an increase in the annual rate of productivity gain from about 4 to 4.5 percent might result. While thse magnitudes are rough guesses, they suggest the range involved.

However this may be, it should be noted that increased private sector saving is not the only way in which the amount of capital formation available to the U.S. labor force can be increased. As noted in my statement, there has been a massive diversion of U.S. corporative investment into foreign subsidiaries which could be retarded and he made available to U.S. labor. Moreover, a substantial part of the increased need for capital formation which is said to arise in connection with environmental requirements is appropriately financed in the public sector, thus calling for public saving, i.e., a higher rate of taxation and budget surplus or a lesser rate of deficit.

Whether a higher ratio of investment to GNP is an essential objective for U.S. economic policy, finally, is not readily answered. Comparison with economies which have only recently emerged from a less developed state (such as Japan) or with economies which are in the process of making a break-through to industrial production for mass markets (such as some of the European countries) are misleading. The high growth rate recorded by these economies is a more or less temporary phenomenon and those countries will settle down to a lower rate, more similar to that of the U.S., after this transition has been completed. The question whether our concern should be with an improved allocation of resources and division of current output, as against an increased rate of growth has been discussed at length in recent years and I need not review it here.

The main point which I tried to make in my testimony does not involve a case for or against policy measures to further growth. Rather, my point was that given a set goal to further the rate of growth, tax measures designed to achieve this objective should be constructed carefully so as to induce savings and investment in a way which will be most compatible (or least incompatible) with the objectives of an equitable tax structure. The capital gains device in particular does not meet this test. It is not an efficient investment incentive while at the same time resulting in benefits which accrue very largely to taxpayers in the high income brackets.

Question. You have noted that equitable treatment of capital gains does require an adjustment for inflation. Could this be done by adding a fixed percentage increase to the basis of a capital asset annually?

Answer. Inflation rates differ greatly by holding periods. The adjustment therefore should not be made on a flat basis but be based on the price rise during the actual holding period. In other words, the case for inflation adjustment cannot be mechanically translated into a case for reducing tax rates automatically for each year of additional holding. Based on the cost of living index, a table for base adjustment can be readily worked out, with the applicable adjustment rate depending on the period over which the asset was held. Thus for 1974, the Treasury would issue a table indicating the inflation adjustment appropriate for assets held for one, two, three. . .ten. . .twenty-five years, with the latter a cut-off base. A new table would then be issued in 1975 covering the then past twenty-five years and so forth for each year.

I must, however, add a qualification: The inflation adjustment (permitting a write-up of base) should be combined with an interest charge to account for the advantages which have been derived from the deferral of tax liabilities. This will add to the tax liability otherwise due so that the combined adjustment may be a plus or a minus depending on the period in question. Adjustment ratios of this sort are given in the article by Roger Brinner in the *National Tax Journal* for December 1973, referred to in my earlier statement. With certain simplifications an annual table allowing for the combined adjustment may be worked out by the Treasury, with application of this table by the taxpayers a simple matter of routine. Since both types of adjustment are an essential part of moving towards an equitable treatment of capital gains, I would be hesitant to undertake the inflation adjustment without also introducing an adjustment for deferral gains.

Question. Is it correct that in addition to urging that capital gains be taxed as ordinary income, you would also reduce the maximum tax on such income to 50%, eliminate the separate tax on corporate income, and change the tax treatment of capital assets transferred by gift or at death?

So, broad changes would be necessary before changing the tax treatment of capital gains?

Answer. Yes, if I had my way, I would combine (1) rate revisions and (2) integration of corporate source income into the individual income tax with (3) full taxation of capital gains. It does not follow, however, that nothing should be done

about (3) in the absence of both (1) and (2). Taxation of unrealized gains (at death or transfer) at the preferential maximum rate of 36% (now applicable to realized gains) should be applied even in absence of integration. While some case can be made for a preferential rate (as applied to corporate shares) as a rough offset for the "double taxation" of corporate source income, this is not a satisfactory way of dealing with the problem. In the longer run, an equitable solution calls for integration of corporate source income with full taxation of gains whether realized or not.

Question. In urging taxation of capital gains as ordinary income you point out that net worth is increased by such gains, whether you sell such assets or continue to hold them and whether you use the proceeds of sale for reinvestment or consumption. Don't we have an important stake in encouraging continued use of these funds in the capital market?

Answer. The question may be divided into two parts, i.e. (a), is it desirable to encourage the investor to hold on to particular assets and (b) is it desirable to encourage him to maintain his net worth and not to dissave?

The answer to (a) is clearly no. The capital market should be fluid and the tax law should not encourage the investor to stay locked in. This can be accomplished either by combining the taxation of real gains with a roll-over provision (as Dr. Ture suggests) or by including unrealized gains in the tax base (as I prefer). Either approach will do. The argument that the investor will disregard taxation at death (as raised by Senator Bentsen) is unconvincing to me; and if it were correct, there would indeed be a strong case for highly progressive estate taxes.

With regard to (b) I refer you again to my answer on the consumption tax question. If we wish to encourage investment and saving, this inducement should be given generally and not only for capital gains. In this case, part of the income tax ought to be replaced by a progressive consumption tax. The capital gains route, as noted before, is neither an efficient nor an equitable way of dealing with the growth problem.

Questions Submitted by Senator Bentsen to Dr. Ture

Question. Would not the effect of your proposal to exempt savings from taxation increase the tax burden on low and middle income families, since they have to consume a higher fraction of their income than higher income families?

Answer. Reducing the tax bias against saving must benefit all taxpayers, directly and indirectly. Widely used in support of tax proposals which would increase the penalty on saving is the notion that only the rich save. The notion is simply incorrect. The vast bulk of personal saving is undertaken by middle-income households. In any event, the present disproportionatley heavy tax burden on saving rests directly on all individuals subject to income and property taxes; the corporation income tax indirectly burdens the saving of everyone as well as directly burdening saving by shareholders. Taxing saving no more heavily than consumption would allow everyone to make consumption-saving choices undistorted by the present tax penalty against saving. To be sure, the proportionate tax reduction for those upper-bracket taxpayers who save a relatively large proportion of their income would be greater than that for a low-bracket taxpayer who saves little, but this is because the present graduated tax rate structure increasingly penalizes saving the higher taxpayer's income. Removing current saving from the tax base would make both rich and poor better off. Moreover, the resulting changes in tax liability distribution by income level would only be the initial impact of providing equal tax treatment of saving and consumption. Far more important would be the subsequent increase in total production capacity, total income, and the increase in labor's productivity and real earnings.

Question. If the capital gains tax were reduced, what would you suggest as to the taxation of other types of return on saving—dividends, interest, etc.?

Answer. The basic proposal for equal tax treatment of saving and consumption requires eliminating multiple taxation of saving and future income provided by that saving. Under the individual income tax, tax is paid not only on the amount of current income saved but also on the future income produced by current saving. Additional tax burdens on the same future income are imposed by the corporation income tax and by the taxation of capital gains. Placing saving on an equal footing with consumption calls for either eliminating current saving from the tax base and taxing all future income and the full proceeds from the sale of capital assets, or if current saving is taxed, eliminating tax on all future income generated by the saving.

22-727 O - 73 - pt. 2 -- 4

Reducing the current tax on capital gains is a temporizing measure, a modest first step toward reducing the tax bias against saving. So long as current saving is included in the tax base, reducing taxes on dividends, interest, rents, etc. would be constructive measures. Personnally, I would prefer excluding current saving from the tax base and fully taxing all return to saving.

Question. Do you have any idea how much capital formation has been discouraged by the disincentive for saving of the income tax? Could you give us some rough idea of the magnitude of this effect?

Answer. It is difficult to estimate precisely the amount of capital formation foregone as a result of the income tax bias against saving. The elements of the rough estimate are:

On the National Income Accounts basis, the average effective income tax rate (i.e., Federal individual and corporation income tax liabilities divided by national income) in 1972 was 15.5 percent. This implies that these taxes increased the cost of saving relative to consumption by 18.3 percent:

a. If the overall effective tax rate is 15.5 percent, the tax increases the cost of consumption by 18.3 percent, i.e., it requires $1.183 of pretax income to have $1.00 after tax with which to buy $1.00 of consumption goods.

b. With the tax, it requires about $1.40 of pretax income to buy the same amount of future income that $1.00 would buy in the absence of the tax, i.e., $1.40 of income before tax leaves $1.18 after tax, and with no change in the pretax rate of return on saving, $1.18 saved from current income will yield $(1-.155)(1.18r)=r$, where r is the pretax yield on saving.

c. Since the tax increases the cost of consumption of $1.18 and the cost of saving to $1.40, the cost of saving relative to that of consumption is increased by the tax by 18.3 percent, i.e., $1.40÷$1.18=1.183 (results are from unrounded numbers). If it is assumed that the elasticity of private saving with respect to the relative cost of saving=1, then the 18.3 percent increase in the relative cost of saving implies an equal percent decrease in the amount of saving. Then the amount of private capital in place is about 18.3 percent less than it would be if the income tax had been so structured as to provide for equal-proportionate tax burdens on saving and consumption.

Question. Although a change in the tax treatment of capital losses for individuals may well be in order, to what extent will such charges increase individual participation in capital markets? After all, isn't the real reason for participation the seeking of gains rather than losses?

Answer. However formal or informal one's investment decision-making, the process involves some weighing of the gains and losses which are to be realized. When one makes an investment, it is upon the decision that the probability of gain exceeds that of loss and that the most likely outcome is a gain sufficiently great as to be at least competitive with that of alternative investments. If the tax treatment of capital losses were improved, the weight of after-tax losses would be reduced relative to the weight of after-tax gains in the probability distribution. Hence, individuals would be more inclined to invest in somewhat riskier outlets, e.g., common stocks, than at present.

Question. How can we keep such a graduated system of capital gains tax from creating a new "lock-in" problem, with securities holders waiting for further tax reductions before disposing of their stock?

Answer. Any downward graduated rate structure for gains is likely to retard realizations to some extent, since clearly if the gain can be maintained for another year, two years, or what have you and realized with less tax thereupon, there is incentive to defer realization. The strength of that incentive depends on how many years one must continue to hold specific assets before the next step-down in rates and the amount of the step-down. Clearly, the longer the holding period and the smaller the rate step-down, the less the incentive to defer realization. And any such incentive must be weighted by the investor in terms of his estimate of future gains on his existing holdings.

A companion measure to step-down of tax on gains might be step-down of ordinary income offset of losses. I recommend against this measure although it would indeed weaken the incentive to defer realizations.

Question. If the thrust of a number of studies is that the average holding period for stocks is quite long, would it be possible to unlock such holdings with a single reduction of the capital gains tax, say after 20 years, rather than an annual reduction of the capital gains tax?

Answer. Any step-down of the capital gains tax rate should unlock some holdings. A step-down which becomes available only 20 years from the date of acquisition of capital assets is of little use in unlocking assets held for any period materially

less than 20 years—for such holdings, the step-down in effect doesn't exist. For assets held close to 20 years or longer, the step-down would presumably represent a reduction from existing rates and might well unlock a substantial volume of them. The extent of such unlocking would, of course, depend on other factors as well, e.g., prospect for further gain or loss, contemplated gift or bequest of the property, with a zero tax on the transfer, etc.

The principal reservation against both a one-shot step-down and a graduated step-down is that they don't confront the main issues of capital gains taxation head-on, viz., so long as both current saving and the return thereupon are taxed, taxing capital gains at any rate is an additional tax penalty on saving. Moreover, once either system is in place, some part—possibly substantial—of the lock-in problem will remain. This is why people refer to the step-down proposal as having principally a "one-shot" effect.

Question. In considering the adoption of "rollover" treatment for capital gains, should this be provided on an unlimited basis, or with some limitation?

Answer. "Rollover" treatment for capital gains would be provided implicitly by tax revision to provide equal-proportional taxation of consumption and saving. Under such taxation, amounts currently saved would be deducted from current income while returns on saving, including the full proceeds from the sale of assets in which savings had been invested, would be fully included in current income. Thus, if an individual sold assets for $1,000 and reinvested the full $1,000 in other assets, the deduction for current saving would fully offset the $1,000 of sales proceeds. In effect, he'd "roll over" any gain included in the $1,000 sales proceeds. No adjustment of basis of the new assets, however, would be required.

Short of the complete revision to provide equal tax treatment of saving and consumption, "rollover" treatment for capital gains should be viewed as a step—modest in magnitude—in the right direction. As an intermediate measure, the "rollover" would, of course, require basis adjustment of the new assets.

The types of assets to which "rollover" should apply if it were adopted in the present-law context rather than as an implicit part of completely neutral tax treatment of consumption and saving is a matter to be resolved on nonanalytical grounds. It probably would be wise to limit such treatment, initially at any rate, to corporate securities and possibly real estate (in addition to the existing rollover treatment for personal residences). In theory, of course, there is no reason why the treatment should not be extended to gains on all capital assets.

If "rollover" were provided, any limitations imposed on the amount of gain eligible for such treatment would be arbitrary. If capital asset eligibility were limited, there would be even less occasion for any limitation on the amount of gains which might be rolled over.

Question. How would you assess the impact of your suggestion to provide an annual exclusion of $5,000 for capital gains realized from the sales of corporate securities? What would be the distribution of such a proposal among taxpayers and how much of a revenue loss would have to be borne?

Answer. Estimating the revenue impact of an annual exclusion of $5,000 of capital gains realized from the sale of corporate securities is particularly difficult, not only because of the problems involved in estimating investors' responses but also because of the volatility of realized capital gains. Data pertaining to capital gain realizations of two years ago, for example, may have little bearing on gains likely to be realized in 1973. Similarly, the amounts of gains which would have been realized in 1971 had the $5,000 exclusion been available might well differ materially from the gains actually realized that year.

With these reservations in mind, it is estimated that a $1,000 annual exclusion would involve an initial impact revenue loss of roughly $600 million. This loss would increase less than proportionately as the amount of the exclusion is increased, since many taxpayers realize gains less than $1,000, $2,000, etc. per year. For many taxpayers, therefore, some part of the annual $5,000 exclusion would be "wasted." A $5,000 annual exclusion, accordingly, would probably involve a revenue loss in the neighborhood of $2 billion (based on 1971 income levels).

Clearly the $5,000 exclusion would cover a much larger proportion of likely gains of small shareholders than of those with large corporate security portfolios. Tax saving per dollar of excluded gain on the other hand, would be less for the lower-bracket than higher-bracket investor, although the maximum differential in tax savings per dollar of excluded gain would be 28 cents (from lowest- to highest-bracket taxpayer).

The preceding revenue estimates take account of the distribution of gains and the estimated proportion of gains attributable to corporate securities in the recent

past—1971. As indicated, it does not necessarily follow that the distribution of tax savings from the $5,000 annual gain exclusion, if made available for 1973, say, would closely follow the earlier pattern.

Question. In pursuing the concept of a graduated capital gains tax, based on length of holding period, how can we accomplish this without unduly adding to the complexity of our tax laws?

Answer. Downward graduation of capital gains tax rates, based on length of holding period, should add little to compliance or administrative burdens. Taxpayers are required on the present tax forms to show the date of acquisition of property on which gain has been realized in the taxable year. Little difficulty would be encountered in adding a separate rate schedule based on length of holding period.

QUESTIONS SUBMITTED BY SENATOR BENTSEN TO MR. KELSO

Question. How do bankers react to your proposal?

Answer. 1. With rare exceptions to date, favorably. Actual participation in Employee Stock Ownership Plan ("ESOP") financing applications to industry, either as lenders, trustees, or through recommending to their clients the study and possible use of ESOP financing, has involved the following banks:

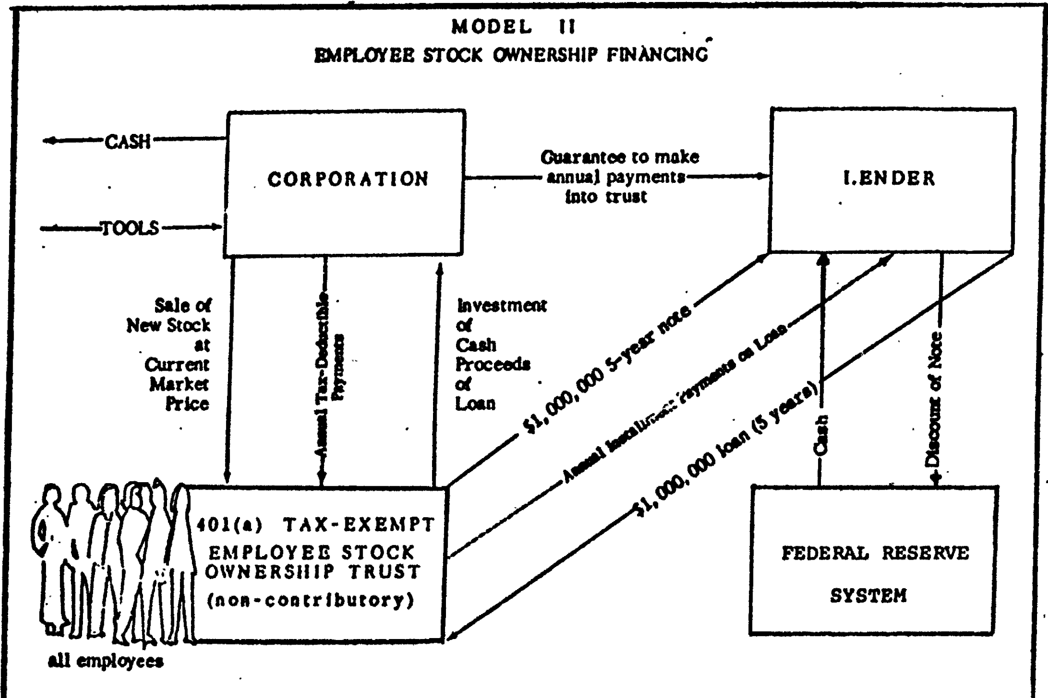
Bank of America
Chase Manhattan Bank
Chase Manhattan Capital Corporation
Union Bank (California)
American Fletcher National Bank (Indianapolis, Indiana)
First National City Bank (New York City)
United California Bank
Wells Fargo Bank
Manufacturers Hanover Bank
Crocker Bank
Mid-City National Bank (Chicago)
First National Bank (San Antonio, Texas)
Marine Midland Bank (New Jersey)
Republic National Bank
U.S. National Bank (San Diego)
First National Bank of Austin, Texas
First Bank of Harvey (Harvey, Illinois)

2. Employee Stock Ownership financing techniques, in every aspect, are designed to make maximum use of the genius of existing financial institutions.

3. The low visibility of two-factor theory at this point in economic history must also be recognized in evaluating this answer. Most bankers do not know about two-factor theory or ESOP financing. Our experience has been that when they become acquainted with the concept and its business and financial applications, they become most interested in studying them. The financial world is the most conservative area of any society. Even where all evidence points to a massive structural (and therefore, theoretical) error in the conceptual thinking behind our economic system, there is a natural reluctance to consider innovation. In banking circles, for example, it violates the conventional wisdom to say, as two-factor theory tells us, that the limiting factors to economic growth can never be a "capital shortage" or "money shortage" or "credit shortage", as long as all the human and other physical prerequisites exist and can be combined for simultaneously increasing new capital formation with increasing consumption. Consider, for example, the following diagram, which simply adds the final missing link to the diagram set forth on page 73 of our written testimony in order to adopt the banking system to the economics of reality:

In connection with pages 72 to 77 of our written testimony, note that this is a method for using *pure credit* in financing the expansion of the economy *after all available past savings have been substantially employed.* Another way of saying this is that it is a technique for *monetizing* new capital formation under conditions where the best minds in the world of business and finance have determined (a) that the newly-formed capital will pay for itself within a reasonable period of time (during which the credit is reversed), and (b) that the newly formed and now paid-for capital will thereafter continue to produce goods and services for the system, its productive power being constantly restored through depreciation procedures which set aside out of gross income sufficient funds to replace the wear and tear on capital instruments before net income is computed. This is the essence of the long range deflationary impact of ESOP financing. The monetization of new productive capital should be compared with the present horribly confused and

disorderly practice of monetizing welfare (creating new consumer dollars with no corresponding increase in real economic output). Government deficit spending is only one form of monetized welfare. "Funny money" is also created when, by closing off more rational opportunities to raise their living standards, we literally compel the labor force to capture control of the monetary system and to monetize welfare through demanding, and *getting* progressively more pay for progressively less actual work input. The prevailing practice of monetized welfare (aided and condoned by government) is the essence of the engine of inflation that is racking every economy on earth today. The inflationary distortion can be reversed by no other technique except under the vigorous discipline compelled by ESOP type financing. Using the logic of business, ESOP financing builds ownership of the *other* factor of production into the masses who invariably do not own capital and whose labor power to produce what they reasonably desire to consume is insufficient and constantly being eroded by accelerating technological change.



4. We will not at this time elaborate upon the simplicity of controls available to the banking system and to the Federal Reserve System for assuring that the transition from a one-factor to a two-factor economy is accomplished smoothly, except to say that such rational controls should be compared with the irrational controls prevailing today. Under these, the escalation of interest rates, the cutting off of credit to small and medium sized businesses, and rising levels of unemployment are the methods used to offset the structural defects arising from holding to a one-factor economic policy in a two-factor real world. These currently-used controls, the misconceived techniques that derive from one-factor thinking, inflict the costs of the conceptual errors behind the economy on the people least able to bear or to resist them.

5. Bankers are very quick to realize, when they study ESOP financing techniques, that a loan secured by the general credit of a corporation and *repayable from pre-corporate-income tax dollars* is a better credit risk than a loan payable only from after-corporate-income tax earnings. Functionally considered, the corporate income tax is both a powerful deterrent to new capital formation in the economy, and, when combined with the personal income tax, makes the personal acquisition of capital ownership by the average man entirely impossible. This is the basic reason why 5% of families and individuals in the economy own virtually all of its equity and debt capital. To put the matter another way, bankers readily see that through ESOP financing; one million pre-tax dollars will pay off one million dollars of the principal of a loan to finance corporate growth. The same loan, made directly to the corporation (assuming a 55% combined State and Federal corporate income tax bracket), requires approximately 2.3 million pre-corporate-income tax dollars to repay the principal. Thus the functional penalty to new capital

formation resulting from the corporate income tax, *when pre-tax dollars can be employed to finance growth*, is *greater* than the amount of capital raised.

6. The slowness of innovation has so far prevented a general awareness by bankers that a broad acceptance of two-factor concepts would result in the bulk of new capital formation being financed through the banking system, thus providing an enormous increase in banking business. It should be remembered here that, year in and year out, about 98% of new capital formation is internally financed by corporations and that the larger portion of this internally financed new capital formation at present is directly financed out of cash flow without resort to external borrowing.

7. The banking community favors economic growth. A broad acceptance of ESOP financing would:

(a) accelerate economic growth by removing *financial* capital limitations and leaving only physical limitations. At the same time, it would correct for the great majority of people the mismatch between the possession of unsatisfied needs and wants and the possession of productive power (therefore market power) to satisfy those needs and wants.

(b) Broad acceptance by the banking and corporate community of ESOP financing would remove the barrier of high interest rates which are used today to control inflation—the natural correlative to one-factor economic policies. Broad use of ESPO financing by the banking system would leave only risk and administrative costs as justifiable components of interest rates, and they would decline to a small fraction of their present levels. No imagination is required to visualize what this would do to accelerate economic growth. High interest rates, in an economy that runs primarily on credit, are the equivalent of entropy in a mechanical system.

8. Any hesitancy on the part of banks to accept the innovation of two-factor economics and ESOP financing, based upon concern for their income or power sources, is not well-founded. Serious reflection should cause any banker to conclude that exactly the opposite would be true. For example, the revenues of banks as trustees of pension and profit sharing trusts should be as great or greater if they are invested in financing ESOP Trusts of blue chip companies as they are if they're invested in the recirculation of outstanding stocks of those same blue chip companies. Such ESOP financing, in appropriate cases, can involve "equity sweetners" in the form of shares of stock or warrants in the companies whose ESOP Trusts are financed. If corporations were persuaded, or induced, or required to pay out their net earnings fully (the wages of the capital factor) and to finance their growth through ESOP techniques, the extent of financing handled by the banking system should be multiplied many times over. By encouraging banking clients to switch from conventional financing techniques to ESOP financing methods, banks could take a major initiative in controlling inflation—something they are presently as powerless as the rest of the society to do, so long as we conform to one-factor conventional financing concepts.

9. Accumulated savings (past savings) held in the banking system are, of course, finite. By understanding two-factor theory and employing ESOP financing methods, banks would no longer be limited in their financing capacity by the accumulation of past savings, but could employ both finite past savings *and future savings* that are limited only by physical factors, rather than by institutional defects.

10. Should government heed our recommendation to establish a Capital Diffusion Insurance Corporation (see the legislative suggestions in our written testimony, page 83, paragraph [6]), the opportunity of bankers in general to finance small and medium sized businesses would be greatly enlarged, and their risks in doing so greatly diminished.

Question. How do union leaders react to your proposals?

Answer. 1. The visibility of two-factor economic theory in the world of union leadership is even smaller than in the banking world. For this no one is to blame, but praise is due for these hearings of the Financial Markets Subcommittee of the Senate Finance Commitee in providing a forum for exposing these concepts to comment, criticism, and controversy.

2. Trade Unionism to date is just beginning to emerge from the dark ages of its class-struggle background. The union leaders who have taken the time to understand two-factor economics pretty much reply in the same vain as the president of a major national union which we will identify here only as the aristocrat of labor unions. His reply was to the effect that "I am fundamently in agreement with what you say and I am profoundly interested. What do we do about it?" The presidents of four major national labor unions have indicated preliminary substantial concurrence with the concept. In every instance, they face the necessity for painful reexamination of the goals of trade unionism with

their well-entrenched union bureaucracies. The process of assimilation of the potential of ESOP financing for trade unionism will, we predict, accelerate spectacularly when the first major union broadens its horizons to contemplate *both* factors of production. That union, not yet identified, will look upon its task as maximizing the opportunities for its members to produce goods and services:

Through employment, to the extent that there are legitimate opportunities (not opportunities synthesized out of boondoggle, featherbedding, or otherwise), and

Through the building of capital ownership into its members by taking advantage of the fact that the use of ESOP financing to finance new capital formation is a collectively bargainable subject.

3. Fortunately, the combined unsatisfied economic needs and wants of the 95% of the U.S. families and individuals who do not own capital is so vast that our economy will require, we estimate, 25 to 30 years of the most intense, full employment to bring into existence the new capital formation required to produce a high standard of living for all families and individuals and simultaneously, to protect the environment in the course of so doing. This will provide a period of some 25 to 30 years of intensely full employment during which most individuals and families can acquire the ownership of viable holdings of productive capital, preparing for the ultimate day when only a portion of the labor force will be required currently to operate a system that delivers a high standard of living for all people.

4. Fortunately, the realities of our economic position are such that we will thus be given 25 or 30 years to educate a new generation of citizens on the economics of reality—two-factor economics—and to condition that generation to live lives dedicated not only to economic work but to work outside the economic order. (See Kelso and Adler, THE CAPITALIST MANIFESTO, Random House, N.Y. 1958, pp. 13–29.)

5. A critical aspect of the significance of two-factor economics, both for the banking and financial world and for trade unionism, is to be found in the absolutely new power, never before available, to build *market power* into the masses who are non-productive or under-productive for the simple reason that they do not own any portion of the factor of production that increasingly dominates the productive scene as a result of accelerating technological change.

Question. Most economists state categorically that new investments depend on accumulated savings. Are you suggesting that industrial growth may be financed on credit not dependent on past savings? If so, where will that credit come from?

Answer. 1. This question has been answered affirmatively in the answers given to two preceding questions.

Question. Is your concept of financing industrial expansion on "pure credit" analogous, at least in its mode of implementation, to the role the Federal Reserve System plays in supplying money to cover government deficits, which, of course, is purely inflationary? Wouldn't your approach be similarly inflationary?

Answer. 1. "Pure Credit" is nothing more nor less than the power of people and their legal institutions to contract with each other under a legal system wherein every party to the contract (and sometimes people who are affected but are not "parties" to the contract) has recourse to the legal system to enforce his rights or redress his injuries. When the central bank monetizes governmental costs which are not, in the accounting sense of the word, self-liquidating, something radically different is involved than in monetizing the new formation of capital under conditions where it will first pay for itself within a reasonable period of years and will thereafter continue to produce goods and services almost indefinitely.

Question. In terms of overall equity, how can we justify elimination of ordinary income or capital gains tax when an employee receives his share of assets accumulated in an employee stock ownership plan trust account?

Answer. 1. In our general outline of an overall legislative program that would, with only the most imperceptible adjustments, correct the fundamental defect in our national one-factor economic policy (see our written testimony, page 83, paragraph 5), we suggested that income tax or capital gain tax upon the receipt by an employee of the securities in his account in the ESOP trust at the time of his retirement or the termination of his employment, should be eliminated. The economic policy for building capital ownership into previously non-capital-owning employees is to raise their economic productiveness. (See our written testimony, pages 70 to 73). This being so, it is totally inconsistent to then reduce the productiveness of the individual or family by taking away his or its productiveness (as represented by its capital ownership) because of the occurrence of either termination of employment, or retirement. Indeed, to do so is perverse and counter-productive. This reasoning can best be illustrated by looking at the owner-

ship of the *other* factor of production, labor. Education, apprenticeship, the accumulation of experience, all raise the productiveness of labor, provided you are dealing with a competent and motivated individual. Would it make any sense to tax a worker because he had graduated from high school or college, or a professional school? Would it make any sense to tax him because he has completed an apprenticeship, or to tax him each year on the basis of examinations demonstrating that he has learned from experience? Similarly, it makes no sense to tax the individual because he has become more productive through his ownership of the non-human factor of production: capital. He should properly be taxed on his income which reflects his increased productiveness, either through his educated or experienced labor power, or through his accumulated ownership of capital, or both. This probably implies the propriety of taxing him at any time that he converts his stock ownership into spendable income, although an economy which has freed itself from most of the costs of welfare (including boondoggle or disguised welfare) might well tax only the actual use of wealth for consumption.

Question. If we were to follow your legislative recommendation on providing these employment stock ownership plan trusts the same tax characteristics accorded to tax exempt foundations to encourage gifts of what you have designated "productive capital," what would we be achieving in terms of its overall benefit?

Answer. 1. The objective of this legislative recommendation (see our written testimony pages 82–83, paragraph 4) is to achieve a more rational match between the possession of unsatisfied consumer needs and wants, and the possession of the power to *produce* sufficient income to satisfy those needs and wants.

2. Conventional techniques of finance and many of our methods of taxation (see our written testimony, pages 71–72) have the effect of building vast concentrations of the ownership of productive power into individuals and families whose present and potential unsatisfied consumer needs and wants are dwarfed—indeed infinitesimal—in comparison to their productive power. But the logic of a free market economy, in the light of two-factor economics, is simply double-entry bookkeeping. Under double-entry bookkeeping, what each individual or family takes out of the economy in the form of purchasing power is supposed to be based upon what each individual puts into the economy in the form of economic productive input. The irrationality of one-factor economic concepts causes us to be quite oblivious to the fact that we build enormous concentrations of productive power into particular individuals or families with complete social unawareness that this inevitably deprives millions of others of the *economic power* to legitimately produce the income required to enable them to enjoy their reasonably desired standard of living. This crude economic ignorance, or in some cases greed disguised and justified through one-factor thinking, forces upon various sectors of the economy and upon the part of government, reactions that are ultimately destructive of the free market itself, of political democracy, and of human freedom. By being oblivious to the fact that we must expand the capital ownership base as technology shifts the burden of production off labor onto capital, we tacitly approve the concentration of the ownership of productive capital. Labor, both to protect itself from serious privation, and to fulfill its destiny of providing mass consumption markets for our mass production economy, must demand progressively more pay in return for progressively less work. The government, stepping in to close the purchasing power breach naturally resulting, must redistribute income, though to do so it violates an historically basic economic principle: *Machiavelli's Law.* Machiavelli's main lesson in economics, given to the political head of the Italian City State in order to help him survive in office, was "Remember Prince, a man will sooner forgive you for killing his father than for tampering with his patrimony." The violation of Machiavelli's Law by modern governments, in all the ways that they seek to take away the property of individuals is one of the chief sources of the strife that besets these societies. We might note, parenthetically, that former President Allende of Chile seemed oblivious to *Machiavelli's Law.* How much better to use the precepts of two-factor economics both to protect the ownership of capital of those who have it, and to provide access to non-capital owning individuals to legitimately acquire the ownership of newly formed capital, and even to provide means whereby the wealthy at death, or before if they desire, can achieve their tax objectives in ways that help the poor to become more self-sufficient through capital ownership. Helping people to help themselves is the highest order of charity and should be encouraged by the same tax laws that affect other forms of charity, most of which merely treat the symptoms, not the causes. At the end of the life of the owner of concentrated wealth, when he comes face to face with the fact that he cannot take it with him, how much better to provide him a vehicle under which he may leave his wealth on earth, as he must, in ways in which it will become reconnected with individuals as

part of an overall plan to motivate their productive energy, their loyalty to the private-property system of production, and to freedom and democracy.

Question. Wouldn't such a plan need very tightly drawn rules to prevent it from becoming a tax-avoidance device rather than a means of dispersing capital ownership?

Answer. 1. The laws and rules have already been well designed and are incorporated in Section 401(a) et seq. of the Internal Revenue Code. There are minor shortcomings in the rules and regulations relating to stock bonus trusts and profit sharing trusts which could be easily changed to make it possible, once an ESOP trust has been used to finance growth and to build ownership into empolyees, to permit diversification of the trust assets by exchanging some of the employer-corporation shares for other shares of equal value and distributing to the employee at retirement or termination a diversified portfolio. Careful study and analysis may reflect refinements and improvements, but it seems to us that they would be minor.

Question. Could you explain the rationale for your legislative recommendation that corporate dividends paid to a qualified employee stock ownership plan be deductible to the corporation making such payments?

Answer. 1. The object here is twofold: (1) to tighten up the private property characteristics relating to the private ownership of capital, and (2) to prevent confusion of the taxpayer by not fully communicating to him the immediate and full impact of taxation upon him. The purpose of all productive activity in the economic arena is, as Aristotle noted, the consumption of economic goods and services by individuals. To impose income taxes on the corporation is to conceal from individuals the critical feedback that tells them how (or even if) their economy is working. Furthermore, and this is a cruel irony, the corporate income tax imposed historically for the purpose of taxing the rich in order to benefit the poor, actually makes the acquisition of capital unattainable by the poor. True, capital in the well managed business will pay for itself, but only if the owner of capital receives substantially the full yield of the wealth produced by the thing which he owns. The corporate income tax cuts into the stream of income that flows from the property itself to the owner of the capital, and thus impairs the ability of a non-capital owner to buy capital on terms where it will pay for itself, although this is the minimal logic which business invariably expects from investment.

2. Two-factor theory calls for the cooperation of business, labor, agriculture, and government to design our economic institutions and to operate our economy in full recognition that the underlying logic is simply double-entry bookkeeping. Since mass production implies mass consumption and politically acceptable as well as socially desirable economic policy calls for institutions which enable every family or individual to *produce* wealth providing it or him with the income level reasonably desired, steps which raise the productive power of under-productive and non-productive families by building capital ownership into them, as well as steps which assure that the producers receive the full income-equivalent of their productive input, are necessary to the efficient functioning of the system. This was recognized by J. B. Say almost two centuries ago in the principle that economists have come to know as "Say's Law". But in one-factor terms, Say's Law is simply inscrutable. In two-factor terms it is obviously the logic of a system dictated by the laws of supply and demand, the logic of double-entry bookkeeping, and the logic of economic morality under which all families and all individuals are expected to *produce* what they reasonably desire to consume.

Question. What's in it for the future of democratic trade unionism?

Answer. 1. This has been partially answered in connection with a preceding question. But it needs be added that the employee-stockholder, being a new creature on the economic scene, stands desperately in need of education about the economy. We predict that unions will become the chief agents in spreading and accelerating the acceptance of two-factor economics and of financing techniques based upon these concepts. Trade unions, through the use of two-factor theory, can marshal the U.S. economy into a more effective competitor in world markets than Japan and Germany are today, and can bring a degree of prosperity and environmental responsibility to the U.S. heretofore undreamed of.

Question. Your proposals would suggest the Congress has placed the cart before the horse, that is, that we have structured our tax system without sufficient consideration of its effect on our productive system. Briefly, what are your views on how we might restructure a simpler and more equitable national tax system and in particular, how does a tax on corporate profits hurt the little man outside the corporation.

Answer 1. In answer to the last part of this question first, the corporate income tax is an inherently discriminatory "double tax" on private incomes from capital. Originally devised as a "populist" measure to redistribute capital incomes from corporate owners and to relieve some of the burdens on the non-owning masses of

rising governmental costs, the corporate income tax has had an anti-populist effect: it constitutes a major reason for the monopoly of access to the ownership of new productive capital by present owners. In our answers to previous questions, we have pointed out that the majority of working Americans are effectively denied the right to share in capital ownership to the extent there is any impairment or diversion—by government or corporate management—of the "wages" of capital, without which neither ownership of newly formed capital nor private capital incomes can become widely diffused to enable every household to pay for its consumer needs, as well as to pay for government services. Moreover, the erosion of "private property" in capital has in turn led to increasingly complex tax countermeasures to protect present owners from further dilution of their property rights, a problem which could have better been avoided had government policy recognized the advantages of making corporate ownership more broadly and equitably available to working taxpayers.

2. A sound tax policy cannot be constructed upon confused or unsound political and economic principles. Our written statement, based upon the concepts of Two-Factor Economics as elaborated upon more extensively in books and writings cited in this presentation, combines proven economic principles from the past within a logical framework more realistically designed to cope with today's industrial world and with the challenges we can expect from accelerating technological change. Some critics, before analyzing the logic of Two-Factor Economics and ignoring the case-tested effectiveness of ESOP financing tools, have charged that our recommendations for tax reform are "tax loopholes", that Congress "would be forcing American taxpayers to subsidize and buy shares for workers." Such assertions, indeed, put the cart before the horse, the tax system before the system of production. If it is a "tax break" that is required to enable more working people—who make up the overwhelming bulk of our taxpaying public—to become economically self-sufficient through capital ownership, then one could make a persuasive case that not only would Congress be hard-pressed to mandate a more desirable social objective but that by design it would strengthen and simplify our tax system and broaden its revenue base.

In contrast, let us compare tax policy and government economic policy that for the past half century have helped to make the rich richer:

The investment credit, which diverts government tax funds into strengthening the capital ownership of existing owners.

Accelerated depreciation does the same thing for the same top 5 percent of Americans who own all of today's capital assets.

Depletion allowances do the same thing.

Numerous leveraged tax-shelter schemes, including tax-free interest from State and municipal bonds.

Low cost housing subsidy laws provide attractive tax-shelters for the wealthy.

Urban renewal creates jobs for the poor but subsidizes capital ownership for the rich.

Agricultural subsidies provide jobs for the poor and concentrate the ownership of agricultural capital in the rich.

Corporate subsidies, such as those to bankrupt and nearbankrupt defense contractors and railroads, benefit only present owners.

Employee stock ownership plans, on the other hand, involves a healthy turnabout in national tax policy. Without government hand-outs, the poor would become self-sufficient by employing the genius of our corporate and financial institutions for the spreading of capital ownership among the many but uniquely not at the expense of today's affluent few.

3. Sound tax policy is based on a re-assertion of the political, moral and social philosophy that once made America "the last best hope of mankind." It recognizes that government does not produce wealth and that every "subsidy" must originate with those individuals whose productive toil and productive capital actually produce society's marketable goods and services. Wealth is produced most efficiently within competing private enterprises vying to satisfy consumer demand. Government, through its taxing and spending powers, can, of course, redistribute wealth, along with its traditional powers of maintaining a just and peaceful society, enforcing contracts, etc. And to the extent voluntary associations and other specialized social institutions like our corporations become disfunctional and create, rather than solve, problems for society, government literally is "forced" to fill the social vacuum. We have reached the point today that as a result of defects in our economic institutions to which our presentation is addressed, government itself is suffering from such an acute case of functional overload. Increasingly burdened with economic matters better handled by individuals and private institutions, the State—civilization's most important social invention—cannot

effectively carry on the highly specialized and limited functions for which it was designed: maintaining an orderly system of justice and peace under which all its citizens can flourish. Since capital within the context of a modern corporation—mankind's second most important social tool—produces an increasing share of the wealth of an industrial society, a sound and just government policy would remove roadblocks to broader corporate stock ownership, so that the need for government intervention and income redistribution would gradually and systematically be reduced.

The necessary costs of government could then be shared by a constantly growing base of citizens with direct private incomes from our corporate sector. Such a policy would also automatically broaden the accountability of corporate management to an expanded stockholder constituency base, making the corporation more "popular" as a social institution and enabling it to make a quantum advance in its own evolutionary development. (In terms of its present constituency base and efficiency as a direct distributor of mass buying power, the modern corporation is still primitive, about at the same stage in its evolutionary history as democratic government was at the time of the Greek city-state.)

4. In our opinion, the soundness of our tax policies should be judged by whether their net effect hold government functions and government costs to an irreducible minimum and whether such costs are derived from the broadest possible base of increasingly self-sufficient taxpayers. In this regard, our proposals would have two beneficial effects on the revenue picture at all levels of government: (1) it would revitalize and stimulate growth within the private sector, thereby enabling under-productive and non-productive workers to be hired by expanding corporations while reducing levels of government spending for welfare, expanded public payrolls, and subsidized jobs in private industry; and (2) it would expand the Federal, State and local taxpayer base from expanded corporate payrolls and from rising capital incomes. At the same time, it would gradually eliminate disincentives to the creation, maintenance, and renovation of productive capital, upon which the quality-of-life of modern civilization depends.

Question: You've made proposals to make corporate employees into capital owners through employee stock ownership plans. What changes in present laws are necessary to do the same for professionals, public servants, teachers, small businessmen, military retirees, the disabled, and others who do not work for major corporations?

Answer. 1. A comprehensive answer to this question would require one or more books. But a preliminary overall answer is to be found in THE NEW CAPITALISTS (Kelso and Adler, Random House, 1961) in which a basic plan for making credit accessible to various segments of the society in planned sequences for the purpose of enabling them to acquire capital ownership in the expanding industries of the economy is outlined. As noted on pages 79–80, of our written testimony, however, careful study needs to be applied to the motivational problems that could be created by making it as easy for the individual to acquire capital ownership without the performance of work in the economy as for the individual *whose working life is linked to his acquisition of capital ownership.* The critical problem to be solved here is to be assured that the labor inputs necessary to build an adequately productive economy are adequately encouraged and rewarded. In the early stages of expanding the productive power of the economy through these techniques, the combination of motivating the potential labor force through providing the opportunity to acquire the ownership of a viable capital holding over a reasonable working lifetime may have to be accompanied by providing reasonable welfare support for those who are simply incapable or unwilling to participate in the task.

Question. Most analysts judge corporate performance by P/E ratios. You seem to reject this. What would you suggest is a better yardstick for measuring the quality of corporate performance?

Answer. 1. The best yardstick for measuring the quality of corporate performance, the value of corporate shares, and the degree to which the integrity of private property of the corporate shareholder is protected *is yield to the stockholder on his investment.* Anything else is artificial and confused and cannot be used to make sound comparisons among competing investments.

Question. How do you handle the problem of investment risk?

Answer. 1. The business world has long ago decided that the way to handle risk is through insurance. Since the cumulative risk of the failure of businesses to produce a net income inevitably falls on the society, with impact localized according to the nature of the case, it is quite clear that this risk is one for which insurance can be designed. The greatest economic risks flow from the mismatch between the unsatisfied needs and wants of potential consumers and their power to produce the income sufficient to enable them to satisfy those needs and wants. Thus, two-factor theory as implemented through ESOP financing and through the Second

Income Plan would eliminate the major historical cause of the economic cycle. As this objective of two-factor economics is accomplished, the task of insuring the risks of economic feasibility would become even easier.

Question. During World War II the Reconstruction Finance Corporation was established to generate credit for expanding firms engaged in war production. Is what you're talking about a sort of RFC approach for building an expanded peacetime economy?

Answer. 1. The monetization of new capital formation through widespread ESOP financing bears some resemblance to the activities of the RFC during World War II. However, presumably two-factor economic theory and its financing applications would be used to accomplish the high levels of economic performance during peace time that such emergency credit activities accomplished during war time emergencies.

STATEMENT OF LOUIS O. KELSO, GENERAL COUNSEL AND NORMAN G. KURLAND, GENERAL COUNSEL, BANGERT AND CO.

INDEX

THE ROLE OF INSTITUTIONAL INVESTORS IN THE STOCK MARKET

Summary—57.
Deliberate Beneficial Change Must Begin With The Right Questions—58.
Basic Assumptions Underlying The Question "What Is, And What Should Be, The Role Of The Institutional Investors In The Stock Market?"—59.
The Role Of The Stock Market Itself In The National Economy—60.
The Primary Stock Market.
The "Secondary Stock Markets" or Public Markets For Trading In Already-Outstanding or Secondhand Securities.
The Confusion Of The Primary Stock Markets With The Market For Secondhand Stocks—61.
The Role Of Financial Intermediaries ("Institutional Investors") In The National Economy—63.
What Is The National Economic Policy And What Is The Logic Of What We Call Our "Economic System?"—64.
What Is A Stock Investor?—66.
What Is A Stock Speculator Or Stock Gambler?—66.
Are The "Institutional Investors" Investors Or Speculators?—66.
A Cautionary Note About Prevalent Myths—67.
Myth: The Stock Markets Are Our Free Capital Markets And Are The Heart Of The U.S. Economic System—67.
Myth: We Must Attract The Small Investor Back Into The Market—67.
Myth: That All Stock Buyers Are "Investors"—68.
Myth: The Stock Markets Provide Pools of Available Capital For The Expansion Of Business—68.
Myth: A Man With A Good Idea And Good Management Ability Can Get Venture Capital To Start A Business With The Hope Of Someday Selling Stock To The Public—68.
Myth: The Institutional Investor Can Provide A Safe Haven For The Owner Of Small Savings And The Participants In Retirement Systems If The Prices Of Corporate Stock Should Collapse—68.
Myth: That It Is Sensible For Institutional Investors To Offer "Fixed Benefit Retirement Plans" To Workers—69.
Myth: The Instant Liquidity of the Public Stock Markets Must Be Maintained At All Costs—70.
Myth: A High Rate Of New Capital Formation In The Economy Is Good In Itself, Irrespective Of Who Owns It—70.
What Should The Role Of The Business, Financial And Economic Institutions In General In The U.S. Economy Be?—71.
Two-Factor Economics—The Economics Of Reality—71.
Can Investment Banking And Business Financing Techniques Constructed Upon The Concepts Of Two-Factor Economics Enable Employees To Buy Capital WITHOUT Using Their Savings or Reducing Their Standards Of Living Through Payroll Deductions?—72.
The Fatal Deficiencies Of Traditional Techniques Of Corporate Finance Other Than Sale Of Stock—72.
The Employee Stock Ownership Plan ("ESOP") Solution To The Deficiencies Of Conventional Corporate Finance—73.

SOME OF THE CRITICAL FINANCING PROBLEMS THAT CAN BE SOLVED THROUGH ESOP FINANCING METHODS

Financing Capital Improvements And Working Capital—79.
Acquisitions—79.
An ESOP Solution To The Problem Of "Locked-In" Close-Holding Stockholders —80.
A Corporation That Does Not Need Capital But Wants To Motivate Its Employees And To Give Them "The Eye Of The Owners"—80.
What About People Not Employed By Corporations: Public Employees, And The Many Kinds Of Unemployed?—80.
Marketability Of Stock Distributed To Employees Through The ESOP—81.
Corporate Planning Of Employee Ownership—81.
The Enormous New Capital Formation Requirements Of The U.S. Economy For The Immediate And Distant Future Should Be Financed Through ESOP Techniques—82.
ESOP Financing Is Not Merely A Negative Case Against The Redistribution Of Wealth And Income—82.
The Erroneous Identification Of Capitalism With The Speculative Securities Markets—82.
A Suggested Program Of Legislative Reforms That Could Accelerate The Broadening Of The Capital Ownership Base In The U.S. Economy, Substantially Transform Its Stock Markets From Speculator Markets Into Investor Markets And Engage Its Institutional Investors In The Activities Thus Entailed—83.

SUMMARY

Collectively, the institutional investors and the public stock markets, both basic components of the overall financial institutions of the U.S. economy, are as presently operated, part of the economy's most serious problems and will continue to contribute to those problems, rather than to contribute to the solutions of those problems, unless some simple but very important structural adjustments are made.

The underlying institutional defects, fortunately, do not require earth-shaking corrections. They arise out of our failure to rationalize our economy—our failure to look at it in system terms.

Bangert & Co.[1] in its written testimony to the Subcommittee on Financial Markets of the Senate Finance Committee has carefully delineated the underlying problems, and the steps required to correct them. Bangert & Co., itself is representative of the nature of the innovation that must be adapted to the institutional investors, to the stock markets, and to the peripheral financial institutions that interface with them. Bangert & Co. performs, essentially, merchant banking functions, but does not engage in any aspects of the brokerage business, in delaing in securities for its own account, or in the purchase or sale of securities either at wholesale or at retail for others. Bangert & Co. specializes in the service of assisting corporations to use a financing technique known as Employee Stock Ownership Plan ("ESOP") financing.

Through ESOP financing methods, corporations enable their employees to acquire beneficial ownership of newly issued stock without taking anything out of employees' paychecks or savings, in the course of financing: (1) new capital formation, and (2) changes in the ownership of business assets through acquisitions, divestitures, spin-offs and reorganizations. ESOP financing methods are also used to enable employees to acquire beneficial ownership, of closely-held stock of an employer or a parent of an employer corporation.

Bangert & Co. was organized on May 28, 1971, and initiated its financial service business in April, 1971, for the purpose of providing on a national and international scale a service it perceives as much needed by modern business but which heretofore has been generally unavailable. It is the analysis of Bangert & Co. that services of the type it renders, particularly if aided by legislative reforms it proposes, can contribute to correcting some of the major deficiencies in the traditional techniques of U.S. investment banking and in conventional corporate financing strategy. These deficiencies center upon the failure of existing financial institutions and practices to take into account that a main function of technological change, upon which the strength of modern industrial economies rests, is to shift the burden of production at an accelerating rate off the human factor (labor) and onto the non-human factor (capital—generally speaking land, structures and machines and intangible capital); that the logic of a market economy rests primarily upon

[1] Bangert & Co., Incorporated, a California corporation, is located at 111 Pine Street, San Francisco, California 94111 (Telephone: [415] 788-7454).

the principles of double-entry bookkeeping, under which each individual's personal outtake (i.e., his personal income) is expected to be based upon his personal productive input into the economy; and that consequently, the traditional techniques of investment banking and of conventional corporate financing strategy, cause a socially intolerable result: they build incremental productive power into people with few, if any, present or potential unsatisfied consumer needs or wants, and fail to build incremental productive power into the overwhelming majority of the population, including the entire labor force, whose unsatisfied needs and wants, when matched with purchasing power, make up the main market for consumer goods and services in our economy.

More particularly, conventional financing techniques build the ownership of the bulk of all newly formed capital (aggregating about $100 Billion per year in the U.S. economy) into the approximately 5% of the consumer units who already own virtually all productive capital. Bangert & Co. concluded that because conventional investment banking and conventional corporate financing strategy both lead to techniques which give the owners of existing capital a monopoly of access to the ownership of newly formed capital, creating no new capital-owning households in the economy, there is a serious need for financing techniques that would use the self-liquidation logic of conventional corporate finance to enable traditionally capital-less employees of business enterprises to buy newly issued stock or outstanding closely-held stock of their corporate employers, on a non-recourse credit basis, paid for under a commitment on the part of the employer corporation to make a relatively high proportionate payout of the pre-tax earnings of the underlying assets to or for the benefit of the employees as new beneficial owners within a tax-sheltered, deferred compensation trust.

In its testimony, Bangert & Co. outlines not only the techniques for accomplishing a broadening of the property base of the economy, but the larger implications of so doing and a program of possible legislative reforms for accelerating the system's transformation.

THE ROLL OF INSTITUTIONAL INVESTORS IN THE STOCK MARKET[3]

In our system of government, it sometimes happens that when things, such as our economy today, are not working well, the American public turns to its Congress and asks that it "do something." The "something" often takes the form of a Congressional hearing. In such event, at the very minimum, Congress has responded and has "done something." The most important single determinative, in our opinion, of whether a Congressional hearing can initiate useful social reform or provide leadership out of serious social problems lies in the formulation of the questions to which the hearing participants direct their deliberations. If the investigation begins with asking the right questions and is sustained until the best possible answers have been developed, the hearing may indeed initiate the correcting of social or systemic errors of the society.

DELIBERATIVE BENEFICIAL CHARGE MUST BEGIN WITH THE RIGHT QUESTIONS

The destiny of a society is determined—absolutely determined—by the questions its leaders ask, rather than by the particular answers to those questions For the wrongness of an answer will sooner or later be controverted and corrected. But where Congressional inquiry begins by asking, with the best of intentions, the wrong questions, the whole society can be diverted from solving its problems for decades, or perhaps forever.

The likelihood of conducting a great cathartic investigation around the wrong questions can be illustrated from some of the deliberations that have taken place in the past. It is quite clear that, in one form or another, our society since the 1930's has been asking and proposing answers to the question: "How can we eliminate the effects of poverty?"

How can we provide income to the underproductive and the nonproductive?

How can we provide health care for those who cannot pay the market price for the services involved?

How can we provide housing for those who cannot afford to buy or rent houses?

How can we provide education for the children of families who cannot select and pay for the school of their choice?

How can we provide jobs for those whose employment is made unnecessary by ever-advancing technological change?

How can we provide income—retirement income—for those who once worked but who for various reasons can no longer work or find compensable work?

---

[3] Copyright, 1973, Bangert & Co., Inc.

One and all, these are wrong questions. It is not the effects of poverty—and each of these questions deals with an effect of poverty—but the cause of poverty we should have been asking about. We predestine ourselves to failure and vain travail by our great controversies about how to cope with the effects of poverty, so long as we do not have the clear-eyed courage and intelligence to ask: Why are people poor? How can we make them not poor? How can we make them rich in the sense of being economically self-sufficient? How can we make them self-sufficient without violating the basic moral nature of man, while taking advantage of the sound and proven economic institutions evolved over centuries?

Rich or self-sufficient families do not have income problems, so they do not need welfare or social security payments or pension payments. They do not need publicly provided health care, because they can select and pay for their doctors and hospitals. They do not have housing problems, because they can select and buy or rent a house of their choice, and the housing market responds to buyers with purchasing power. Rich or self-sufficient families do not need government assistance to attain education for their children, because they can select the school of their choice; even build their own schools, and pay for them.

Rich families do not need jobs if their members are too old to work or are disabled, or are technologically redundant, because they produce wealth and income through their privately-owned capital. Unemployment in the economic order, as those who have tried it have found, is not at all uncomfortable—for those who can afford it and who turn their energies and talents to leisure work, the unlimited order of work of the mind and spirit, and to a reasonable amount of recreation and play.[3]

Economically self-sufficient people—rich people in the functional sense of the word rather than in the selfish and greedy sense of the word—do not have retirement income problems; they produce wealth and income to the ends of their lives through their privately-owned capital. They need not burden the labor of others, or the capital of others, in order to produce viable and secure incomes. They do not impose economic threats to the young and to the unborn generations with the burdens of their support.

We recognize that it is quite as much the responsibility of the witnesses who appear before the Financial Markets Subcommittee of this Senate Finance Committee as it is of the Committee itself, to use the most rigorously disciplined methods to focus on the right questions. Indeed, as lawyers, as well as economists, we are aware that the main function of the principles of pleading and the laws and principles of evidence in judicial hearings is to assure that the questions subjected to scrutiny are relevant questions, and that the evidence and debate in seeking answers are directed towards those right or relevant issues. We attach no less importance to the rightness or relevance of the questions in this Congressional inquiry.

BASIC ASSUMPTIONS UNDERLYING THE QUESTION "WHAT IS, AND WHAT SHOULD BE, THE ROLE OF THE INSTITUTIONAL INVESTORS IN THE STOCK MARKET?"

It will contribute towards the assurance that we direct our attentions to the right questions if we first identify basic assumptions implicit to the above questions, and if we can obtain the concurrence of those involved in this investigation as to the identity of those implicit assumptions. If it should turn out that no general consensus about the implicit assumptions is possible, this would be tantamount to acknowledging at the outset that the efforts of those involved will likely solve no problems in the real world.

The most important of the underlying basic assumptions, as we see them, relate to: The role of the stock market itself in the national economy. The role of the financial intermediaries we refer to as "institutional investors" in the national economy. The logic of that which we call our "economic system." The nature of a stock investor. The nature of a stock speculator or stock gambler. Whether "institutional investors" are investors or speculators. The logic or rationale of the activity which we call business investment. What is it supposed to accomplish? Does the same logic apply to individuals and to business institutions? The function of the corporation in a free-market, private capital ownership economy.

We will begin by examining each of these component assumptions and by defining each of them in a way that seems to us to be consistent with the facts of life in a free-market, private property industrial economy, even if being thus realistic causes us, as it will, to depart from the conventional wisdom concerning many of the subjects covered.

[3] See Kelso and Adler, The Capitalist Manifesto, Random House, New York, 1958, pp. 16-20.

After all, the U.S. economy is not working well either internally or internationally. It is not working well in one way or another from the standpoint of a large proportion of the people in it, including those who participate in the activity we call the "stock market," and it is not working well from the standpoint of most of our institutions, including the stock market itself. To here marshal the litany of facts necessary to support those unpleasant conclusions would be to assume—which we do not—that Congress is not aware of the evidence that pours forth daily in the news media and in the serious journals. We have full confidence that no one concerned in this societal self-examination has any doubt that because of the gravity of our economic, political, sociological and moral plights, a mere cosmetic investigation of the problems surrounding the stock market will not suffice.

THE ROLE OF THE STOCK MARKET ITSELF IN THE NATIONAL ECONOMY

We confine our testimony to the "stock" or equity securities markets only. Equity securities represent the ownership of business, whereas debt securities, even debt securities which are convertible at the option of the holder into equity securities, are money claims against the issuer. While a general analysis of the capital markets comprehending both debt and equity securities would undoubtedly have deep significance for the role of the institutional investor in the stock market, our references to that larger significance will be confined to the relative importance of debt and equity financing of new capital formation in the U.S. economy.

To understand the role of the stock markets, including both the registered securities markets and the over-the-counter stock markets, in the U.S. economy, one must realise at the outset that in the functional sense, there are really two types of stock markets:

The primary stock market

The primary stock markets involve the issuance of new equity securities by corporations to the public for cash. The hallowed importance which the idea of the "stock market" has in the American society derives from this function. The rise of the U.S. economy to industrial supremacy in the world has initiated and propelled to its great rate of growth primarily through the sale of stock to investors. Those early purchases of equity securities are the foundations of virtually all of the great American fortunes. Since it is the efficiency of new capital formation and the rate at which the formation of capital takes place that is decisive of the wealth and power of a modern economy, it is no wonder that the stock markets, which were crucial to giving the United States economy its initial leadership, occupy something of the position of a sacred cow in the business and political world. Nor is this early importance of the stock markets diminished by the fact that there often "wasn't too sharp a line between 'pioneering' and 'buckaneering.' "[4]

It is of the utmost importance, however, to recognise the minimal significance of the stock market in financing new capital formation in U.S. enterprise today. During the eleven years from 1955 to 1965, a mere one-half of one percent of the aggregate new capital formation in U.S. corporations (which account for well over 80% of the total output of the private economy) was financed through the sale of new stock at all.[5] During the six year period from 1965 through 1970, the sale of equities for cash (including a large proportion of private placements) to provide funds for nonfinancial corporate businesses averaged a mere 2.36% of total capital funds provided for those businesses.[6] The large number of registration statements filed with the Securities and Exchange Commission in 1973 and thereafter withdrawn, combined with the rapidly expanding practice of corporations to repurchase their own shares because of a belief that their stocks are "bargains" and are "underpriced" by the public stock markets, virtually assures that the net new capital formation resulting from the sale of new equities, including both private placements and public offerings, will be a negative figure in 1973 as it was in each of the years 1959–1963, and in 1968.

---

[4] See *Investment Banking Functions*, Merwin H. Waterman, University of Michigan, Ann Arbor, 1958, p. 26.
[5] See Kelso and Hetter, *Two-Factor Theory; The Economics of Reality*, Viking Press, New York, 1967, p. 6, Note 5 and References.
[6] *Statistical Abstract of the United States*, 1972, p. 473, Table no. 754, (Based on Federal Reserve Data).

The "Secondary Stock Markets" or public markets for trading in already-outstanding or secondhand securities

In contrast to the almost insignificance of the sale of new stocks for cash to the public to finance corporate growth in the last decade and a half, the secondhand securities market has steadily grown to gargantuan proportions. The dollar volume of stock sales on registered exchanges in the United States rose fairly steadily from seven billion dollars in 1940 to 147 billion dollars in 1971. The corresponding increase in the number of shares traded on registered exchanges rose from 283 million in 1940 to 4,265,000,000 in 1971.[7] It is well known that until recent severe retrenchment in the securities brokerage business, during which hundreds of small brokerage houses have disappeared from the scene and many of the largest have merged, the industry was geared to a trading requirement, if it was to "break even," of 15 million shares per day.

THE CONFUSION OF THE PRIMARY STOCK MARKETS WITH THE MARKET FOR SECONDHAND STOCKS

There is, of course, a relationship between the primary stock markets and the secondary or secondhand stock markets. It has never been stated more clearly than in the study sponsored by the Joint Committee on Education Representing the American Securities Business, a summary of the findings of which were published in a book entitled "Investment Banking Functions—Their Evolution and Adaption to Business Finance," by Merwin H. Waterman.[8]

"Actually an issuer does not "sell" new securities in the market; the corporation issues securities in exchange for cash (or property or services). The investor in his turn does not "buy" new securities; he accepts them as evidence of his participation in the enterprise. But this whole process has become known as the "Primary Securities Market," and the most significant feature of this market lies in its competitive relationship to the "Secondary Securities Market". It is a fact that the transfer of securities from issuer to investor follows a pattern similar to that followed in the transfer of securities from one investor to another; the latter is the transfer of "second-hand" securities, if you will, in contrast to the "new" securities which evidence the raising of new capital by an issuer.

When new securities are issued they are priced and sold in competition with old securities available as alternative investments. The secondary market thus serves an important purpose in providing value perspective to the investor and to the issuer. Further, the existence and also the quality of a secondary market will often determine an investor's willingness to buy (invest in) a new security, because he seeks a degree of liquidity in his investments that he cannot get from the corporate issuer. Important and significant studies of the secondary markets exist, and here reference is made only to the fact that the organized securities exchanges and the over-the-counter securities markets play an important role in the new capital-raising process. Not only is the relationship between primary and secondary markets as close as described above, but also many personnel and the organization of practically all investment banking firms are so arranged as to participate in both types of markets. It is safe to conclude that the primary securities market and the whole process of new capital raising would not and could not exist in their present form without the coexistence of such institutions as The New York Stock Exchange, The American Stock Exchange, the several regional stock exchanges throughout the country and the over-the-counter securities market. The transferability of capital between investors which is made possible by the operation of these secondary markets is a condition essential to the original commitment of capital to business by creditors or shareowners."

We believe that two conclusions are important here. Firstly, in considering the role of the stock market itself in the U.S. economy, we must note that the public stock markets are relatively insignificant with respect to financing the growth of the economy, *the function that originally gave them their prestigious position in our business and political thinking*. The upsurge in the proportion of net new capital funds raised by sale of stocks to the public from zero in 1965 to about 6½% of the source of funds for new capital formation in 1970 corresponds with the period of the sale of new "hot issues" to "little guys" by the overheated hucksters of the brokerage industry, which has in turn led to the disappearance of the "little guy" from the public stock markets today. Secondly,

[7] *Statistical Abstract of the United States*, 1972, p. 457, Table no. 724, (Based on Securities and Exchange Commission Data).

[8] *Michigan Business Studies*, Vol. XIV, No. 1, Published by the Bureau of Business Research of the School of Business Administration, University of Michigan, Ann Arbor, 1958.

the chief functional importance of the stock markets in recent years, the statistics clearly show, is to provide a virtual "instant liquidity" for the fifty or fewer "upper tier" glamour stocks held in gigantic concentrations by the institutional investors, provided no attempt to sell any significant part of these giant holdings is made, and a sort of halting liquidity (or "illiquidity," depending on one's point of view) for the hundreds of other stocks traded on the stock markets.

We well later address the subject of liquidity itself.

One other point seems relevant here to the role of stock markets themselves in the national economy. Professor Waterman's historic book, "Investment Banking Functions," above cited, was sponsored by the entire "American Securities Business."[9] This soul searching by the "American Securities Business" was inspired by a massive antitrust suit brought against the securities business by the Government. The final decision in the case was rendered by Judge Harold R. Medina in favor of the seventeen defendants.[10]

Professor Waterman actually defined the function of the primary stock markets indirectly by defining the functions of the people who in fact operate the public stock markets:

"The observations in this study are directed primarily, if not exclusively, to discovery and disclosure of the nature and functions of investment banking as they apply to the raising of capital for private business enterprise. . . . In effect, it will be viewed as a "material-handling device" in the capitalistic process. (p. 1)

The problem to be examined here is, in its basic elements, a simple one. On the one hand the private business enterprises in our economy have a need for capital funds to expand our productive capacity and to finance the flow of goods to the consuming public. From another point of view there are the individual and institutional savers, the real creators of potential capital, who have produced in excess of their immediate needs, and thus have funds available for investment. The problem is how best to implement the transfer of these capital funds from those who have them for investment to those who need them for production. (p. 2)

While the South remained primarily agricultural, industry grew apace in the North, so that the need for capital-moving machinery became as important as the need for capital itself. (p. 20)

The entire era 1900 to 1930 was one of great industrial development in this country from investor to user. . . . Factually there is no doubt that the investment bankers played a significant part in the "capitalization" of our economy. They laid the tracks and developed the financial transportation system over which the supplies of capital funds were routed and carried from their sources to their points of use; on the return trip they carried the securities from the issuers to the investors. . . . Their job was essentially that of reconciling the needs and desires of security issuers on the one hand and investors on the other. (p. 56)

Except in strict agency transactions securities do "go through" the investment banker on their way from the issuer to the investor, and the funds ultimately flow through the same channels in reverse direction. (p. 118)

The end results of greatest interest to all concerned are basically simple and have been held up as the tests of effective operation throughout this analysis—they are (1) raising capital for private enterprise, (2) raising it in the amount and at the time needed, (3) matching the capital requirements of investors, and (4) performing these functions efficiently and with profit. This implies not positive direction of the flow of capital by the investment bankers, but provision of machinery which issuers and investors may use to facilitate the movement of capital in the amounts and in the direction of their choice." (pp. 184–185)

Several conclusions concerning the role of the stock markets themselves in the national economy, based in part upon the foregoing considerations and in part upon the analysis which follows (see pp. 63–65, 70–72), should be set forth here:

1. If financing of the growth of new capital formation in the U.S. economy were dependent in more than the most trivial and insignificant way upon the sale of equity securities to the public in the public stock markets, it is perfectly clear that the growth of the economy would stop and it is more than probable

---

[9] The direct sponsors were: The American Stock Exchange, The Association of Stock Exchange Firms, The Investment Bankers Association of America, The National Association of Investment Companies, The National Association of Securities Dealers and The New York Stock Exchange, and from a number of investment banking firms.

[10] See 118 Fed. Supp. 621 (1953).

that the economy would collapse. For presumably good and sound reasons under prevailing circumstances, business, particularly well-established businesses, do not choose to finance their growth through sale of new stock.[11]

2. The public stock markets are mechanisms for satisfying the passion for quick liquidity primarily of "Institutional Investors" (who account for some seventy percent [70%] of the trading volume) who must trade outstanding securities back and forth in a ceaseless ebb and flow of at least fifteen million shares per day to keep the securities business healthy. If this endless churning of the "deeds" to the ownership of the means of production in the U.S. economy serves any rational purpose it can be justified and public concern for the health of the "stock market" would seem appropriate, but if this restless churning and surging of shares of stock representing the ownership of capital in the American economy does not serve a rational purpose, or even worse, if it is positively deleterious, then the far more important questions would seem to relate to whether there are more rational means of financing the growth of the U.S. economy.

3. It has elsewhere been shown[12] that all the conventional techniques of corporate finance operate as Professor Waterman describes the function of the investment banker. They function in one direction to transport funds from those who have excess above their consumption needs and desires to the corporations and entrepreneurs whose business enterprises require new capital in order to increase their productive output. And they function in the opposite direction as transporters of the ownership of the newly formed capital in those growing productive enterprises to the wealthy five percent (5%) of families and individuals in the U.S. economy who own all of its productive capital. In other words, the public sale of newly-issued stocks in the stock markets, so far as it contributes to the financing of new capital formation, is a minor function of the stock markets at best, and has the functional effect of building incremental productive power into the tiny minority of families and individuals who are already excessively productive. At the same time, it deprived the capital-less majority whose desperate responses are slowly but surely destroying the supremacy of the American economy of the incremental productive power they need.

THE ROLE OF FINANCIAL INTERMEDIARIES ("INSTITUTIONAL INVESTORS") IN THE NATIONAL ECONOMY

We will comment here only upon certain principal financial intermediaries, beginning with the most basic of all financial intermediaries, the business corporation.

THE CORPORATION

In any functional sense of the word, the business corporation is the most basic of all financial intermediaries. It is of course not an "institutional investor" in the sense that the term is here used. However, it is man's greatest social invention for bringing together through financial and contractual arrangements the raw materials, the know-how, labor power, and the capital (both tangible and intangible) required to produce goods and services in a technological society. It is the capital stock of the business corporation that identifies the owners of the corporation. If that ownership has the true characteristics of private property, then it is the owners of the corporation that are entitled to the net income of the corporation, just as it is the owners of the labor power employed by the corporation who are entitled to the wages and salaries for their productive input as workers.

The institutional investors, including retirement system trusts, the insurance companies, the mutual funds and the charitable foundations, to the extent that they invest in the stock of American enterprise, invest in the stock issued by this basic financial intermediary, the business corporation.

Whatever the constituency of the "institutional investor", and whatever the character of that constituency, it must of necessity be evaluated in terms of its effects upon the relationship between individuals and the basic financial intermediary, the business corporation. The goods and services of the economy that make up the quality of its economic life, and its power and strength in the world economic community, are primarily produced in the business corporations of the economy. If the "institutional investors" do in fact render a valuable investment

[11] The notable exception in the case of established businesses is public utilities, which are required by regulatory authorities to finance a portion of their growth through sale of equities.

[12] See Kelso and Adler, *The Capitalist Manifesto*, Random House, 1958, and *The New Capitalist*, Random House 1961, and Kelso and Hetter, *Two-Factor Theory; The Economics of Reality*, Vintage Press, New York, 1967.

service in the economy, that value must be measured in terms of the relationship which their activities create between the families and individuals and the productive corporate enterprises.

In the functional sense there are but two basic input sources into the production of goods and services: the human factor (the workers, whatever the nature of their work, whether physical or mental, or innate or acquired skills) and the nonhuman factor (capital, generally speaking land, structures, and machines, and in certain situations intangible capital).

The institutional investor has no role whatsoever in connecting individuals with the ownership of labor power. In a free society each man owns his own labor power, and the concentration of the ownership of labor power is made impossible by the laws that prohibit human slavery.

So it is only with respect to one of the two input factors of production that the institutional investor is significant: it influences the pattern of ownership of capital and the character of that ownership. Functionally, because the essence of the private ownership of capital is the right to receive all of the net income produced by that capital, the institutional effectiveness both of the business corporation and of the institutional investor, must be measured by the extent to which the full per share net income of the business corporations involved is received by the direct constituents of the business corporation and by the indirect constituents of the business corporations who derive their interest in them through the institutional investor. These are, in the first case, the direct stockholders of the corporation, and in the second case, of course, they are the beneficiaries of the private retirement systems, the policy holders and annuitants of the insurance companies, and the "public" at large in the case of the charitable foundations.

Measured by these standards, and drawing in part upon the remainder of this memorandum, we draw the following conclusions:

1. The role of the institutional investor in the national economy appears to be one of evaluating, selecting, and diversifing the investments made on behalf of their constituents in the stocks of the primary financial intermediary, the business corporation. The business corporation itself is under no legal compulsion to pay out the "wages of capital," its net earnings, to its owners, the stockholders, except to the extent that it may choose to do so. Many corporations do not choose to do so, and few ever choose to pay out more than half. It is inevitable that the yield to the ultimate constituent of the institutional investor will be less than his yield if he were invested directly in the stocks of the business corporations which the institutional investor holds for him, for the institutional investor is in business for profit and the yield to the ultimate constituent is reduced by that profit. In the desperate effort of the institutional investor to show a higher apparent net income than the receipt of whatever dividends are paid on the stocks which it holds, (since the laws of private property, under which the owner is entitled to the full yield of the property which he owns, are not enforced in our corporate sector), the institutional investor must resort to the capital gains game. That is, the institutional investor must buy low in order to sell high and sell high with the hope of buying low to show better "performance" for its constituents. That there is a loser in every trade of outstanding securities as well as a winner goes without saying. As long as institutional investors are trading in the ownership of outstanding shares of corporate stock it is a zero sum game. Nothing is created and nothing is lost—except of course the assets of the ultimate constituent used to pay for the services of the players in the zero sum game and the brokerage commissions involved.

2. That the institutional investor can make a better portfolio selection than an ininformed beneficiary of a retirement trust seems probable, though the studies that have been made are not particularly flattering. That institutional investors in stock as a whole can get in yield, either through dividends or through capital gains, any more than their ultimate constituents would get if they held the stocks directly seems quite impossible. The actual studies that have been made tend to suggest that year-in and year-out, on the average, the institutional investor will get no more out of the stock which it holds and trades than the basic financial intermediary, the business corporations themselves, put out.

WHAT IS THE NATIONAL ECONOMIC POLICY AND WHAT IS THE LOGIC OF WHAT WE CALL OUR "ECONOMIC SYSTEM?"

The overall problem of the role of the institutional investor in the stock market cannot, we believe, be accurately appraised without recognizing that our national economic policy, the Employment Act of 1946, is a one-factor policy. Like tradi-

tional economic theory as a whole, including laissez-faire free enterprise theory, neoclassical theory, Keynesian and post-Keynesian theory, socialism and communism, our national economic policy recognizes in the functional sense, only one-factor of production: labor.

The physical function of capital—land, structures and machines, and even intangibles—so these conventional economic theories hold, is to amplify the productiveness of labor. Thus, in the mathematical sense, the production of goods and services is regarded as a unitary or mono-factor process, under which certain ingredients can be added to the production process that "raise the productivity" of labor. This phrase, repeated ad nauseam in business, economic, and political circles, means, with some rare exceptions of no practical importance, that the output of labor per hour of labor input has risen, and that the capital-amplified productiveness of labor is the cause. The addition of structures, machines, improved land, etc., to the production process "raises the productivity of labor" according to the conventional wisdom. Since the Puritan Ethic is the morality of our economic system (and of all other economic systems as well, for it reflects a permanent aspect of human nature), under which the purchasing power received by each consumer unit is supposed to be based on what that consumer unit contributes to the productive process, the way to have a happy and prosperous economy in order to enable everyone to live well—so conventional theory holds—is to have full employment and to maximize capital investment in order to "raise the productivity of labor."

Unfortunately, this is simply beautifully preserved and ossified pre-historic nonsense. The production of goods and services is not—in the real world—a mono-factor system at all, but a binary or two-factor system.

Capital (physical capital, that is, and in some situations intangible capital as well) produces goods and services in the same senses—physical, economic, political, and moral—as does labor. The addition of capital instruments, or improved capital instruments, to the production process does not make labor more productive at all. It increases output because the productive input of the capital is added to the productive input of the labor, or in many cases, displaces and supersedes that of the labor altogether, with a resulting increase in output. The reality of the matter in most modern production processes is that actual output rises only to the extent that the increased productiveness of capital offsets the decreasing productiveness of labor.

Who gets what from the production process is determined by who puts what into the production process. And who puts what into the production process is determined by who owns each of the two particular input factors involved. Workers get wages and salaries because each worker owns his labor power, which he contributes to the production process. The capital owners—usually stockholders—get dividends, rents, royalties, etc., because they own directly, or through capital stock, indirectly, the non-human factor of production: capital.

The purpose of technological change is to shift the burden of production off labor and onto the non-human factor, and to produce greater quantities and new kinds and better qualities of goods and services than labor alone could ever produce.

The Puritan Ethic does not command each consumer unit to produce by some pre-industrial method in order to receive income; it only commands that the value of economic out-take must be based on the value of economic input. The form of input should be a technical decision: one for engineers, scientists, managers and farmers, not one to be made by economists, politicians, moralists or educators.

Furthermore, at the present stage of technological development of the U.S. economy, most of the productive input already is made by the non-human factor, not by labor. Economic history is a long story of concurrent diminishing labor input and rising economic output. If we insist on the equal opportunity of every family and individual to produce a good economic life as a means of enjoying a good economic life, then we have no choice but to equip each consumer unit with capital ownership whether or not there is in reality a demand for full employment, or for 95% full employment, or for 50% full employment.

If we recognize on one hand that it is timely for Congress to enlarge the National Economic Policy to include not only the facilitating of full employment (to the extent that there is a legitimate market demand for employment), but also to adopt a legislative program that will channel the ownership of new capital formation into the underproductive majority who do not own capital and away from the excessively productive minority who own it all, then we can evaluate whether the entire business of corporate finance is being properly conducted or, if not, whether it could be better conducted. It is quite evident that the combina-

tion of our one-factor economic policy in a real world where most of the productive input is made by capital, the other factor, and techniques of corporate finance that build the ownership of all future capital formation into the same tiny and shrinking minority who already own all productive capital, is the source of virtually all of the grave ills that beset the U.S. economy.[13]

In two-factor terms, the logic of a free market private property economy is neither more nor less than double-entry bookkeeping. Under it, what each individual takes out of the economy is expected to be based upon the productive input which he makes into the economy. If there are two input factors, labor and capital, and each individual is innately equipped only with one—his labor power—and the stage of technological development is such that the other, the capital factor, provides most of the productive input, then the conclusion that the economy will not work is unavoidable. That the institutions of our society must make it possible for men born without capital to buy it, pay for it, and own it in order to engage in production through that ownership, then seem unassailable.

That the stock markets as we know them and the institutional investors as we know them have failed to do this is undisputed history. Furtunately, as we hope to demonstrate, the nature of our stock markets can easily be reformed, so that we will raise the economic productiveness of the underproductive and nonproductive, using to the maximum the genius of our existing institutions, the role of institutional investors, and the role of the investment banker, with relatively minor changes, can be modified to help make the economy function both internally and in the world community.

WHAT IS A STOCK INVESTOR?

A stock investor is one who acquires the ownership of stock capital for the purpose of holding it and engaging in production through its ownership, in order to enjoy the net income produced by the underlying capital. An investor buys to hold, to own, to receive the yield and to enjoy. He does not buy merely to sell, and he does not sell merely to buy something else. An investor may well conclude from a long range analysis of a stock that he holds, the price of that stock that a prospective buyer will pay, and the characteristics of alternative investments, that he should sell one capital stock in order to acquire another. But the investor makes that decision on the basis of the present and prospective yields of the stock, not on the basis of a capital gain that he can make by a fast switch.

WHAT IS A STOCK SPECULATOR OR STOCK GAMBLER?

He is the other type of stock buyer. He buys low in order to sell high, and he sells high in order to buy something else low and to repeat the process. He does not buy to own or hold. When he has sold a stock, he could not care less whether the underlying business is leveled by an earthquake or a fire or technologically superseded, or goes bankrupt. He is a gambler. He is not an investor. His psychology was once articulated by Joseph H. Hirshhorn who is reputed to have asserted after selling his stock holdings for $4,000,000.00 just before the 1929 crash "I'm not an investor. I'm a speculator. I'm not interested in blue chips and their dividends. They're okay for grandma and the kiddies, but I've always wanted the proposition that costs a dime and pays ten thousand dollars."[14]

ARE THE "INSTITUTIONAL INVESTORS" INVESTORS OR SPECULATORS?

We suspect that to a large and increasing degree institutional investors are not investors, but rather are speculators. In the first place, it is rare indeed for the pension-trust or for any bank trustee (except for the bank trustees of Employee

[13] While the quantitative studies indicate some 30 million shareholders in the U.S., the qualitative studies show virtually all the stock in the top 5%. As to indirect ownership, through financial intermediaries such as insurance companies and mutual funds, such investments are almost never acquired on a self-liquidating basis, so they do not make a net increase in the buyer's standard of living. They substitute income from capital for income from labor, but they rarely raise the economic productiveness of the individual. Such investments evidence a reduced present standard of living and the "storing" of purchasing power, subject to the effects of inflation, for future use. In our advanced industrial economy, it is rare indeed for one to acquire through personal savings, a capital holding that would yield a viable income. On the degree of concentration of ownership of productive capital, see Robert J. Lampman, National Bureau of Economic Research, The Share of Top Wealth-Holders in National Wealth, 1922–1956, (Princeton: Princeton University Press, 1962) pp. 23, 108, 195; (Wharton School Stock Ownership Study, Proceedings of the American Statistical Association, Business and Economic Statistics Section, 1963), pp. 146–168; McClaughry Associates Inc. Expanded Ownership, the Sabre Foundation, Fond du Lac, Wisconsin, 1971. At pages 101–198 is a comprehensive survey of the studies on The Distribution of Wealth in the Twentieth Century, by Professor James D. Smith of the Pennsylvania State University. All of the studies surveyed confirm the general accuracy of the Lampman analysis.

[14] Quoted in *The Art Crowd*, by Sophy Burnham, David McKay Co., Inc., N.Y., 1973, p. 266.

Stock Ownership Trusts, which we will discuss later) or for a mutual fund, to buy stocks upon original issue. Thus they do not, as buyers of stook original issue contribute to the financing of the growth of the economy. That their purchases in the secondhand market from the original purchaser may in certain situations encourage investors to buy newly-issued stocks is possible, but the relatoinship seems to be a very tenuous one.

As to insurance companies, they are by laws of their state of incorporation quite generally prohibited from becoming joint purchasers on original issue with investment bankers or venture capital firms, and in practice, it is rare for them to do so or to buy an entire original issue except in a rare private placement.

It is equally rare for a charitable foundation to purchase stock on original issue. Stocks acquired by such foundations are normally the result of gifts motivated on the one hand by failure of the donor either to take his portfolio with him at death, or, because of our estate and gift tax laws, to be able to leave very much of it to his family or friends.

Overall, it seems inevitable that the institutional investor is principally a combination investor and speculator in the secondhand market. What is known for certainty is that except in a rare and unusual instance, the institutional investor does not have access to means of investing that will meet the test of basic business logic: invest on terms where the asset purchased will pay for itself. The most obvious reasons for this are that the institutional investor is buying in the secondary markets stocks yielding a rate of return that is less than the market value (that is the current interest rate) of the funds invested. If the ravages of inflation, resulting automatically from our defective National Economic Policy and our failure rationally to broaden our capital ownership base, are offset against the appreciation in market value of stocks held by institutional investors, it would appear that most institutional investors are capable at best of delivering to their ultimate constituents somewhat less than what was originally entrusted to them. In other words, our system of institutional investors are a means of accumulating capital for their ultimate constituents only to the extent that they help those constituents to discipline themselves and to reduce their current spending for consumption. It is not at all clear that this is a very valuable form of assistance in the overall picture when it is recognized that the very profitability of the corporations whose stocks are held by the institutional investors depends upon the health and strength of the consumer markets for the products of the business corporations!

A CAUTIONARY NOTE ABOUT PREVALENT MYTHS

In examining the assumptions implicit in the question of the role of the institutional investor in the stock markets, it is already clear that there are certain disparities between rational function and the conventional wisdom in the field of finance.

The awesome fact is that there is no area of our society more replete with sheer mythology than the financial world. An indispensable step in the direction of defining the role of the institutional investor in the stock market, or even the role of the stock market itself, requires brief allusion to some of the prevalent myths that tend to confuse thinking in this area.

MYTH: THE STOCK MARKETS ARE OUR FREE CAPITAL MARKETS AND ARE THE HEART OF THE U.S. ECONOMIC SYSTEM

Obviously the truth is that the overwhelming bulk of new capital formation comes from a combination of direct use of cash flow by business enterprise and borrowings repaid from cash flow. As a source of business capital, the stock markets are not only minimal, but erratic, unreliable, and often counterproductive. By the latter, we allude again to the fact that the public flotation of stocks on original issue is simply one of the key mechanisms for concentrating the ownership of capital—the single most serious defect in the structure of the U.S. economy. This is because the stock market provides no means by which an individual without excess funds can finance the purchase of capital stock on terms where it will pay for itself.

MYTH: WE MUST ATTRACT THE SMALL INVESTOR BACK INTO THE MARKET

That the gamblers in the secondhand market for outstanding stocks need the "little guy" as a buyer at a handsome multiple of their original costs seems entirely plausible. That this practice is good either for the economy of the small investor or

small speculator (normally the latter) is rather doubtful. The "little guy", like the institutional investor itself, cannot buy an equity stock on terms that make business sense, namely where its yield will pay its cost of acquisition within a reasonable time, except in a case of a freak accident or an illegal tip. This raises a generous doubt as to whether there is any social need or individual need on the part of the "little guy" for the "little guy" to return to the public stock market.

MYTH: THAT ALL STOCK BUYERS ARE "INVESTORS"

The very unexamined and chaotic state of our concepts of corporate finance and our half-valid, half-invalid National Economic Policy, and our failure to develop a rational theory of a capitalist system, all conspire to insure that most stock buyers, individuals as well as institutional investors, are really speculators or gamblers.

MYTH: THE STOCK MARKETS PROVIDE POOLS OF AVAILABLE CAPITAL FOR THE EXPANSION OF BUSINESS

It has already been shown that while it was true in decades prior to 1929 that one of the chief methods of raising capital for certain types of business enterprise was through the sale of stock, in recent years the funds provided for the expansion of business by sale of new stocks to the public amount to only a few drops compared to the pools of capital provided internally by corporations, or through debt financing repaid out of internal cash flow. In a significant proportion of the last fifteen years, the functioning of the stock markets has actually reduced the capital available for business expansion because the values established in the erratic, emotion-ridden public stock markets have so dismayed managements that they have caused corporations to expend their cash reserves to repurchase more publicly held stock than the amount of new stock issued during those years. This was true in each of the years 1959 through 1963 and in 1965 and 1968, and in all probability it will be true for 1973.[15]

MYTH: A MAN WITH A GOOD IDEA AND GOOD MANAGEMENT ABILITY CAN GET VENTURE CAPITAL TO START A BUSINESS WITH THE HOPE OF SOMEDAY SELLING STOCK TO THE PUBLIC

This should be known as the "free economy illusion." The odds in today's world against success in small business startups are enormous. If the small business entrepreneur is able to obtain courageous venture capital suppliers to back him, it is not the entrepreneur who normally hopes someday to sell his stock on the public stock markets, but the venture capital supplier. The venture capital suppliers, at least the successful ones, are shrewd risk-takers who expect to help get a business started and then to sell out at a respectable multiple of their investment. The venture capital supplier is a combination between an investor and a speculator; he is a short-term investor, and the shorter the term is, provided he can sell out at respectable profit, the better he likes it. For the entrepreneur himself to sell out short of retirement is grounds for suspicion that he is bailing out because he expects the ship to sink. At most, it can be said that the public stock markets are good for the entrepreneur because, except for the possibility of selling out at a profit, the venture capital supplier will not be interested even in the most promising of new companies.

As we shall note later, there is much to be said for the merits of the venture capital supplier selling out his investment to the employees of a new business through Employee Stock Ownership Plan Financing than in selling to the disinterested, or rather the merely financially interested public. There are a dozen reasons why this is a better solution to the problem of the venture capital supplier who has accomplished his objectives and wants cash for his investment, than sale through the public stock markets.

MYTH: THE INSTITUTIONAL INVESTOR CAN PROVIDE A SAFE HAVEN FOR THE OWNER OF SMALL SAVINGS AND THE PARTICIPANTS IN RETIREMENT SYSTEMS IF THE PRICES OF CORPORATE STOCK SHOULD COLLAPSE

This is perhaps one of the most insidious of all the myths involving public stock markets and institutional investors. Of course, diversification by any efficient means will protect the ultimate constituent from being at the mercy of a radical

[15] "Economic Report of the President," 1961, p. 196, Table C–60; same for 1966, p. 287, Table C–66; "Personal Investing," Fortune, May 1964, p. 75; Statistical Abstract of the United States, 1966, p. 500, Table 705, and p. 472, Table 658; U.S. Statistical Abstract, 1972, p. 473, Table 754.

drop in the price of a particular stock in which he may be invested, if other stock prices hold up. But the evidence is rather substantial that stock prices in the non-glamour stocks can progressively move lower over a long period of time while the actual earnings and inherent success of the corporations involved rise at a healthy rate. Furthermore, the herd instinct of institutional investors, it would appear, causes them to drive the price of the glamour stocks up to absurd levels and to hold them there by incessant churning of their favorites. This would seem to be nothing more than sustained unreality.

The logic of business investment lies in selecting investments which will pay for themselves out of the income they produce. This is the basis upon which corporations buy capital assets, and acquire other corporations. A rule of thumb is that the assets should be expected to pay for themselves in three to five years; rarely longer than ten. When a stock is purchased at a price of forty times the per share corporate earnings, it is perfectly clear that the buyer is a gambler, not an investor at all. An investor would know that even with luck, under our prevailing corporate strategy, no more than one-half the corporate net earnings will ever be paid out in dividends. He will also know that he must pay an income tax on those earnings before he can use the residue to pay off the price of the stock, or to reimburse himself for the investment. Thus, in terms of the auto-financing logic of business investment, the investor is buying a stock on terms where his after-tax yield from the security might take at least one hundred years to pay off the price of the stock, even if he allows for a zero rate of interest on the funds invested! Such stock purchase is made solely in reliance upon the expectations that the herd-zeal of other speculators will drive the price even higher, so that the outrageous price plus a profit will be recouped from an even more outrageous sale.

More importantly, since there are only two things that produce goods and services, namely people and capital, and only one of those two things produces goods and services vicariously for its owner (and that is capital), it is quite obvious that there can be no such thing as a "safe haven" in any economy where a significant sector of corporate enterprise is depressed, profitless, or bankrupt.

This subject cannot be adequately examined without realizing that the "prudent man rule" calling for a diversification of investments is a guideline postulated for keeping a substantial capital estate intact, if not gradually growing. It is a rich man's rule. But, since the capital in the U.S. economy is entirely owned by 5% of the families and individuals, it is only that 5% to whom the so-called "prudent man rule" applies. When the prudent man rule is applied by the institutional investor to the accumulation of private retirement funds, insurance companies, and mutual funds, it has the effect, as we have already seen, of keeping the poor and capital-less poor and capital-less.

The only rule that will make it possible for the man born without capital and who has no desire to become an ascetic (and perhaps who realizes that a mass production economy cannot afford ascetics anyway) is the "prudent estate builders' rule" announced by Andrew Carnegie in his biography. The rule is "put all your eggs in one basket; watch the basket and stay very close to it and see that the eggs hatch, and that those chickens lay more eggs that are in turn hatched." That is the rule that made the rich—or the ancestors of the rich—rich. It is the only rule that has any promise of enabling the capital-less to become "rich" in the sense of becoming self-sufficient through the ownership of viable capital holdings.[16]

MYTH: THAT IT IS SENSIBLE FOR INSTITUTIONAL INVESTORS TO OFFER "FIXED BENEFIT PLANS" TO WORKERS

The evidence adduced by the several Congressional committees that have studied fixed benefit retirement systems—pension plans—has left no doubt but that the level of "fixed benefits" promised is dependent upon the "lottery effect" under which something like only one in ten individuals covered by the plans will ever receive the "fixed benefits." Even so, there are constant actuarial adjustments that increase the costs of such pension plans; there is no doubt that their burden is on the one hand a powerful inflationary force in the economy and on the other hand a depressant to business. The myth lies in the pretense that there is something besides the corporate enterprises whose stocks are held by the institutional investor that somehow or other can magically distribute effective purchasing power irrespective of the state of those underlying enterprises. This simply is not so.

[16] See pages 72 to 77 herein.

Perhaps more importantly the whole mechanism of fixed benefit pension financing is such that its costs are pure cost to the employer companies. The stocks purchased by the pension trustees are purchased on the basis that their yield will never pay their costs of acquisition, if any realistic factor is allowed for the costs of the funds themselves. If we then subtract the inflationary erosion flowing from this combination of malstructured retirement system and irrational corporate finance, we are holding out a promise of safety where none in fact can exist. In the terms of the systems engineer, we are seeking to get more out of the system than we put into it. It is simply not possible.

In this age of automation, we seek to design mechanical, electronic, and even social systems so that there is feedback from the system to its participants. A fixed benefit pension system is expressly designed to isolate the pension participants from feedback from the underlying capital which is the only possible source (other than cleverly concealed redistribution of wealth) for their vicarious production of income. "The ultimate effect of shielding men from the effect of folly is to fill the world with fools," said Herbert Spencer.

For a means through which employees, over a reasonable working lifetime, can accumulate a viable holding of productive capital without imposing any signficant costs on business, so that it becomes in the interest of business itself to maximize that capital holding, see the discussion of Employee Stock Ownership Financing on pages 72–77 of this memorandum.

MYTH: THE INSTANT LIQUIDITY OF THE PUBLIC STOCK MARKETS MUST BE MAINTAINED AT ALL COSTS

To say the very least, the value of instant liquidity to an investor is enormously exaggerated; but its value to a speculator or gambler cannot be exaggerated. We strongly suspect that if the price of achieving instant liquidity for investors is the maintenance of a 15-million share per day gambling casino in the New York Stock Exchange alone, then the price is vastly too high.

The investor owns capital for its yield. We submit that it would be a fruitful area for Congress to investigate means whereby corporations could be motivated, or perhaps required, to pay out the "wages of capital" fully like the wages of labor, for the simple reason that the double-entry bookkeeping logic of the economy requires it. If, at the same time, existing accumulations of capital can be maintained and protected while being used to build the ownership of the newly formed capital into the labor force that owns none, as it can through Employee Stock Ownership Plan ("ESOP") financing, and where that source of limited financing can be supplemented by the unlimited use of self-liquidating credit to finance any level of feasible growth in the corporate sector, as it can through ESOP financing, then a great deal less emphasis on instant liquidity through the stock market would be indicated.

There are few transactions by investors that require "instant liquidity." The proof of that, of course, is to be found in the field of real estate investing. Land and the structures erected upon land constitute the largest repository of productive capital in our economy. Yet in that field "instant liquidity" is unknown, and certainly would be undesirable. To a large degree this is because the buyers of real estate are far more often true investors and far less frequently speculators than in the case of the public stock markets.

Finally, it would seem that the encouragement given to the development of a single national stock market by the Securities and Exchange Commission places the emphasis where it should be. The larger the market, the easier to have a reasonable degree of liquidity without a vast frenzy of speculative gambling and churning for the sake of producing commissions or capital gains.

MYTH: A HIGH RATE OF NEW CAPITAL FORMATION IN THE ECONOMY IS GOOD IN ITSELF, IRRESPECTIVE OF WHO OWNS IT

Once we view the economy as built upon a binary system of production with each of the two factors, the human factor and the non-human factor, producing goods and services in precisely the same senses—physical, economic, political and moral—it then becomes possible to define the logic of the economic system. That logic, as we have noted above, is simply double-entry bookkeeping.[17]

[17] The Economist's term for this is "Say's Law." See Kelso and Hetter, Two-Factor Theory: The Economics of Reality, Vintage Press, New York, 1967, p. 10, Note 10.

At the same time, it quickly becomes evident that a sound national economic policy calls for all reasonable means to solve the income distribution problem by raising the productiveness of the nonproductive and the underproductive individuals and families who do not own capital. The question of who owns the newly formed capital that is brought into existence, and of who become the owners of existing accumulations of capital when their present owners depart this potentially good life, is every bit as crucial as the rate of new capital formation and maintaining the productiveness and efficiency of the existing capital stock.

Once we recognize that in the real world the economy operates through two factors of production, not just one as our National Economic Policy might lead us to believe, we can see that it is nothing short of an outrage to so operate our economy that a J. Paul Getty, reputed to own $2-billion of productive capital, can obtain a third billion dollars additional capital, than it is for most of the capital-less 95% of the American population to acquire over an entire working lifetime sufficient productive capital to yield an income of a hundred dollars a year. What does a man, owning the productive power that would support (depending on rate of return) from 8,000 to 16,000 families at $20,000 per year capital incomes, do with additional capital capable of supporting another 8,000 families at similar capital income levels? The total goods and services consumed over any significant period of time is identical with the amount of goods and services produced. The economic basis for personal income under the logic of the system is productive input. If a minority of the families and individuals of the economy are permitted to monopolize the means of producing wealth through capital ownership, the economy will slowly, but perhaps from here on out not so slowly, grind to a halt.

It is a matter of the utmost urgency for Congressional leadership to recognize that the pattern of the ownership of capital—the design of the "invisible structure" of our economy—is as crucial as maintaining the integrity and growth of that economy itself. We will not have a healthy economy until we correct the mismatch between the possession of productive power and the possession of unsatisfied reasonable needs and wants. We must so plan the growth of capital ownership, and we must so manage normal changes in capital ownership, that we build market power and economic self-sufficiency into the underproductive and the nonproductive families and individuals.

WHAT SHOULD BE THE ROLE OF THE BUSINESS, FINANCIAL AND ECONOMIC INSTITUTIONS IN GENERAL IN THE U.S. ECONOMY?

The general rule, which follows from the logic of the system itself, is that business institutions, including the corporations, the stock markets, the institutional investors, the retirement systems, the insurance companies, the mutal funds, the savings and loan institutions, etc., should facilitate the growth of new capital formation and trade within the economy and between the economy and other economies in the world community, and at the same time make a maximum contribution towards the building of productive power (market power) into the underproductive and the nonproductive individuals and families. The business and financial institutions should avoid the discontinuity (a self-stimulating evil) which results when excess productive power is concentrated in families or individuals. It would seem to be sound public policy to use the logic of the system as a whole to make individuals and families self-sufficient, in the sense of their being able to produce the value-equivalent of what they wish to consume, whatever reasonable standard of living may appeal to them.

TWO-FACTOR ECONOMICS—THE ECONOMICS OF REALITY

Within the concept of Two-Factor Economics [18] and the techniques for applying it to build the ownership of productive capital into the property less 95% of American consumer units (and into all families and individuals everywhere) lies the possibility of the first modern attack since the Homestead laws in our agrarian period on the causes of poverty: The low productiveness of the worker who has nothing to sell in the most highly industrialized economy in history, save his labor power, and the nonproductiveness of the worker, even a Ph. D. in aerospace engineering, who finds no actual demand for his services at all except demand in the facade economy synthesized on boondoggle.

Two-Factor Economics enables us to ask the right questions, to discover and formulate the right answers, and effectively to apply the indicated solutions in the real world.

[18] See Kelso and Hetter, Two-Factor Theory: The Economics of Reality, Vintage Press, N.Y., 1967.

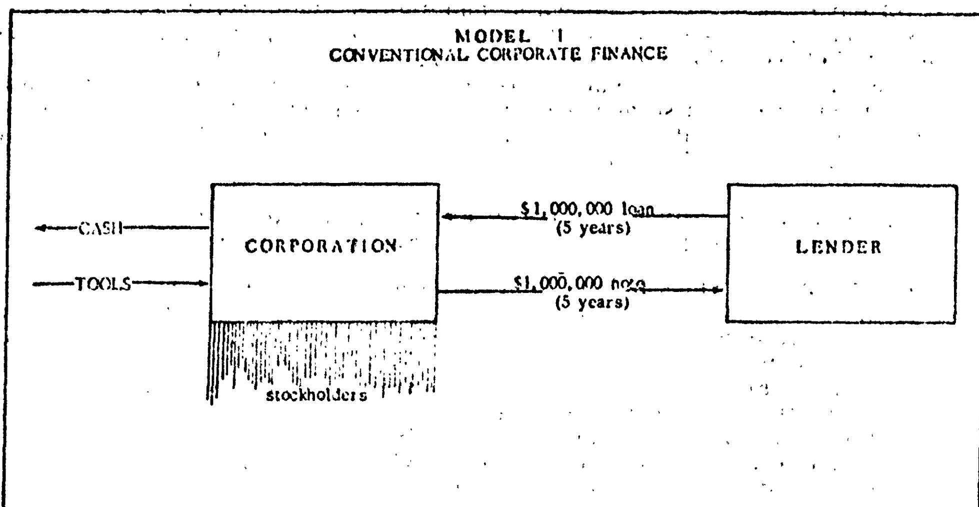
The Economics of Reality is as applicable to the underdeveloped world as to the developed world, for if a social science is a "science", it is applicable everywhere and at all times.

CAN INVESTMENT BANKING AND BUSINESS FINANCING TECHNIQUES CONSTRUCTED UPON THE CONCEPTS OF TWO-FACTOR ECONOMICS ENABLE EMPLOYEES TO BUY CAPITAL WITHOUT USING THEIR SAVINGS OR REDUCING THEIR STANDARDS OF LIVING THROUGH PAYROLL DEDUCTIONS?

The answer is "yes, of course." To fully see both the problem and the answer, a comparison of conventional corporate finance and of Employee Stock Ownership Plan ("ESOP") financing techniques is necessary.

THE FATAL DEFICIENCIES OF TRADITIONAL TECHNIQUES OF CORPORATE FINANCE OTHER THAN SALE OF STOCK

The process by which newly formed capital (improved land, new structures or structural additions, and new machines and tools) is brought into existence under conventional financing techniques can be functionally analyzed from the following example. Suppose a corporation has done its feasibility study for a contemplated expansion (self-liquidation within a reasonable period of years is the essential logic of business investment) and concludes it should spend a million dollars for new tools in order to increase output of goods and services for which it foresees a profitable market. The corporation goes to its bank or other lender, convinces the lender of this "feasibility," and borrows the necessary funds—let's say repayable in installments over five years. The picture looks something like this:



The important aspects of this technique of finance are:

When the loan is paid off, the incremental productive power represented by tools costing one million dollars has been built into a stationary stockholder base. An individual may sell stock which he owns in the corporation, and another individual with capital may buy the stock, but no net new capital owners are created in the process.

Since, as a matter of fact, virtually the entire personal ownership of productive capital in the U.S. economy lies in the top 5% of wealthholders, it is clear that a principal contributor to this concentration of ownership of productive power (productive input being the business basis as well as the moral basis for personal outtake or income) under the double-entry bookkeeping logic of a market economy, lies in a technique of finance that builds all incremental productive power into a tiny stock ownership base that already owns functionally excessive productive power, having in mind that the economic purpose of production is consumption. Those who must constitute the great majority of ultimate customers for business—the people with present and potential unsatisfied consumer needs and wants—do not acquire incremental productive power through this process.

Those who are in fact already excessively productive (in relation to their present or potential consumer needs or wants) through it acquire all incremental productive power.

The other principal methods of financing new capital formation, those using internal cash flow such as retained earnings, investment credits, depletion, accelerated depreciation, etc., all have precisely the same concentrating effect. In the aggregate, all of the conventional techniques of finance above mentioned accounted for nearly 98% of new capital formation during the past fifteen years.

As we have already observed, the sole remaining financing method, the sale of new equities for cash, has the same concentrating effect: the new stock is sold to people with capital—the top 5% of wealthholders—who can pay cash for it.

In short, the logic used by business in making investments—the logic of investing in things that will pay for themselves—is not available to the 95% of U.S. residents born without family capital ownership. As the non-human factor increases in quantity and in relative productive power, its ownership remains concentrated in a stationary fraction of the population. With rare exceptions, employees, including management employees, do not own functionally significant amounts of productive capital.

The conventional economists have failed either to see the problem or to propose significant solutions.

This can be demostrated no more effectively than by referring to Simon Kuznets' definitive book on Capital in The American Economy: Its Formation and Growth, published in 1961 by the National Bureau of Economic Research. In this volume, Dr. Kuznets (pp. 394–399) answers the question of why financing is necessary in connection with new capital formation by saying that it is because businesses have a need for capital instruments before they have saved the funds to buy and pay for them.

However, Dr. Kuznets seems totally oblivious to the fact that in a private property industrial economy, all households have a need to own equity capital before they have saved the funds to pay for it. Indeed, they need to own equity capital so that they can save the funds to pay for it. Yet it takes no argument to demostrate that while we have devised elaborate means for financing the purchase of consumer goods (which produce no marketable wealth and thus do not assist buyers to pay for their cost), we have virtually no techniques for financing the purchase by individuals of newly issued equity securities, although new capital formation which takes place under reasonably competent management normally produces income in successive cycles in amounts sufficient to pay for stock representing it over and over again.

THE EMPLOYEE STOCK OWNERSHIP PLAN ("ESOP") SOLUTION TO THE DEFICIENCIES OF CONVENTIONAL CORPORATE FINANCE

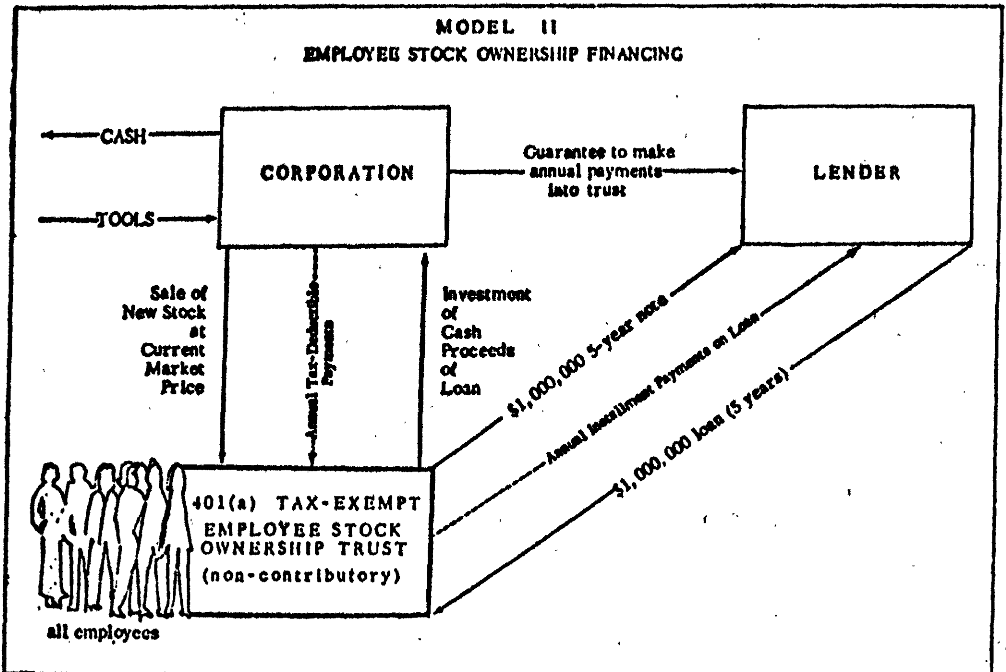
The solution to the conventional mismatch between the ownership of productive power and the possession of present or potential unsatisfied needs and wants is to facilitate financing a significant portion of new capital formation and normal business changes in the ownership of existing assets, such as the transfers of ownership of closely-held businesses, or acquisitions, divestitures or mergers by corporations, by techniques that legitimately build the ownership of viable capital holdings into corporate employees without taking anything from their take-home pay or their universally inadequate (or non-existent) savings, and without impairing the property rights of existing capital owners.

The basic building block for bringing about such change in the pattern of ownership of captial in the U.S. economy is ESOP financing (the possible variations are numerous). Using the assumptions referred to in connection with the above discussion of traditional financing, the following diagram shows how it works:

The most important aspects of the ESOP financing technique are:

The loan is made not directly to the corporation, but to a specially-designed ESOP Trust that qualifies as a tax-exempt employee stock bonus trust under Section 401(a) of the Internal Revenue Code and corresponding provisions of State laws. Such trusts normally cover all employees of the corporation and their relative annual compensation (however reasonably defined) over the period of years that the financing is being paid off. The trusts are normally under the control of a committee appointed by management and its membership may include labor representatives.

The committee invests the proceeds of the loan in the corporation by purchasing newly issued stock at its then current market value.



The trust gives its note to the lender, which note may or may not be secured by a pledge of the stock. If it is so secured, the pledge is designed for release of proportionate amounts of the stock each year as installment payments are made on the trust's note to the lender and the released stock is allocated to participants' accounts.

The corporation issues its guarantee to the lender assuring that it will make annual payments into the trust in amounts sufficient to enable the trust to amortize its debt to the lender. Within the limits specified by the Internal Revenue Code, such payments are deductible by the corporation as payments to a qualified employee deferred compensation trust. Thus the lender has the general credit of the corporation to support repayment of the loan, plus the added security resulting from the fact that the loan is repayable in pre-tax dollars.

Each year as a payment is made by the corporation into the ESOP Trust there is allocated proportionately among the accouuts of the participants in the trust a number of shares of stock proportionate to the participant's allocated share of the payment. Note that this permits the employees to acquire stock in increments over a period of years at a price fixed at the time the block of stock is first purchased. Special formulas have been designed to counteract the relatively high proportion of early amortization payments used to pay interest and the relatively high proportion of later amortization payments used to repay principal.

As the financing is completed and the loan paid off, the beneficial ownership of the stock accures to the employees. Most trusts are designed to permit the withdrawal of the portfolio in kind, subject to vesting provisions, either at termination of employment, or at retirement. However, it is desirable to so design the ESOP and Trust that any dividend income on shares of stock that have been paid for by the financing process and are then allocated to the employees' accounts may be distributed currently (with a minim m two-year deferment possibly required by law) to the employee-participants, thus giving them a second source of income.

Diversification of the assets of the Trust can be achieved if desired after a particular block of stock has been paid for by exchanging the stock, at fair market value, for other shares of equal market value. Since the Trust is a tax-exemp entity, such diversification is without tax impact.

A brief comparison of conventional financing methods represented by Model I, with ESOP financing represented by Model II, is as follows:

A Brief Comparison of Conventional Finance, Represented by Model I, With Employee Stock Ownership Financing, Represented by Model II

Model I	Model II
CORPORATE GROWTH FINANCED IN CONVENTIONAL WAYS [19]	CORPORATE GROWTH FINANCED THROUGH EMPLOYEE STOCK OWNERSHIP TRUSTS [19]
TAX TREATMENT OF INTEREST	
Interest deductible for corporate income tax purposes as such.	Interest deductible for corporate income tax purposes as a contribution to a qualified trust.
TAX TREATMENT OF PRINCIPAL [19]	
Repayment of the principal, which is not deductible for corporate income tax purposes, requires $2.3 million pre-tax dollars.	Repayment of principal, which is deductible for corporate income tax purposes, requires only $1 million pre-tax.
WHO OWNS THE STOCK WHEN IT HAS PAID FOR ITSELF	
When the financing is paid off, the employees have acquired no capital ownership. Since their labor is their only means of making productive input, and they are faced with rising living costs and taxes, employees must demand ever higher compensation for the same or less work input.	When the employee stock ownership financing is paid off, the employees, including executive employees, each in proportion to his relative income from the corporation, have *purchased* through their trust, on installment credit that is non-recourse as to them, newly issued stock, under conditions where the proceeds to the corporation are invested in new tools, and where the employees, in economic theory (as distinguished from tax theory) are entitled to receive a preferential dividend representing the "full wages" of their new capital to enable them to pay for it.
CORPORATE STRATEGY IMPLICATIONS	
The corporation, by constantly replacing labor input with capital input, without recognizing the need of employees to make up for their declining economic productiveness through ownership of capital instruments, forces employees to demand more pay for the same or less work. This raises costs without raising output.	The corporation, by financing its expansion on terms that are not only more favorable to it but which also build equity ownership into employees without diminishing takehome pay or invading their savings, puts employees in a position to build a capital estate without reducing spendable income and within a few years to add a growing second income to their wage or salary.

[19] Comparison based upon an assumption that a corporation has determined to invest $1 million in new plant, and has persuaded its bank to loan that amount on a five-year installment payout basis.

INTERNATIONAL COMPETITIVE ADVANTAGE TO U.S. BUSINESS

Model I

Because the corporation cannot provide better increasing economic security or increased incomes to its employees except by increasing its costs, its only hope, vis-a-vis foreign competitors, is that they suffer the same or a worse fate.

Model II

Because the corporation can provide increasing economic security and, after the stock has in effect paid for itself, increasing income for its employees *without increasing its costs*, it puts itself progressively in a better position vis-a-vis its competitors, domestic and foreign.

ECONOMIC ALIENATION

Model I

The natural antipathy between owners (who generally do not work in the corporation) and workers, who own no part of the corporation, grows, and reflects itself in alienation of the workers, lack of common goals, decline of craftmanship, high turnover, waste, social unrest, and, in extreme cases, even sabotage.

Model II

There is a growing unity of interest between owners and employees, as employees become equity owners through their tax-exempt, in-house mutual fund, the ESO Trust, having been given the opportunity to invest on the same terms the corporation traditionally insists upon for itself when it makes an investment—that it pay for itself.

GOING PUBLIC VS. GOING PRIVATE

Model I

Close holding stockholders may remain in a position where either they or the corporation, or both, will at some future time be required to make an expensive public sale of stock to establish its market value to provide valuation and liquidity to handle estate tax problems.

Model II

The ESO Trust itself can buy close-held stock, on pre-corporate income tax dollars, and solve normal estate tax problems and return the full fair market value of the stock to the selling stockholders, without subjecting either the corporation or its stockholders to the vagaries of the public stock market, while building equity ownership into corporate employees in the meanwhile.

RETIREMENT SECURITY AS AN OPPRESSIVE BUSINESS COST OR AS A SOURCE OF NEW CAPITAL FORMATION?

Model I

No anxiety of the American working man or woman could be better founded than the concern for income after retirement. Most corporate and public employers have policies of mandatory retirement at 65 or less. Unless the typical employee reduces his current standard of living (and his potency as a customer for business) sufficiently during his life to accumulate a fund to provide ⅓ to ½ his income throughout his retirement, even with pensions and Social Security, his income drops to the poverty level on retirement.

Model II

In terms of accumulation for retirement of corporate or governmental employees who participate in Employee Stock Ownership Trusts, it is realistic (and theoretically sound) to look at payments made by the employers into the trust as part of the yield (along with dividends) on the trusts' original investments. Thus in economic theory (as distinguished from tax theory), the contribution is simply the preferential dividend that enables the investment on non-recourse credit (as to the employee) to pay for itself in pre-tax corporate income dollars. It amounts to relatively full payout of

Nevertheless, inadequate as governmental, union, and corporate pensions are, they are a devastating cost to corporations and taxpayers. The reason is quite apparent: the funds so accumulated are mostly invested in outstanding pieces of paper (stocks or bonds) at yields that assure that the investments will *never*, if the market cost of money is considered, pay for themselves. Corporations for their own accounts, would never knowingly or intentionally make investments that will never pay for themselves, but for their conventional pension and profit sharing trusts, they, like governments and unions, almost invariably do!

So year after year, the corporate, union, and governmental costs of pensions go up. Year after year their inflationary impact pushes up the cost of living, for they contribute nothing to the output of goods and services to offset their costs. In other words, the sums invested do not go directly into new capital formation. Year after year the functional inadequacy of retirement plans in the face of rising costs of living and rising taxes brings grief, privation and frustration to those who have looked forward to depending upon them. At the same time, many corporations would be insolvent or stripped of most of their equity, if their retirement plans were currently fully funded. Their stocks would plummet in the market place.

the "wages" of capital to enable the new beneficial owners (the employees) to pay for their new capital out of what it produces.

Since the average pre-tax yield on invested capital for U.S. corporations is, and for many years has been, 20% per annum and better, the potency of ESO Trust financing per dollar invested by the employer in building capital ownership in the employee is 400% to 600% greater than conventional corporate, union, or governmental retirement plans *and it is not a corporate cost*, for corporate growth financed in the conventional way would cost as much or more!

Employee Stock Ownership financing can be adapted both to governmental and union use, and is currently being employed by a growing number of corporations.

22-727—78—6

LABOR-BUSINESS STRIFE OR LABOR-BUSINESS PEACE?

The employees are gradually conditioned to think in terms of the permanent employee-management warfare, using raw coercion and the threat of coercion to extract more pay from the employer in return for the same or a diminished work input. The "economic solution through coercion" syndrome involves maximizing inconvenience to trade, business, the economy and the public as a means of making coercion of the employer more effective. Income, in the mind of the worker, becomes more a function of coercive power than of quality and quantity of productive input, so coercion grows, and the quantity and quality of goods and services shrinks.

The employees are gradually conditioned to think like owners because they become owners. As the reality and awareness of ownership grows, the identity of interest between stockholders, management and employees grows. So does their interest in underselling competitors, domestic and foreign, their pride in quality, their resentment of waste, their solicitude for public goodwill. Pay for nonproduction equally hurts the property and income of the employee, the manager, and the stockholder.

CONFORMITY TO ECONOMIC REALITY

Model I

Although the objective of traditional economic policy is to solve the income distribution problem solely through full employment, every technological advance diminishes the relative input of labor and increases the relative input of capital per unit of output in all areas of economic production. Thus pure science, applied science, engineering, and management—the disciplines involved in economic production—work for disemployment, the exact opposite of the national economic policy. The concentration of ownership of capital expands the productive power of those without needs or wants. The nonownership of capital by 95% of U.S. families with vast unsatisfied needs and wants prevents their *legitimately* (i.e., other than through coercion) increasing their productive input and thereby enlarging their incomes and their consumption of goods and services. This failure to broaden ownership of capital becomes a main cause of unemployment, which can then only be alleviated by governmental boondoggle and make-work producing non-consumer goods and services.

Model II

This financing technique provides the missing link in corporate strategy. It raises the power of corporate employees with unsatisfied needs and wants to consume as it expands the power of the corporation to produce. Its effect in raising employee purchasing power is real for the only way for a mature employee to become more productive is for him to acquire ownership of productive capital. An employee is not made more productive in any real sense by coercing higher pay for the same or less work input when there is a labor surplus. When workers legitimately acquire capital ownership as the corporation expands, their personally owned productive power grows simultaneously with the corporation's ability to produce goods and services. Their increased incomes do not result in increased costs, but increased output. This is the reverse effect of conventional financing, which forces employees to demand more pay without more productive input—a direct source of cost-push inflation.

INFLATIONARY OR ANTI-INFLATIONARY?

Because this technique of finance leaves employees no choice but to demand more pay without more work input, it amounts to packing the wage base of every employee with personal welfare and forcing the corporation to use the price system to tax the public for the cost. Soon after, the employees rediscover that they *are* the public. Their gains are cancelled by their rising living costs. The process starts again. It is the engine of inflation itself.

Because this technique depends upon the business logic of self-liquidating investment, it is not only not inflationary; it is deflationary.

MORE JOBS OR FEWER JOBS

Conventional corporate strategy is built upon three tenets: (1) maximizing production and sales, (2) minimizing costs, and (3) staying out of trouble (being a good corporate citizen). When this is combined with conventional finance, which builds no capital ownership into employees, the foundations for a shrinking employment base are laid. Minimization of costs is best accomplished by eliminating labor through technological innovation and capital investment. This results in shrinking consumer demand, which further diminishes labor demand.

The U.S. economy would have to be expanded somewhere between seven and twelve times over (with further adjustment for population increase) to be capable of providing the goods and services necessary to provide comfortable lives for all U.S. citizens and residents. Accomplishing that task alone would require between 25 and 30 years of the most intensive full employment. But such employment—and such growth—can only come about if levels of consumption rise commensurately, a result only possible in a market economy if increased productive power of the vast majority with unsatisfied needs and wants is proportionately raised. This can only come about with expanding private capital ownership.

Some of the Critical Financing Problems That Can Be Solved Through ESOP Financing Methods

Financing Capital Improvements and Working Capital

By solving two problems with a single expenditure, ESOP financing can lower the cost of financing capital improvements. This may not be true if a short range point of view is taken, but is normally will be true over a longer period of time.

Since the ESOP financing technique enables a corporation to finance growth and working capital in pre-tax dollars, it is realistic to measure the saving resulting from ESOP financing (as compared with conventional Model I financing) in pre-tax dollars. So considered, *the tax saving results in a cash-flow accumulation of useable funds in the corporation normally equal to or exceeding the amount of the debt repaid,* (i.e., in a 50% effective corporate income tax bracket, the tax saving in pre-tax dollars would equal the amount of the debt, to which saving is added year by year an increment proportional to the company's rate of return on invested net worth. This comparison is significant, of course, only when comparing with conventional debt financing or other financing from internal cash flow or borrowings repaid from internal cash flow. It does not apply when comparing with sale of stock to the public for cash, but the latter is, as we have noted, regarded as a very unpopular and expensive method of financing.

Employee Stock Ownership financing builds retirement security and retirement income in ways that benefit the corporation by financing its growth. Thus, in effect, the corporation can maximize employee retirement security because of the indirect advantage to the corporation itself. The cost of providing good retirement security over a reasonable working lifetime is *eliminated,* because such provision is simply the result of planning the *ownership* of capital by employees in the course of financing activities of the corporation. The corporation in effect gets double mileage on its investment. This should be compared with conventional private retirement systems where the fund accumulations are used merely to play games with outstanding securities in the irrational public stock markets. Such funds do not go into new capital formation (and thus new productive power), nor do they go into financing the growth of the sponsoring corporation itself.

The corporation derives economic advantages from not putting its labor force in a position where it must demand progressively more pay for progressively less work, as every other conventional type of corporate finance does. While some of the costs of the resulting labor strife can be passed on to the company's customers in the form of higher prices, it is clear that the corporation must suffer some competitive disadvantage (particularly when competing with foreign producers), and that corporate profits, before wage increases were restrained by pay controls, have been noticeably falling for a number of years. The advantage flows from creating a property relationship between the corporation and the employee through which the employee identifes with his company; the gradual damping of labor demands for more and more pay in return for diminishing work input because of the growing awareness of the worker that by so doing he is impairing his own investment; reduction of costs to the company from eliminating or at least reducing resistance to technological improvement; the reduction or elimination of featherbedding, sabotage, employee thefts and pilferage, and the taking of dope and alcohol on the job—all evidences of worker alienation. Worker alienation begins with denial of opportunity to acquire ownership of capital in an economy where most production is carried out through capital and where the American economic dream is the ownership of a viable holding of productive capital.

In other words, properly designed ESOP financing should not create any dilution of earnings over a reasonable period of years. This is precisely what you would expect if employees are given the opportunity to acquire capital through use of the traditional self-liquidating logic historically used by business itself.

Acquisitions

Whether a corporate acquisition takes the form of acquiring stock or assets, if the acquiring corporation intends to pay cash, arranging the financing through the ESOP Trust enables the purchaser to effect the acquisition on pre-tax dollars while building equity ownership into employees. The labor force of the acquired business can be added to the acquiring corporation's labor base for purposes of the ESOP.

AN ESOP SOLUTION TO THE PROBLEM OF "LOCKED-IN" CLOSE-HOLDING STOCKHOLDERS

The ESOP Trust provides an in-house, private market for the stock of close-holding stockholders. These trusts are designed to be invested primarily, or at least initially, in company stock. They can buy new stock from the company: they can buy it from close-holding stockholders; they can buy it from venture capital suppliers who have taken a risk to help finance the company's growth, and who seek to participate in that growth through their equity. The trust can borrow money so that it can make stock acquisitions. It can make those acquisitions in pre-tax dollars. If the corporation should try to solve the problem of the close-holding stockholder by a redemption, it would cost over twice as much because the corporation would have to pay taxes on corporate net income before it could use the residue for a stock redemption. Thus, the venture capital supplier can withdraw his capital and his profit, which is his reason for investing, without forcing the company into the arms of a conglomerate, which may disorganize it and ruin it for all time, or without forcing it into the public market, a step which may be equally disastrous because it becomes tied to wild, irrational forces that cause the value of its stock to fluctuate in ways that have no direct and dependable relation to what goes on inside the business or in the markets for its products. No doubt there is some correspondence over a period of years between the income performance of the corporation and the price of its stock in the stock markets, but as of any particular moment (and purchases or sales are made as of particular moments) this correspondence is at best a coincidence.

A CORPORATION THAT DOES NOT NEED CAPITAL BUT WANTS TO MOTIVATE ITS EMPLOYEES AND TO GIVE THEM "THE EYE OF THE OWNERS"

In this case the ESOP provides an excellent answer. A corporation may establish an ESOP and each year issue to it a number of shares of stock determined by the Board of Directors. The corporation takes a tax deduction under state and federal corporate income tax laws for the fair market value of the shares transferred to the Trust, significantly increasing the corporation's cash flow. No tax is imposed on the employees until they ultimately remove their stock from the Trust.

WHAT ABOUT PEOPLE NOT EMPLOYED BY CORPORATIONS: PUBLIC EMPLOYEES, AND THE MANY KINDS OF UNEMPLOYED?

While the details of methods for building the ownership of equity stock into these through financing techniques employing Two-Factor Economics are beyond the scope of this article, Two-Factor Economics is a universal concept. It is not limited to its applicability to any particular sector.

ESOP financing techniques can displace most conventional financing of new capital formation in the public sector: building ownership of capital facilities of municipalities, counties, states, colleges and universities, the Federal Government, the Post Office, etc. into public employees. The effect of such financing would be that the staggering costs of public retirement systems could be eliminated, taxes reduced and retirement capital and incomes of retired public employees vastly improved.

The necessity for building a far larger productive economy to bring about general affluence will, we estimate, provide the most intense full employment in the U.S. economy for every employable worker for somewhere between 25 and 30 years. During that time, with a broad use of financing techniques built on Two-Factor Economics, every consumer unit will be acquiring its viable capital estate.

But what about the unemployable? The sick, the handicapped, the aged? In "The New Capitalists,"[9] Kelso and Adler showed that the opportunity to buy capital by paying for it out of what it produces can be extended to *anyone:* sick, old, or totally disabled. But because it is necessary to motivate the building of a "Second Economy" capable of producing enough goods and services to provide general affluence and of protecting the environment as well, careful consideration should be given to first extending the opportunity to acquire capital ownership to workers—public and private—and, in the meanwhile, to continue, and to improve, welfare for the sick, old, and disabled. To make it as easy for a non-worker to acquire a viable capital estate as for a worker could diminish the motivation re-

[9] Random House, New York, 1961.

quired during the next 25 years to build a sufficiently powerful economy to simultaneously produce general affluence and to protect the environment. We cannot overnight correct the effects of a century of one-factor economic policies that bedevil our economy.

MARKETABILITY OF STOCK DISTRIBUTED TO EMPLOYEES THROUGH THE ESOP

If the corporation's stock already is traded in a public market, then easy marketability of stock distributed to an employee requires only that it be properly registered under SEC requirements. In general, the purchase of stock from the corporation by the ESOP is regarded as a private placement. Shares purchased by an ESOP from a close-holding stockholder or from public stockholders would have the same status under the Securities Act of 1933 as they had in the hands of the sellers. Distribution of shares from the Trust to an employee is probably an "exempt transaction" because the employee does not pay for them in the conventional sense of the word, although this is a presently uncertain area. Shares distributed to an employee can be sold back to the corporation or to the Trust without registration, but cannot be sold to others unless they are registered. For companies reporting under Sections 13 or 15 of the Securities Act of 1934 or that agree voluntarily to so report, the highly simplified S-8 form of registration is applicable so that employees receiving stock from an ESOP Trust and desiring to sell it to persons other than the Trust or the issuing corporation will have fully registered shares.

But suppose there is no public market for the company's stock or, as is frequently the case, the stock is subject to a "right of first refusal" agreement, pursuant to which it must first be offered back to the Trust at its fair market value if the distributee desires to sell it. In such cases the ESOP itself becomes a very effective, and a rational "in-house" market for the stock.

In some instances, employees are additionally given a "put" which enables them to require the repurchase of their stock at fair market value by the ESOP Trust. Usually in such cases the ESOP's are given the power to make payment of the price in installments over a reasonable period of time to protect the Trust from undue surges in demands on cash. However, such ESOP's have the power to borrow, which also helps to alleviate liquidity problems of the Trust. Stock so repurchased is reallocated to remaining employees. This has proven in practice to be an entirely workable solution to the problem of providing a solid, dependable and mutually beneficial market for such shares.

Another means that may be used to solve the marketability problem in non-public companies that have ESOP's is to establish options on the part of retiring or withdrawing employees to exchange common stock in the corporation for fixed-income preferred stock or debentures that will provide income security for the retired employee, or for the ESOP Trust periodically to make secondary offerings of the employer's stock to the public and to invest the proceeds in a diversified portfolio of securities. To make this latter method fully effective under U.S. tax laws possibly requires a change in law to permit such diversification for stock bonus trusts.

Clearly, the problem of being "locked into" the investment in a closely-held employer's stock is one that is easily solvable in practice through the use of an ESOP Trust.

CORPORATE PLANNING OF EMPLOYEE OWNERSHIP

By planning in advance to build a reasonable share of the ownership of the corporation's growth into the labor force, management puts the employees in a position where their economic security and future income growth can occur without their demanding more and more pay for the same, or for less, work. Every argument that can be made against the class conflict approach to labor relations justifies ESOP financing from the corporation's and the employees' standpoints. ESOP financing attacks the causes of inflation by enabling the employee to build his economic security without demanding progressively more pay for progressively less work, the force that has powered the engine of inflation for forty years or more.

ESOP financing, we are confident, is not just a simple, tangible step in the implementation of a realistic economic policy and corporate strategy in the U.S. economy, but it is the dawn of a new age in corporate finance, and a new age in corporate and labor union relations.

THE ENORMOUS NEW CAPITAL FORMATION REQUIREMENTS OF THE U.S. ECONOMY FOR THE IMMEDIATE AND DISTANT FUTURE SHOULD BE FINANCED THROUGH ESOP TECHNIQUES

Estimated capital requirements for the U.S. economy during the coming decade exceed a trillion dollars. These include the capital requirements of energy-related industries, financing for rapid transit and other transportation systems, financing of new towns and the revitalization of old towns, housing, automation to lower costs of production and to recapture lost markets, the construction of recreation and leisure facilities, and the protection of the environment. If these enormous capital requirements are financed in the traditional ways, so that ownership of the new capital is built into the already excessively productive small capital-owning class, then we can say with confidence that we can see the future, and it won't work.

Only ESOP financing techniques attack the causes of poverty—the low productiveness of people who have nothing to contribute to the productive process except their labor power. Only by building capital ownership into the propertyless masses can adequate market power be created to sustain a healthy, happy, and virtually welfare-free economy.

Only when most individuals and families become self-sufficient through the ownership of viable capital holdings can we say that economic power is sufficiently diffused throughout our society to protect political freedom and democracy.

ESOP FINANCING IS NOT MERELY A NEGATIVE CASE AGAINST THE REDISTRIBUTION OF WEALTH AND INCOME

Methods for applying the to individuals, self-liquidating logic of investment that corporations have traditionally used for themselves are simply methods for solving the income maintenance problem through enabling every individual to *produce* more, not merely to receive more. They are a positive alternative to the redistribution of wealth and income by government fiat, coercion, fraud and theft. They are disigned to link the performance of useful work over a reasonable working lifetime with the acquisition of a viable capital estate, without cost burdens to business, and without decreasing take-home pay to workers. They are a means for avoiding the saddling of the labor and capital of the economically productive with the costs of maintaining income for the economically underproductive and economically nonproductive.

THE ERRONEOUS IDENTIFICATION OF CAPITALISM WITH THE SPECULATIVE SECURITIES MARKETS

Without Two-Factor Theory, it was perhaps inevitable that the enemies (and even the bewildered friends) of economies that systematically build incremental productive power into those without present or potential future need for such additional productive power, which systematically deny the acquisition of additional productive power to the masses whose needs are virtually unlimited, should come to be identified with the speculative securities markets. For those markets have provided some spectacular examples of the accumulation of wealth without the production of any useful goods or services.[21] Of course, the gains of the few were always offset by the losses of others—usually the many. It is the function of the "little man" in this legalized casino business of the public stock markets to be milked for the enrichment and amusement of the dairyman who operates the casinos.

In the light of Two-Factor Economics, the importance of the speculative stock market casino diminishes enormously. There is no social rationality in encouraging men to buy stocks solely for the purpose of selling them at a higher price, and to sell stocks solely for the purpose of buying them at a lower price. That is not owning a factor of production in order to engage in the productive process and to derive the resulting income. Rather it is gambling in the ownership of the means of production, a practice calculated to bring economic suicide to any society that indulges it. Of course, it is important to have an orderly way to buy and sell capital holdings, but both common sense and history tell us that this need not be done

[21] In double-entry bookkeeping terms, this is essentially larceny.

instantly or even speedily. Instant liquidity satisfies the purposes of the brokers—the croupiers in the gambling casino of the organized securities markets—and of the speculators. The degree of importance of a high-turnover securities markets to the economy as a whole is thoroughly demonstrated by the fact that less than 2% of new capital formation requirements takes place through those markets. While these markets have a real importance to the casino operators and speculators, they have only an illusory importance to the capital-less individual who is misled into believing that he can acquire the ownership of capital through investments made on terms where they will *never* pay for themselves.

A SUGGESTED PROGRAM OF LEGISLATIVE REFORMS THAT COULD ACCELERATE THE BROADENING OF THE CAPITAL OWNERSHIP BASE IN THE U.S. ECOMONY, SUBSTANTIALLY TRANSFORM ITS STOCK MARKETS FROM SPECULATOR MARKETS INTO INVESTOR MARKETS AND ENGAGE ITS INSTITUTIONAL INVESTORS IN THE ACTIVITIES THUS ENTAILED

The economy of the United States has endured the mythology of one-factor conventional economic concepts in a two-factor real world to the point where change can no longer be avoided.

Either we set about speedily repairing the mismatch between the possession of economic productive power and the possession of present and potential unsatisfied consumer needs and wants, so that we can achieve both a free and a genuinely affluent society, or we must accept growing totalitarianism to convert the erroneous one-factor mythology into nationalistic dogma as the totalitarian socialist economies all do.[22]

So close to breakdown is our myth-ridden, over-inflated, labor-strife-torn, craftsmanship-atrophied, debt-burdened, bureaucratized boondoggle economy, that steps to broaden the capital ownership base must be given priority over every other aspect of economic reform if we are to recapture the American innocence that once made the United States the epitome of a good society.

We offer some suggestions in nontechnical language of rather obvious legislative reforms that could accelerate the program of expanding the capital ownership base. We think they demonstrate how minor the required changes are.

We suggest consideration be given to making the following changes in Federal laws, with corresponding adaptions in State laws where necessary:

(1) Expand the present National Economic Policy, which is embodied in the Employment Act of 1946, from a policy relying solely upon full employment to solve the income distribution problems (and impliedly on welfare when that doesn't work) to a National Economic Policy calling for (a) maximizing the economic productiveness of every family and individual both through full employment, to the extent that such employment is required to meet the market demand for humanly useful goods and services and is not contrived to artificially "create jobs," and (b) rapid expansion of the capital-ownership base through financing techniques built upon Two-Factor economics. A proposed draft of such legislation is set forth as an appendix to *Two-Factor Theory: The Economics of Reality*, pp. 167–186, inclusive.

(2) Increase the limits of deductibility for corporate income tax purposes of payments into an ESOP Trust (now 15% of covered payroll) to 100% of payments used by the Trust to pay interest and 150% of amounts used to pay principle, but not exceeding in any event 30% of covered payroll.[23]

(3) Make dividends paid into qualified ESOP Trusts deductible by the corporation if paid out currently by the Trust to the participants under the Plan.

(4) Give qualified ESOP Trusts the same tax characteristics as tax-exempt foundations presently enjoy, so far as donors are concerned. Such amendments would encourage affluent taxpayers to make gifts of productive capital, which they otherwise might socialize in tax-exempt foundations, to ESOP Trusts in order to reconnect the ownership of capital with private individuals. Such Amend-

---

[22] The most profound student of the subject, Karl Marx, was quite aware of the requirement of totalitarianism to make one-factor economic concepts feasible in the real world. He then proceeded to invent another myth, the myth that the instinct to own the means of production—the acquisitive instinct—would "wither away" under the dictatorship of the proletariat. See Kelso, "Karl Marx: The Almost Capitalist" *American Bar Journal*, March 1957, Vol. 43, No. 3. The recent overthrow of the Allende Socialist government in Chile by the middle class capital owners (trucks, shops, small farms), and their sympathizers among the aspiring workers and the military, suggests that human patience with one-factor socialist mythology is growing short.

[23] Suggestion (2), (3) and (4) are taken from S. 1370 introduced by Senators Fannin on March 27, 1973, and a companion bill, H.R. 8500, introduced into the House of Representatives on June 12, 1973 by Congressman Frenzel.

ments to the Internal Revenue Code and corresponding provisions of State laws would in due course increase Federal and State revenues, because the end result would be to build capital ownership and increased incomes into employees. No loss of revenue to the Federal or State governments would be incurred, since such contributions made to charitable foundations are already exempt from taxation. Had such legislation been in effect, a Henry Ford could have put all of the employees of Ford Motor Company, and of its distributors and dealers, in a position where, over a reasonable lifetime of diligent work, they would have accumulated substantial capital estates. The tax effect on his own personal estate would have been the same as that achieved by turning his estate over to the Ford Foundation, and with no greater immediate loss to the government, although it would be reasonable to expect that this arrangement would significantly raise the value of all stock of the Ford Motor Company, including that retained by Ford heirs. The effect would have been to reconnect the capital of that industrial giant to specific people—the employees—in order to make them bigger taxpayers, motivate them, and to assure them higher incomes before and after retirement. The Ford Motor Company by that arrangement would be placed in a position to raise the incomes and economic security of its employees *without raising its costs.*

(5) Modify the Internal Revenue Code to eliminate any ordinary income or capital gains tax at the time (normally at retirement or upon termination of his employment) that an employee is distributed the assets in his ESOP Trust account. The object of building capital ownership into otherwise non-capital-owning individuals and families is to make them *more productive.* It makes no sense, at the very moment that the productive assets are taken into hands of the participant in the ESOP Trust to undo a significant part of the results thus achieved by taxing away and separating him from the ownership of part of his capital estate. Individuals should be taxed on income, including the conversion of capital assets into income, but not merely upon increases in their productiveness. It would not be logical to tax individuals upon their graduation from high school or college or graduate schools merely because the productiveness of their labor power is thereby raised. Similarly, it seems singularly counterproductive to deprive them of a portion of their capital estates, carefully accumulated over a working lifetime, the purpose of which is also to make the individuals more productive.

(6) Congress should consider legislation establishing a governmental insurance agency, which might be known as the Capital Diffusion Insurance Corporation "(CDIC"). Its purposes would be to insure banks, insurance companies, and other lenders, who make loan financing to ESOP Trusts, much as the Federal Housing Insurance Agency insures banks which make consumer loans on home financing. Such an insurance company, which might id[illegible]lly be imitated by private insurers, as the FHA now is, would facilitate and encourage the readiness of banks and other lenders to make such loans, and it could serve, along with the Federal Reserve Board, as a regulatory mechanism for phasing the new economic policy into the economy. The methods used in establishing the Federal Housing Insurance Agency could approximately be followed in establishing the CDIC.

(7) Amend the Federal and State banking laws and Federal and State retirement systems laws to give public employees access to non-recourse credit (as ESOP Trust does under present law for corporate employees) to buy stocks newly issued in the course of financing the expansion of the economy by qualified corporations. Criteria, already highly developed, for identifying and selecting profitable enterprises that could qualify to finance their expansion in this manner should be adopted in order to "qualify" stocks of particular businesses for this type of financing. Corporate dividends paid into such trusts should be deductible from corporate income tax. In exchange for having access to virtually unlimited financing for growth (so long as it meets the feasibility tests), corporations should be required to pay out the "wages of capital" (corporate net earnings) fully to the owners of the corporation's capital—the stockholders. Not only does mass production of humanly useful goods and services imply their mass consumption, but the double-entry bookkeeping logic of a free market economy requires that the wages of capital be paid out fully like the wages of labor to make such mass consumption possible with a minimum of enervating consumer debt. Consumer debt merely diminishes the market power of the consumer by the amount of interest paid over the life of the loan. In housing, for example, the buyer often pays the equivalent of two price-inflated houses in loan interest in order to buy one price-inflated house!

(8) Legislation should be developed and adopted to enable banks and insurance companies, and other qualified lenders (which should include savings and loan associations) to discount loan paper insured by the Capital Diffusion Insurance

Corporation with a Federal Reserve Bank, pursuant to regulations to be adopted by the Federal Reserve System. This would amount, in effect, to a process for monetizing productive power (represented by capital purchased under an arrangement where it will pay for itself). The ultimate effect of wide-spread ESOP financing would be deflationary. This is so because once the newly formed capital has paid for itself and the credit advanced has been reversed, the newly formed capital continues to throw off goods and services virtually indefinitely, its productive-power being restored and protected by depreciation procedures that set aside, before net profits are computed, sufficient funds for this purpose.

(9) Legislation should be adopted to provide an opportunity for careful reflection upon the New Economic Policy in connection with labor relations controversies, and to relieve the economy and the society from the enormous damage done by strikes and lock-outs, the coercive tools used today in seeking or resisting the inflation-forcing demands for more pay in return for the same (or even less) work input. Such legislation should give the President power, in all instances involving interstate commerce, to suspend the use of strikes and lock-outs for a reasonable period of time while the parties involved investigate the possibility that ESOP financing might reconcile their differences in a manner consistent with the public interest and their own mutual prosperity. ESOP financing techniques normally benefit both the corporation, by giving it access to lower-cost capital, and the union, by building the ownership of productive capital into its members with unprecedented speed. The end result is to raise employee incomes without proportionately raising business costs and without raising the price the public pays for the company's products, all of which are in the public interest.

(10) Steps should be taken to formulate a policy within the Anti-Trust Division of the Department of Justice, and within the Federal Trade Commission, with implementing legislation if necessary, to assure that in all divestitures, primary emphasis is placed on sale, where this is financially feasible, of divested assets to employees in the subsidaries or divisions being divested through ESOP financing techniques. This procedure should include consideration of installment pay-out arrangements with the seller, partial payment through the issuance of subordinated debentures to the seller, and possibly governmental financing assistance through CDIC insurance or otherwise where adequate financing under prevailing market conditions is not readily available.

(11) Steps should be taken to establish a policy within the Interstate Commerce Commission, the Federal Aviation Administration, the Federal Power Commission, and within other appropriate Federal regulatory agencies to use their powers, where the best interests of the regulated industries, their employees and the public can thereby be promoted, to encourage the use of Employee Stock Ownership financing to rapidly build significant capital ownership into such employees. It is clear that if employees of transportation and other regulated enterprises progressively demand more pay in return for diminished work input—as they must to maintain or improve their standards of living if they have no access to the ownership of capital—and the regulatory bodies do not automatically permit these increases to be charged to shippers, passengers, and other users of the services of such regulated industries, the transportation enterprises or other regulated industries will sooner or later collapse—as the entire north-east railroad system of the United States is undergoing at the moment. In fact, it is safe to predict, that the thousands of urban mass transit systems needed by all of our cities, in addition to efficient inter-urban transit systems, cannot and will not be built (except by governments) until techniques for substituting the growing ownership of capital for inflationary wage and salary demands are developed. The same is true in the airline industry as well, and in other public utilities such as the electrical, gas, and telephone industries.

(12) Consideration should be given to tax and other measures which would encourage conglomerates seeking voluntarily to divest themselves of subsidiaries or divisions or other assets, to use ESOP financing techniques to sell these assets to employees of the entities which will ultimately operate after divestiture.

(13) Studies should be made of the extent to which Federal leadership, cooperating with the appropriate regulatory bodies of the states, can encourage public utilities to finance a major portion of their expansion through a combination of Employee Stock Ownership Plan financing techniques and techniques that build ownership into *customers* of public utilities, in order to raise the power of the public to pay for the services. In the light of the American dream that every family and individual hopes to acquire an independent source of income through the private ownership of a significant holding of productive capital, it seems illogical to grant monopoly franchises to corporations without requiring them to

finance a major part, if not all, of their expansion in ways which would build second sources of income into their employees and into their customers.

(14) In the case of sale by the U.S. Government Atomic Energy Commission of atomic fuel plants to private enterprise, and in the case of all such similar privatization transactions, studies should be made of the means of selling a major part of the equity of such enterprises to employees, and of other means of broadening the ownership base of the resulting new companies.

(15) In order to relieve the Federal Government, the states, cities, towns, and other municipal corporations, school districts, college districts, universities, and various quasi-public corporations of multitudinous debt and tax burdens, Federal and state legislation should be drafted to encourage the privatization of facilities now owned and operated by such governmental agencies and quasi-public corporations. This legislation might be modeled on the Eisenhower Post Office Law, which was designed to encourage private construction and ownership of post office buildings thereupon leased to the Federal Government. Rather than to encourage the highly concentrated private ownership of such facilities, however, they should be owned by the employees who work for the governmental agencies and quasi-public corporations involved. Such employees can be made the employees of the respective facilities' corporations with arrangements for the "leasing" of the employees to the governmental agency at cost, and the leasing of facilities at fair market value. The end result would be the building of private capital ownership into civil servants and other governmental and quasi-public corporation employees so as to give them private security and second sources of income. The staggering costs of present public retirement systems could thereby be enormously reduced—perhaps even eliminated.

(16) A governmental policy should be adopted for the privatization of all publicly owned assets where the ownership of such assets can be acquired by employees of entities operating such assets through the use of ESOP financing. Each step in such privatization will reduce the public payrolls and at the same time raise the tax base and the private incomes of the employees involved. The motivational implications in raising the efficiency of the economy and the power of the American workers to buy and enjoy the output of business and industry should be desireable by-products of such steps.

(17) Legislation should be developed to provide the use of ESOP financing techniques in connection with the building of new towns. Each new town represents a vast new collection of capital instruments. If those capital instruments become owned by the top 5% of wealth holders, following the patterns of the past, the new towns will quickly reach the state of economic stagnation characteristic of all old towns and cities today. To bring into existence vast amounts of productive capital without commensurately raising the power of people affected to engage in production through the ownership of the newly formed capital, as well as through their employment, is to invite the repetition of the crushing problems which we now face at every level of the economy.

(18) Legislation should be adopted to require the Federal Power Commission, which has options under the Federal Power Act to purchase some 270 used hydroelectric plants at prices which represent a fraction of their current fair market value, to assure that such plants are purchased by employees and by propertyless people who are now deprived of an opportunity to be sufficiently economically productive. It is virtually certain that these assets can be purchased on terms where they will pay for themselves quickly. Such a policy would help raise the productive power of thousands of unproductive and underproductive citizens, disalienating them, raising the Government's tax base, and carrying out the spirit of the new industrial Homestead Act policy above outlined.

(19) Our labor-management relations laws should be modified to facilitate and encourage organized labor's trading off its present legal right to coercively abolish the law of supply and demand with respect to wages and salaries (a product of one-factor economics) for fast and effective access to the acquisition of capital ownership and second sources of income through ESOP financing. This would enable workers—and everyone else—to enjoy a reversal of inflation, higher incomes, and greater legitimate leisure and economic security. It would again enable U.S. industry and agriculture to produce the highest quality and lowest priced goods and to out-compete anyone anywhere—even after our example is imitated abroad.

(20) We should eliminate or radically reduce the capital gains tax imposed under present Federal and state income tax laws on rich individuals who sell their holdings of equity stocks to ESOP Trusts of corporations or to the ESOP Trusts established for public employees. Not only do we have the problem of

guiding the new capital formation of the future away from the excessively productive rich to the underproductive and nonproductive non-capital-owning masses, but we facilitate the broadening of the ownership of the enormously concentrated present holdings in such manner as to respect and protect private property. It should be remembered that a rich man with "liquidity" can diversify his holdings under the "Prudent Man Rule" by re-investing in other securities or assets. The "Prudent Man Rule" is a rule to live by for the rich whose capital estates have reached the caretaker stage. But the "Prudent Man Rule" which keeps the rich man rich, if mistakenly followed by capital-less workers, has the effect of keeping them poor! It is the "Prudent Capital Estate Builder's Rule" of applied Two-Factor Economics that the propertyless many must follow—and be educated and encouraged to follow.

(21) Finally, the formulation and refinement of legislation pertaining to the foreign economic policy of the United States should be undertaken. The power of business and Government of the United States, through the use of ESOP financing techniques and related means, to show the developing economies how to make "haves" (that is, capital owners) out of the "have-nots," without taking from the present haves, should be the first instrument of our foreign policy. This is an awesome power, capable of relegating coercion to a secondary role in international relations. It would be a positive means of making America again a symbol of good will in the world. There would appear to be no other way for U.S. corporations to build their stockholder constituencies abroad to the degree necessary to enable the citizens of the host economies to consume their share of the goods and services which the multinational corporations wish to produce and sell in those economies.[24] In no other way can U.S. managerial talents, merchandising know-how and financial statesmanship be sold year-in and year-out to friendly nations for the mutual profit of all. And in no other way can U.S. enterprise avoid the confiscation of its assets by the governments of developing economies (and even developed economies) in order to help solve domestic economic problems which would automatically have been solved if the proprietary base had been broadened as those economies underwent industrialization.

Statement by Norman B. Ture, President, Norman B. Ture, Inc.

Summary

Financial market results this year appear to be seriously at odds with the vigorous expansion of the economy in 1972 and early 1973. Of particular concern is the substantial decline in the participation of individual investors. A large number of factors undoubtedly account for the apparent puzzling performance of the stock market this year, and no single, simple answer will deal satisfactorily with the complex questions raised by that performance. Notwithstanding this reservation, changes in tax policy can contribute significantly to improving the efficiency of our financial markets.

The efficiency with which the financial markets perform their basic function of valuation of business enterprises and of allocating saving is a matter of concern for the entire economy, not merely those who are active participants in the market. Impediments to efficient functioning of financial markets prevent the most efficient allocation and use of the economy's resources and distort the consumption-saving choices of the private sector.

A serious impediment to market efficiency is the thin participation which has prevailed for some time past. The market's thinness is principally attributable to inadequate participation by individual savers-investors.

One of the factors accounting for the reluctance of individuals to invest directly in corporate equities is the anti-saving thrust of tax policy. A number of the basic features of taxation in the United States exert a bias against saving. When viewed against the standard of equal treatment of consumption and saving, the present income tax treatment of capital gains and losses turns out to be an important element of this anti-saving bias.

Excluding capital gains and losses entirely from the income tax base would significantly reduce the present disproportionately heavy tax burden on saving and the barrier to capital asset transactions. A less drastic change would be to extend "rollover" treatment, now provided for gains on personal residences, to a larger

[24] See Kelso and Hetter, "Uprooting World Poverty—A Job For Business," Business Horizons, Fall 1964.

list of capital assets—at the least to corporate securities. More modest revisions include a lifetime exemption of, say, $50,000 to $100,000 of capital gains realized on corporate securities and other specified types of property or alternatively an annual exemption of, say, $5,000 of such gains. Significant liberalization of the capital loss offset provisions are also called for.

Downward graduation of the capital gains tax rate with length of holding period has been proposed as a means of unlocking the very large amouut of gains frozen in capital assets which have been held for very long periods of time. This approach would also implicitly make allowance for the inflation component of much long-term gains in determining tax liability. A more direct approach to eliminating inflation gains from the tax base would be to provide an explicit inflation adjustment in determining the amount of taxable gains.

STATEMENT—TAX POLICY, INDIVIDUAL INVESTORS, AND FINANCIAL MARKETS

I. Introduction

The performance of the major U.S. financial markets this year has been a source of widespread concern and bewilderment. Against the background of vigorous economic expansion in 1972 and early 1973, as measured by indicators of real—as opposed to monetary—aggregates, the principal indicators of financial market activity appear to have been much more closely in line with a stagnant economy, if not, indeed, one in recession. Aside from a fillip in late 1972 and early 1973, the NYSE composite index shows at best no trend in common stock prices, and in all probability, a downtrend. The price-earnings ratios of all but a relative handful of stocks have been astonishingly low throughout the year. Transaction volume has been so limited as to push many brokerage firms to—or over—the brink. There are numerous indications, moreover, that institutions have accounted for a very substantial part of total volume, while individual savers-investors appear largely to have withdrawn from the stock market.

There is a common and readily understandable proclivity to insist on simple answers to complex questions. In the case of the financial markets, it is tempting to identify one or a few factors as the source of its puzzling behavior. The true explanation, however, is probably as complex as that for any current economic phenomenon. I hasten, therefore, to disabuse this Subcommittee of any idea that my discussion and recommendations are submitted as exhausting either the causes of the financial markets' present conditions or recommendations for dealing with these factors.

The current concern about the financial markets should stem from recognition of the fundamental role those markets play in the U.S. economy. However recondite or esoteric the operations of the stock market to the man in the street—Main, not Wall—or even to the economist, it is obvious that no advanced and diversified economy depending largely on private enterprises for the conduct of business in free markets could function efficiently without a well developed capital market. When evidence that the capital market is not doing its job effectively begins to accumulate, the occasion for concern far transcends the effects on the immediate capital market participants; it extends to the entire economy public and private sectors alike. Surely we do not need a repetition of the great market crash of 1929 to have its lessons well in mind.

II. Functions of Financial Markets

Before proceeding, perhaps it would be advisable to go over some familiar ground concerning the functions of financial markets in order to be clear about the context of the discussion to follow.

First of all, financial markets provide valuations. When these markets operate efficiently, they provide objective and impersonal information about the capitalized values of the expected earnings of a huge number of business entities. This information is a summary of consensus of the varying assessments by the market participants of what future earnings are likely to be, what risks are associated with those future earnings, what costs will be incurred to realize them, and finally, how much those future earnings are worth today. Moreover, the information about any one company and its valuation takes into account the corresponding information and valuation of all others. For any one company, therefore, an efficiently operating financial market's valuation reflects its worth relative to that of all other companies.

For companies that are guided in their activities by the objective of maximizing their profits and the net worth of their shareholders, the valuations provided by financial markets are essential. They are assessments by the market participants of how well such companies have performed and of how well they are expected to

perform in the future. Changes in those valuations are cues to management with respect to virtually every aspect of their conduct of business. And they are important inputs in the determination of the cost to the company of using capital services, hence of company investment decisions, even if capital outlays are largely internally financed.

A corollary function of financial markets is to facilitate the efficient allocation of saving. In brief, the condition for efficient allocation of saving is that at the margin the present value of the future income contributed by every dollar of saving is the same (when adjustment for differences in risk are taken into account). In an efficiently operating financial market, information about company performance and prospects is quickly translated into valuation of the equity interest in companies, and changes in these relative valuations are cues to savers-investors as to changes in the composition of their investments which they can make in order to maximize the future income they can realize from their saving.

Moreover, the aggregate of all such market information provides savers-investors with the essential information about the relative cost of saving—how much current income otherwise available for consumption is required to buy a given amount of future income. Clearly, this information is a basic determinant of the allocation of income as between consumption and saving.

It is evident, I trust, that these functions of financial markets are not peripheral but are basic to the efficient operation and progress of a free-market economy. Impediments to effective performance by financial markets, therefore, also prevent the most efficient allocation and use of the economy's resources, which means that the economy as a whole is deprived of valuable output which it otherwise would enjoy. By the same token, the amount of saving and investment which the economy as a whole undertakes is likely to be less than it would be if financial markets were free of serious impediments; the consequence is slower growth of production capability and output, to the cost of all of us.

Efficient financial markets, therefore, are an important concern for all of us, not only those who are active participants at any time. If those markets cannot do their job properly, the working American is likely to find himself working with fewer, older, less efficient tools than otherwise. His productivity, hence his real earnings, will be less than otherwise. And he is more likely to be exposed to job displacement by foreign competition. Finally, those markets will afford him less assistance in putting his savings to their most productive use in his efforts to save for retirement or the proverbial "rainy day."

This Subcommittee, I am sure, has heard and will continue to receive a substantial amount of testimony pertaining to deficiencies in our financial markets and to the factors responsible for them. Rather than attempt to go over that ground again, I should like to focus on one aspect, the inadequacy of individual investor participation, and to offer some suggestions to increase that participation. One of the basic conditions for efficient operation of any market is that its structure is highly competitive. In turn, satisfying this condition in the general case requires a sufficient number of buyers and sellers so that the actions of no one can significantly affect the price(s) of the product(s) traded in that market. While economic theory affords no basic for determination of the minimum number of buyers and sellers required for effective competition, it does not support the generalization that reducing the number of market participants tends to increase the obstacles to competition. When the number of buyers and sellers is very large, of course, even a substantial variation in that number is likely to have little impact on the effectiveness of competition. But as the number of participants decreases, their influence on market outcomes increases, and market results tend to become more dispersed, less of a measure of consensus of participants, less meaningful as measures of relative values, and therefore less effective in allocating resources. Thinning out market participation, accordingly, is likely to result in a loss of efficiency by the market in the performance of its functions.

It is, of course, no news to the members of this Subcommittee that thin participation has been the rule rather than the exception in the operations of the U.S. financial markets for some time past. Volume of transactions is, to be sure, only a proxy for the number of buyers and sellers, but in the case of the securities markets there is other evidence to support the inference that the downtrend in volume during the past 18 months has been associated with a downtrend in the number of buyers and sellers. In the month of August this year, average daily volume on the New York Stock Exchange was only 11.8 million, lower by far than any other month in 1972 and 1973. The average daily volume through August of this year has been about 14.9 million shares, compared with 16.5 million for

the whole of 1972. And except for January and July, the average daily volume each month this year has been lower than in the corresponding months of 1972.

These volume data, while not themselves establishing a reduction in invididual investors' participation in the market, are nevertheless highly indicative. They strongly suggest that the 800,000 decline in the number of shareholders in the United States recently reported by the N.Y.S.E. has continued through 1973. Continuation of this decline will inevitably be associated with reduction in the number of buyers and sellers and with increased concentration of volume in the very large institutional market participants for the efficiency of the market has already been noted.

What accounts for the inadequate participation of individual savers-investors? Obviously a great many factors, which have been explored before this Subcommittee in its earlier hearings, contribute to the reluctance of individuals to hold directly equity interests in U.S. corporations and to manage these interests actively. In my judgment, the thrust of tax policy in the United States is one of these factors.

III. Taxation and Individual Saving and Investment

Generally overlooked in the periodic furor over tax reform is that taxation in the United States, particularly at the Federal level, is heavily biased against private saving. The demonstration of this bias on analytical grounds has been made by numerous economists at one time or another, and I shall not burden the Subcommittee at this time with an elaborate exposition of this analysis. If I may, however, I should like to call the Subcommittee's attention to my testimony on February 5 of this year, to the Committee on Ways and Means in the House of Representatives. This testimony was addressed explicitly and at length to various basic elements of the Federal tax system and their disproportionately heavy weight on asking as compared with consumption. May I also take the liberty of referring the Subcommittee to the publication by the NAM early this year of my study of *Tax Policy Capital Formation, and Productivity*, in which I have attempted to demonstrate not only the existing tax bias against saving and capital formation but also the adverse consequences of that bias for the rate of advance of labor's productivity and real earnings.

On this occasion, I'd like to concentrate on the Federal tax treatment of capital gains and losses. As this Subcommittee is well aware, the differential between the taxes imposed on capital gains and on ordinary income is one of the principal targets of the standard list of tax reform proposals. This differential is alleged to be one of the principal "loopholes," primarily availed of by upper-income individuals. In principle, it is argued, capital gains are in no significant way different from ordinary income, and, it is claimed, they should be similarly taxed. And so on.

In fact, however, when the present tax treatment of capital gains is viewed against the standard of equal treatment of consumption and saving uses of income, it turns out not to be a "loophole" but an additional tax burden on saving—a negative loophole. Perhaps an extended example will help to make this clear.

Suppose for the moment a tax-free economy. Individuals in that society continuously make choices between the use of their current income for consumption or for buying additional income in the future, i.e., saving. The amount of future income which any given amount of saving buys depends on the contribution at the margin of the additional capital in which the savings are invested. The cost of any given amount of future income is the amount of current consumption which must be foregone by the saving needed to acquire it. Many considerations, of course, enter into individuals' consumption-saving decisions, but given these considerations, those decisions depend on the relative cost of saving and consumption.

As an example, suppose that in the tax-free economy a person might be able to buy some given quantity of consumption goods for $1,000 or he might use the same $1,000 instead to buy common stock in a company earning, say, $120 per share, when the market rate of interest is 12 percent. Now suppose an income tax is levied; for ease of illustration, suppose the tax rate is 50 percent. With the tax, the cost of the same amount of consumption goods goes up 100 percent in the sense that it now takes $2,000 of pretax income to buy the same $1,000 of consumption goods. But the cost of saving goes up much more. To have $120 per year of additional income, one has to receive $240 of pretax income. But with no change in the market rate of interest, one must now buy $2,000 worth of the stock to get $240 per year.[1] And to have $2,000 with which to buy the stock,

[1] Assuming no income tax is separately levied on the corporation income.

$4,000 of pretax income is needed. The 50 percent income tax, thus, has doubled the cost of consumption, but it has quadrupled the cost of saving. Thus the tax has doubled the cost of saving relative to the cost of consumption.

The effect of the tax on the total volume of private saving depends on how responsive people are in their consumption-saving choices to changes in the relative cost of saving. Some economists assume that this response is zero, that personal saving decisions are unaffected by changes in the real rate of return on their saving. I find this assumption untenable on analytical grounds and unverified by actual experience. Rather, it seems to me, an increase in the real cost of saving relative to the cost of consumption will reduce the proportion of income used for saving.

To return to our example. Suppose the corporation whose stock the individual purchasers uses the proceeds of the stock sale to buy a $1,000 machine. Suppose, to simplify the example, the machine is expected to last forever. To warrant the investment of $1,000 in the machine if there were no tax, the machine would have to add $120 per year to the company's net revenues. But if an income tax, applicable to both the corporation and the individual at a marginal tax rate of, say, 50 percent, were imposed, the machine would no longer earn $120 per year, after taxes. The corporation income tax itself would reduce the after-tax earnings to $60.00 per year. And if the corporation were to distribute the after-tax cash flow to the shareholder, he would net only $30.00 per year on his $1,000 saving.

If before the tax was imposed he required $120 per year to induce him to give up $1,000 of current consumption, he will hardly be likely to settle for $30.00. Clearly, he will reduce his saving-investing. So will others like him.

Collaterally, the corporation is hardly likely to invest $1,000 in a machine that returns only $60.00 per year after tax. With no change in the market rate of discount of future earnings, $60.00 per year is worth $500, not $1,000. If the company's objective is to maximize its profits and the net worth of its shareholders, the after-tax earnings of the machine will have to increase to $120 per year; pretax earnings, then, will have to go up to $240 per year to justify the investment, if earnings are retained. And if earnings are distributed to the shareholders, pretax earnings would have to increase still further—to about $480 per year.

Obviously, a great many capital outlays which would contribute enough to the corporation's net revenues to warrant their undertaking in the absence of the tax become unprofitable and are foregone when the tax is imposed. The reduction in saving and capital formation resulting from the tax will continue until the stock of capital falls relative to the amount of labor services used in production sufficiently to generate the required pretax and after-tax earnings.

To complete the example, suppose that after the adjustments in saving and investment are completed, the corporation retains its after-tax earnings and buys another machine which will also add $240 per year to pretax earnings, hence $120 per year to the company's after-tax earnings. The market value of the shareholders' stock in the company will go up from $1,000 to $2,000. This increase in value, of course, is exactly equal to the present or discounted value of the additional $120 per year of after-tax earnings, discounted at 12 percent as before.

Recall that every dollar of the corporation's earnings on the original machine out of which the $1,000 to buy the new machine was accumulated was taxed as it was earned. And every dollar of the earnings of the new machine will also be taxed as it is earned.

If the shareholder decides to sell his share of stock in the corporation he will realize a capital gain of $10,000. Under the present tax treatment of capital gains he'd pay an additional tax of $250 on this realized capital gain. This additional tax is properly viewed as a surcharge on the tax already paid on the prior years' earnings on his initial investment or equivalently as a surcharge on the tax that will be paid over the succeeding years on the new machine's earnings. In either case, the same future earnings stream will be taxed twice, once at the 50 percent rate as the earnings are realized each year, and again at 25 percent (in our example) on the capitalized value of that future stream of earnings.

The present tax treatment of capital gains, therefore, when evaluated against the standard of equal proportionate taxation of consumption and saving uses of income, emerges not as a loophole but as an additional, heavy burden on saving. Coming as it does on top of the disproportionately heavy individual and corporate income tax load on saving, the taxation of capital gains significantly increases the relative cost of saving.

But this is not the sole effect of capital gains taxation. The tax is imposed on gains not as they accrue but only when they are realized by sale or exchange of the assets. The occasion for the tax, then, is not merely the increase in value but the

transfer of the asset as well. Taxing capital gains not only increases the relative cost of saving but also increases the cost of changing the composition of the assets one owns. The interaction of these two effects of capital gains taxation is to increase the difference between the expected returns on alternative investments required to make a shift in asset holdings worthwhile.

Unless it could be established that people are utterly unresponsive to changes in transaction costs, taxing capital gains must reduce the frequency of transfers and impede prompt changes in the composition of assets in response to changes in their relative values. In turn, this clearly impedes the efficient functioning of the financial markets in providing valuations of alternative uses of saving and in allocating saving optimumly.

The present tax treatment of capital losses further burdens private saving and impedes prompt change in the composition of asset holdings. Under present law, capital losses are offset against capital gains and up to $1,000 of ordinary income. Any losses not so offset may be carried forward for an unlimited number of years, but in the case of individuals, no carryback to earlier taxable years is allowed. Since capital gains are fully subject to the additional tax in the year they are realized, the tax cushion against losses may very well be less than the additional tax burden on gains.[3] The risk of investment is increased. In addition, where losses have accrued on an investment, the limitation on their deductibility tends to deter liquidation of that investment and its replacement by other assets. Loss treatment, therefore, accentuates the bias against saving and shifts in asset holdings imposed by the taxation of capital gains.

The weight of these tax impediments to efficient performance by the financial markets is difficult to measure in precise quantitative terms, but there can be little doubt that they are significant. There are a number of studies which show that the average length of time stocks are held is astonishingly long. And unless one attributes these very long holding periods to irrationality on the part of savers-investors, the tax treatment of gains and losses must be held largely accountable for the immobilization of huge amounts of past saving. It must, therefore, be viewed as a serious impediment to financial market efficiency.

This is not to say that taxation alone accounts for the declining role of individual investors in our security markets or even that those tax considerations are primarily responsible for the security market conditions now causing so much concern. Nor do I mean to suggest that changes in the tax law to ease the existing burden on saving and on transactions will, of themselves, reverse the trends in the securities markets with which this Subcommittee is concerned. But surely appropriate changes in the tax law will make an important contribution to a higher rate of private saving, to greater participation by individuals in the financial markets, and to more efficient functioning of those markets.

IV. Tax Changes To Encourage Individual Investment

Any discussion aimed at changes in the tax treatment of capital gains and losses in the interests of mitigating the existing tax bias against saving and ready transferability of assets faces a huge barrier of conventional wisdom arguing for even heavier tax burdens on capital gains. That argument is oriented primarily to so-called equity considerations. It is predicated on a concept of income deemed to be needed if the principal purpose of taxation is to equalize economic status, without regard to the impact of implementing that income concept on the neutrality of taxation with respect to the consumption-saving choice. That income concept insists that capital gains are in no wise different from any other kind of "income" for purposes of measuring economic status of various individuals, and that taxing capital gains less heavily than other income defeats the purpose of progressive taxation. The conventional wisdom is clearly based on highly circular reasoning. But it has so broadly permeated the policy forum that any proposal to alter the tax treatment of capital gains and losses in the interests of neutrality—equal treatment of saving and consumption—is more often than not received as special pleading for "fat cats."

As an economist, I profess no expertness regarding tax equity. Both the historical record and abstract analysis strongly suggest to me that government tax and expenditure policies and programs are ineffective in redistributing income and are likely to be counterproductive. The interests of all active participants in the economy—that is, the overwhelming majority of us—rather lies in a tax system that as little as possible interferes with our private choices as to how we obtain and use our income and wealth. Such a tax system should as little as possible change the relative costs of the alternatives we face in the market place. And given the enormous requirements for additional capital we face in the coming years

[3] In such cases, the mean value of the probability distribution of the aftertax outcomes of any given investment is reduced. The investment, then, is not only less productive but also riskier.

if we are to maintain—let alone advance—our productivity and living standards, top priority in tax policy should be given to reducing the existing heavy tax bias against saving.

The tax proposals presented following are oriented toward reducing this tax bias. In my judgment, they are also likely to make the tax laws fairer. But that judgment, just as the contrary judgments of others, should be taken as expressions of preference, not as scientifically derived truth.

It follows from my earlier argument that one important revision to reduce the existing income tax bias against saving and capital asset transactions would be to eliminate capital gains and losses entirely from the tax base. In the context of the history of the U.S. income tax, of course, this would be a drastic change. But this Subcommittee surely is aware that the income tax laws of few other advanced industrial nations apply to capital gains.

A less drastic approach would be to extend the present "rollover" treatment of gains on personal residences to a larger list of capital assets—at the least to gains on corporate securities. Under this treatment, the tax on capital gains would be deferred so long as the proceeds from the sale of eligible assets were fully reinvested. The basis of the property acquired upon reinvestment would be proportionately adjusted downward by the amount of the tax-deferred gains.

This proposal would in effect tell the saver-investor that he could maintain the value of his eligible asset holdings as long as he fully reinvests the proceeds from the sale of any of these assets. This rollover treatment, therefore, would exert a powerful incentive for remaining an active investor without penalty for engaging in capital asset transactions.

Both of these proposals, of course, encounter the objection that they would primarily benefit the affluent. As indicated, I am highly skeptical about the relevance and validity of this objection. To the extent that such measures increase saving and business investment, their principal effect is to increase the amount of capital with which labor services are used, hence to increase the rate of advance of labor's productivity and real wages. In evaluating proposals for tax changes, it is important to look beyond their initial impact on the distribution of tax liabilities to their ultimate effects. Failure to do so is largely responsible for the existing tax bias against saving and for resistance to tax changes to reduce that bias.

But insofar as egalitarian preferences restrict the opportunities for constructive tax changes, there are a number of less drastic revisions in the tax treatment of capital gains and losses which would provide significant abatements of the existing anti-saving tax bias and encouragement for individual ownership of equity interests in American business. One of these revisions would be to allow everyone a lifetime exemption of up to, say, $50,000 or $100,000 of capital gains realized on corporate securities and perhaps other specified types of property. A variation of this approach would be to exempt up to some specific amount of capital gains per year, say $5,000, realized on corporate securities. The tax abatement in this general approach would obviously be far more significant to persons of modest incomes than to those with very large portfolios.

A companion change would be to increase substantially the amount of capital losses which might be offset against ordinary income. The limit under present law is $1,000. This might be increased to, say, $10,000 or $20,000. Indeed, full offset of losses against ordinary income would be highly desirable and effective. And a three- or four-year carryback of losses should be added to the present carry forward provisions for losses which cannot be offset in the current taxable year.

A proposal currently receiving a great deal of attention would provide for a downward graduation of the capital gains tax rate the longer the capital assets had been held. For example, the rate applicable to gains on property held for 5 years or less might be 25 percent, that on property held as long as 10 years might be 20 percent, and so on, with a bottom rate of 10 percent on property held for 20 years or longer. As noted earlier, there is a large amount of gains locked up in capital assets which have been held for very long periods of time. The downward graduation of rates with length of holding period would certainly result in a flood of realizations of long-held appreciated capital assets.

To the exent that accrued gains on long-held assets reflect primarily inflation, the graduated step-down proposal would afford at least partial recognition of this fact in determining tax liability. A more direct way of dealing with this serious difficulty would be to provide an explicit inflation adjustment in determining the amount of taxable gain.

Both of these proposals would be effective in freeing up assets which would be realized but for their illusory appreciation. Both would somewhat reduce the

22-727—73——7

additional tax burden on saving. Neither, however, deals head-on with the fundamental bias against saving in the present income tax and capital gain provisions. While these proposals deserve serious consideration, I hope that they would be regarded as merely very modest first steps toward the more basic revisions suggested earlier.

V. Conclusion

In my introductory remarks, I alluded to the proclivity to look for simple answers to complex questions. Mindful of that caution, I do not offer the above suggestions for tax revisions as a panacea. Many factors other than taxes impact on the functioning of the financial markets and influence market results. But these tax changes should make a significant contribution to mitigating existing impediments to efficient operation of these markets. Hopefully, these proposals at the least will spur a more innovative search for constructive tax reform than is usually found in the standard reform program.

Statement by Richard A. Musgrave, H. H. Burbank Professor of Political Economy, Harvard University

The concern of this subcommittee, as I take it from the material given to me by the staff is (1) that the stock market has been dominated increasingly by large investors, to the detriment of the individual investor; and (2) that this has resulted in a "two tier" market in which small and growing firms cannot obtain capital at reasonable cost. Moreover this has lead (3) to such companies being scooped up by foreign investors at bargain prices. Specifically, the problem before this panel is the extent to which this situation was caused by or can be remedied through tax policy, in particular the treatment of capital gains.

Since I am not an expert on the stock market and since the long run concern of the Senate Finance Committee is with the development of an equitable tax structure, I will address myself primarily to this tax issue. However, a brief look at the broader problem is needed to set the stage. As I see it the growing role of institutional investors is a largely inevitable development, reflecting as it does the desire of individual savers to delegate their investment management to such institutions. At the same time this development has been encouraged by tax advantages and can be retarded somewhat by their removal. The resulting diversion of funds towards established companies with increasing cost of financing for smaller firms on the other hand is not an inevitable development. At the same time it is not one the remedy of which calls for regulatory rather than tax policy measures. A further widening of the capital gains preference in particular is not the proper remedy; and the two-tier issue now before you should not be permitted to divert the Finance Committee from the goals of tax reform, goals which I believe call for a tightening rather than a relaxation in the tax treatment of capital gains.

A. THE CASE AGAINST CAPITAL GAINS PREFERENCE

Let me therefore begin with a brief statement why the current capital gains preference should be curtailed and why most students of taxation are agreed that an equitable income tax calls for the taxation of capital gains as ordinary income. In principle, at least, such taxation should apply whether capital gains are realized or not. Let me briefly explain why this is the case.

Underlying principle

1. Under the income tax a person's ability to pay should be measured in terms of the accretion to his economic capacity which he has experienced during the tax year. This addition, broadly defined, equals the increase in his net worth plus his consumption over the period. Or, what is the same, it equals his consumption plus saving. Two people, who have had the same addition of say $20,000 have the same economic capacity; and this is the case independent of how the income was derived or the uses to which it was put.

2. As to sources, the tax treatment of income—as a measure of broad based taxable capacity—should not differentiate between wage or capital income, nor should it distinguish between different types of capital income. Thus, dividend income should be treated in the same way as interest income, and capital gains should be treated in the same way as these two. A dollar is a dollar and in all cases there results the same addition to the taxpayer's economic capacity. Moreover, it should make no difference whether capital gains are realized or not. If my net worth has increased by $1,000 I have become wealthier by $1,000. Whether

I choose to sell and reinvest, or to retain the particular asset is merely a matter of deciding how to use the gain or to arrange my investments.

3. Turning to uses, the income tax should be indifferent as to whether a person decides to consume or to save, to swap investments or to maintain his portfolio unchanged. How the taxpayer uses his economic capacity is his business. The tax is to be based on his gain in capacity, that is all.

4. All this is quite straightforward. Income measured as accretion therefore calls for the inclusion of capital gains in the tax base. At the same time, I do not deny that a case can be made for other forms of taxation. In particular, a tax might be based on a person's consumption rather than his income. That is to say, saving may be excluded from the tax base and having done so, a personal and progressive rate tax (similar in form to the income tax) might be imposed on consumption expenditures only. There are some difficulty with implementing this but it can be done.

In my view, income is preferable to consumption as a measure of taxable capacity, since it provides a more comprehensive measure, but the consumption base is not nonsensical. However, an argument for a consumption tax (an "expenditure tax") as against an income tax is *not* an argument for the exclusion of capital gains (or their preferential treatment) under the income tax. If the tax is to be on consumption, than *all* income which is not spent but saved should be excluded from the tax base, and not only capital gains. Under neither tax are there valid arguments, from the point of view of tax equity, to accord special treatment to capital gains.

5. There has been a literature over the years in which it is argued that a consumption tax is preferable to an income tax because the latter "double taxes" capital income. After the confusion which surrounds this argument is cleared away,[1] one is left with the conclusion that the income tax may be said to interfere with the choice between present and future consumption whereas the consumption tax does not, and that this interference may impose an "excess burden" which is avoided under the latter. There are serious qualifications to this argument and its quantitative importance is questionable. But even if such a point can be made, it does not follow that the consumption tax is preferable on balance. If the income base is preferred to consumption on equity grounds, an income tax may nevertheless be considered superior. After all, the only tax which does not disturb economic decisions is a head tax but few people would argue that this tax, being totally unacceptable on equity grounds, should be preferred to all others.

Practical importance

The capital gains problem is not a minor aspect of tax reform but of fundamental and strategic importance. Such is the case for two reasons:

1. Failure to tax capital gains as ordinary income has been the dominant source of tax avoidance by high income groups. Capital gains as a percent of AGI rise from less than 1 percent for returns below $30,000 to 21 percent for returns above $100,000 and to over 40 percent for returns above $500,000. Counting capital gains fully, these shares are 2, 35 and 60 percent respectively. No wonder that for returns above $100,000 tax savings from capital gains account for about half of all savings from tax preference.[2] The treatment of capital gains thus accounts in large part for the fact that the effective tax rate (ratio of tax liability to AGI) hardly rises above 30 percent at the upper end of the scale. While one may debate how high bracket rates should rise, a zero rate on unrealized gains and a 36.5 percent rate on realized gains are hardly adequate upper limits: and even if they were, there is no excuse for applying them to taxpayers with capital gains but not to those who receive them from other sources and must pay rates of up to 50 or 70 percent. Effective taxation of capital gains is essential to making progressive taxation stick and to do so in an equitable fashion.

2. Failure to tax capital gains as ordinary income is an all pervasive source of trouble in the Internal Revenue Code. Many or most of the tax shelter problems (at least the domestic ones) are linked to the capital gains and accelerated depreciation issue or, most typically to the two in combination. The only satisfactory solution to these difficulties, I believe is through reform of capital gains treatment. Other remedies such as limiting depreciation to the taxpayers' equity in the asset

[1] One of these confusions relates to terminology. For purposes of economic theory economists have defined income as the present value of a future consumption stream which to the nontechnical reader suggests that there is no income without consumption. This, of course, is a non-sequitor. Using this terminology, we need merely say that capital gains give rise to a potential increase in present and future consumption and this is all that matters for our purposes. The fact that such potential increase exists means that there is a gain in economic capacity. This, however, is a fine point in economic semantics with which I hope this committee will not be bothered.

[2] See J. A. Pechman and B. A. Okner, "Individual Tax Erosion by Income Classes," in economics of Federal Subsidy Programs, Joint Economic Committee, U.S. Congress, 1972.

or interest deduction to interest received are questionable in principle and only makeshift improvements. Combined with the minimum tax approach they lead us away from facing up to the need for redefining taxable income in equitable form.

3. The importance of the capital gains problem cannot be belittled by the fact that the revenue significance of moving towards full taxation is limited. About $15 billion obtainable from full taxation of gains (taxation at ordinary rates of realized gains and of accrued gains at death or gift) may not be much, given a total take of $250 billion, although it is not chicken feed. But revenue is not the entire story. Failure to tax capital gains equitably, means failure to tax high incomes equitably; and this in turn makes it impossible or exceedingly difficult to collect the remaining $230 or $240 billion in an equitable fashion.

Problems of implementation

Acceptance of the principle that capital gains *should* be taxed as ordinary income does not relieve one of facing the practical difficulties of so doing. Here as in other aspects of life, an ideal solution is not possible but a good deal can be done to improve matters.

1. Obviously, full taxation of realized gains without taxation of unrealized gains at death or gift would exert too heavy a lock-in affect. Obviously also, taxation of all current but unrealized gains on an annual accrual basis would be unmanageable. The solution, as has been pointed out many times, lies in taxation of accrued gains at death or gift, combined with periodic taxation (say every five years) of accrued gains on readily negotiable assets such as traded shares. Losses, in turn would have to be recognized and treated on a symmetrical basis, and adequate provision for averaging would have to be made. All this involves difficulties but they can be overcome; indeed the new problems which arise may be small compared to those encountered in dealing with capital gains based tax-shelters on a piecemeal basis.

2. The frequently raised objection that taxation of gains not realized by sale is unfair because the taxpayer has no cash with which to pay his tax poses a valid concern only where family farms or enterprises are involved. In these relatively small number of cases, special solutions may have to be found, just as such difficulties must be dealt with under the estate tax. For the bulk of the cases, I see no problem. If the taxpayer owes a tax debt, let him sell part of his assets to meet his obligations. This is only fair, provided that he is given sufficient time (at interest) to avoid losses through forced sale.

3. What is needed in capital gains tax reform is to face up to the problem of including unrealized gains in the base. Little is to be gained by tinkering with minor measures and some such proposals will make matters worse rather than better. Discarding the special 25 percent rate would be helpful as a tidying up operation but it would not make a great deal of difference. Inclusion of gains in the minimum tax helped a little. Lengthening the holding period for short gains or returning to the step-down rate structure of the thirties, however, would set us on a wrong course. There is little economic basis to the notion that short term speculation is wicked while long term holding of investment is virtuous. Indeed, prefential treatment of long holdings adds to the inequities which result from deferral of taxation of such gains, a matter which I shall consider presently.

The crux of the problem, I repeat, is not in reforming the treatment of gains realized by sale, but in first tackling the taxation of gains not thus realized. A proposal for taxation at death and gift was made by President Kennedy in 1963 and repeated in the Treasury's tax reform proposals submitted to this committee in 1969. Moreover, legislation along this line has recently been adopted in Canada. Bringing capital gains into the tax base is possible and there can be no honest to goodness tax reform without doing so.

Tax deferral and inflationary gains

In concluding this part of my discussion I shall note two further aspects of the problem, i.e. (1) the role of tax deferral and (2) that of inflation.

1. Capital gains are taxed when realized rather than when they accrue. This would be the case even if taxation at death or gift was applied. The taxpayer who receives income in the form of capital gains thus enjoys a benefit of tax postponement, whereas others who receive their income as wages or dividends must pay at once. Receiving a tax postponement is valuable to the taxpayer since it is equivalent to receiving an interest free loan. Or putting it differently, postponement reduces the present value of the tax. A tax of $100 payable in 10 years, discounted at a rate of 8 percent is similar to a present tax of $46 only, so that the taxpayer is given a tax benefit of 54 percent. This suggests that to treat capital

gains wholly similar to other income, an interest charge would be needed. In any case, reducing the rate of tax with the length of the holding period works precisely in the *wrong* direction, as it adds to the benefits which long holdings already have obtained from tax postponement.

2. Income as a measure of taxable capacity should be viewed in real rather than in nominal terms. Capital gains which merely reflect a rise in prices do not constitute a real gain in net worth and should not be taxed. An equitable treatment of capital gains calls for an inflationary adjustment. Since such an adjustment is not made, it has been suggested that the present preferential treatment may be viewed as a substitute therefore.

Regarding realized gains, the rise in share prices over the years has tended to be in excess of consumer prices, suggesting an inclusion ratio of 67 percent for assets held over the period from 1947 to 1972 and a 49 percent for assets held from 1960 to 1972. More recently, of course, the picture has been reversed with share prices falling together with a rise in the general price level. It must be noted however that unrealized gains are not taxed at all; and since such gains are a multiple of realized gains, the conclusion remains that capital gains are undertaxed under present law.

This conclusion is reinforced if deferral gians are allowed for. Moreover, there is the further question whether allowance for inflation in the taxation of capital gains would be appropriate unless similar allowance is made for real losses suffered by creditors and real gains made by debtors.

B. ECONOMIC EFFECTS

I now turn to the effect of fuller taxation of capital gains on the health of the economy.

Effects on Progressivity

Preferential treatment of capital gains being a powerful factor in reducing the effectiveness of progressive taxation, fuller taxation could greatly increase progressivity over the higher income ranges. This conclusion follows, but only on the premise that there would be no offsetting reduction in bracket rates. Inclusion of gains combined with a reduction in rates to a maximum of 50 percent (as now applies to earned income) would cushion the increase in progressivity, while leaving us with a substantial gain in "horizontal equity," i.e. a substantially more equal treatment of people with equal taxable capacity or income.

Tax Burden on Capital

The argument may be made that capital income is taxed more heavily than wage income since it is not only subject to the personal income tax but also to the corporation profits tax and to property taxes. This being the case, is not the preferential treatment of capital gains a justified offset to this discrimination? My response is that preferential treatment of capital gains is not the appropriate remedy. If the tax burden on capital income is to be reduced, the proper remedy is to treat all capital income alike, and not to limit the relief to capital gains. This would combine full taxation of gains with integration of corporate source income into the individual income tax, without there being an additional corporation tax. Such an approach would improve horizontal equity as well as close the loophole which the preferential treatment of capital gains now provides for high bracket taxpayers.

Effects on economic growth

In considering the effects of fuller capital gains taxation on the level of investment and economic growth, a distinction must be drawn once more between the overall level of capital taxation and how it is imposed. Fuller taxation of capital gains would shift a larger part of the burden to this form of capital income; but unless the overall level was increased in the process, the burden on other forms of capital income would be reduced. On balance, I see no presumption that the effect would be harmful to growth. Preferential treatment of capital gains as a whole is not an efficient way of giving tax incentives to investment. At the same time, it is a highly inequitable way. Tax policy aimed at furthering growth must be designed to accomplish this objective with the least damage to tax equity and from that point of view the capital gains preference is a very poor approach.

Bearing on financial markets

In concluding, I return to the bearing of tax policy on financial markets and the particular concern of your Committee with the growing role of institutional investors.

This growth, of course, is no recent phenomenon, but a continuation of a long-term trend, extending back to the beginning of the century. As capital markets broaden and become more complex, individual investors naturally wish to delegate their investment decisions to experts who are in a better position to make intelligent choices. This is merely a sensible division of labor. Moreover, this development reflects the changing structure of saving. As income rises, people are enabled to retire sooner, and this requires savings to be placed into forms which serve the retirement purpose, i.e., savings institutions of various kinds. For this and other reasons, the growth of institutional investment management is a natural development, and I see no need for deploring it. Indeed, one would expect the needs of both savers and the capital market (though not perhaps the brokerage business!) to be served better in the process.

At the same time, the case for institutional investment does not call for excessive and growing concentration in this business. Indeed, the evils of excessive concentration in this industry may well be more pernicious and the potential gains in productivity less than in other industries. The specter of Japanese-type financial concentration is indeed a frightening one. At the same time, I find it somewhat difficult to understand why the increased importance of institutional investors must lead to a two-tier market and resulting dearth of funds for small firms. Should one not expect that institutional investors, being larger in size (even without being huge), will be better able to undertake the investment research required for detecting promising small firms than the individual investors for whom the purchase of well-known shares may be the only feasible solution? The recent tendency for institutional investors to concentrate on a relatively small number of large glamour stocks may thus be somewhat of a fad. As time goes on, this fad will subside (there are already indications thereof), and bubbles may arise in other sectors of the market. Nevertheless, the very existence of large portfolios may cause such bubbles to develop and to interfere with an even-handed market. If so, this accentuates the overall problem posed by heavy concentration in the investment industry.

The way to deal with it, however, is not through tax adjustments. The obvious remedy is to limit the size of investment management firms and to break up the ten or twenty largest firms that now dominate the market. This should pose no great difficulty, as no physical plant or production structure is involved. If the result is insufficient and there is still a dearth of capital for small firms, a requirement to hold *x* percent of assets in such issues could be considered. However, the proper approach to small-business relief, if it is to be granted, is to go the direct route of subsidy. Certainly, the answer is not to give tax relief which combines inefficient aid to small business with effective but inequitable grants to large investors.

In this connection, it is important not to be misled by a picture of the market that shows "little individuals" driven out of the market by "huge institutions." The fact of the matter is that these institutions (which, I agree, should not be permitted to be so huge) reflect, to a substantial degree, the interests of the little individual who has placed his investment into life insurance, savings accounts, or mutuals, whereas the individual investor (though little in terms of his market share) is typically a very substantial person in the high-income brackets. While his participation in the market may be increased somewhat by reducing the taxation of realized gains, provided that the additional funds do not go into mutuals, the further deterioration in tax equity would be too high a price to pay. The structural problem with which you are concerned, therefore, is not a tax problem (except perhaps for certain measures to tighten the tax treatment of pension funds) but one of excessive size; and the proper remedy lies in a ceiling on the portfolio which may be managed by any one firm.

Finally, a further word about the lock-in effect of capital gains taxation. Just as an increase in the tax on realized gains, taken by itself would increase this effect, so would a reduction reduce it. This, however, is not the only way in which to approach the problem. As I have noted before, the lock-in effect is reduced also by inclusion of unrealized gains in the tax base; and, as a matter of equitable taxation, this is the approach toward which we should move. I hope that the Committee's current concern with the two-tier problem will not lead you to lose sight of this more important and lasting objective of tax reform.

[Whereupon, at 12:15 p.m. the subcommittee was adjourned to reconvene at 10 a.m. on Tuesday, September 25, 1973.]

FINANCIAL MARKETS

TUESDAY, SEPTEMBER 25, 1973

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE OF FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:10 a.m., in room 2228, Dirksen Senate Office Building, Senator Lloyd Bentsen [chairman of the subcommittee] presiding.

Present: Senators Bentsen, Bennett, and Roth, Jr.

Senator BENTSEN. The committee will come to order.

We have run into a conflict this morning with the full Finance Committee and at least for a time we will not have the other members of this subcommittee with us.

I would like to ask Mr. James Lane and Mr. Quentin Ford if they would please take the witness stand and we will do this as a panel. If those two gentlemen would come forward.

Mr. James M. Lane and Mr. Quentin U. Ford.

Pension funds are one of our principal sources of institutional investment. Over $14 billion a year is presently being contributed to private pension funds, as a result of provisions in our tax code which encourage the creation of such funds.

The indirect tax subsidy from the Federal Treasury to private pension funds is estimated to be in the area of $4 billion a year.

Now, we have just passed in the Senate a major pension reform bill and with the funding requirements that it calls for and with the early vesting that it calls for, you are going to see an acceleration of funds going into pension funds.

This morning we are going to receive testimony from Mr. Edward Malone, vice president of trust operations for General Electric. That company has chosen to manage its own pension fund. However, most companies do not retain control of their funds but turn them over to outside managers—such as bank trust departments.

We will also hear from representatives of two such trust departments this morning, Mr. Quintin Ford, senior vice president of Bankers Trust Co., and James M. Lane, executive vice president of the Chase Manhattan Bank

Trust departments have been growing very rapidly. The trust department of Mr. Ford's bank has almost doubled in size in the last 5 years. His trust department together with Mr. Calloway's of Morgan Guaranty—whom we heard from in the first round of hearings—holds more stocks and bonds than all of the 500 mutual funds in the United States.

When you total all the securities held by bank trust departments, it comes to $330 billion. That is a staggering amount of market power.

And it's starting to buy some rather staggering shares of American industry. The 10 largest banks now hold almost 30 percent of Polaroid. They own almost as much of Xerox, more of Avon, and nearly 40 percent of Walt Disney.

The magnitude of these trust funds and the size of such holdings raise serious questions about concentration of economic power and about the safety of these funds.

These are the questions which we will be examining.

I do not want to see American banks control American business the way German banks control German business. In Germany, 1 of the largest 3 banks owns 25 percent of over 20 nonfinancial companies, and the largest bank owns 25 percent of the country's largest shipping company. We do not have that in this country, but I am concerned we may be moving in that direction.

Now, Mr. Lane, would you please give your statement first and then we will call on Mr. Ford and then we will go to some questions.

STATEMENT OF JAMES M. LANE, PRESIDENT, CHASE INVESTORS MANAGEMENT CORPORATION, NEW YORK, ACCOMPANIED BY RICHARD A. STARK, COUNSEL OF MILBANK, TWEED, HADLEY AND McCLOY

Mr. LANE. Thank you, Senator.

Mr. Chairman and members of the subcommittee, my name is James M. Lane and I am president of Chase Investors Management Corp., New York, a wholly owned subsidiary of the Chase Manhattan Corp.

With me today on my left is Richard A. Stark, counsel of Milbank, Tweed, Hadley, and McCloy. Chase Investors was formed November 1, 1972, to carry on certain investment management functions formerly conducted by the fiduciary investment department of the Chase Manhattan Bank, N.A., also a wholly owned subsidiary of the Chase Manhattan Corp.

A purpose for formation of Chase Investors was to provide increased general management flexibility, as well as to permit greater focus on institutional types of accounts which we felt——

Senator BENTSEN. Mr. Lane, would you hold there for a moment? Do we have prepared statements from you?

Mr. LANE. Yes, you do.

I pointed out that one of the purposes of the formation of Chase Investors was to provide increased general management flexibility as well as to permit greater focus on institutional types of accounts which we felt required concentrated and specialized investment management. Another purpose for restructuring investment responsibilities within the Chase group was to consolidate the investment management functions pertaining to personal trust and domestic individuals in the Bank's trust department.

We thus have separate management teams focusing on marketing and managing investment services to institutions and to individuals. We also have separate investment decision centers utilizing, however, the same investment research base which is provided by Chase Investors.

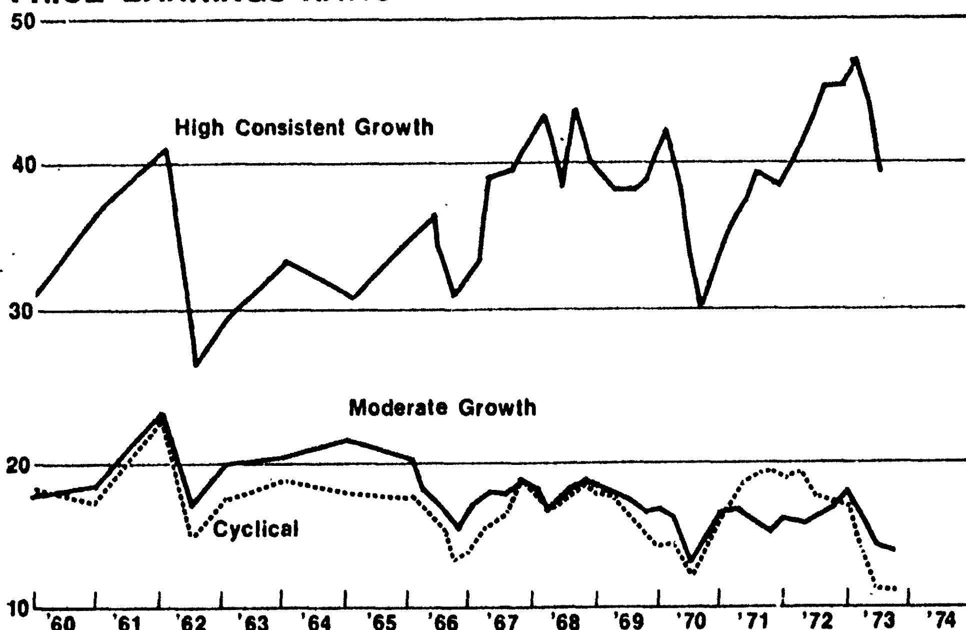
Chase Investors is registered with the Securities and Exchange Commission under the Investment Advisory Act of 1940, and in addition, as a subsidiary of a national bank holding company, comes under the jurisdiction of the Federal Reserve Board and the Comptroller of the Currency.

I have been asked to comment on one of the prime concerns of these hearings, namely, that large institutional investors are said to be responsible for causing what has been referred to as a "two tier market" by concentrating their holdings in a selected few large corporate issues.

There is nothing new in disparities between price earnings ratios of common stocks. For some time we have been charting price earnings ratios for indexes representing high consistent growth companies, companies we have classified in the moderate growth category, and cyclical issues. The high consistent growth group has usually sold at multiples ranging between 30 and 40 times their most recent 12-month earnings, while the moderate growth and cyclical groups have generally sold at about 15 to 20 times their comparable earnings. I have attached a chart portraying these relationships.

[The chart referred to follows:]

PRICE EARNINGS RATIO



Mr. LANE. The disparity between the multiples of the high consistent growth issues, generally synonymous with the top tier of the two tier concept, and the other groups widened noticeably in 1971 and 1972, reaching its widest gap in the fourth quarter of 1972. A significant contribution to this disparity was the general lowering of multiples of issues in the lower tier, as most investors were cautiously appraising the improving earnings results of these stocks, indicating lack of confidence in the staying power of the better earnings.

Broad economic conditions during the past few years have made successful investment in common stocks a difficult assignment. Corporate profits after taxes reached a peak of nearly $50 billion in 1966. It was not until 1972 that that figure was exceeded.

During the 6-year period the Consumer Price Index rose almost 30 percent from 97.2 in 1966 to 125.3 in 1973. Thus, measured in constant dollars, after tax corporate profits were still substantially below the 1966 level.

The trend in domestic operating profits was even less favorable; reported profits before taxes include an inventory valuation adjustment that amounted to about $7 billion in 1972, compared to less than $2 billion in 1966. In addition, a growing portion of profits was derived from overseas operations.

Recently, these profits have included a significant, hopefully nonrecurring, amount that resulted from the devaluation of the U.S. dollar.

I might also point out that for the 3 fiscal years 1971 through 1973 the Federal budget deficit totaled more than $60 billion. Inflation has been a continuing problem and, for more than 2 years, investors have had to cope with freezes and phases, all of which has culminated in a 6 percent increase in wholesale prices for the month of August. In addition to Government price and wage controls, most industries and companies in our economy have been subjected to increasing governmental regulation and restraints. Equity investors have also had to contend with short term interest rates moving to unprecedented peaks.

During this period, political and ethical, as well as economic, values have come under serious question and reappraisal. In short, investors have had much to worry about and their confidence has been severely tested.

Under the circumstances, it is not surprising that investors have tried to concentrate their investments where they thought earnings results would be most assured—in companies with excellent records, that could most readily control their cost/price relationships and be less vulnerable to the impact of economic and regulatory developments.

I would also like to make a brief comment concerning the changing structure of the market.

It has been pointed out that institutions have been consistently increasing their share of equity holdings as well as trading activity. This seems only natural as various services benefiting individuals have been growing including insurance, retirement and profit sharing programs and collective investment through mutual funds. Institutional investing is primarily the professional investment implementation of various programs designed for the benefit of millions of individuals.

It is likely that the growth in these financial programs has replaced at least a portion of assets that would otherwise have been invested directly. Also, speaking very generally, institutionally invested funds, while subject to great competition among the various managers, are relatively conservatively oriented when compared to funds invested directly in equities by individuals.

Were an exaggerated two tier market to continue for a prolonged period, it is conceivable that serious capital acquisition or takeover problems would occur some companies. However, I believe that the relatively extreme disparity is a temporary one and will be corrected through the working of economic and market forces.

Perhaps we should remember that individual investors experienced serious capital losses in the aftermath of the booming new issue market and the popular "high-flyers" of the late sixties.

What is needed is an environment of sustainable, relatively non-inflationary growth which can provide renewed confidence on the part of investors, within the framework of appropriate monetary, fiscal and regulatory policies.

In the marketplace, equity valuation trends are generally a matter of degree as various investors register their own judgments. To help us in the formulation of our own particular judgments, we have a large staff which does economic, industry, and security research, evaluation of outside research, computer oriented analysis, and provides portfolio management perspectives. These efforts all contribute to a decision procedure that, of course, places ultimate responsibility with our investment policy committee.

We, for example, for some time have felt that a somewhat more balanced approach to structuring a portfolio was appropriate as compared to that which has generally been ascribed to large institutional managers. Such an approach was not extremely rewarding in a year like 1972 when almost all of the market's advance was provided by a rather limited number of issues.

Incidentally, it is somewhat paradoxical that some corporate executives complain about the lack of investor interest in the so-called second tier or lower earnings multiple issues, and yet they press for top investment performance over relatively short periods in their pension funds.

This attitude may have a tendency to reinforce at least temporarily such trends as we are discussing.

I think it is pertinent to note that a correction from an excessive stretch in relative values appears to be taking place currently in the market.

For example, as of a recent date, 9 of the best 10 performing stocks for this year among our 50 largest holdings have price earnings ratios of less than 25. This represents a major change from the prior year. Also, the broad unweighted indexes have recently been doing better than the popular market weighted averages, which are importantly influenced by the largest companies. This is a change both from 1972 and the first 6 months of 1973. Thus, there is increasing evidence that the gap between the two tiers is narrowing.

In looking over the briefing material prepared by your staff and the statement on behalf of the Committee of Publicly Owned Companies, one gets the feeling that institutions are not only accused of creating the "two tier" market, but also are apparently being held accountable for the ills of the brokerage industry, the disruption of capital markets, the takeover of U.S. companies by foreigners, the lack of interest of the individual in the equity market, and a number of other problems.

I would like to briefly explore some of these other issues, as well as certain attitudes concerning the field of investment management which I feel are misconceptions.

The trend toward less direct involvement by the individual in the securities market is nothing new.

According to SEC data, the individual's share of equity holdings has been declining quite consistently for almost 20 years. Individuals owned 73.5 percent of all outstanding equities in 1955 and the proportion declined to 62.9 percent in 1972.

This really indicates a slow and gradual decline, in percentage but not in dollar amount, which was more than offset by indirect ownership through mutual funds, pensions or insurance equities.

A likely cause for the individual's reduced market participation is his apparent loss of confidence in Wall Street. The individual investor who withdrew from the "hot issue" market in the last few years, of course, made a wise decision and should be congratulated. It should not be overlooked that the individual has recently had interesting alternative investment vehicles.

Currently, he can earn a return of close to 10 percent in short term fixed income investments. Fixed income mutual fund shares have been sold successfully by brokers in competition with common stocks and some firms have been successful in shifting their customers' interest from equities to commodities.

There have been a few cases of foreign companies acquiring domestic business enterprises. Again, direct foreign investment in our country is nothing new. The most obvious factor that prompted some of the take-overs is the change in relative currency values after two devaluations of the U.S. dollar, as well as the depressed state of major segments of the U.S. securities market.

It should be kept in mind that foreign investment in the United States, including acquisitions of U.S. companies, help our balance of payments just as our acquisition of foreign companies has strengthened their payments balance. Moves to discourage takeovers may result in retaliation by foreign governments and work to our detriment since our investment overseas exceeds by several fold the foreign investments in the United States.

The importance of the securities markets to the raising of equity capital is, I believe, overstated. The institutional investor study of 1971 made the following statement: "The National Bureau of Economic Research Report concludes that, in the aggregate corporations rely very little on the equity market as a source of funds." A study of our own concluded that during the 5-year period 1965–69 net sales of stocks amounted to an insignificant $7 billion for the period. Thus, less than 1½ percent of total corporate needs for funds or only 3 percent of their external sources was supplied by new issues of common stock—by contrast, sales of bonds for the same 5-year period exceeded $55 billion.

I would like to turn now to a few of the misconceptions pertaining to the investment management business—at least from the point of view of what I consider a substantial and reputable investment management firm.

The first of these is the matter of conflict of interest. One sometimes hears accusations regarding situations where the interests of a client's account are said to have been subordinated to the interests of the investment manager. Statements have been made that, when a commercial bank buys securities of companies that do business with the bank, loan and deposit arrangements are taken into consideration in determining purchase or sale programs, and that insider information is received from the commercial lending officers.

I can assure this subcommittee that in the Chase group, we have followed a practice—for as long as I can remember during my period of senior management responsibilities—of maintaining a strict ban

on the exchange of any insider or sensitive information between the commercial and investment management areas of the organization.

I can also say that I have never received interference or pressure or even suggestions as to the course of investment action with respect to any specific security from any Chase banker outside the investment department.

Another popular misconception is that large institutional investors often unite to manipulate the market in a particular security or agree to take turns in buying or selling.

Nothing is further from the truth. All of us keep alert to any major signs of market activity, shifts in emphasis, trading in large blocks and the like—but we do this independently. This is and should be expected of any astute professional.

When an investor's trading section tests the market in a particular security and finds considerable strength on the buy side, or weakness on the sell side, the trader certainly is expected to try to determine the causes and sources of the activity.

Conversely the initiator of the activity is doing his best to cloak his activities. If the direction one wishes to take is the same as the market trend—that is, if he wishes to buy when the market is strong or sell when it is weakening—a decision has to be made whether to proceed and possibly accelerate the direction, or to stay on the sidelines hoping for a restoration of balance.

The decision is a matter of independent judgment.

A related concern involves to so-called dumping of stocks which we believe is an exception rather than a rule. Such action is usually prompted by news or other factors interpreted as being adverse to the company. Naturally, there is a question as to whether or not, in each instance, all holders, be they institutions or others, will come to the same conclusion to liquidate. In fact, some consider such news as buying opportunities and thereby supply a degree of stability to the market during a liquidation.

Generally, liquidation is done in an orderly manner, as is the accumulation of securities. There are few who are not concerned about unduly influencing the market for an issue when they are buying or selling.

Restriction on liquidation would, we believe, result in dangerous erosion of the marketplace. Liquidation creates purchasing power for commitment in other issues being offered and, in a sense, supports the auction market function.

Still another misconception is that institutional investors desire to exert control over portfolio companies either unilaterally or in concert with others. Speaking for my own organization, I can assure you that our interest in portfolio companies is strictly in their attributes as investments. We view them with the eyes of our clients, how they might impact client accounts, and not with any self-interest on our own behalf. Our interest is in managing the portfolios entrusted to us in a fully competitive manner. Thus, our concerns completely coincide with those of our clients.

Suggestions have been made that some legislation dealing with institutional disclosure of holdings and transactions should be enacted. Similarly, various proposals were made for legislation that would impose restrictions on trading or limit ownership of securities by institutional investors.

We are on record as favoring the disclosure of holdings and transactions. I would like to take this opportunity to make a proposal in this regard that we feel would be responsive to the public's right to be informed concerning our investment activities.

We believe that a procedure for quarterly reporting of holdings of 20,000 shares or more would meet this need.

Additionally, we would support a requirement to report significant transactions made during the quarter. We would also suggest that these reports be segregated to indicate those holdings and transactions over which the investment adviser or manager has sole discretion and those which result from sharing the investment responsibility with others.

We urge that any legislation enacted will not hamper the ability of investors to conduct operations properly and serve the best interests of their clients and the public.

We would like to note that, however good congressional intent may be, legislative intrusion into the market mechanism can cause more problems than it solves.

I urge that most careful consideration be given any legislation which would restrict ownership or trading.

For example, I have no doubt which action will have a more repressing effect on the market—the sale by an institution of a large block of stock or the announcement by the same institution of its decision to sell a block of stock of a similar size, thus indicating publicly that a large number of shares is and will be overhanging the market. It would definitely be the latter.

Some recent difficulties of our security market were heightened by the attractive opportunities for investment in foreign markets. During the past few years, stocks have performed better on a number of foreign exchanges, and in addition, gains of up to 50 percent were added by the devaluations of the dollar. In contrast, foreign investors suffered through devaluation of the dollar on their U.S. investments. Looking ahead to the elimination of the Investment Equalization Tax in 1974, we must make sure that our security markets will remain competitive with foreign stock exchanges.

Unduly restrictive legislation will hamper the willingness and ability of foreign institutions to invest in the U.S. market and may lead some domestic investors to look for greener pastures overseas.

Like this subcommittee, we are interested in viable and liquid security markets in which we can transact business in the best interests of our clients. But just as recent attempts to cure temporary economic imbalances have provided another reason for investors to search for companies with "earnings visibility," it is important that legislative remedies aimed at temporary dislocations in the market not cause more serious, more lasting problems.

Thank you, Mr. Chairman, for this opportunity.

Senator BENTSEN. I believe you have raised enough questions that perhaps we should just ask questions at this point before we go ahead to the next witnesses.

Let me say first that on the question of restrictions in trading which might result in a significant number of shares overhanging the market, I share that concern with you.

I am not one who would support that kind of an approach. But insofar as limitations of ownership percentagewise in a corporation, in that regard I think that we will have to come to something like that on the discretionary accounts. For years it has been done with mutual funds. For years insurance companies who operate in the State of New York had to do it and I do not see that it has had any adverse effect on their investment decisions. To the contrary, I think it puts them in the position where they do not have the exposure that they might have with undue concentrations in a particular stock and might result actually in more safety for the fund itself.

With some 1,400 stocks on the New York Stock Exchange, I don't think that is an undue limitation on the options for investment that are available to the portfolio managers.

Now, the statement has been made that Chase in no way passes information from the commercial side to the trust department side and I hope that is correct. But the information was provided to us that in the case of Leasco's attempted takeover of the Chemical—that Chemical Bank immediately got the list of stocks over the Leasco from their trust department and availed themselves of that information. So if you have been fairly responsible in this situation it does not appear that all of the major banks have been.

Can you tell me what role Chase played in the refinancing of Boise Cascade which began last year?

Mr. LANE. No, sir, I cannot.

Senator BENTSEN. You cannot.

Mr. LANE. No.

Senator BENTSEN. My information is that the Chase Trust Department had a position in Boise Cascade that approached a million and a half shares. Is that correct?

Mr. LANE. That could be correct.

Senator BENTSEN. Wouldn't that be a significant holding?

Mr. LANE. Yes; it would, but the holding was importantly reduced about that time. And we knew nothing about what was going on in the commerce department.

Senator BENTSEN. You had no idea that they were going through the refinancing on the commercial side of Boise Cascade, a particularly important decision, it seems to me, for the bank because it was a major refinancing. Who had the ultimate decision finally on refinancing?

Mr. LANE. It would be the corporate department. The corporate banking department would have that decision.

Senator BENTSEN. Do you believe that they had no idea of the size of the holding that the trust department had in Boise Cascade?

Mr. LANE. I doubt it very much, although there are certain funds that are published. However, if the disclosure suggestion that we are making were to take hold, then they would know precisely what our holdings would be just as other members of the public would know. But under current circumstances they don't know, although perhaps they can see it as a holding—that is, in a pool fund where holdings are published or perhaps in our own thrift fund if holdings happen to be there.

Senator BENTSEN. So you have absolutely no knowledge whether the people who made the decision for refinancing Boise Cascade had information that would apprise them of the amount of holdings of Boise Cascade that were held in the trust department?

Mr. LANE. I'm sorry. I failed to catch the question. You mentioned the holdings.

Senator BENTSEN. Are you saying to me that the people who made the decision at your bank on the commercial side for the refinancing of Boise Cascade had no knowledge of the size of holdings on the trust side?

Mr. LANE. Well, as I say, I think they can have a feel of holdings because there are certain publicly available documents that indicate that we may have been holders at the time. But they have no precise information on that score, and I don't think that is their responsibility. Their responsibility is to do an appropriate financing job for Boise Cascade. They are not concerned with our holding in terms of their decision.

Senator BENTSEN. You don't think that influenced them at all?

Mr. LANE. No, sir, I'm sure it did not.

Senator BENTSEN. In 1969 I understand Chase sold 750,000 Pan-Am shares for $7.5 million in 5 percent subordinated notes in Resorts International, Inc. and for a 15-year option to purchase 1.5 million Resorts class A shares, one-half at $40 a share and the other half at $60. I also understand that Resorts International is principally involved in gambling casinos and real estate in the Bahamas.

Can you give me a feel why you exchanged Pan-Am for interests in Resorts International?

Mr. LANE. At that time we felt that the outlook for Pan-Am was not attractive from an investment point of view. I think subsequent events have proved that this was a correct decision. Unfortunately, the alternate investment has not proved rewarding either, although the profit and loss comparison is quite favorable in comparison with Pan-Am's history since then. But it was done in the view of improving the investment posture of the accounts.

I might add that obviously this was not what one would call a first-tier investment. It was not deemed to be in the most conservative segment of the account as far as asset holdings. But it was very small, less than one-half of 1 percent of any single account.

Senator BENTSEN. Let me explore the current IBM situation. The other day when the judge awarded substantial damages to Telex, the stock dropped some 37 points in 2 days for a paper loss of about $4½ billion. What did your Trust Department do? Did they step in and buy then?

Mr. LANE. No. We were not active on either side of the market on that day.

Senator BENTSEN. In the week following that decision, did you buy IBM stock?

Mr. LANE. Frankly, I'm not positive whether we bought or sold any shares, but we were not large factors, I can say that.

Senator BENTSEN. Now, a statement was given to us that a major foreign institution stated that they were buying only the 25 recommended stocks of a major bank in New York because they felt that that bank would support the price of those stocks. Now, you are in a position to have self fulfilling prophecies for the amount of funds that are coming in. Now, if we have that kind of a rippling effect where even foreign investors are following the lead of major institutions in the U.S.A., you are in a situation where you can manufacture your own prophecies, aren't you?

Mr. LANE. No, sir, I don't agree with that statement at all.

Senator BENTSEN. If you had over $1 billion a year in new money coming in, and chose to put it in selected issues, aren't you in a position of being able to support the price of that stock?

Mr. LANE. Well, Senator, unfortunately, we don't have $1 billion a year coming in, for one fact.

Senator BENTSEN. Well, at least one department of one of the banks does.

Mr. LANE. Apparently so, but I think that this suggestion of a follow-the-leader approach, this kind of trend, could possibly work for a limited period of time but, as I have indicated in my prepared testimony, I think that economic and market factors become self-correcting. Price, after all, is a factor and at some point, no matter how attractive the outlook for a company is, you are just paying too much for it. I think that if people want to follow this as an investment approach, the approach of the foreign investor you cited, they are welcome to try it for a while but I don't recommend it as an investment policy. I don't think it would be a successful approach over any period of time.

Senator BENTSEN. Mr. Lane, I don't either, but in the short run it can be and that concerns me very much.

You know, when you talk about the lower tier stocks and the depreciation in their market value, I don't know how much of that is because the individual investor has left the market and how much of it is because the major institutions do not buy those stocks, but concentrate their investments otherwise, and as I understand the gist of your statement, the banks are being made scapegoats for an unhealthy market situation caused by factors such as inflation. You stated there is an unfair indictment of banks that they are only looking after their fiduciary relationships as trustees of pension funds. Do you think the concerns of the Finance Committee, of the Banking and Currency Committee, two former Chairman of the Securities and Exchange Commission, the Governor of the Federal Reserve, the Chairman of the Anti-Trust and Monopoly Subcommittee of the Senate Judiciary Committee, of the actual or potential dangers of successful concentration in the securities market are totally without foundation?

Mr. LANE. I don't think I suggested that. I think that—I have no problem with giving a lot of thought to this particular focus that you have outlined.

In fact, we think about this all the time in terms of an investment approach. However, I think the question is one of pinpointing the cause of the problem and what may be its solution. I think that, as I suggest in my final sentence, it could be a real mistake to artificially restrict investment action in terms of what—in the two-tier concept—may be somewhat of a temporary disparity.

Senator BENTSEN. I would say to you, Mr. Lane, that this committee doesn't want to do anything in the way of legislation that won't stand the test of time. We don't want to do anything that keeps investors from acting like investors and we are not talking about restrictions that are really beyond what have been put on other institutions.

Senator Bennett.

Senator BENNETT. Thank you very much.

As I understand your statement, Chase has one division which manages institutional accounts and another division, your trust department, that manages individual accounts. Do both of these divisions have access to the same information sources?

Mr. LANE. Yes, sir.

Senator BENNETT. There is an active interchange of source material and opinion between the managers of the two divisions?

Mr. LANE. That is right, Senator. As I have indicated in this statement, Chase Investors, which is the separate affiliate of the bank, does provide investment research for the trust department. In other words, the portfolio management is in the trust department but they have access to our research product. We, in effect, sell our research product to the trust department.

Senate BENNETT. For our record, could you supply us some kind of information about the comparative performance of these two divisions?

Mr. LANE. Well, this is a brand new reorganization as I have also indicated. Formerly, we were organized as a fiduciary investment department, as we called it in the bank, of which I was head and all of the activities were in one department. For reasons that I stated previously, we felt that it would be appropriate to organize in this way in terms of the future. But I think the history is not yet long enough to give you any meaningful data in that regard.

Senator BENNETT. Was the purpose to separate investment counseling from normal banking services?

Mr. LANE. That is partly the purpose. I think the key purpose was to give us increased general management flexibility as I have indicated, and we can do that. We think that, looking ahead, the competitive picture from time to time in the future will be a difficult one, and we wanted to organize ourselves to be sure we are competitive on that score.

Second, I think that both the marketing approach and also the investment approach differs in terms of the institutional type account and the individual. We want the prime focus for both markets to be the main responsibility of various individuals, so by separating those functions, we think we both—both markets are better served.

Senator BENNETT. Can you tell us approximately what percentage of your total investment accounts are in each of these two areas?

Mr. LANE. Very roughly, 66⅔ to 75 percent, I would say, is institutional, and the balance is individual.

Senator BENNETT. Are there any special services you supply the institutional investors that are not available to the individual?

Mr. LANE. No, sir. I don't believe so.

Senator BENNETT. One of the characteristics of institutional favorites is that they seem to be inflationproof, capital intensive. Many appear to be industries with high degrees of concentration. Could it be that their ability to bring a healthy rate of return in good times and bad is related to the fact that they can easily pass on any increased cost to the consumer because of their market power? Do you think there is a coincidence in the fact that many of the institutional favorites, IBM, Xerox, Exxon, Eastman, et cetera, are under investigation for antitrust violations?

Mr. LANE. Is the thrust of your question that the market power of these companies has something to do with their attraction as investments?

Senator BENNETT. And your interest, the interest in them particularly on the institutional side.

Mr. LANE. As a matter of fact, Senator, I believe that the individual side would have a larger percentage of investment in the so-called first-tier than the institutional side. I think that this relates partly to a slightly more conservative emphasis, perhaps, in the individual area. Secondly, the tax factor is, of course, more important in the individual side than the institutional side which is largely tax free. So, in terms of your question, I would suggest that the typical first-tier stock would be more widely held in individual accounts than in institutional accounts. And, as I have indicated in my talk, our particular portfolio structure has not been quite as heavily weighted in the direction that several comments in the briefing material suggest is typical for our type of institution.

Senator BENNETT. Currently Avon seems to be an institutional favorite. Its present stock value is greater than that of the entire value of the stock of the entire U.S. steel industry. Can you tell us why Avon stock value is $7 billion today?

Mr. LANE. Well, I think the company has certainly demonstrated an impressive record. I believe the 10-year growth rate is something like 17 percent in terms of earnings per share which is severalfold better than that of any steel industry company, I believe. Certainly this is true in terms of the steel industry generally. Obviously, investors are seeking maximum corporate results and Avon has offered that to investors.

I think in the case of Avon, as I read in my statement, it is always a matter of degree and judgment. Probably the biggest question an investor has to face is: is he paying too much—not is the company going to do better than American industry generally.

Senator BENNETT. I am tempted to wonder whether Avon may be reaching the top of the spiral, tlat that kind of a paper value——

Mr. LANE. Well, I think it is a most valid question. I must say that people have been asking that question for quite a few years and at least to date it has been premature. But, again, I think you are talking about individual judgments, and if we were posting our holdings, you would find that our holdings of Avon are not as large as those of most institutions.

Senator BENNETT. Just, if you know, are your holdings of Avon on the institutional side greater proportionately than on the individual side?

Mr. LANE. I am not sure, Senator, but I believe that the statement that I made earlier would hold for Avon, namely, that I think they would be larger on the individual side proportionately.

Senator BENNETT. No other questions, Mr. Chairman.

Senator BENTSEN. Senator Roth.

Senator ROTH. Yes.

Mr. Lane, I would like to go back to this question of saying that the two departments work independently and are airtight. One of my concerns is under the law your board of directors and your officers, under your State law in particular, have an obligation to act in the best interests of the entire corporation. So how can they manage a company and not be aware of what is going on throughout that company and still live up to its corporate responsibility?

Isn't it a——

Mr. LANE. You are correct, that the board of directors is responsible for the entire corporation.

Senator ROTH. And the officers.

Mr. LANE. Pardon?

Senator ROTH. As well as the officers.

Mr. LANE. Yes.

Senator ROTH. Am I not correct——

Mr. LANE. Two officers, the chairman of the board and the president, oversee the entire corporation. Only those two officers in effect have responsibility across the board. Those two officers and in addition, of course, the board of directors.

Senator ROTH. How many vice presidents are on the board of directors, any of them?

Mr. LANE. There are four officers, what we call the executive office—the chairman, the president, and two vice chairmen—are members of the board of directors.

Senator ROTH. But are you trying to say that a vice president does not likewise have a fiduciary responsibility under the general corporate law to look after the best interests of the corporation? He is able to isolate his activity to a limited area?

Mr. LANE. That is right. He certainly has responsibility to the corporation, Senator, but he is charged with the responsibility of doing the job in his particular department and, if he is involved in trust or investment activities, his responsibility is to work for those particular customers or clients of the bank.

By the same token, if he is a loan officer, he is working for the corporate, institutions, or individual customer on that side of the bank. Since he does not have knowledge of specifics in terms of what is going on in the other area, his focus is completely in terms of his area of responsibility.

Senator ROTH. Now, let me ask you this.

Exxon—you are a large holder in Exxon?

Mr. LANE. Yes, sir.

Senator ROTH. And do you have any interlocking members of the board?

Mr. LANE. Well, the chairman of Exxon is on our board of directors, yes.

Senator ROTH. And do you manage any of the Exxon employee benefit funds?

Mr. LANE. Yes, we do.

Senator ROTH. Is it realistic to think that the various departments can work independently of each other as a member of top management, whatever level, chairman or lower—would it be realistic to think that the selling of stock, of Exxon stock, for example, let's say that is happening theoretically—is it realistic to think that selling of Exxon stock might not have some repercussions with respect to the deposits that Exxon may have with your bank?

Mr. LANE. Senator, the fact is that we are completely free to sell Exxon stock without consideration of the deposits. I think it is absolutely realistic to think that way.

Now, whether that is believable in terms of a third party is another question. But, believe me, the pension business is very, very competitive, and we have lost accounts or had reduced proportions of

pension accounts in terms of companies represented on our board of directors, if indeed those companies feel that we are not matching the competition investmentwise. So, as far as I'm concerned and my people are concerned, the only thing that counts is to do, as I said in my statement, a fully competitive investment job. If I had to worry about such considerations as you mentioned, I don't think this would be possible. In fact, I know so. So, it is realistic to think that way, although I can see that it is difficult to agree that this is what is going on, if you are a third party.

Senator ROTH. What has been the performance of Exxon common stock in the last 3 years?

Mr. LANE. I think in the last 3 years it has been rather good, particularly last year and this year, but it has not always been so. And I must say that our positions have changed quite importantly from time to time. We are much heavier holders today than we were 2 years ago. But we were heavier holders several years prior to that. Mr. Chairman, in the last comments you made before you turned it over to Senator Bennett, you expressed an agreement with us that you weren't interested in any artificial restrictions that would impair the marketplace. The thrust of our comments was that, if we did have the kind of disclosure that we suggest in our talk, some of the questions that are being asked would become clear. The disclosure would reveal certain facts and we could see that some of the fears that exist today are, I think, unwarranted. Additional disclosure, I think, would bear that out.

Senator ROTH. Just one general comment. Perhaps Chase Manhattan is able to keep these operations separate, but it seems to me to be a difficult concept for banks generally.

Let me change to another area. Do you have any suggestion as to how we can get the small investor back into the market?

Mr. LANE. Well, again I think that what has happened in the market is the product of economic and other aspects—as well as, let's say, political and some of the ethical reappraisals that have been going on. All of these things have worked to reduce confidence. Also, going back to the late 1960's, we witnessed the exact opposite to what we see today. In other words, in the late 1960's, the individual was in the market very importantly. The new issue market was very alive and, unfortunately, in retrospect, the individual was tempted to buy indiscriminately. Some goods, in retrospect, were not worthy of his interest, and he suffered. So, both in terms of economic history recently and in terms of market experience, the individual has been hurt.

So, I think the basic thing that is needed is, as I indicated, a healthy sustainable growth rate in our economy, hopefully with a lower rate of inflation than we have experienced. That is basic.

Now, secondly, I do think that some of the tax suggestions that have been discussed are certainly worthy. I heard your comments at the New York society, Mr. Chairman, and I think the idea of elongating the holding period or taking that into consideration in terms of reduced capital gains rate, would be most helpful in unlocking some of these first-tier stocks. That is where the really big profits are. Therefore, this is where the tax factor hinders sales the most. This is another reason why individuals probably hold these types of stocks even in greater proportion than institutions, which indeed can sell

Avon without a heavy tax penalty. An individual who has held Avon for 10 years has a tremendous tax bite to consider. On this point, I am in support of my colleague here on the right in the banking business. In his speech—I quickly read the last part—he seems to agree with that, too.

Senator ROTH. Mr. Chairman, I will waive any further questions at this time.

Senator BENTSEN. Mr. Ford, would you give us your statement at this time?

STATEMENT OF QUINTIN U. FORD, SENIOR VICE PRESIDENT, BANKERS TRUST CO., ACCOMPANIED BY JAMES T. BYRNE, JR., ASSISTANT GENERAL COUNSEL, BANKERS TRUST CO.

Mr. FORD. Yes, sir.

Mr. Chairman, first let me say that I believe you have a copy of the statement which I will try to brief somewhat.

I am Quintin U. Ford, a senior vice president of Bankers Trust Co. of New York, in charge of its investment department. With me on my right today is James T. Byrne, Jr., assistant general counsel of Bankers Trust Co.

As a representative of a major institution engaged in the management of trust assets for over 70 years, I welcome this opportunity to appear before this committee as I feel strongly that the role of the institutional investor, particularly that of the fiduciary, has been misunderstood.

In presenting my testimony, I would first like to point out that the current discussion of the two-tier market and, most particularly, some of the suggested ideas to remedy the alleged situation completely overlook the fiduciary responsibilities of institutional investors. This oversight is most important when one considers that the Bankers Trust Co., for example, acts as trustee for the benefit of several thousand private individuals and close to 4 million employees (active and retired) of company pension plans which we administer in whole or in part. The proper discharge of this fiduciary obligation can hardly be underestimated when it involves the financial security of millions of Americans.

Implicit in the prudent man rule which has been reaffirmed by Congress in its proposed pension reform legislation is an obligation which may at any given time result in fiduciary ownership of either of the so-called tier stocks.

Perhaps, if the committee were made cognizant of how an experienced trustee responsibile for some $20 billion of fiduciary assets goes about the business of fulfilling its fiduciary obligations, it would help to dispel certain notions that large investing institutions by design concentrate only in high multiple growth stocks.

Selection of common stocks for investment purposes at Bankers Trust Co., has traditionally been based on a number of factors that are continually being studied by over 30 security analysts, actively following 800 different companies in 70 industries, with the assistance of a large economic staff and sophisticated computer models. Formulating our investment thinking is the current and, more importantly, the anticipated future state of the United States and world economies.

Underlying long-term economic and demographic trends are analyzed to determine how fast the overall economy can be expected to grow in the next 3 to 5 years, and which broad segments are likely to advance the most rapidly. Within this framework, the faster growing industries are selected for further investigation. Companies within these industries, or those that produce products and/or services that are related to accelerated growth areas, and which have demonstrated ability to continually increase profits, on a basis consistent with fulfilling their social obligations, are then chosen as possible investment vehicles.

Conclusive data is then discussed with portfolio managers who assess the particular client's goals to determine if the security under consideration can be effectively used to carry out the specific investment objectives of the portfolio.

Very short term special situations, however, that periodically arise and affect only one company uniquely are generally not sought out as investment opportunities. We do not encourage the type of short term trading which results from this approach.

Once a security is selected for purchase it is not forgotten. Review of the fundamentals within the company, the industry, and the economy with an eye toward any changing developments that may dampen the outlook, is a continuing task. Should a change occur, we attempt to determine if the factors are temporary, only the expectation of basic deterioration in future earning power or price considerations of exhorbitant proportions would cause us to turn negative, whereupon we would initiate an orderly sales program. While our investment research division is the main source of investment ideas, Bankers Trust Co. has placed growing emphasis on the role of 50 individual portfolio managers in the investment decisionmaking process. This replaces a procedure or committee system that promulgates an approved list of securities and accordingly tends to discourage concentration in that the day-to-day decisions on an individual trust are now made by accountable portfolio managers—within the framework of the bank's overall policy—and often reflect the individual investment style of these managers.

The record shows that over any reasonable period of time common stocks on the basis of total return have produced better results than fixed income investments. Recognizing this, we began investing a substantial portion of our trust funds in equities in the early 1950's—a time when many trustees were continuing to concentrate their investments in fixed income securities. Since then we have held to this approach.

As long ago as 1967, for our employee benefit accounts we embarked upon the purchase of smaller capitalized companies having what we considered to be outstanding growth prospects in an effort to find, if you will, the "Xerox's" and "IBM's" of tomorrow. Ever mindful of our fiduciary obligations, we felt the most prudent approach to this quest was through the establishment of a pooled fund thereby diversifying the risk inherent in this type of security. At the end of last year this fund, whose sole purpose is to invest in emerging companies that have yet to earn the distinction of any "tier" ranking, was valued at close to a billion dollars. This fund currently represents approximately 15 percent of the common stock commitment of our

participating employee benefit trusts. I have with me additional copies of our Supplemental Equity Fund report if the committee should care to have them. Additionally, I would like to call the committee's attention to the fact that through two venture capital funds and a restricted securities fund we have provided "seed" money to some 65 embryonic business endeavors. The aggregate dollars we have committed primarily through these special purpose funds in the securities of over 300 companies of considerably less stature than those designated as "first tier", demonstrates, I believe, in a very positive and dramatic way that we are, within the parameters of prudence, contributing our share of financing to the small and intermediate and less seasoned company. Additionally, as a corporation we and a number of other banks participate in small business investment corporations which provide to new ventures equity financing which may otherwise not be available.

While it is currently in vogue to allude to companies with the best earnings history and the most predictable prospects as "top tier" stocks, it does not seem illogical that they should be accorded above average price/earnings ratios. The price/earnings ratio that investors are willing to put on these stocks is high only as it relates to the ratios of that much larger group of stocks lacking these characteristics. These high price/earnings ratios are merely reflective of increased investor recognition and awareness of those relatively few companies having greater abilities to control their destiny and cope with the inflationary environment. Perhaps other investors are saying, as are we, with a portion of our funds, that these stocks in the current environment of a controlled economy represent the best investment.

However, history shows that investment styles go through periodic changes. For example, in the early 1960's many cyclical industries such as automobile, tire and rubber, airlines, and oils outperformed the averages and many of the "glamour," or today's "first-tier" stocks underperformed the same averages. Later in the decade the stocks of conglomerate and congeneric companies were favored by many investors. These in turn were then replaced by equities of small sized so-called concept companies which helped to fuel the "Go-Go" funds.

In sharing with you some of the thinking that results in our present investment mix, I hope I have been able to demonstrate our complete objectivity in the discharge of our investment function. The obligation of a fiduciary is to produce the best possible investment rewards for his beneficiaries consistent with the investment risks assumed. If our response to this obligation results in a type of common stock investment which over the longer term consistently produces the rewards desired, it is not a matter of "follow the leader" or a self-fulfilling prophecy of supporting the market. Rather, it is the action of independent trustees attempting, to the best of their ability, to discharge their fiduciary obligations.

In our particular case, as a result of a flexible investment approach, our portfolios are far from static. This is evidenced by the fact that of our 50 largest common stock holdings, only 16 were in common for the years ending 1963 and 1972, respectively. In other words, 70 percent of the names appearing as our top 50 at the end of 1963 were replaced with other names over the decade. In addition, over this

10-year period (1963–72) there have been a total of 124 different companies which have appeared among our 50 largest common stock holdings.

It is our view that the alleged "two-tier" market is not sinister and will be self-correcting as investment opportunities change. It is the obligation of a fiduciary to be aware of these changes, and I predict that the 50 largest common stock holdings of Bankers Trust Co. 10 years hence will show as significant a change as has occurred over the past 10. The economic world is constantly changing, and we expect to change with it. Unless we do, we will fail our trust beneficiaries.

As one of the major trust institutions of long experience, we are acutely aware of our fiduciary responsibilities and, accordingly, we must take a jaundiced view of suggestions that could impair the proper functioning of a trustee's activities. Prescriptions to remedy the "two-tier" market that involve mandatory trust investments and limitations on a trustee's investment flexibility can only impair the discharge of these duties in a most harmful manner. This is not an idle fear but stems directly from our experience with the inferior investment performance which results when testators under wills have sought to limit our investment flexibility. For example, in 1949, we established two common trust funds; one for trusts where there were no investment restrictions, and the other for trusts which were restricted to New York State legal investments. The legal fund between 1960 and 1972 increased in value only 60 percent while the discretionary fund during the same period appreciated over 290 percent. The gain in income for the legal fund was only 63 percent compared with over 100 percent for the discretionary fund.

As another example of the consequences of restricting the flexibility of a trustee, in 1939 we received a $492,000 trust which was restricted solely to bonds. A recent valuation indicates a decline to $490,000. A fully discretionary trust over the same period produced a gain in value of over 400 percent, which was a rather representative investment result for this period during which the purchasing power of the dollar declined 67 percent.

Senator, we are ever mindful of our fiduciary responsibilities.

In this respect, Senator, we thoroughly support the remarks of Dean E. Miller, Deputy Comprtoller of the Currency for Trusts, in his statement to the Iowa Trust Association which I have quoted in my prepared statement.

Your second question concerned the limits of the amount of stock that an institution could own in a single company, and would this tend to force large institutions to diversify their holdings?

Our response would be simply that there is no cornucopia of promising "second-tier" companies which stand the test of our research, and we question whether any fiduciary is going to risk investment of the major portion of its trust moneys in the common stock of unacceptable second-tier companies. Limits on the amount of stock that an institution could own in a single company would not automatically divert money to "second-tier" companies. Given the alternative of investing in unacceptable second-tier companies or fixed income securities, the money would go into the latter type of investment. In fact, there is an inherent defect in——

Senator BENTSEN. Let me ask you, is the assumption there that all second-tier companies are unacceptable?

Mr. FORD. No, sir, it is not. I think I mentioned second-tier companies that meet the standards, if you will, of our research, of our analysis. No. That is not the assumption.

In fact, we feel that there is an inherent defect in arbitrarily limiting the amount of stock an institution can own in a single company because, by definition, it would be self-defeating since such a limitation would also place a ceiling on the amount of money which could be invested in promising second-tier companies meeting the fiduciary investment criteria, which, I believe, answers your question.

With regard to the sharp declines in the prices of Clorox and Tropicana, I can only say, Senator, that we have no information on whether the sharp declines in the prices of certain stocks were substantially the result of large institutional sales. However, differing investment opinions among institutions can have only a salutary effect on the market as in the case of Tropicana, where we, Bankers Trust Co., were a net buyer during the market decline earlier this year.

We do have some suggestions in regard to your fourth and last question concerning equitable tax incentives that Congress could enact to encourage small investors to enter the market. I might just read these very briefly.

The small individual investor is confronted with various alternative investment opportunities which compete for his commitment. Among these are savings accounts, bonds, and common stocks. There is normally a higher degree of risk in a common stock investment than is the case with the two other examples mentioned. The risk of loss, therefore, is undoubtedly a real deterrent to attracting the small investor back into the stock market.

We think one approach——

Senator BENTSEN. Mr. Ford, we will have to recess for a few minutes so that I can go to the floor of the Senate for a vote.

[Recess.]

Senator BENTSEN. Gentlemen, thank you very much for your patience. The committee will come to order.

We will have to terminate the hearings this morning at 12 o'clock because of other commitments that we have made.

I might state that concerning the so-called wall between the commercial side and the trust department of banks, I am sure there is a sincere desire on the part of many banks to see that they have such a wall. It is a pretty difficult thing, it seems to me, to administer. We have here the statement in a "Boston College Industrial and Commercial Law Review" article saying:

> Another important form of wall breakdown illustrative of the limited delegation of authority to a wall division may occur when the Trust Department wishes to sell a large block of stock in a corporation which is a valued commercial customer. In one such case where the customer had earlier evidenced a sensitivity to such "disloyal" behavior on the part of one of its major banks, the matter was placed in the hands of the Chief Executive Officer of the bank. So it was the top officer in that instance rather than the ranking Trust Department executive who gave clearance for the sale.

That is part of the problem a bank runs into. Let me say Mr. Ford, I share very strongly your concern about the fiduciary relationship. In a modest way I have been in the management position of a bank and I have sat on boards of banks, trust departments, and I have owned financial interests in banks, and been in the same position in

mutual funds and life insurance companies, and in each of those things the fiduciary relationship is paramount. And I am concerned about it, too. But perhaps from a little different aspect, I wonder what would happen if you had the multiplicity of antitrust suits against IBM, for example, and then you gentlemen in your wisdom decided that you had better be moving out of IBM or one of the others, it seems to me that gate gets pretty small in getting out. I am sure that you must place some kind of a self-imposed limitation on the amount of stock you think is prudent to buy in one company. Do you not have one, Mr. Ford?

Mr. FORD. Yes, sir, Senator. We do have a self-imposed limitation, and that really in effect stems from what you might call prudence. The limitation will vary in relation to the confidence that we have in the particular company that is under question. But we do that with all of our investments and have met with a fair amount of success in limiting our investments, if you will, in relation to the prudent man rule.

Senator BENTSEN. I understand that for one stock, Morgan has 8 percent in this one particular company, Chemical Bank has 9 percent in it, the Bank of New York has almost 10 percent. That is just listing three. It seems to me that is quite a commitment of total assets in one company of some very, very major institutions in this country.

Mr. FORD. Senator, I share your concern. However, I think there is one redeeming factor, if you will, and that is that the assets currently under management are becoming considerably more diversified in terms of investment managers employed. In other words, there are more professional managers managing portions of employee benefit funds, and I think Mr. Lane also alluded to this—I know in our own case that this shifting of funds is going on all the time. From an investment point of view, I thoroughly believe that all investors don't look at a particular situation in the same light. I think the interpretations are somewhat different.

You have alluded to IBM and the current litigation. From our standpoint to the best of my knowledge we did not sell any IBM. We have a rather positive approach toward the company, if you will.

Senator BENTSEN. What were your actions in the first week following the decision of the courts in the *IBM-Telex* case?

Did you buy or sell or hold?

Mr. FORD. In the case of IBM?

Senator BENTSEN. Yes.

Mr. FORD. No, we did not sell in any quantity. As I mentioned before, we have 50 portfolio managers who are operating with a certain amount of independence, but to my knowledge there was no major sale of IBM stock. And I do have a great deal of faith in how investors, sophisticated investors, interpret situations, the outlook, fundamentals, et cetera.

Senator BENTSEN. Do you have some limitation in your own mind that you think would be prudent as to how much of your assets should be in one company no matter how good the reputation of that company was, of its management or what at the moment looks like its future—I can't help but remember, too, some of these vogues, what is in and what is now out?

Mr. FORD. Yes, sir.

Senator BENTSEN. I can't help but remember the early fifties in life insurance companies. I can't help but remember the so-called

"Go-Go" funds, where some of these young portfolio managers got their sideburns burned off. I can't help but remember some of these new issue stocks, where they doled out a few shares to you as almost a reward. But before the banks get too virtuous about this, I can't help but remember also that back in the fifties, supposedly mutual funds were so outperforming banks and today even though we don't have full information from the satisfied look on some of the bank portfolio managers, you can't help but think that they must be outperforming mutual funds.

Mr. FORD. We hope so.

Senator BENTSEN. Now, with a little more disclosure, we will know how smug they should look or not. But they have chosen to go into what has been popularly called the first-tier stocks and those, just like broad ties and narrow ties, these things may pass, too, and here again it is my concern as to letting that marketplace properly work, and I get disturbed about the ability of an institution, whether you agree or not, having some ability to have a self-fulfilling prophecy if it wants to. We are talking about a subjective judgment area, and it is very difficult to determine whether the portfolio manager is trying to protect himself or protect his beneficiary.

Mr. LANE. Mr. Chairman——

Senator BENTSEN. Senator Bennett.

Senator BENNETT. No, I have no questions. I am looking at the clock. We will have to move along.

Senator BENTSEN. Let me ask you, when you decide to sell a stock that is a very major holding, that is spread across a number of portfolios, how do you decide to allocate the number of shares sold among the portfolios?

Mr. FORD. Well, we have—we use the various market mechanisms available to us which you are familiar with—including the block houses to come extent. From the standpoint of controls if you will, in the employee benefit area which obviously represents the large bulk of our assets, sales are all allocated on an equity table basis. In other words, if an order is entered, the stocks are sold over—the stock in question, rather, is sold over a period of time depending on what mechanism has been available to us in the marketplace, and the prices are allocated equitably to the various portfolios involved on any given day. If the price ranges, let's say, between $35 and $40 a share, each participating trust will have an average sales in that area.

Senator BENTSEN. Would it be possible that you might be selling IBM out of one portfolio and not out of another because of differences in the investment objectives of the two portfolios?

Mr. FORD. Oh, yes, that is a very real possibility. This again alludes to the fact that I don't believe all investors react the same about any given situation.

Senator BENTSEN. Well, I certainly agree with that statement, but my concern is whether you have a consensus in your investment department or in your trust department and then apply it equally over all of the portfolios?

Mr. FORD. The instances of that are very rare, Senator, at least in my experience. For instance, IBM as a case in point—while we didn't sell any stock, I question whether we bought any because other than where new money is involved or, say, a new fund of some sort,

there would really be no reason, again getting back to the prudence question, no reason to add to our holdings.

Senator BENTSEN. Mr. Ford, under the limitations of time——

Mr. FORD. Could I make one point, Senator?

Senator BENTSEN. Yes.

Mr. FORD. I just wanted, if I could, to conclude on some of the very brief tax suggestions we have, as I believe your committee concerns itself with taxes.

I was referring earlier to the risk in common stock ownership, and one approach that could be taken to offset part of this high risk factor would be to allow small investors a full deduction against ordinary income for net capital losses. Our suggestion would be to increase the present allowable limit of $1,000 to perhaps something in the area of $5,000. In order to restrict this proposed change to small investors, a provision could be added limiting the increased deduction to individuals with gross income below some appropriate amount.

Another approach to encourage the small investor into the market would be to permit brokerage commissions, again within limits, to be deducted against ordinary income in the year incurred. Under current tax rules, as you are aware, brokerage commissions paid on the purchase or sale of investment securities are treated as capital adjustments rather than as current deductions against income.

Additionally, we endorse previous proposals to defer the capital gains tax on securities sales in cases where the entire proceeds are reinvested in other securities; and to reduce the amount of capital gains subject to tax on a graduated scale dependent upon the length of time a security is held. Consideration might also be given to a lifetime exemption of moderate amount for realized capital gains similar in nature to the lifetime gift tax exemption.

Senator BENTSEN. Thank you very much.

Mr. FORD. Thank you very much, Senator.

Senator BENTSEN. We appreciate your comments on that, and I am very pleased to hear about your 50 different portfolio managers. I hope they have an independent view.

Thank you very much.

We are going to submit additional questions, if you have no objections, to each of you, and we would appreciate very much having your responses in the record. Is that agreeable to you gentlemen?

Mr. LANE. Certainly.

Senator BENTSEN. Thank you very much.

[Mr. Ford's prepared statement follows:]

STATEMENT OF QUINTIN U. FORD, SENIOR VICE PRESIDENT, BANKERS TRUST COMPANY

Mr. Chairman, Members of the Committee: I am Quintin U. Ford, a Senior Vice President of Bankers Trust Company of New York in charge of its Investment Department.

As a representative of a major institution engaged in the management of trust assets for over 70 years, I welcome this opportunity to appear before this Committee as I feel strongly that the role of the institutional investor, particularly that of the fiduciary, has been misunderstood.

In presenting my testimony, I would first like to point out that the current discussion of the "two-tier" market and, most particularly, some of the suggested ideas to remedy the alleged situation completely overlook the fiduciary responsibilities of institutional investors. This oversight is most important when one

considers that the Bankers Trust Company, for example, acts as trustee for the benefit of several thousand private individuals and close to 4 million employees (active and retired) of company pension plans which we administer in whole or in part. The proper discharge of this fiduciary obligation can hardly be underestimated when it involves the financial security of millions of Americans.

With this in mind, I refer to the Prudent Man Rule which requires that a trustee ". . . shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." As you gentlemen are aware, the Prudent Man Rule has been reaffirmed by Congress in its proposed pension reform legislation.

Implicit in this definition is the responsibility of fiduciaries to administer trust monies in the best long term interests of their numerous beneficiaries. This obligation which is neither easily nor lightly discharged may at any given time result in fiduciary ownership of either of the so-called "tier" stocks. In this connection, it seems ironic that we and other responsible investing institutions are being unfairly singled out for having attained above average long term results for our trust beneficiaries, pensioners, and investment advisory customers.

Perhaps, if the Committee were made cognizant in some detail of how an experienced trustee responsible for some $20 billion of fiduciary assets goes about the business of fulfilling its fiduciary obligations, it would help to dispel certain notions that large investing institutions by design concentrate only in high multiple growth stocks.

Selection of common stocks for investment purposes at Bankers Trust Company has traditionally been based on a number of factors that are continually being studied by over 30 security analysts, actively following 800 different companies in 70 industries, with the assistance of a large economic staff and sophisticated computer models. Formulating our investment thinking is the current and, more importantly, the anticipated future state of the United States and world economies. Underlying long term economic and demographic trends are analyzed to determine how fast the over-all economy can be expected to grow in the next 3 to 5 years, and which broad segments are likely to advance the most rapidly. Within this framework, the faster growing industries are selected for further investigation. Companies within these industries, or those that produce products and/or services that are related to accelerated growth areas, and which have demonstrated ability to continually increase profits, on a basis consistent with fulfilling their social obligations, are then chosen as possible investment vehicles.

The selection process, however, does not end here. Detailed analysis of company balance sheets, profit and loss statements, the quality of management, recent or future changes in product lines, acquisition policies and a host of other internal factors are studied, as is the current purchase price of a stock—relative to expected future earning ability as well as its relevance to other securities—either within or outside its universe. Conclusive data is then discussed with portfolio managers who assess the particular client's goals to determine if the security under consideration can be effectively used to carry out the specific investment objectives of the portfolio.

Shorter time horizons than the 3 to 5 year outlook, typically 12 months out, are of necessity also considered in the investment process. The cyclical nature of the economy encourages us to be flexible during periods of changing growth patterns—resulting in the purchase of securities of companies typically more sensitive to an up trend in the economic cycle and a reversal of the process in anticipation of a slowdown in the economy's growth rate. During periods of economic uncertainty, companies that exhibit strong growth characteristics and which are also less vulnerable to the overall economic environment generally represent superior investment values. Very short term special situations, however, that periodically arise and affect only one company uniquely are generally not sought out as investment opportunities. We do not encourage the type of short term trading which results from this approach.

Once a security is selected for purchase it is not forgotten. Review of the fundamentals within the company, the industry, and the economy with an eye toward any changing developments that may dampen the outlook, is a continuing task. Should a change occur, we attempt to determine if the factors are temporary, in which case we would not modify our investment stance. If the factors represent a basic shift, we would embark upon an orderly sale of the stock. Thus, as long as the fundamental growth of a company remains relatively strong, we continue to

view its common stock favorably; only the expectation of basic deterioration in future earning power or price considerations of exorbitant proportions would cause us to turn negative.

While our Investment Research Division, which we currently budget at over $2 million a year, is the main source of investment ideas, Bankers Trust Company has placed growing emphasis on the role of 50 individual portfolio managers in the investment decision-making process. This replaces a procedure or committee system that promulgates an "approved list" of securities and accordingly tends to discourage concentration in that the day-to-day decisions on an individual trust are now made by accountable portfolio managers—within the framework of the Bank's overall policy—and often reflect the individual investment style of these managers.

The record shows that over any reasonable period of time common stocks on the basis of total return have produced better results than fixed income investments. Recognizing this, we began investing a substantial portion of our trust funds in equities in the early 1950's—a time when many trustees were continuing to concentrate their investments in fixed income securities. Since then we have held to this approach in investing in equity securities, and, at present, our trusts are invested approximately 75% to 85% in common stocks. This is not to say, however, that we are adverse to utilizing fixed income securities when they appear to provide a more attractive return than equities on a shorter term basis, or where they are particularly appropriate in meeting the stated objectives of a trust portfolio.

As long ago as 1967, for our employee benefit accounts we embarked upon the purchase of smaller capitalized companies having what we considered to be outstanding growth prospects in an effort to find, if you will, the "Xerox's" and "IBM's" of tomorrow. Ever mindful of our fiduciary obligations, we felt the most prudent approach to this quest was through the establishment of a pooled fund thereby diversifying the risk inherent in this type of security. As I mentioned in my letter to you of August 1 in response to the questions posed in the Finance Committee's press release of July 18, at the end of last year this fund, whose sole purpose is to invest in emerging companies that have yet to earn the distinction of any "tier" ranking, was valued at close to a billion dollars. This fund currently represents approximately 15% of the common stock commitment of our participating employee benefit trusts. (I have with me additional copies of our Supplemental Equity Fund report if the Committee should care to have them.) Additionally, I would like to call the Committee's attention to the fact that through two venture capital funds and a restricted securities fund we have provided "seed" money to some 65 embryonic business endeavors. The aggregate dollars we have committed primarily through these special purpose funds in the securities of over 300 companies of considerably less stature than those designated as "first tier," demonstrates, I believe, in a very positive and dramatic awy that we are, within the parameters of prudence, contributing our share of financing to the small and intermediate and less seasoned company. Additionally, as a corporation we and a number of other banks participate in small business investment corporations which provide to new ventures equity financing which may otherwise not be available.

While it is currently in vogue to allude to companies with the best earnings history and the most predictable prospects as "top tier" stocks, by way of investment rationale at least, it seems logical that they should be accorded above average price/earnings ratios. The price/earnings ratio that investors are willing to put on these stocks is high only as it relates to the ratios of that much larger group of stocks lacking these characteristics. These high price/earnings ratios are reflective of increased investor recognition and awareness of those relatively few companies having greater abilities to control their destiny and cope with the inflationary environment. Perhaps other investors are saying, as are we, with a portion of our funds, that these stocks in the current environment of a controlled economy represent the best investment.

However, history shows that investment styles go through periodic changes. For example, in the early 1960's many cyclical industries such as automobile, tire and rubber, airlines, and oils out-performed the averages and many of the "glamour", or today's "first tier", stocks under-performed the same averages. Later in the decade the stocks of conglomerate and congeneric companies were favored by many investors. These in turn were then replaced by equities of small sized "concept" companies which helped to fuel the "Go-Go" funds.

Whether the goal is long term growth, security of income, or preservation of capital, the approach that was effective yesterday may be the wrong one tomorrow. The accelerated pace at which the world is changing makes the investment process more complex and calls for constant reappraisal of investment decisions. Governments, for example, are continuously expanding their economic role. Technological process is introducing rapid changes in our way of living and doing things. Political and social movements are upsetting old values and establishing new priorities.

In sharing with you some of the thinking that results in our present investment mix, I hope I have been able to demonstrate our complete objectivity in the discharge of our investment function. The obligation of a fiduciary is to produce the best possible investment rewards for his beneficiaries consistent with the investment risks assumed. If our response to this obligation results in a type of common stock investment which over the longer term consistently produces the rewards desired, it is not a matter of "follow the leader" or a self-fulfilling prophecy of supporting the market. Rather, it is the action of independent trustees attempting, to the best of their ability, to discharge their fiduciary obligations.

In our particular case, as a result of a flexible investment approach, our portfolios are far from static. This is evidenced by the fact that of our 50 largest common stock holdings, only 16 were in common for the years ending 1963 and 1972, respectively. In other words, 70% of the names appearing as our top 50 at the end of 1963 were replaced with other names over the decade. In addition, over this 10-year period (1963–1972) there have been a total of 124 different companies which have appeared among our 50 largest common stock holdings.

It is our view that the alleged "two-tier" market is not sinister and will be self-correcting as investment opportunities change. It is the obligation of a fiduciary to be aware of these changes, and I predict that the 50 largest common stock holdings of Bankers Trust Company 10 years hence will show as significant a change as has occurred over the past 10. The economic world is constantly changing, and we expect to change with it. Unless we do, we will fail our trust beneficiaries.

As one of the major trust institutions of long experience, we are acutely aware of our fiduciary responsibilities and, accordingly, we must take an extremely jaundiced view of suggestions that could impair the proper functioning of a trustee's activities. Prescriptions to remedy the "two-tier" market that involve mandatory trust investments and limitations on a trustee's investment flexibility can only impair the discharge of these duties in a most harmful manner. This is not an idle fear but stems directly from our experience with the inferior investment performance which results when testators under wills have sought to limit our investment flexibility. For example, in 1950, we had two common trust funds; one for trusts where there were no investment restrictions, and the other for trusts which were restricted to New York State legal investments. The legal fund between 1950 and 1972 increased in value only 69% while the discretionary fund during the same period appreciated over 290%. The gain in income for the legal fund was only 63% compared with over 100% for the discretionary fund.

As another example of the consequences of restricting the flexibility of a trustee, in 1939 we received a $492,000 trust which was restricted solely to bonds. A recent valuation indicates a decline to $490,000. A fully discretionary trust over the same period produced a gain in value of over 400%, which was a rather representative investment result for this period during which the purchasing power of the dollar declined 67%.

My message gentlemen, is simple: We are ever mindful of our fiduciary responsibilities and we believe we have the ability to adjust to the ever-changing investment environment. Beyond the present restrictions of the Prudent Man Rule, we seriously question the wisdom and necessity of legislation which would limit the flexibility of trustees and probably affect adversely the financial security of millions of Americans. We do, however, strongly endorse the provision contained in the proposed pension reform legislation which would require that all managers of pension funds be held accountable for the proper discharge of their fiduciary responsibilities under the Prudent Man Rule. This is definitely a positive step in the right direction for the protection of those American employees covered by pension plans.

Before concluding, Mr. Chairman, I would like to respond to the four questions contained in your letter to me of August 7, which are:

1. Would disclosure requirements for the holdings and transactions of all institutions increase the confidence of small investors in our securities markets as well as provide a greater source of information to the Congress?

Although Bankers Trust Company voluntarily discloses its 50 largest common stock holdings, as do a number of other large bank trust departments, we fail to see how such disclosure has increased in the past, or would increase in the future, the confidence of small investors in the securities markets. Relevant to this point, in May of this year, in an address to the Iowa Trust Association, Dean E. Miller, Deputy Comptroller of the Currency for Trusts, stated in part:

> ". . . I think it should be recognized that the only way we are going to get this man of modest means into the stock market is through the device of the no-load mutual fund—that and indirectly through his pension fund.
>
> "Our governmental concern should be toward the effectuation of a system which permits as many as possible choices of such funds to him, including some administered by banks. He is not going to invest directly in the stock market more if he knows that there is a massive bin somewhere in this country containing detailed minutia of the investments and transactions of everybody who has more money than he.
>
> "To be more specific, increased disclosure of bank trust department holdings is going to be of no benefit at all to him. Neither will the implementation of a few more government agencies and a few additional cost burdens upon banks. They will only redound to his detriment."

Unlike a mutual fund, a large bank trust department administers several thousand diverse accounts with multiple investment objectives. Accordingly, the aggregating of securities or transactions of thousands of these diverse accounts to comply with disclosure requirements can be meaningless and misleading for those it is intended to aid.

2. Would limits on the amount of stock that an institution could own in a single company (with a grandfather clause) tend to force large institutions to diversify their holdings and focus a greater amount of their investments in promising companies in the second tier?

Bankers Trust Company already conducts a great deal of research in seeking out promising companies in the "second tier" and, when identified invests in them. Unfortunately, there is no cornucopia of promising "second tier" companies which stand the test of our research, and we question whether any fiduciary is going to risk investment of the major portion of its trust monies in the common stocks of unacceptable "second tier" companies. Limits on the amount of stock that an institution could own in a single company would not automatically divert money to "second tier" companies. Given the alternative of investing in unacceptable "second tier" companies or fixed income securities, the money would go into the latter type of investment. In fact, there is an inherent defect in arbitrarily limiting the amount of stock an institution can own in a single company. By definition it would be self-defeating since such a limitation would also place a ceiling on the amount of money which could be invested in promising "second tier" companies meeting fiduciary investment criteria.

3. Have sharp declines in the prices of such stocks as Clorox and Tropicana been substantially the result of large institutional sales and have these declines further eroded the confidence of small investors in our securities markets?

The stock market is an auction market and, historically, has always been subject to significant percentage gains and losses in total and in individual stocks. Imbalances between supply and demand of stock can cause sharp price fluctuations particularly when developments concerning a company are favorably or unfavorably interpreted. Also, a generally weak stock market will cause similar gyrations as occurred in 1962, a time when according to statistics presented to this Committee institutions were not alleged to have "dominated" the stock market. Nevertheless, many quality stocks declined 50%. It would seem axiomatic that market declines erode the confidence of small investors in securities markets generally.

We have no information on whether sharp declines in the prices of certain stocks were substantially the result of large institutional sales. However, differing investment opinions among institutions can have only a salutary effect on the market as in the case of Tropicana where Bankers Trust Company was a net buyer during the market decline earlier this year.

4. Are there any equitable tax incentives that Congress could enact to encourage small investors to enter the market?

The small individual investor is confronted with various alternative investment opportunities which compete for his commitment. Among these are savings accounts, bonds, and common stocks. There is normally a higher degree of risk in a common stock investment than is the case with the two other examples men-

tioned. The risk of loss, therefore, is undoubtedly a real deterrent to attracting the small investor back to the stock market.

We think one approach that could be taken to offset part of this higher risk factor would be to allow small investors a full deduction, within limits, against ordinary income for net capital losses incurred during the year. Our suggestion would be to increase the present allowable limit of $1,000 to, perhaps $5,000. In order to restrict this proposed change to small investors, a provision could be added limiting the increased deduction to individuals with gross income below some appropriate amount.

Another approach to encourage the small investor into the market would be to permit brokerage commissions, again within limits, to be deducted against ordinary income in the year incurred. Under current tax rules, as you are aware, brokerage commissions paid on the purchase or sale of investment securities are treated as capital adjustments rather than as current deductions against income.

Additionally, we endorse previous proposals to defer the capital gains tax on securities sales in cases where the entire proceeds are reinvested in other securities; and to reduce the amount of capital gains subject to tax on a graduated scale dependent upon the length of time a security is held. Consideration might also be given to a life-time exemption of moderate amount for realized capital gains similar in nature to the life-time gift tax exemption.

Thank you, Mr. Chairman and the Committee for the opportunity to present our views on the role of institutional investors in the stock market.

Senator BENTSEN. Let's now hear from Mr. Malone, vice president of trust operations, General Electric Co.

Mr. Malone, I apologize. Rather than holding you over, why don't you summarize your testimony and we will take all your testimony in the record, and then we will submit questions to you for your answers, if you will.

STATEMENT OF EDWARD H. MALONE, VICE PRESIDENT, TRUST OPERATIONS, GENERAL ELECTRIC CO.

Mr. MALONE. Very fine, sir.

My name is Edward H. Malone. I am vice president, trust operations of the General Electric Co. I should immediately note, however, that the opinions in this statement largely represent my personal views as an aging practitioner in the investment management business, and are not necessarily the views and opinions of the General Electric Co., or the trustees of our pension fund.

General Electric, as you know, unlike most American corporations, manages the assets of its pension trust internally with five trustees assisted by a staff of investment professionals, all of whom are employees of the company. Our pension trust is one of the largest in American industry, in keeping with the company's position as one of the largest employers in the country. Our trust, like most pension funds, has committed a substantial portion of its assets to equity-type securities. Common stocks and convertible securities owned aggregate just short of $2 billion, equivalent to 71 percent of total investments of the trust.

I have read with interest the testimony and staff briefings presented to this committee during their July hearings. I particularly share the obvious concerns, expressed repeatedly during your hearings, about the continuing ability of our system to provide and allocate the ever-increasing capital investment needs of our society. And it is the alleged failure of, or threats to, our capital-raising mechanisms that would appear most fundamental to the inquiries of this committee.

I would like to suggest that the two-tier market and institutional concentrations are but symptoms of the far more fundamental weak-

enings of our economic and investment infrastructure. This committee's hearings represent a needed inquiry into our securities markets and its participants, but I would be concerned that well-intentioned efforts to increase public participation in the marketplace or to place restrictions on institutional trading or ownership could well result in even more serious dislocations in other sectors of the economy, while simultaneously failing to remedy the far more basic structural defects of our system. We must seek out ways to encourage incremental savings and capital formation. We should remain most cautious in tinkering piecemeal with the free market mechanisms that have historically served so well in providing Americans with a quantity and quality of life unequaled in the world.

Individual participation: As you have already so aptly described the situation, Mr. Chairman, "individuals contribute the great variety of opinions and judgments that make a free marketplace" and give our markets "vitality and * * * ready reservoirs of capital." There is little doubt that individual participation in our stock markets has been declining in a relative sense over a long period of years. On the other hand, I sense in much of the testimony to your committee an overemphasis on the relative shift in ownership and trading proportions, with too little attention given the fact that in absolute terms, public participation in and ownership of American industry has expanded at remarkable rates over the past two decades. To be specific, the number of individual shareowners of public corporations has increased almost five-fold over the past two decades.

Since 1968, the public has reduced its investment in equities and has diverted three-fourths of its incremental savings to bank and thrift accounts where it has the satisfaction and assurance of protecting its principal, while obtaining a competitive return on capital accumulations.

I am fully convinced this same keen sense of value relationships will undoubtedly again prevail as the public's confidence in our system is revived and the investor foresees the opportunity for relatively more attractive returns from stocks than from the other competitive alternatives for savings.

Tax constraints: Encouragement of broad public participation in our securities markets certainly remains a highly desirable objective and some of the means for achieving this which have been suggested during your hearing would appear constructive; indeed in at least two areas, they appear long overdue from the standpoint of equity to the individual investor. I believe some form of sliding scale, capital gains tax amendment would materially improve the liquidity aspects of the stock market and simultaneously, is likely to result in some narrowing of the substantial dichotomy of valuations that have existed within our equity markets.

The $1,000 annual limitation on the deductibility of capital losses against income would also seem worthy of modification. Since 1942, the per capital dollar aggregates of our national product and personal income have increased more than sixfold, but the $1,000 limitation on losses remains constant. Certainly, a move to liberalize this aspect of our tax laws would encourage risk assumption and provide much needed capital flows to our Nation's emerging industries and companies.

I would also hope that the forthcoming tax reform hearings would broaden in scope, beyond the so-called loophole closings, to include detailed consideration of ways to encourage private and corporate savings and capital formation. One of the Nation's greatest challenges in the years ahead relates to the fact that prospective demands for capital will considerably exceed presently visible flows of individual and corporate savings. We are, in fact, already beginning to suffer from the shortfalls in capital investment over the past decade. Our failure to match investment growth with the substantial growth in employment has already severely restricted productivity improvements and thereby intensified cost pressures in our highly inflationary environment. Even an early redress of our capital formation and investment shortfalls will be unlikely to forestall a series of capacity shortages and supply crises in many of our basic industrial commodities, where returns on investment have too long remained below levels necessary to justify and attract incremental investment.

To sum up on this matter of tax constraints, we should certainly encourage any modifications which would ameliorate existing inequities and of equal importance, which would tend to improve efficiencies in the allocation of capital investments by removing tax-induced or constrained impediments to otherwise sound investment decisions. At the same time, such modifications should ideally seek to foster increased savings, rather than simply a reallocation of existing savings, which might do considerable harm to other capital markets and users.

So much has already been said about the two-tier market and institutional concentrations that I hate to belabor the issue, but you might be interested in the concentrations that prevail in our own pension trust. Our 20 largest stock positions account for 44.1 percent of the market value of our total equity holdings. Those same 20 holdings, however, account for 20.6 percent of the cost value of our equity portfolio. Even more significant is the fact that when we single out the 10 holdings in this group of 20 largest that typically are referred to as "religious growth" stocks, the cost market comparisons are more revealing. At market value these 10 issues account for 28 percent of our equity portfolio, but on the basis of portfolio cost, they represent but 7.2 percent of the total.

Obviously, these 10 highly successful American companies account for a significant share of our equity investment success over the years and this is true of most institutional and, I suspect, individual portfolios as well. Extraordinary concentration, then, is the inevitable result of the business success of a few companies, not of a deliberate diversion of funds from investment alternatives.

While our pension trust's concentrations are substantial, it is important to recognize that there is considerable breadth in the balance of our portfolio. In all, we hold positions in the equity securities of 176 companies. This total incidentally represents a material expansion of our list in the past 5 or 6 years, prior to which, as a matter of portfolio policy, we limited the number of names to 100.

We have invested in a limited number of venture capital-type companies and, also, occasionally, participate in the new-issue market. Our aggregate dollar commitments in such areas, however, are necessarily limited by the nature and obligations we have with respect to the funds entrusted to us, and by a strong dedication to those fiduciary responsibilities.

Senator BENTSEN. Mr. Malone, due to time limitations I would like to have the rest of your statement submitted for the record, and we will submit questions to you, and we would like to have your answers. I am interested in the fact that you spend a good deal of your time talking about your concern about ownership limitations and then, as you get on into your statement, that you say:

I doubt anyone's ability to be 100 percent sure, for all time, of any one company and to the extent therefore that an institution exceeds more than a fixed percentage ownership of a particular company's shares in its discretionary accounts, perhaps the 10 percent limit contained in the Investment Company Act, then in such circumstances the sale of, say, more than 10 percent of such holdings might properly require a registered offering.

That is an interesting comment.

Let me say on one of the previous statements that was made, and this was a statement made by Mr. Lane, "The National Bureau of Economic Research report concludes that in the aggregate corporations rely very little on the equity market as a source of funds," and then goes on to say, "Less than 1½ percent total corporate needs for funds or only 3 percent of their external sources was supplied by new issues of common stock. By contrast, sales of bonds for the same 5-year period exceed $55 billion."

Let me say I don't really believe that is representative at all, because what you are talking about there generally are very large corporations. I can't help but remember going to the equity market to raise equity, to sell stock for a company that I had formed, and I wouldn't have had any chance of selling long term bonds. But the investors went into what had to be a risk enterprise and I had the satisfaction of creating jobs, of bringing a competitive product to the marketplace, of having some financial rewards myself. But the small companies, the new companies, that is what I am concerned about. For them the equity market represents a very major source of money. For large corporations which generate enough cash income and can float bonds to expand, the equity market may not be as significant. However the equity market is of great significance to new companies that don't have the long history which would make it easier to sell bonds.

I don't believe that your figures are really representative. I still want to see the time in this country when we can have a new IBM get started, when we can have a new Xerox, when some young fellow who has the courage to get out and start a company, puts in the hours that are necessary, and when he succeeds, to be able to expand and build a corporation and not be faced with the problem that he is running into today, that when he has a chance to expand, he can't finance it, and he ends up with a merger or an acquisition or takeover. I think that is a sad commentary on the present situation. I hope it will correct itself.

Well, thank you very much.

[The prepared statement of Mr. Malone follows.]

STATEMENT OF EDWARD H. MALONE, VICE PRESIDENT—TRUST OPERATION, GENERAL ELECTRIC CO.

My name is Edward H. Malone and I am Vice President—Trust Operations of the General Electric Company. I should immediately note, however, that the opinions in this statement largely represent my personal views as an aging practitioner in the investment management business, and are not necessarily the views and opinions of the General Electric Company.

To further identify my role, I should add that General Electric, unlike most American corporations, has a Pension Trust managed internally by Trustees, assisted by a staff of investment professionals, all of whom are employees of the Company.

General Electric's Pension Trust is one of the largest in American industry, concomitant with the Company's position as one of the largest employers in the nation.

GENERAL ELECTRIC PENSION TRUST, SUMMARY OF INVESTMENT HOLDINGS, AUG. 31, 1973

	Market value (millions)	Percent total portfolio
Short term investments	$84	3.0
Government and coproration bonds	323	11.6
Mortgages	174	6.3
Real estate leasebacks	224	8.0
Total fixed income	805	28.9
Equity investments	1,980	71.1
Total investments	2,785	100.0

Our Trust, like most pension funds, has committed a substantial portion of its assets to equity-type securities. Common stocks and convertible securities owned aggregate just short of $2 billion, equivalent to 71% of total investments of the Trust.

We can return later to questions you might well have about the Trust's investment policies and practices, but for the moment I simply wanted to provide some perspective and dimension to my interest in the deliberations of this Committee.

I have read with interest the testimony and staff briefings presented to this Committee during their July hearings. My interest derives from convictions common to the members of this Committee, namely, a profound belief in, and dedication to, the American economic system. I particularly share the obvious concerns, expressed repeatedly during your hearings, about the continuing ability of our system to provide and allocate the ever-increasing capital investment needs of our society. Capital formation and investment is the lifeblood of our economic and social objectives and expectations. And it is the alleged failure of, or threats to, our capital-raising mechanisms that would appear most fundamental to the inquiries of this Committee.

Regrettably, much of the testimony before this Committee, as well as the relevant business magazine articles preceding your hearings, have tended in typical American breast-beating fashion, to single out one aspect of the capital resource problem (the two-tier market and institutional concentrations) as a convenient scapegoat. On the contrary, I would like to suggest that the two-tier market and institutional concentrations are but symptoms of the far more fundamental weakenings of our economic and investment infrastructure. This Committee's hearings represent a needed inquiry into our securities markets and its participants. but I would be concerned that well-intentioned efforts to increase public participation in the marketplace or to place restrictions on institutional trading or ownership could well result in even more serious dislocations in other sectors of the economy, while at the same time failing to remedy the far more basic structural defects of our system. Rather, we must seek out ways to encourage incremental savings and capital formation. At the same time, with capital requirements, or at least expectations, considerably in excess of our resources, we must be increasingly conscious of national strategies and priorities in the allocation of that capital through the public and private capital markets. In the meantime, we should remain most cautious in tinkering piecemeal with the free market mechanisms that have historically served so well in providing Americans with a quantity and quality of life unequalled in the world.

INDIVIDUAL PARTICIPATION

As you have already so aptly described the situation, Mr. Chairman, "individuals contribute the great variety of opinions and judgments that make a free market place" and give our markets "vitality and . . . ready reservoirs of capital." There is little doubt that individual participation in our stock markets has been declining in a relative sense over a long period of years. On the other

hand, I sense in earlier testimony to your Committee an overemphasis on the shift in ownership and trading proportions, with too little attention given the fact that in absolute terms, public participation in and ownership of American industry has expanded at remarkable rates over the past two decades. To be specific, the number of individual shareowners of public corporations has increased almost five-fold over the past twenty years. Even in the past decade alone, shareownership has increased at about a 6% compounded annual rate, while the volume of trading by the public has increased at better than a 10% annual rate. These statistics would suggest that the public's longer range interest in owning a piece of America remains intact, albeit temporarily discouraged by the relatively unfavorable climate for investment success in recent years. Various public opinion surveys clearly show that public attitudes towards, and confidence in, virtually all of our public and private institutions have declined to record lows. Equity frauds, accounting gimmickery and confusion, Watergate, inflation and all the other promoters of uncertainty have hardly provided a compelling environment for equity investment.

As Stock Exchange surveys suggest, the individual investor does have some concerns about the increasing institutionalization of our equity markets, just as I would be concerned about my chances of success in a tennis match against Billy Jean King or even Bobby Riggs. But, if the apparent professional edge of an institution, in the quest for reasonable stock market returns, is presumed to be a major impediment to individual investor interest, I would necessarily ask: why then has the public deserted the mutual fund industry and the institutional professionalism that it proffers? The statistical record seems clear; since 1968 the public has reduced its investment in equities and has diverted three-fourths of its incremental savings to bank and thrift accounts where it has the satisfaction and assurance of protecting its principal, while obtaining a competitive return on capital accumulations.

In retrospect, our individual investor has perhaps been more discerning and responsive to relative investment values and risks than many of our professional investors. This same keen sense of value relationships will undoubtedly again prevail as the public's confidence in our system is revived and the investor foresees the opportunity for relatively more attractive returns from stocks than from the other competitive alternatives for savings.

TAX CONSTRAINTS

Encouragement of broad public participation in our securities markets certainly remains a highly-desirable objective and some of the means for achieving this which have been suggested during your hearings would appear constructive; indeed in at least two areas, they appear long overdue from the standpoint of equity to the individual investor. Some form of sliding scale, capital gains tax amendment should materially improve the liquidity aspects of the stock market and at the same time is likely to result in some narrowing of the substantial dichotomy of valuations that have existed within our equity markets. Moreover, such a graduated tax scale is unlikely to materially impact tax revenues; in fact, in the initial years at least, the Treasury could well reap considerable incremental tax revenues.

The $1,000 annual limitation on the deductibility of capital losses would also seem worthy of modification. Since 1942, the per-capita dollar aggregates of our national product and personal income have increased more than sixfold, but the $1,000 limitation on losses remains constant. However, merely adjusting the $1,000 figure for the effects of inflation is not an adequate response to the problem. I am obviously not a tax expert, but as a taxpayer, and individual investor, I fail to understand why capital losses are not accorded the same treatment as capital gains. Certainly, a move to liberalize this aspect of our tax laws would encourage risk-assumption and provide much needed capital flows to our nation's emerging industries and companies.

Beyond these specific suggestions for a more equitable tax treatment for individual investors, I would hope that the forthcoming tax reform hearings would broaden in scope, beyond the so-called "loop hole closings," to include detailed consideration of ways to encourage private and corporate savings and capital formation. One of our nation's greatest challenges in the years ahead relates the fact that prospective demands for capital will considerably exceed presently visible flows of individual and corporate savings. We are, in fact, already beginning to suffer from the shortfalls in capital investment over the past decade. Our failure to match investment growth with the substantial growth in employment has already

severely restricted productivity improvements and thereby intensified cost pressures in our highly inflationary environment. Even an early redress of our capital formation and investment shortfalls will be unlikely to forestall a series of capacity shortages and supply crises in many of our basic industrial commodities, where returns on investment have too long remained below levels necessary to justify and attract incremental investment.

To sum up on the matter of tax constraints, we should certainly encourage any modifications which would ameliorate existing inequities and of equal importance, which would tend to improve efficiences in the allocation of capital investments by removing tax-induced or constrained impediments to otherwise sound investment decisions. At the same time, such modifications should ideally seek to foster increased savings, rather than simply a reallocation of existing savings which might do considerable harm to other capital markets and users. I would note, for example, the importance of our thrift intermediaries in the financing and achievement of our national housing goals. A return of the individual investor to the securities markets would be partially at the expense of our thrift institutions and ultimately, therefore, to the detriment of our residential mortgage markets.

INSTITUTIONAL CONCENTRATIONS AND THE TWO-TIER MARKET

Possibly too much has already been said and written about the two-tier market and institutional concentrations in 30 or 50 growth stocks, but with your indulgence, I would like to add a few thoughts to this much-maligned subject.

At the outset, I must admit to dismay and disbelief over the amount of abuse which has been thrust upon the leading practitioners of growth stock investing. There has always been a "herd instinct" among investors—indeed, this in a sense is a fundamental premise of the Massachusetts' prudent man rule—but implied suggestions of collusion or buying pools are so wide of the mark on the basis of my observations, that I don't believe they are worthy of further comment. Instead, I would simply refer to several studies of bank-trust departments that have been made which show a considerable degree of diversity and breadth to their respective investment holdings.

Much is made of Morgan Guaranty's substantial holdings of such issues as IBM, Kodak and Avon, but in each case such holdings are not that disproportionate to the relative aggregate market value weighting of those issues in the total stock market universe, particularly when it is recognized that through appreciation, the most successful stocks will always become an increasingly larger proportion of a typical institutional portfolio.

In that connection, you may be interested in the concentrations which prevail within our own Company's Pension Trust. Our twenty largest stock positions account for 44.1% of the market value of our total equity holdings, a figure which approximates Morgan's reported concentrations, but the main point I wish to make is that those same twenty holdings account for only 20.6% of the cost value of our equity portfolio. Furthermore, when we single out the ten holdings in this group that are typically referred to as religious growth stocks, the cost-market comparisons are even more revealing. At market value, these ten issues account for 28.1% of our equity portfolio, but on the basis of portfolio costs, they represent but 7.2% of the total. Obviously, these ten highly successful American companies account for a significant share of our equity investment success over the years and this is true of most institutional and I suspect individual portfolios as well. Extraordinary concentration, then is the inevitable result of the business success of a few companies, not of a deliberate diversion of funds from investment alternatives.

I believe our experience is representative of other institutional investors and I can only be proud of the fact that we were fortunate to recognize the growth qualities of such companies at a reasonably early stage in our investment process and that we have not been tempted too frequently to liquidate such holdings even though they periodically appear overpriced relative to alternative equity opportunities.

While our Pension Trust's concentrations are substantial, it is important to recognize that there is considerable breadth in the balance of our portfolio. In all, we hold positions in the equity securities of 176 companies. This total incidentally represents a material expansion of our list in the past five or six years, prior to which, as a matter of portfolio policy, we limited the number of names to 100.

We have invested in a limited number of venture capital-type companies and, also, occasionally, participate in the new-issue market. Our aggregate dollar commitments in such areas, however, are necessarily limited by the nature and obligations we have with respect to the funds entrusted to us, and by a strong dedication to those fiduciary responsibilities. The extent of our interest in smaller entities is also naturally constrained by the size of our portfolio assets and by a dilution of investment management attention which any significant expansion of our individual equity list might entail.

In this latter connection, I think it is appropriate to note that any considered limitation upon the asset size of institutional investment managers would tend to restrict the quality and depth of the investment organization's management strength, thereby further limiting the availability of such institutions to effectively and prudently consider equity investments in many small and medium-sized companies. Few bank-trust companies make much money in their trust operations, according to the Federal Reserve, but at least the size and quality of their existing research and portfolio management staffs has enabled them to be an important source of equity capital for hundreds of our smaller, emerging companies.

Overall, I think the leading bank-trust companies are to be congratulated rather than criticized for their past investment actions, including the investment concentrations that have been a product of those successes.

RESTRICTION ON INSTITUTIONAL TRADING AND OWNERSHIP

Your Committee has heard a number of recommendations aimed at restricting institutional activity in the equity markets. It has even been suggested that a limit should be placed upon the degree of price movement permitted any given stock in one trading session.

Each of these suggestions appears not to have been subjected to the tests of alternative impact and, in general, represent a frightening response to the problems to which this Committee has addressed itself. Most would be counterproductive at best and, at worst, could ultimately, seriously jeopardize the efficient functioning of the marketplace which is so vital to the creation and allocation of capital in our system. I believe this Committee already recognizes the risks of such trading limitation proposals and, therefore, will not belabor the point.

On the subject of limitations on the ownership of any company's shares by individual institutions, I must admit I find myself in an ambivalent position. On the one hand, interference with free market forces is an anathema, and yet I do find myself somewhat concerned about individual institutional ownership of as much as 10% or 15% of a company's outstanding shares. My concerns, I should add, do not stem from any fears of an American Zaibatsu. On the contrary, I hold considerable faith in the code of ethics and sense of social responsibility prevailing within the major institutional investment organizations. On the other hand, I find it easy to criticize the accumulation of such substantial ownership positions. Thus, while I share the enthusiasm for the one-decision mode of investment, I doubt anyone's ability to be 100% sure, for all time, on any one company. To the extent therefore that an institution exceeds more than a fixed percentage ownership of a particular company's shares in its discretionary accounts (perhaps the 10% limit contained in the Investment Company Act), then in such circumstances, the sale of say more than 10% of such holdings might properly require a registered offering. In this way, the public and other institutional investors would be adequately exposed to and updated on the particular companies operating results and financial position, as well as be put on notice of the intentions of the selling institutions.

With the exception of that kind of requirement on disposition, I would not be in favor of any percentage ownership restrictions, since this would likely do more harm than good to the smaller companies seeking the interest of major investment institutions. Clearly, percentage ownership limitations would not serve to broaden institutional equity lists as some of its proponents imply.

As one final note on this subject, I might mention that our Pension Trustees established many years ago some self-imposed restrictions on size of holdings, in terms of percentage ownership as well as in terms of portfolio proportions. In recent years, the percentage ownership limitation has been set at 5% of outstanding shares for companies whose shares outstanding have an aggregate market value of over $100 million and 10% of outstanding shares for companies with less than $100 million of equity at market. As a practical matter, in only a small proportion of instances do we own more than 2% of the outstanding shares of companies in our Trust portfolio.

DISCLOSURE

In brief, I would share the Committee's views that periodic disclosure of institutional holdings and transactions is appropriate. I have not had a chance as yet to read Sen. Williams' bill (S. 2234) but I would hope that the reporting requirements were kept to reasonable and practical proportions. I would also hope that such legislation will, by its terms, preempt the field to avoid the possibility of duplicate filings being required at state levels. Xerox is a great growth company because of Americans' uncanny propensity to make untold duplicates of data of frequently dubious value.

FOREIGN TAKEOVERS

Some testimony before this Committee has expressed concern about the acquisition of American companies by foreign interests, particularly so, as many American corporations are selling at "depressed" prices. I do not share such concerns and one need only look at the economic and investment aggregates of the United States and the rest of the Free World to realize that potential acquisitions by foreigners are effectively limited to reasonable proportions. Despite a doubling over the past decade, the value of foreign direct investment in the U.S. is only $15 billion today, while the value of U.S. investments abroad is over $100 billion. In any event, we should welcome the infusion of foreign capital, both as a palliative to our capital deficiencies and as a means of cutting into that $100 billion of Eurodollars that has been a source of considerable distress in our international monetary relationships. The U.S. has been a major source of capital investment for other nations of the world for decades and with our long range balance of payments position likely to remain troublesome, we should indeed be encouraging foreign investment in our securities markets and have no right or reason to fear foreign acquisitions of entire companies.

CONCLUSIONS

I have certainly appreciated the opportunity to express my views before this Committee and I would conclude with a few overall observations.

It is obvious that the substantial growth of institutional investors is impacting in various ways the traditional security market mechanisms that are integral to our capital system. The inquiries of this Committee and other legislative and regulatory groups are, therefore, very much in the public interest. It is regretably however, that these hearings coincide with what hopefully might prove the nadir of what may be the most protracted bear market in American History, albeit disguised in the popular market averages by the exceptionally fine earning and price performance of several dozen of America's great companies. Most investors and businessmen have not fared at all well in these past five or six years, with their stock portfolios or options, or with their long range business and financing plans. Nor is the recent past a period of solace to our securities market makers. The brokerage and investment banking community is suffering with its own private recession in the midst of a booming general economic environment. Overall, therefore, the participants in the marketplace are at least, emotionally-charged in their perspective and, at worst, inclined to reach out for laws, regulations or controls which might appear rational in the heat of the moment, but when viewed in the proper longer term perspective, are likely to prove detrimental to the common good. I frankly find the pleas of many of your distinguished witnesses from the business world and Wall Street to be a close parallel to similar cries of businessmen in the very recent past for economic controls. I suspect that the vast majority of those proponents of wage and price controls now view these programs as ineffective, if not a disaster. I would anticipate that this Committee and your legislative colleagues will not over-react to problems and aberrations of the moment, but rather will permit natural market forces to be reasserted.

Again, my sincere thanks for your kind attention and interest.

Senator BENTSEN. This will close the hearings for today. The hearings will be resumed at 10 a.m. on Thursday.

[Whereupon, the subcommittee was adjourned at 12 noon, to reconvene at 10 a.m., Thursday, September 27, 1973.]

FINANCIAL MARKETS

THURSDAY, SEPTEMBER 27, 1973

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:05 a.m., in room 2228, Dirksen Senate Office Building, Senator Lloyd Bentsen [chairman of the subcommittee] presiding.

Present: Senator Bentsen.

Senator BENTSEN. The committee will come to order.

At our last meeting on Tuesday, Mr. James Lane, of the Chase Manhattan Bank, testified that the importance of the security markets as a means of raising capital is badly overstated. He cited figures indicating that between 1965 and 1969 new issues of common stock accounted for only 1½ percent of total new corporate funds.

I said at that time that my feeling was that these figures were misleading, that major companies are able to fund a lot of their growth out of cash flow, that major companies have the financial history and stability that lets them sell bonds so that they do not necessarily have to go to the stock market for capital.

However, when you have a small, new company which is just starting or a middle-sized company that has not been in existence too long, they do not have that kind of history which allows them to go out and sell bonds. I have had personal experience in that and I have seen a lot of my business management associates over the years who have had that same kind of problem and they have had to go to the equity market to raise money. New companies and smaller companies may represent a small percentage of the total capital structure in the capital market, but I think they represent a very important part because these companies are the ones that finally some day grow into Xeroxes and IBM's and Polaroids and I do not think we should ever have the day when they do not have the chance to do this.

I can remember a few years ago when everyone was forming a venture capital deal, and I can recall the great numbers that came from Boston and New York to Texas with their funds and had them available and they wanted 10 percent of the deal, 20 percent of the deal, or 30 percent of the deal. But one of the things they always had in mind was that some day they could sell, that they could go to the stock market, they could have their new issue and they could move on to the next deal, that they could turn their capital over, here was their pay-off.

But who do they sell to today? That is the problem they are facing. Today we still have some venture capital outfits around but they want 40 percent of the deal, 50 percent of the deal, or 70 percent of the deal

because they feel like they are locked in, they feel like they are entitled to that.

Now, I have had the staff check and I find that the figures that were used by Mr. Lane really are not representative. He used the figures 1965 to 1969.

During the more recent period between 1970 and 1972 common stock accounted for 16½ percent of the total funds raised from sources other than appreciation of present assets.

So I think the health of the securities market is extremely important for the modest size company, in particular, and new companies and if we want a growing healthy economy which accurately reflects the price of the goods we all buy then we must have a stock market which is also growing and healthy and which accurately reflects the value of the companies trading thereon.

I think that the layman can more easily understand the problem if you think of a game of Monopoly. If you have finally won all the property, who do you trade with, how do you determine values. If we are not careful we will get into that kind of a situation in this country.

Our witnesses this morning will be addressing themselves to the health of the market, and I would like Mr. Roger G. Kennedy, vice president of financial affairs of the Ford Foundation, to be our first witness.

Mr. Kennedy, would you take the witness stand and give us your statement?

Mr. KENNEDY. Thank you, Mr. Chairman.

Senator BENTSEN. Mr. Kennedy, we are very pleased to have you here this morning and look forward to hearing your comments.

STATEMENT OF ROGER G. KENNEDY, VICE PRESIDENT FOR FINANCIAL AFFAIRS, FORD FOUNDATION

Mr. KENNEDY. Thank you very much, Senator.

Could I just say at the beginning that I share intensely your anxieties about the relationship between the growth points in American society and the American economy, and the overall capital structure. There is a difference between a growth point obviously, and a long established firm and we are concerned with those growth points.

I would like to thank you for an opportunity to be here, and my name is Roger Kennedy, vice president for financial affairs of the Ford Foundation.

I don't formally represent the Ford Foundation here but I do hope to be suggesting some ideas of my own that stem from my own experience.

The first subject suggested by your staff for discussion is the "two-tier market" about which a good deal has been said. The upper tier of that market is a row of extremely uneven eminences now running across a very uneven terrain. It has not become elevated as some have said, above the lower tier, like the Rocky Mountains or by any gigantic or sudden volcanic upthrust of investor interest. Instead, the two tiers became distinct while some stocks maintained their values and most others eroded away around them, until quite recently.

Why has the topography of the market, then, come to look like southeastern Wisconsin, and it is landscaped? Why has the investor interest washed away from the great multitude of equity securities held in this country and exposed the granite in others?

The answers, I think, break into three groups: Economic, psychological, and structural. There is good cause at the moment, since this statement was written a week and a half or so ago, to think that the system is operating right now to bring investor capital back into the great mass of the companies and we all want to encourage that flow.

To do that we should look first at why investors are in the top tier. They put their money there because inflation has hurt the earnings of many companies, because antiinflationary remedies have hurt the earnings of others, but the top tier companies do seem to be able to keep on growing regardless of inflation.

Second, those big top tier companies, not all of them so terribly big, they have shown steady, predictable earnings in all weather and investors pay for stocks according to their estimates of the discounted cash flow of future earnings, and they want to be as sure as they can be about those future earnings.

Third, there isn't anything phony about the proclaimed virtues of these stocks. There are such things as real growth companies and analysts can find them when their records are good and their managements are good and their position in the economy is distinct.

Some of them are unique. Some of them dominate an industry, in many cases an industry they created and you mentioned two or three in your earlier statement. Some of these companies retain ingenious and inventive and hard-working managements. They seem likely to many investors to be able to hold on to the markets they created.

The question really is, I suppose, why aren't investors searching out new ones. Why aren't they finding out these growth points, why don't more stocks attract confidence. This brings me to a second group of reasons for the two-tier market, the psychological reasons.

The first one is memory. The last great speculative updraft around 1968 sucked a lot of people, a lot of small investors, into investing in companies they didn't know much about. Many people need only roll back their cuffs to find the scar tissue where they were burnt then. It will take a long time before they will reach out again.

Senator BENTSEN. Mr. Kennedy, I keep on my dresser a half bottle of shaving lotion that cost me about $25,000 in a new venture.

Mr. KENNEDY. Yes, sir.

Senator BENTSEN. But that does not mean they are all bad. There are some splendid ones and it is distinguishing the good ones from the bad ones that is hard for the small investor, especially if he is not getting good competent advice.

Mr. KENNEDY. Second, there is an inhibition that arises from fiduciary psychology. There has been talk here, right talk, that an individual investor, that trustees, unlike individual investors, and certainly unlike speculators, would prefer to invest in the known, the large the proven. Trustees will generally accept a little less return for a little less risk than a rich individual might. And trusteeship does increasingly affect the market.

Third, just a thought in mind I suggested in my written testimony, that there is an association of the predictability of earnings in some large companies and the predictability of returns from bonds. I do not want to over-emphasize this in my verbal testimony. It is perhaps an idiosyncratic view but I suggest it to you because I think it is right.

Finally, there are some structural reasons. One of them, to be very direct about it, is that on a cost/benefit basis a dollar spent on the anal-

ysis of a big company is likely to be just about as much, it costs you just about as much to analyze some companies as some complicated little company, and a prudent fiduciary who knows every dollar he spends for analysis is a dollar out of the hide of the old age pension or the charity; or which he is responsible is going to get as much use out of a dollar of analysis in investment dollars as he can. That is a structural reason.

It is true that the top tier companies are often so thoroughly researched by "the Street", Wall Street or other streets like State Street, that virtually no research effort is required to make an investment decision.

We use more than 50 research houses, 40 or 50 of them outside of the city of New York, and there is an awful lot of research available on many stocks.

Senator BENTSEN. Let me ask you this, if I may interrupt since I do not have any of the other members here yet——

Mr. KENNEDY. Yes, sir.

Senator BENTSEN [continuing]. I read an interesting article the other day on illiquidity of research

Mr. KENNEDY. Yes, sir.

Senator BENTSEN. Did you read that one? The question there was that there was, you say there is, a great amount of research available, and I know that.

Mr. KENNEDY. Yes, sir.

Senator BENSTEN. But that there was more and more focusing on just a very few research firms.

Mr. KENNEDY. Yes.

Senator BENTSEN Who have built a reputation.

Mr. KENNEDY. Yes.

Senator BENTSEN. And the argument of the author of this particular article was that there was illiquidity in research.

Mr. KENNEDY. In the sense that there are fewer and fewer——

Senator BENTSEN. Yes; that is right.

Mr. KENNEDY [continuing]. Large companies in which research people have a great deal of confidence? Is that the point that the article made?

Senator BENTSEN. This was the research firms.

Mr. KENNEDY. Yes, sir.

Senator BENTSEN. And, therefore, that ax the institutions focused more and more in on these particular firms, they are all getting the same feedback on a very few stocks. That was the rationale of the argument.

Mr. KENNEDY. It is true that if after you found you had gotten some bad advice or bad research you would tend not to return to the same source of information. It is true some people are better at research than others, more consistently thorough, competent, skillful—that is as true in research as it is in any other field. You will tend to return more often, when you really want a thorough job of inquiry made, to a place that does it well. I believe, sir, that it is almost as natural there as it is in any other field.

Back to my written statement—or another point about the reluctance of some institutional investors to invest in some smaller or less well-known companies. Second, I want to make a particular point

about the fear of jeopardy that afflicts, and must, concern many fiduciaries.

Included in the rules set out by the Tax Reform Act of 1969 for private foundations are provisions which expose officers and trustees to personal tax liability for the making of investments found to be sufficiently risky to jeopardize a foundation's charitable purpose. Naturally, this counsel of caution, and there are many counselors of caution, diminished the readiness of such officers and trustees to reach out beyond successful, solid, well-researched, thoroughly researched companies toward those which were newer, attractive, but less completely tried.

The regulation of one fiduciary has become caution to another, thus the law applied to philanthropy in 1969 has produced, I think, a genuinely chilling effect on imaginative, out-reaching money management, and not just for those directly affected by the law. Officers and trustees for pension funds and endowments could see a warning light flashing and that warning light, as I would like to suggest in a moment, has become more than just a warning light later. Under that light was a sign reading, "Play it safe."

If I could, sir, I would like to insert some new language because in some recent action by the Senate—in my prepared statement which I would like, if I might, to read in except for a couple of paragraphs.

Senator BENTSEN. So ordered.

Mr. KENNEDY. Subsequent events seem to have justified that spreading caution. Private pension plan legislation enacted by the Senate a week ago, that is H.R. 4200, I think would apply a prudent man standard to the investment of pension funds and would impose on fiduciaries personal liability if that standard were not met. Senate bill S. 1179, which was a forerunner of the legislation enacted and was reported favorably by this subcommittee's parent committee, would have followed the jeopardy investment concept applicable to foundations by specifically requiring that pension plan fiduciaries discharge their duties in a manner which did not jeopardize any income or assets of the plan and would have imposed on fiduciaries a penalty tax and personal liability for losses due to jeopardy investments. Although the jeopardy investment standard was eliminated, pension plan fiduciaries may conclude in light of this legislative history, that the prudent man standard—as yet very undefined in the context of Federal pension plan regulation, and a little bit undefined in terms of its application to foundations, embodies many of the same concepts, placing additional restraints on their flexibility in selecting investments.

Practically speaking, the effect upon the person who is responsible for those funds is to discourage him from reaching out very far. He is going to be very likely to try to be sure that he invests in companies that have had a kind of good housekeeping seal of approval, often by a very large institution in the neighborhood. That seems to me to be an influence contrary to the desires of spreading capital a little more widely.

Senator BENTSEN. I think you made a very salient point. When you get into this area of subjective judgment it is pretty hard to legislate.

Let me ask you about one thing: I recall that under the Nebraska State insurance laws, for example, insurance companies could invest a very small percentage of their total assets.

Mr. KENNEDY. Yes, sir, the so-called "basket clause."

Senator BENTSEN. A basket clause—I used to refer to it as the gold mine stock clause—and they could just put anything they wanted to——

Mr. KENNEDY. Yes.

Senator BENTSEN. They could have the full freedom to take the risk, on that one. Is there a way to structure something like that?

Mr. KENNEDY. Yes, sir.

I believe myself that it is not beyond the capability of man to devise a mechanism for permitting large funds covered by fiduciaries to take what might be called a higher risk, or accept higher "volatility" as expressed in academic circles, for a proportion of the portfolio. This could be carefully worked out so that it did not represent too large a proportion of the portfolio. It does not mean that the fiduciary should not make a good solid inquiry, to try to do the safest job he can, but to go into a new company which does not require such standards as do some State insurance acts' 5 years of positive earnings.

There are a lot of new companies that may have a bad year or two in their start-up period, and such inhibitions, it would seem to me, would have a deterrent effect upon getting money to growth points.

Yes, sir, I think this is something that could and should be worked out.

Senator BENTSEN. In other words, you might take as low as 1 percent of your total assets or something like that?

Mr. KENNEDY. Certainly.

I guess I do want to emphasize that provisions like those which prohibit foundations jeopardizing funds are certainly necessary. There have to be ways of insuring that they do not make improper use of their assets. But I did want to also express the effect of these provisions upon concentration of investment.

If I may, I would be awfully grateful for the chance to include that couple of paragraphs and then pickup my prepared statement with these words.

Senator BENTSEN. Do that.

Mr. KENNEDY. There are some reasons for, these are some of the reasons for the high relief in the topography for the two-tier market. I think, because of our rather widely spread portfolio, in comparison to others, I certainly hope that the gap between the tiers is closing and that many more companies will rise up, so to speak, to the top tier. But this will only happen after investors have actually had the experience of a more modest rate of inflation which appears to be reasonably predictable and of specific price improvement in stocks. They are going to have to have a little success.

I tried a diagnosis and I hope for a moment you will just permit me to make a personal expression about the work of this committee which I did a little earlier and I will retrace it.

I just think it is of the greatest of importance to the vitality of capitalism, the vitality of our society, that we do seek ways of getting money into the growth point of our society. I think this committee has done a splendid service in providing this focus.

We, in foundations, have to derive funds for further educational and charitable purposes from portfolios made up of those stocks. We are particularly cognizant of that.

The best remedy, of course, is I think a return of confidence justified by a strong and consistent anti-inflationary national economic policy. It is a very big subject, but it is really the heart of the matter.

A number of other ideas have been suggested which do not reach the fundamental problem of investor confidence. They may just be symptomatic relief, but I think they are important too and we ought to study them.

I would like to make a couple of very brief comments on a couple of thoughts.

First of all, we share the general view that the publication of investment transactions, not just investment positions, is a very good idea. We should have full disclosure often enough to inform but, obviously, not so often as to put an unreasonable cost burden on the pensioners and the charities that pay for them.

In deciding about publication requirements, there are two questions everybody would always want to ask. One of them is, will you spend too much money disclosing, and the second one, are you reasonably sure somebody is going to use the information disclosed?

Senator BENTSEN. I would agree with you, Mr. Kennedy. We do not want to see the SEC flooded with paperwork which they are not going to utilize. Perhaps disclosure can be limited to institutions and transactions of a certain size.

Mr. KENNEDY. Yes, sir.

Senator BENTSEN. That will be helpful, I think, to everyone concerned.

Mr. KENNEDY. Yes, sir.

Senator BENTSEN. But you run into a diminishing return pretty fast when you get into very minute transactions.

Mr. KENNEDY. Yes.

We publish, of course, our portfolio annually and we could publish ours quarterly, but we have to do it anyway and it would not trouble us very much, but it would be a burden to a number of smaller institutions.

Limitation on the size of security holdings have been discussed frequently here and they have been familiar to mutual funds and life insurance companies for many years, and to foundations since the Tax Reform Act of 1969. A percentage limitation of the amount any one investor may own in the voting stock of any company makes sense, but I think it is important to point out that there is a social cost here, too.

Limitations can discourage institutional investors from looking for opportunities among smaller companies because they cannot get a benefit which really helps them from the small dollar investment while, at the same time, taking account, we have to take account of the danger of excessive control.

There is a balance here. Under regulation within general legislative limits, I believe we can achieve the objective of encouraging investment by such institutions in these companies perhaps by escalating upward a permissible percentage of ownership as the size of capital, say, diminishes.

We spoke of venture capital first. Venture capital firms, we think, when they are well and responsibly run, provide a very, very important service. We are trying very hard to encourage some portion of our portfolio in that direction, despite the counsels of caution.

22-727—73——10

The investor wants a position large enough to have a real effect upon the portfolio. The company wants money without giving too much power over its affairs to an individual stockholder, and, once again, I believe we can work out a balance between these two objectives.

On the other hand, I am afraid that some of the medicine suggested could make a recovering patient pretty sick again. For instance, limitations upon the size of trades could seriously retard the flow of capital, retard it toward the second-tier companies, of smaller companies in particular, for a subtle reason.

Our objective is to increase activity in the securities of these companies, to encourage investors who have been scared off. If trades are limited, or forced to be spread across a long period of time, the brokers will benefit. But will the economy? Will a little company?

Senator BENTSEN. Mr. Kennedy, let me tell you I certainly agree with you there. I think it would be an unreasonable burden on an institution to have to spread its trade over a lengthy period of time, and I would hate to be the broker who had to handle the execution of the later sales.

Mr. KENNEDY. Yes, sir.

Senator BENTSEN. I do not think that the members of this committee want to do anything that keeps investors including institutional investors from acting like investors.

Mr. KENNEDY. Then I certainly will not read through my next couple of paragraphs, which put in a little midwestern language, what a lot of the fellows have been saying in a little more complexity, about the same point. I have a very strong feeling that we want to encourage a lot more activity in these securities, we need to broaden the capital market, make it work more efficiently, more openly and more fairly.

I do not think, I gather it is not in anyone's mind to clutter it or to confuse it.

Senator BENTSEN. Let me ask you, Mr. Kennedy, about the concentration of investments in some of these companies that you referred to as being almost inflation-proof and which are also ably managed corporations.

What would happen if there were a series of antitrust suits that were successful and some of these large institutions had a substantial percentage of their assets in the companies being sued and all of these institutions tried to get out of that stock at the same time? It seems to me that this creates a problem and there is some risk involved which has to be balanced off against the fact that these are inflation-proof companies or seemingly so?

Mr. KENNEDY. Yes, sir, that is a difficult problem, and the presence on the statute books since Senator Sherman's efforts in the 1880's, the Clayton Act, have had an influence upon the analysis of all securities on the part of skillful thorough research analysts, the possibility of antitrust actions against companies which do occupy a dominant position, has certainly affected earnings estimates on the part of such thorough and competent analysts in the past.

Senator BENTSEN. Let me ask you, do you have a self-imposed limit on the percentage of your assets that you invest in one security?

Mr. KENNEDY. Yes, sir, we do.

We not only have our self-imposed limit, but also an elaborate formula under the Tax Reform Act, and I will try to state it, and I am sure counsel will want to correct my testimony if I misstate it in any way.

The practical effect of it is when you get over 2 percent you begin to worry because after 2 percent you have got to find out whether any disqualified person, which includes your trustees, your donors, anybody who is related in any way to the institution, may also have a security holding in that enterprise.

Senator BENTSEN. You are referring there to the insiders.

Mr. KENNEDY. No. There is a special description of people related to foundation—excess business holdings is what my friend tells me is the appropriate descriptive title for that proportion. As you get on up toward 20 percent you begin to run into extremely severe tax penalties which, I believe, are something in the neighborhood of 200 percent if you find you have a holding in aggregate of all these persons and yourself of over 21 percent. It is often hard to find out if you have a lot of disqualified persons, including the relatives of the trustees, and so forth.

So we worry about that quite a lot.

What that has done to us is when we get over 2 percent we report to our trustees that we are getting over 2 percent and maybe, of course, the company, the security is just growing in value.

When we get over 5 percent, which we have, I think in only——

Senator BENTSEN. Mr Kennedy, I have an important phone call and I will be back in just a moment.

Mr. KENNEDY. Should I remain, sir?

Senator BENTSEN. If you will just stay there and I will be right back.

[Short recess.]

Senator BENTSEN. Mr. Kennedy, looking at the time and realizing we have two more witnesses, I think we will proceed to the other witnesses. The information that you have given us will be helpful to us. I am particularly interested and intrigued by the idea that you instigated that there ought to be some way that foundations and institutions could invest a portion of their assets in high risks, small corporations and new emerging corporations.

Thank you.

Mr. KENNEDY. Thank you, Senator.

[The prepared statement of Mr. Kennedy follows:]

STATEMENT OF ROGER G. KENNEDY, VICE PRESIDENT FOR FINANCIAL AFFAIRS, FORD FOUNDATION

I would like to thank you, Mr. Chairman, and the Members of your Subcommittee, for your invitation to appear here today. My name is Roger Kennedy, and I am Vice President for Financial Affairs at the Ford Foundation. I do not formally represent the Ford Foundation in these discussions, but I hope to be useful in suggesting, here, some ideas that stem from my own experience.

The first subject suggested by your staff for discussion is the "two-tier market." The upper tier of that market is a row of uneven eminences running across a very uneven terrain. It has *not* become elevated above the lower tier as did the Rocky Mountains, by a gigantic or sudden volcanic upthrust of investor interest. Instead, the two tiers became distinct while some stocks maintained their values and most others eroded away around them. Why has the topography of the market, then,

come to look like southeastern Wisconsin? Why has investor interest washed away from the great multitude of equity securities held in this country and exposed the granite in others?

The answers to these questions break into three groups, intertwined but distinguishable in emphasis: economic reasons, psychological reasons, and structural reasons. There is good cause to think that our economic system is operating right now to bring investor capital back toward the great mass of companies, but our purpose here is how to encourage that flow. To do that we should look first at the economic reasons for the interest of investors where it now is: in the top tier. Investors put their money there because inflation has hurt the earnings of many companies, and because anti-inflationary remedies have hurt the earnings of others, but the top-tier companies seem to go on growing in earnings regardless of inflation. Second, the top-tier companies have shown steady, predictable earnings in all weather, and investors pay for stocks according to their estimates of the discounted cash flow of future earnings. Third, there is nothing phony about the proclaimed virtues of these stocks. There are real growth companies. They aren't hard to identify: their records are good; their managements are good; and their position in the economy is distinct. Some are unique: they dominate an industry. In fact, in several instances they created an industry and retain ingenious, inventive and hard-working management. These seem likely to be able to hold onto the markets they created.

The question is not why these companies are such good investments, but why aren't investors searching out new ones, why don't more stocks attract confidence? This brings me to the second group of reasons for the two-tier market, the psychological reasons.

The first one is *memory*. The last great speculative updraft around 1968 sucked many people into investing in smaller, little-known companies. Many people need only roll back their cuffs to find the scar tissue where they were burnt then. It will take quite a while before they will reach out again toward unfamiliar names.

Second is *fiduciary psychology*. It is no wonder that trustees, unlike individual investors, and certainly unlike individual speculators, prefer to invest in large, proven, well-known companies rather than small unproven companies. Trustees generally will accept a little less return for a little less risk than might a rich individual. And, as previous witnesses have testified, trusteeship increasingly affects the market.

Third is *the use of stocks as surrogates for bonds*. Uncertainty about national economic policy, uncertainty about the means which will be selected to fight inflation and their effects upon corporate profits, and uncertainty about the degree to which, as a society, we will charge corporations more of what we are now calling "external costs" have built up a general unwillingness on the part of investors to take the sort of risks which they were willing to assume in more tranquil times. This has a depressing effect upon the price/earnings multiples which mark the fever-chart of investor confidence.

I would like to suggest the somewhat unorthodox view that stocks in the top tier of the two-tier market are now being used by many as substitutes for bonds. They are comforting to investors who have been trained to prefer stocks to bonds but are no longer willing to accept general equity risks. Investing in many smaller companies might give these people high returns, but they feel, to them, too chancy. When investors, large and small, are scared, they aren't likely to be venturesome. They like the tried, true and presumably predictably, and they pay more for those qualities than for a "piece of the action" if the trajectory of the action is very hard to predict. They may buy a bond or a top-tier stock for the same psychological reasons.

Finally, and much less important, are certain *structural reasons*. One of these is the cost of analysis. Large funds will naturally lean toward companies with large capitalizations because the analysis of a company prior to investment (analysis required by law of a prudent fiduciary) often costs about the same whether that company is large or small, and, therefore, the analytical cost per dollar invested is less to buy 2 percent in a large company than to buy 2 percent in a small company. Indeed, many of the top-tier companies are so thoroughly researched by the Street that virtually no additional research effort is required to make an investment decision. (In fact, many investors believe only one such decision is required—to buy such a stock.) Since cost of investment is a charge either against the investors or against the pensioners or the charities for which many of these investors are responsible, they give attention to cost-effectiveness.

Second, we must take account of the fear of jeopardy. Included in the rules set out by the Tax Reform Act of 1969 for private foundations are provisions which expose officers and trustees to personal tax liability for the making of investments found to be sufficiently risky to jeopardize a foundation's charitable purpose. Naturally, this counsel of caution diminished the readiness of such officers and trustees to reach out beyond successful, solid, well-researched companies toward those which were newer, attractive but less completely tried.

The regulation of one fiduciary is a caution to another. Thus, the law applied to philanthropic investment in 1969 has, I think, produced a chilling effect on imaginative money management, and not just for those directly affected by the law. Officers and trustees for pension funds and endowments could see a warning light flashing. Under that light was a sign reading: "play it safe."

Subsequent events have seemed to justify such caution. Pending legislation concerning the Federal regulation of private pension plans has concerned itself in part with articulation of standards governing the conduct of pension plan trustees. Legislation reported favorably by this Subcommittee's parent committee (S. 1179) would follow the jeopardy concept applicable to foundations by specifically requiring that trustees of pension funds discharge their duties in a manner which does not jeopardize any income or assets of the funds and would impose on trustees a penalty tax as well as personal liability for losses due to jeopardy investments.

Provisions such as those enacted for foundations and those proposed for pension plans may be necessary, but their effect is to lead to concentration of investments in companies which have been thoroughly analyzed and discussed and are already stamped with the approval of giant bank trust departments. If you were personally liable for a loss to a fund or a penalty tax under these rules, would you not be most comfortable in those stocks which no one could possibly describe as speculations?

These are some of the reasons for the high relief in the topography of the two-tier market. I think (and because of our rather widely spread portfolio, in comparison to others, I certainly hope) that the gap between the tiers will close—that many more companies will join the top tier. But this will happen only after investors have actually had the experience of a more modest rate of inflation which appears to be reasonably predictable and of specific price improvement in stocks.

Having tried a diagnosis, I hope you will permit me a comment on the work of this Committee. I think it is of very great importance to the vitality of capitalism in this country for us all to seek means to make easier and more consistent the flow of capital into good, growing concerns which may not yet be so big or so familiar to investors as the top-tier companies. I think this Committee has served very well in focusing attention upon the erosion of investor confidence. This focus is very welcome to foundations which must derive the funds which further educational and charitable purposes from portfolios largely made up of the common stocks in American industry.

Diagnosing causes can suggest remedies, and the best remedy is a return of confidence, justified by a strong and consistent anti-inflationary national economic policy. That is a very large subject, well beyond the limits of today's discussion.

A number of other ideas have been suggested, none of which reach this fundamental problem of investor confidence. All are worth careful study, but at best would represent only symptomatic relief. Nonetheless, some brief comment may be useful about that symptomatic relief:

(1) First, as to *publication* of institutional investor holdings and trading: we should have full disclosure, sufficiently often to inform, but not so often as to put an unreasonable cost burden upon the pensioners and the charities which would bear the burden of computing, printing and distributing results. Disclosure is generally a good idea; it can cost a lot of money; and, of course, in each instance the questions arise: how often should it be required and for whose practical use?

(2) *Limitations* of the size of securities holdings have been familiar to mutual funds and life insurance companies for many years and to foundations since the Tax Reform Act of 1969. A percentage limitation of the amount any one investor may own of the voting stock of any company may make sense, but there is a social cost here, too. Limitations can discourage institutional investors from looking for opportunities among smaller companies because they cannot get a benefit which really helps them from a small dollar investment, while at the same time taking account of the danger of excessive control. Under regulation within general legislative limits, we may achieve our objective of encouraging investment in these companies by escalating upward a permissible percentage of ownership as the size of capitalization diminishes. The investor wants a position large enough

to have a real effect upon the portfolio. The company wants money without giving too much power over its affairs to any individual stockholder. It is not beyond the mind of man to achieve a proper balance of these two objectives. which is what the public wants.

(3) On the other hand, some suggested medicines could make a recovering patient sick again. For instance, *limitations upon the size of trades* could seriously retard the flow of capital toward second-tier companies for a subtle reason. Our objective is to increase activity in the securities of these companies, to encourage investors who have been scared off. If trades are limited, or forced to be spread across a long period of time, the brokers will benefit. But will the economy? Won't the stickiness, inefficiency and ponderousness of such a market further reduce the price/earnings multiples of the stocks which are our concern? Many observers believe that the reason that the U.S. equity market has produced higher price/earnings ratios than many European markets is that our market has been relatively fast and efficient. If that market is made to operate in a vat of glue, it will not move efficiently, and the companies most in need of an active market will suffer most.

Furthermore, if an investor knows that he can only trade a limited amount of stock at any time, or if he must dribble out his trades over time, he will be very, very cautious—even more cautious—about the stocks he is willing to buy. If you were told that you would be "locked into" your stocks, which would you be most likely to buy: a big, well-known company with plenty of admiring banks to buy its stock, or * * *

Senator BENTSEN. Our next witness will be Mr. Ralph P. Coleman, Jr., president, Over-the-Counter Securities Fund, Inc.

STATEMENT OF RALPH P. COLEMAN, JR., PRESIDENT, OVER-THE-COUNTER SECURITIES FUND, INC.

Mr. COLEMAN. My name is Ralph P. Coleman, Jr. I want to thank you, Senator Bentsen, for the opportunity of testifying before this subcommittee.

For the past 18 years I have been president of Over-the-Counter Securities Fund of Oreland, Pa. I am also editor of Over-the-Counter Securities Review and executive director of the National Association of OTC Companies. So I do have a rather extensive acquaintance with the type of companies we have been talking about today, the less researched companies and the smaller and emerging companies.

I founded the fund in 1955 and have been its chief executive and portfolio manager since that time.

We currently have assets of about $6.4 million and around 4,000 shareholders.

An initial investment of $10,000 in our fund in June 1956 would recently have been worth over $66,000, with all dividends and capital gains reinvested.

Senator BENTSEN. I did not know any mutual fund founded in 1955 still had the same chief executive.

Mr. COLEMAN. That is right, I think I am the world's oldest living mutual fund executive, from a service standpoint, anyway. Sometimes I feel it. But our fund has the highest alpha rating according to Weisenberger's rating service over the past 10-year period.

I cite these examples not to blow our own horn, but to demonstrate that it is possible to invest successfully on an institutional basis without becoming involved in the so-called two-tier market game. Ours was the first fund to invest exclusively in over-the-counter securities and, with one exception, we are still the only fund in that area. With scattered exceptions, over-the-counter securities have never been big institutional favorites. Even today, although the market value of

all OTC stocks totals around $150 billion—about 25 percent of the market value of all NYSE stocks—institutional holdings of OTC stocks constitute less than 5 percent of the market value of all institutional portfolios.

Yet it is in the over-the-counter market that the great growth companies of today first became available to the investing public. The "superstocks" of 1973, such as Xerox, Avon, Polaroid, McDonald's, Walt Disney Productions, all traded OTC within the past 10 to 15 years and at small fractions of their present prices. And it is in the OTC market of today that the growth companies of tomorrow are being nurtured.

Ironically, the so-called professional investors rarely buy growth stocks before they grow—when the biggest opportunities for capital appreciation are possible. Rather, most institutions prefer to buy their growth stocks when they are pretty well grown and the possibilities of geometric growth in market value are that much more limited. For example, if IBM were to show the kind of market appreciation over the next 23 years that it did over the past 23 years its market value would rise to around $2.8 trillion, compared to its recent market value of around $40 billion.

Almost $3 trillion—or about three times our present annual gross national product.

The hard fact of the matter is that institutions—who concentrate their holdings in the "top twenty" or "favorite fifty," or whatever number you want to give it—are really living in the past.

Of course, the analysts at these institutions don't really expect the fabulous past growth of these companies to continue at the same rate in the future but they believe the momentum is sufficient to make them "safe" and profitable investments in the years ahead.

I sincerely believe that such an investment philosophy is fraught with danger—not only to the economy and stock market as a whole, as other witnesses have so eloquently testified, but to these institutions themselves and to the investors who have entrusted their funds to them.

When an institutional investor goes into a stock yielding 1 percent or 2 percent and selling for 30 to 40 times earnings he's shutting himself off from two potentials that exist in many other stocks.

With a 1 percent or 2 percent return he's certainly not buying the stock for dividend yield. And with the stock selling at 30 to 40 times earnings he's certainly not buying it with the hope that another company will come along and offer to buy the company out at a price greater than 30 to 40 times earnings. Yet these are the possibilities for capital enhancement that exist in many high yield, low p/e ratio stocks that most institutional investors consider beneath their portfolios.

As to the portfolio of Over-The-Counter Securities Fund, probably 75 to 80 percent of the individual issues we own are not owned by any other institution at this time. I say "at this time" because it has been our experience that over a period of years, if the company is successful, it will eventually attract institutional support—usually after most of the big appreciation is out of the stock.

For example, we were probably one of the first institutional investors in Marriott Corp. in the early 1960's when the stock traded OTC.

Now the stock is on the NYSE, it's a big institutional favorite but it's selling at a price that is more than 15 times what we originally paid for the stock.

However, finding a Marriott is not an easy task. A more likely scenario is for the fund to purchase stock in a company and then have the company acquired by another larger company.

Over the past 7 years, this has happened to over 50 of our portfolio holdings and, on the average, the sale price was about 50 percent above what we originally paid for the stock. I will give you an example of what just happened yesterday. Early this spring we bought stock in the Baltimore and Ohio Railroad which most people lump with the Penn Central. Actually they will earn a record $40 million this year but they were 95 percent controlled by the C. & O. and there had been an offer about 10 years ago and we had a feeling with the improved B. & O. earnings that eventually there would be another offer. Well, we paid about $10 for the stock. It will probably work out at $25 to $26 a share in C. & O. stock because they are taking over the balance. Now this B. & O. is not on the list of any institutional investor, yet we saw an opportunity and we acted on it, and other institutional investors can find this same sort of data if they dig deep enough.

Senator BENTSEN. Let me ask you. How has your performance been since 1968 when there has been such a setoff?

Mr. COLEMAN. In 1968 we are ranked among the first 15 funds. This year, for example, we declined about 9 percent in asset value per share. I think it is one of the beauties of a mutual fund. You know exactly where you stand. This is one of the areas where the banks must be brought into the same type of equality with the mutual funds in terms of performance.

Senator BENTSEN. To what extent are you involved in letter stocks?

Mr. COLEMAN. Not at all.

We have never purchased any letter stock. It has been against our policy, and we never expect to buy any. We buy common stock primarily on the open market.

A number of ingenious proposals have been offered about what to do about the institutional investor and the "two-tier" market. Although I appreciate the problem I do not agree with those persons who advocate a limit on how much stock an institution can sell at any given time; who suggests a "limit" on the price a stock can drop in any one day; or who urge 30 days notice of the intention of an institution to buy or sell any large quantities of stock in their portfolios.

These are very artificial, galling restrictions that would interfere with the free market process in a most disastrous way.

However, having said this. I would hasten to add that I am very much in favor of establishing disclosure rules on the holdings of all institutional investors along the line that the Securities & Exchange Commission has established for mutual funds. That includes the trust departments of banks, insurance companies, selfadministered pension funds where the funds of a substantial group of employees is involved, and similar entities.

Our fund has been subject to continuous SEC regulation since its inception. While we may have become occasionally vexed over some particular situation we believe the Commission has generally acted in an evenhanded and constructive manner. And we feel reasonably

certain that subjecting banks and insurance companies to SEC disclosure regulations would work no great hardship on them and would help the investing public to understand better the workings of these giant institutions.

Certainly, there is a greater public interest involved in the workings of a bank trust department handling a $100 million pension fund for a company with 50,000 employees than in the workings of $6 million mutual fund with 4,000 shareholders. Yet under present rules, the portfolio holdings and investment record of the bank trust department can remain veiled from public scrutiny while the mutual fund must operate in a virtual fish bowl of disclosure.

We're not complaining about the fish bowl, but let's at least get the really big fish into the bowl.

Investment Company Act regulations limit the size of a holding in a single company to 5 percent of the fund's total assets and limit ownership to 10 percent of the voting securities. We believe these rules should be applied to the investment operations of banks, insurance companies and other institutions. These 5- and 10-percent regulations should not be applied to holdings that such institutions own when they would be subject to SEC supervision. However, all portfolio purchases thereafter should be subject to the 5- and 10-percent rules that already apply to regulated investment companies.

One of the most pernicious practices of many mutual funds and other institutional investors is the concentration of their investments in a relative handful of stocks—with many funds having over 50 percent of their assets in as few as 10 stocks. Such concentration has not produced superior results for most of these mutual funds.

Our own fund, with one of the best investment records in the industry, has followed an opposite policy.

We currently have 240 different securities in our portfolio. Many people have told us to cut down on this number. Perhaps we should, but the proof of the pudding is in the eating and in our case our portfolio policy has helped us build a good record.

Senator BENTSEN. Let me ask you how you can afford to bother with that many stocks and do the research with assets of $6.5 million?

Mr. COLEMAN. Well, I can only say that we have done it. Like anybody else we have had a few bloopers there.

The overall record has been a good one and I will tell you, quite frankly, that we work primarily from published sources such as annual reports, prospectuses, offering circulars. In most cases we do not have direct contacts with the management. Sometimes we prefer it this way because we do not want to get involved on the prongs of insider disclosure, you know—contacts, disclosure and that type of thing. As it is now management can tell you nothing that they do not publish, and in our case we buy, hold and review.

You take the situation on Xerox and Polaroid and IBM. Most everybody knows these situations inside and out, yet that there are analysts who spend their complete time on IBM. Of course, with the market value of the company that probably is proper, in that case. But in our case we have tried to spread our research out. We put out a special report service which each month goes over four different companies all over the counter. We feel that in this case we are performing a worthwhile service in broadening investor interest in a variety of companies.

Senator BENTSEN. If you will proceed with your statement because I think we have a vote coming up on the floor in just a few minutes.

Mr. COLEMAN. All right.

I will just quickly say that why don't the large institutions go into more stocks, I think in many cases they follow the leaders and if things go badly well, the small fry can always say the "biggies" in the institutional world were the ones who originally invested in it. I also think that this concentration in a few stocks has resulted from the failure of many analysts to really do their homework, to get off their duffs and to learn about companies that may have their headquarters in nonmetropolitan areas, especially in the Midwest, the Southeast and New England. Too many analysts are really quite parochial, acquainted only with their "chosen few" stocks, and fundamentally ignorant of the vast body of companies which are the backbone of the U.S. economy. It's about time some of these analysts do some really original research I think you mentioned that yourself where you had spoken of illiquidity of research. There are many excellent companies out in the hinterlands or the sticks which an analyst has not visited in years or if at all.

And finally, to summarize, when IBM lost 38 points in 2 days last week that was a paper loss of over $5.5 billion in that particular stock. At the low in 1973, it was a shrinkage of almost $14 billion of market value.

Now if a decline, a precipitous decline, like this can take place in a premier institutional issue where 50 percent of the stock is owned by institutions cannot a decline of greater magnitude be expected of superstocks of lesser magnitude? I question very much the theory of the one-decision stock not only in terms of its impact on the market, but in terms of the market value of the portfolios holding those stocks.

And the final point I would make concerns portfolio turnover.

I will not cite specific examples but I believe that the portfolio turnover rate of some institutional investors is so high as to border on a sophisticated form of churning. They are violating one of the basic rules of true investing. Long-range investing requires that the stock can grow with the company, I believe that a period of time must pass before the fruits of true investing can be harvested. This reduces portfolio turnover to a minimum. In our case portfolio turnover has never been over 7 percent over the past 3 years. As long-term investors, we list the year which we purchased the stock.

Senator BENTSEN. May I interrupt just a moment?

Mr. COLEMAN. Yes.

Senator BENTSEN. You make this point of high turnover and you use the term churning and you get into the question of a fundamental judgmental area and a subjective judgment involved. Do you think that can be regulated by legislation?

Mr. COLEMAN. No; I did not suggest that. I think a fundamental shift in investment thinking, is needed, I think it is a hard thing to regulate and I am not so sure I would be in favor of regulation that might freeze transactions. But it is a cleansing of the mind basically and taking an entirely different attitude that many—the many mistakes here have been primarily in the mutual fund areas among the so-called go-go funds, I cannot judge the banks and insurance com-

panies because we do not know their portfolio turnovers, but we do know about mutual funds and some of them have a turnover of over one hundred percent. I am ashamed to be part of an industry that engages in this type of thing. It concerns me considerably. Some of these high portfolio mutual funds may have a good investment record but in most cases excessive portfolio turnover is accompanied by mainly poor results.

Senator BENTSEN. I remember one time looking at a mutual fund management company out in Colorado. How frustrating it was to see how their charter was one that provided that they would invest in certain companies and they just stayed in those companies, period.

Mr. COLEMAN. Yes.

Senator BENTSEN. And they didn't change. It was frustrating to me to see how well they had performed over all those years.

Mr. COLEMAN. I know some funds have had a legal list and some have done quite well when they have been restricted that way.

Senator BENTSEN. Mr. Coleman, your testimony has been very interesting and we appreciate it very much.

Mr. COLEMAN. Thank you very much.

[The prepared statement of Mr. Coleman and articles from the Over the Counter Securities Review magazine follow:]

TESTIMONY OF RALPH P. COLEMAN, JR., PRESIDENT, OVER-THE-COUNTER SECURITIES FUND, INC.

My name is Ralph P. Coleman, Jr. May I thank you for the opportunity of testifying before this Subcommittee. For the past 18 years I have been president of Over-The-Counter Securities Fund of Oreland, Pa., I am also editor of Over-the-Counter Securities Review and executive director of the National Association of OTC Companies.

I founded OTC/SF in 1955 and have been its chief executive and portfolio manager since that time. We currently have assets of about $6.4 million and around 4,000 shareholders. An initial investment of $10,000 in our Fund in June 1956 would recently have been worth over $66,000, with all dividends and capital gains reinvested. According to Wiessenberger's Mutual Fund Rating Service, which ranks all mutual funds on a risk reward basis, our Fund has the highest "Alpha" rating of any mutual fund over the past ten year period. Other mutual fund performance authorities also give our Fund superior ratings.

I cite the above examples of our investment record not to "blow our horn" but to demonstrate that it is possible to invest successfully on an institutional basis WITHOUT becoming involved in the so-called "two-tier" market game. OTC/SF was the first fund to invest exclusively in over-the-counter securities. With scattered exceptions, OTC securities have never been big institutional favorites. Even today, although the market value of all OTC stocks totals around $150 billion—about 25% of the market value of all NYSE stocks—institutional holdings of OTC stocks constitute less than 5% of the market value of all institutional portfolios.

Yet it is in the over-the-counter market that the great growth companies of today first became available to the investing public. The "Superstocks" of 1973, such as Xerox, Avon, Polaroid, McDonald's Corp., Walt Disney Productions all traded OTC within the past 10 to 15 years and at small fractions of their present prices. And it is in the OTC market of today that the growth companies of tomorrow are being nurtured.

Ironically, the so-called professional investors rarely buy growth stocks BEFORE they grow—when the biggest opportunities for capital appreciation are possible. Rather, most institutions prefer to buy their growth stocks when they are pretty well grown and the possibilities of geometric growth in market value are that much more limited. For example, if IBM were to show the kind of market appreciation over the next 23 years that it did over the past 23 years its market value would rise to around $2.8 TRILLION, compared to its recent market value of around $40 billion. Almost THREE TRILLION DOLLARS—or about three times our present annual gross national product!

The hard fact of the matter is that institutions who concentrate their holdings in the "Top Twenty" or "Favorite Fifty", or whatever number you want to give it—are really living in the past. Of course, the analysts at these institutions don't really expect the fabulous past growth of these companies to continue at the same rate in the future but they believe the momentum is sufficient to make them "safe" and profitable investments in the years ahead.

I sincerely believe that such an investment philosophy is fraught with danger—not only to the economy and stock market as a whole, as other witnesses have so eloquently testified, but to these institutions themselves and to the investors who have entrusted their funds to them. When an institutional investor goes into a stock yielding 1% or 2% and selling for 30 to 40 times earnings he's shutting himself off from two potentials that exist in many other stocks. With a 1% or 2% retrun he's certainly not buying the stock for dividend yield. And with the stock selling at 30 to 40 times earnings he's certainly not buying it with the hope that another company will come along and offer to buy the company out at a price greater than 30 to 40 times earnings. Yet these are the possibilities for capital enhancement that exist in many high yield, low p/e ratio stocks that must institutional investors consider beneath their portfolios.

As to the portfolio of Over-The-Counter Securities Fund, probably 75% to 80% of the individual issues we own are NOT owned by any other institution at this time. I say "at this time" because it has been our experience that over a period of years, if the company is successful, it will eventually attract institutional support—usually after most of the big appreciation is out of the stock. For example, we were probably one of the first institutional investors in Marriott Corp. in the early 1960s when the stock traded OTC. Now the stock is in the NYSE, it's a big institutional favorite but it's selling at a price that is more than 15 times what we originally paid for the stock. However, finding a Marriott is not an easy task. A more likely scenario is for the Fund to purchase stock in a company and then have the company acquired by another, larger company. Over the past seven years, this has happened to over 50 of our portfolio holdings and, on the average, the sale price was about 50% above what we originally paid for the stock. There ARE other ways to make money in stocks than in investing in the supergrowth issues and hope that an ongoing bootstrap operation will provide all participants with capital appreciation ad infinitum.

A number of ingenious proposals have been offered about what to do about the institutional investor and the "two-tier" market. Although I appreciate the problem I do not agree with those persons who advocate a limit on how much stock an institution can sell at any given time; who suggests a "limit" on the price a stock can drop in any one day; or who urge 30 days notice of the intention of an institution to buy or sell any large quantities of stock in their portfolios. These are very artificial, galling restrictions that would interfere with the free market process in a most disastrous way.

Having said this, I would hasten to add that I am very much in favor of establishing disclosure rules on the holdings of ALL institutional investors along the line that the Securities & Exchange Commission has established for mutual funds. That includes the trust departments of banks, insurance companies, self-administered pension funds where the funds of a substantial group of employees is involved, and similar entities. Over-The-Counter Securities Fund has been subject to continuous SEC regulation since its inception. While we may have become occasionally vexed over some particular situation we believe the Commission has generally acted in an even-handed and constructive manner. And we feel reasonably certain that subjecting banks and insurance companies to SEC disclosure regulations would work no great hardship on them and would help the investing public to understand better the workings of these giant institutions. Certainly, there is a greater public interest involved in the workings of a bank trust department handling a $100 million pension fund for a company with 50,000 employees than in the workings of a $6 million mutual fund with 4,000 shareholders. Yet under present rules, the portfolio holdings and investment record of the bank trust department can remain veiled from public scrutiny while the mutual fund must operate in a virtual fish bowl of disclosure. We're not complaining about the fish bowl, but let's at least get the really big fish into the bowl!

Investment Company Act regulations limit the size of a holding in a single company to 5% of the fund's total assets and limit ownership to 10% of the voting securities. We believe these rules should be applied to the investment

operations of banks, insurance companies and other institutions. These 5% and 10% regulations should not be applied to holdings that such institutions own when they would be subject to SEC supervision. However, all portfolio purchases thereafter should be subject to the 5% and 10% rules that already apply to regulated investment companies.

One of the most pernicious practices of many mutual funds and other institutional investors is the concentration of their investments in a relative handful of stocks—with many funds having over 50% of their assets in as few as ten stocks. Such concentration has NOT produced superior results for most of these mutual funds. Our own Fund, with one of the best investment records in the industry, has followed an OPPOSITE policy. We currently have 240 different securities in our portfolio. Many people have told us to "cut down" on this number. Perhaps we should, but the "proof of the pudding" is in the eating and in our case our portfolio policy has helped us build a good record. We really feel quite badly, when we look at our limited assets of under $6.5 million, and realize that there are many excellent stocks we would like to buy but for which we lack the money.

I think the failure of many institutional investors to invest in greater numbers of different stocks can be traced to two factors. First, most of them want to play it safe by following the leaders. If things go badly, the "smaller fry" among these investors can simply say that everybody else made the same mistake, including the "biggies" of the institutional world. Secondly, I think this concentration in a few stocks results from the failure of many analysts to really do their homework, to get off their duffs and to learn about companies that may have their headquarters in non-metropolitan areas, especially in the Midwest, the Southeast and New England. Too many analysts are really quite parochial, acquainted only with their "chosen few" stocks, and fundamentally ignorant of the vast body of companies which are the backbone of the U.S. economy. It's about time these analysts did some really original research on entirely new companies—maybe even a few OTC corporations. Perhaps they would be able to broaden their investment horizons and realize there are OTHER companies that might just make BETTER investments than the grossly inflated superstocks many of them are presently up to their eyeballs in.

When mighty IBM lost 38 points in two days last week after the Telex court decision there was a paper loss of over $5.5 billion or about 13% of that stock's market value. Since then IBM stock has recovered somewhat with the general market. At its 1973 low IBM stock was more than 25% below its high for the year—a shrinkage in market value of almost $14 billion. If such a precipitious decline can take place in the premier institutional issue—over 50% of the stock is reportedly owned by institutions—cannot declines of even greater magnitude be expected for the superstocks of lesser magnitude? Certainly the recent IBM price performance should give pause for reconsideration of the theory of the "one decision" stock, not only in terms of its impact on the market as a whole but in terms of the market value of the portfolios holding IBM or any other superstock similarly affected.

There is one final point I would touch on in these hearings. That point concerns portfolio turnover. Without wishing to cite specific examples, I believe that the portfolio turnover rate of some institutional investors is so consistently high as to border on a sophisticated form of "churning." I recognize that this may be a harsh thing to say but I believe it to be true. To the extent that this churning—excessive portfolio turnover—takes place institutional investors are violating one of the most basic rules of true investing—that such investing is usually carried out on a long-range basis with holdings held over a period of several years so that the stock can "grow with the company." I do not wish to imply support of the "one decision" theory of stock investing but I do believe it must be recognized that a period of time must pass before the fruits of true investing can be harvested. Such a viewpoint reduces portfolio turnover to a minimum. In the case of our own Fund our portfolio turnover rate over the past three years has never been above 7%. And, as long-term investors, we practice what we preach, listing in our portfolio reports the year in which we first purchased a particular holding. A number of our holdings go back for 5 to over 15 years. Institutional investors who maintain high rates of portfolio turnover may ALSO have a good investment record. However, in most cases excessive portfolio turnover is NOT accompanied by a good investment performance and often it is accompanied by plainly poor results.

[From the Over the Counter Securities Review]

The Institutional Investor—Who Needs Him?

Several months ago, a magazine catering to the interests of the institutional investor, carried an article which was entitled "The Public—Who Needs 'Em?" the main theme of which was that in tomorrow's investment world the private investor had no real role and that he really wouldn't be missed at all. This viewpoint has been put into practice by a number of brokerage firms, some of whom quite ostentatiously told the individual or "retail" investor that they no longer wanted his business and that they were going to concentrate on the "big money" of the institutions. As the stock market has sagged in recent weeks and Wall Street has felt the reverberations in sharply reduced profits or outright losses, the investment community seems to be taking a new look at the once spurned individual investor. Comments Monet Gordon, analyst for the Dreyfus Fund: "Public participation is the key to a solution" (to the lack of consistent volume on the NYSE) "but the conditions are not right yet. Too many people got hurt in 1969 and 1970 and they are skeptical." Chimes in James Needham, Chairman of the New York Stock Exchange, about the drop in public participation: "the securities markets need the individual investor, both small and large, to provide liquidity and contribute to a smooth and efficient functioning of the auction market process."

No doubt the NYSE people are encouraged to look to the individual investor again because the abolition of fixed commissions on transactions above $300,000 has made the big block of trades of institutions much less profitable than they used to be. Nevertheless, there is a real rationale underscoring the importance of the small investor, the man or woman whom a few years back was being encouraged to own a share of America. There are STILL over 32 million individual investors, although, according to the NYSE, this number dropped by 800,000 in 1972, the first decline in a decade. These investors ARE vital to the economy of this nation and anyone who does not think they are important is doing a disservice to the nation in general and to the investment community in particular.

Which brings us around to the subject of our editorial—The Institutional Investor. In three past editorials we have inveighed against the dangers of institutional investing, as it is presently practiced, by all too many supposedly "professional" investors. The characteristics of this new breed of institutional investing can be summarized as follows:

1. Short-time investing in securities to reap short term profits if the stock goes up or to quickly "cut losses" if the stock goes down. By definition this is NOT investing it IS speculation, because true investing is a procedure requiring a period of time, usually running to a number of years. Following this short-term policy, some institutional investors, including the once staid trust departments of some banks, are achieving extraordinarily high turnover ratios in the equity portions of their portfolios.

2. A fascination with stocks selling at high price/earnings multiples. One of the great growth mutual funds of this era last year had an average p/e ratio of 35 for its portfolio stocks. Although the recent market debacle has cut back this high multiple it is still well above 25. Some institutionals seem positively suspect about a stock simply because it is selling at a lowly multiple of 10 to 12 and they reason that there must be comething terribly wrong with a stock currently priced at 6 to 8 times earnings. Such managers simply wouldn't be caught dead with such cheap merchandise in their portfolios!

3. A sudden and total lack of confidence in management of a portfolio company if the company fails to increase quarterly earnings or if earnings do not reach previous estimates, usually developed outside the company. The new breed of portfolio manager usually expresses his lack of confidence quite concretely—by unloading the stock as quickly as market conditions will permit. In our opinion, this is the basic reason for the "air pockets" that have caused a number of stocks, mainly on the NYSE, to lose as much as one quarter to almost one half of their market value in a single day on the heels of a declining earnings report. The new portfolio manager doesn't allow for or forgive mistakes—except his own. Management must "perform" in terms of ever-rising earnings or "out they go."

4. The result of the above concentration on increasing earnings per share is to confine most institutional investors to literally a handful of stocks and to ignore the vast majority of issues which happen to have occasional dips in earnings but are otherwise excellently managed, thoroughly viable companies. Of course, when

institutions get so loaded to the gills with certain stocks they keep the p/e ratio for those "premier" growth stocks at unrealistically high levels even if the companies fail to produce yearly earnings gains. A classic example of this act of financial levitation is Polaroid Corp. whose earnings have gone nowhere except down since 1968 but which still supports a p/e ratio of around 90. Too many institutions would take too big a bath if Polaroid were suddenly to fall out of bed, even though this situation could change drastically if the company's highly touted new camera isn't the financial cornucopia it's supposed to be.

The Institutional Investor—who needs him? Seriously, we are beginning to wonder. From the standpoint of the securities market, he's injected a great element of instability into an already delicate situation. He rushes into and out of stocks with abandon, totally ignoring the need for orderly markets which should be the hallmark of the professional money manager. He's created an intolerable and dangerous gap in price/earnings ratios between the "have" companies—those who "have" institutional investors in significant quantities—and the "have not" companies—those who do not have appreciable institutional interest. By narrowing his perspectives to only a relatively few securities the institutional investor has created an awesome and potentially lethal concentration of investment power. In so doing, many of these so-called "pros" tend to completely ignore the over-the-counter market. We recently attended a conference of professional investors and we suggested to a young bank investment officer (whose bank is traded OTC) that he take a look at a certain OTC stock. His flip response was "tell me about it when it's listed." Ironically, three of the big growth companies discussed in detail at this meeting were Avon, Xerox, and Polaroid—all three of which traded OTC a few years ago at fractions of their present prices! Finally, as concerns the indispensability of the institutional investor we detect an increasing disenchantment on the part of many corporate managements with these professional investors who are your dearest friends when earnings are on the way up but don't even know you are living if earnings show a decline. Most businessmen have the sense to realize that sales and profits usually have a cyclical, up and down movement to them that is a natural part of the economic process. Unfortunately, some institutional investors are so naive and ignorant of business that they fail to realize this very fundamental fact of economic life, which applies to the vast majority of companies and even to an occasional patented, certified "growth" stock.

[From the Over the Counter Securities Review]

Playing With Investment Fire

When the stock market broke wide open in the Spring of 1970 and stocks suffered their worst slide since the Great Depression there were many observers, ourselves included, who believed there was at least one lesson that was learned by investors from that holocaust. That lesson was essentially this: He who plays with fire can get burned by the fire, if not incinerated. This "fire", in the investment sense, included, in the first group, stocks selling at high price/earnings ratios, mainly because the company had shown a good record of growth in earnings per share and/or it was in an industry or embraced a "concept" that was "in fashion." A second group of stocks where there was "fire" were 100% speculations, often "hot" new issues, in which the company was in a start-up stage, perhaps was operating at a loss and was probably in poor financial condition. The so-called "go-go" mutual funds, managed by the young "gunslingers," plowed into both groups of stocks, making wholesale purchases of stocks of the most questionable investment merit and not caring a whit what they paid for the stock in terms of its price/earnings ratio. Well, as too many investors know, most of these "houses of cards (or certificates)" came tumbling down in 1969–1970, with some of the more adventurous mutual funds recording asset value losses of 40% to 60% and over.

We thought, after the horrendous experience outlined above, that mutual fund and other so-called "professional" money managers had learned their lessons well and that for at least the next decade we could look forward to a period of relative investment sanity and conservatism. How wrong we were! In the almost two years since the market touched bottom on May 26, 1970, there has been a snowballing revival of the same type of speculative investment thinking that sowed the seeds of the 1970 debacle. By this thinking we mean some very specific things:

1. Unbalanced concentration on just one set of figures about a company—growth in earnings per share. This concentration is so all-encompassing and short-range that it involves not only yearly projections but quarterly projections. And

pity the poor company that misses its earnings projection by a few cents. Analysts have been known to virtually throw fits when such projections are not met, taking their "revenge" on management by a wholesale dumping of the stock. Wrigley stock on the NYSE was a classic example of this pique last year when it dropped 30 points in a single day. More recently, Bausch & Lomb drew the ire of the institutional investors when it announced that projected quarterly earnings would not measure up to what some sources in the "Street" had been estimating.

2. By massive concentration on growth in earnings per share this investment thinking completely ignores just about every other component of financial analysis: Financial condition—working capital, current ratio, cash and equivalent position, etc. Capital structure—ratio of debt to equity, debt service, dilution potential, etc. Industry position—a study of the position of the company in its industry and its various strengths and weaknesses, from product, plant and management standpoints. Analysis of the dividend yield and dividend record of the company. Since some of the stocks currently favored by investment managements pay no dividend at all and plan to pay none in the "foreseeable future," dividend analysis can be rather academic. In sum, what we are saying is that investors who buy on an EPS basis usually ignore all of the other fundamentals of security analysis.

3. A concentration on certain industry and economic groups to the neglect of virtually all companies outside these "chosen few," regardless of how well they may be doing. In 1967–68 the concentration was on fast-food franchisers, computer leasing companies, nursing homes et al. Today the magic industries include almost anything connected with homes—from home building and furniture to mobile homes and mortgage banking.

A typical example of current professional investment thinking is afforded in a *New York Times* interview by Vartanig G. Vartan with Eugene C. Sit, 33, Chinese-born vice president and portfolio manager of Investors Diversified Services New Dimension Fund and IDS Growth Fund. Mr. Sit discusses his recent portfolio purchases in three categories: Smaller and medium-sized companies with the potential of rapid growth: Vetco Offshore, Tropicana Products and Scott's Home Builders. In the consumer sector of the economy, Sit has added Church's Fried Chicken and Ponderosa System. And in the technology area, his most recent additions were National Semiconductor, Data General and Hewlett Packard. We took Mr. Sit's eight selections and analysed them further. Here are the results:

Company and market traded	Rec. price	Percent div. yield	P/E ratio	Earnings per share: Last 12 months	Earnings per share: 1969	Earnings per share: 1967	Percent of stock held by institution
Vetco Offshore: ASE	$64.50	0	57	$1.13	$0.54	$0.31	25
Tropicana Products: NYSE	83.00	0	56	1.53	.71	.34	11
Scotty's Home Builders: ASE	32.38	.2	59	.55	.30	.18	6
Church's Fried Chicken: OTC	64.00	0	41	1.55	.70	.16	8
Ponderosa System: ASE	45.50	0	61	.75	.18	.03	7
National Semiconductor: ASE	51.50	0	54	.96	.36	.57	42
Data General: OTC	79.25	0	92	.86	.19	----------	22
Hewlett-Packard: NYSE	55.25	.4	60	.93	1.01	.81	5

Sketching the parameters of Mr. Sit's recent purchases we find these characteristics:

1. The current price/earnings ratios of the stocks purchased ranged from a low of 41 (Church's Fried Chicken, one of two OTC companies purchased) to a high of 92 (Data General, a mini computer maker, also OTC.) The average p/e ratio of the stocks purchased by Mr. Sit was 60-to-1. The present p/e ratio of the Dow Jones Industrials is around 17 or less than one-third the p/e ratio of Mr. Sit's eight selections.

2. Only two of the eight issues purchased pay cash dividends. And in the case of the two stocks which are paying cash dividends the yield is nominal—0.2% in the case of Scott's Home Builders and 0.4% in the case of Hewlett-Packard.

3. The extent of institutional investment in Mr. Sit's issues varies from a low of 5% for Hewlett-Packard (which has over 26 million shares outstanding) to 42% for National Semiconductor. For the eight stocks, institutions held an average of 18% of the stock outstanding.

BEST AVAILABLE COPY

4. From 1967 to the latest 12 mos., all seven companies reporting earnings for the period, had fairly substantial increases in earnings per share—ranging from a 25-fold increase for Ponderosa System (restaurant operator), from $0.03 to $0.75 a share, to an advance of under 20% for Hewlett-Packard (electronic instruments), from $0.81 to $0.93 (which Mr. Sit regards as an "excellent cyclical play").

Is Eugene Sit "playing with fire" in the aforementioned purchases? In his interview he admits to having "to be able to accept high price/earnings ratios, high volatility and occasional disappointments." Maybe so. But how high can a p/e ratio be and still be an intelligent investment? Can it be 50, 60 to 90 times earnings? Such premier growth issues as IBM and Xerox command between 40 and 50 times earnings. Is it proper to put a much higher p/e ratio on much less established, much less proven companies than IBM or Xerox? Of course we're familiar with the cliches about "new growth companies" vs. "old growth companies." And we remember 1969–70 only too well to forget that today's appealing growth stock can become tomorrow's unwanted dog—IF that magic skein of ascending earnings per share in each year happens to be broken by some unexpected development. What does a portfolio manager think of when he buys a stock at 60 times earnings? First off, there are a number of reasons for which he CANNOT be buying the stock:

1. He's obviously not buying the stock as a "turnaround" situation. A stock selling for 60 times earnings is probably a highly profitable company, in terms of both profit margins and return on equity and growth in earnings per share.

2. He's not investing in the issue for the cash dividend paid. This is apparent from the virtually nominal yield on Mr. Sit's portfolio purchases.

3. He's certainly not purchasing the stock as a prospective merger candidate. Very few, if any, companies selling at 60 times earnings are reasonably-priced prospects for acquisition by another company—unless that company is selling for an even higher p/e ratio, a highly unlikely situation. The earnings dilution suffered by a purchasing company when it buys a company selling for 60 times earnings can be fantastic, especially if an exchange of stock, is involved.

Why, then, do portfolio managers, such as Mr. Sit, willingly accept stratospheric price/earnings ratios for certain issues? Patently, they are expecting a continuation of the strong growth pattern of per share earnings gains. but when a company starts at a relatively small earnings base, as all of these companies did, with the exception of Hewlett-Packard, there is usually a deceleration in the rate earnings growth as the company increases and accumulates its earnings. For example, Church's Fried Chicken increased earnings per share over 12-fold by advancing earnings from $300,000 in 1967 to around $3.7 million in 1971. But to achieve a similar 12-fold earnings over the next four years profits will have to rise to almost $45 million—which is a lot of chicken any way you cook it. Even Mr. Sit doesn't expect Church's Fried Chicken to do that well but such a projection points up the difficulties of maintaining a certain percentage earnings gain each year as a company becomes bigger and more profitable. At the ultimate, for example, IBM would have to clear an extra $1 billion plus to double present earnings of $9.38 a share on its approximately 115 million shares outstanding. On the other hand, a company with only 100,000 shares outstanding and earning $1.00 a share must earn only an extra $100,000 to double earnings.

Do Mr. Sit and his "growth stock" cohorts really believe that companies that are selling for 50 to 90 times earnings will continue to maintain those kind of p/e ratios?

In our view, Mr. Sit and other "growth stock" specialists expect one of two things:

1. Other investors will be willing to pay even higher price/earnings ratios than these stocks are now enjoying. Our opinion is that application of the "greater fool" theory is a highly unlikely development. P/E ratios above 50 are already rich and are fraught with tremendous downside risk.

2. The company will continue its spectacular growth in earnings per share, the p/e ratio will be maintained, and that because of this combination a higher price will result for the stock. This is the more probably of the two expectations but again it's a situation that allows for little, or no slow down, in the rate of earnings growth.

What it all boils down to is this: Institutional and other investors caught up in the "growth stock" theory are confusing a good company and a good stock. The stock of any good company, even IBM, can become highly speculative IF the price of the stock goes beyond a reasonable price/earnings ratio.

[From the Over the Counter Securities Review]

INSTITUTIONAL INVESTING DANGERS—III

For several years this publication has deplored the increasingly speculative tactics employed by supposedly prudent institutional investors. Two years ago, when the market was going through its most severe shakeout in the post-war era, we devoted two editorials to "Institutional Investing Dangers." Lately, we found support for our concern from several distinguished sources, including columnists for *The Wall Street Journal*, *Barron's* and *Forbes*.

In his July 3 "Abreast of the Market" column in *The Wall Street Journal*, Dan Dorfman examines the situation. "Growing institutional hunger for 'instant profit'—with many funds narrowing their money-making time horizons—is still another hurdle confronting cyclicals. It's generally agreed there are big earnings recoveries in store for a lot of cyclical companies, far superior, in many cases, than the large growth-oriented concerns. Yet, there's the continuing almost *dogmatic* belief in many quarters that there's a quicker gain in the offing from quality growth concerns with earnings visibility." Dorfman goes on to point that this is one of Wall Street's major dilemmas—the substantial and growing disparity in price-earnings multiples between the quality growth stock and cyclicals.

Smilen & Safian, a brokerage house which keeps an index of 25 growth stocks and an index of 23 cyclical companies reports that the growth stock index, composed of Merck, Kodak, Polaroid, et al. is currently selling at 32 times last 12 months' earnings and is 23% above April 1971, which was the market's peak. By contrast, the cyclical index, including Ford, General Motors, Goodyear and Alcoa, is selling for a multiple of 15, or less than half that of the growth group. Further the cyclical group has shown a loss of about 6% since the April 1971 high.

The undying attachment to growth stocks, even if it defies reason, is poignantly expressed by Thomas C. Pryor, chairman of the investment policy committee of White, Weld & Co.: As for such high-multiple growth stocks as Kresge, Disney and McDonald's, Mr. Pryor says that "the near-terms risks are greater." But he adds: "I think they should be owned because of their longer term superior growth potential." This hesitancy to ever "let go" from the quality growth stocks is further exemplified by the remarks of Donald R. Spaidal, senior investment officer at Manufacturers Hanover Bank ($9 billion in investment assets). Mr. Spaidal is bearish at the moment believing the DJIs may drop to the 870–880 level by the end of July and he doesn't think the quality growth stocks are attractively priced, but, he quickly adds: "We'd be buyers on weakness because we prefer earnings visibility." His candidates for purchase are hardly unique: Merck (p/e ratio—44, yield—1.4%); American Home Products (p/e—36, yield—1.7%); IBM (p/e—40, yield 1.4%); Minnesota Mining & Mfg. (p/e—39, yield—1.26%); Corning Glass (p/e—43, yield—1.4%). Obviously, nobody would buy the above stocks for their dividend yields—well under 2%. At the price/earnings ratio they sport—an average of slightly over 40—we can see only limited upside potential and considerable downside risk. The common sense of Mr. Spaidal's recommendations becomes even more suspect when it is noted that from 1967 to 1971, Merck's earnings per share advanced only 30% or 6% a year; American Home Products gained 62% or 10% a year; IBM's rose 60% or 10% a year; Minnesota Mining's increased 36% or 7% a year; and Corning Glass Works' actually DECLINED 27%. To the old question: "What price growth?" Mr. Spaidal's answer is plain—"Plenty!"

In the July 3 *Barron's*, Alan Abelson, our favorite "ferret of the footnotes" withdraws himself sufficiently from his perusal of the black magic of the balance sheets to succinctly observe: "We've had a de facto two-tier market for months now: one tier consisting of half a hundred big 'growth' stocks and their loyal institutional admirers; the other made up of the thousands of hum-drum issues and just-plain-folks investors. The notion occurs to us that perhaps in some fashion the set-up should be formalized. Thus, a section of the market officially set aside for the exclusive use of the big players and their chosen playthings, more or less like an African game preserve, if only in the interests of public safety. For sure as shooting, should the institutional gamesmen tire of the sport, many an innocent might be trampled in the resulting stampede. We're still convinced that one major excess of this bull market—the institutional herding into a rela-

tively few stocks—has yet to be remedied. And when it finally is, chances are the nasty effects will ripple out through the rest of the list. But there are a few tentative signs that we may have at least a little breathing room before the reckoning."

Attacking the institutional speculators with evident zest, Martin T. Sosnoff, general partner of Atalanta Partners, New York, writes in the July 1 issue of *Forbes*: "The overriding circumstance today is that speculation has become institutionalized and is in the hands of the banks. Whereas the mutual funds were the wolf pack leaders from the late Fifties through 1960, they no longer have the cash flow to regain trend setters. There must be a full dozen growing bank money pools of $5 billion to $10 billion, and hiding behind the marble pillared facades are the banks' money managers whose fearsome power makes Tyrannosaurus Rex look like a pussy cat. . . . The major demand thrust for stocks comes from pension fund cash flow which is largely managed by the banks. It is obvious today that the banks have chosen to go the growth stock route to the exclusion of much of the cyclical and basic industrial sectors, which today are relatively cheap. This trend can continue even while the basic industrials continue to show handsome profits momentum. Values in oil, automobiles and others are dismissed. Growth stock speculation has become pervasively institutionalized.

"Presently, the banks treasure their growthies to the exclusion of everything else, and this trend is self-reinforcing if new money is earmarked for the growth goods. It would be a mistake to think that more than a temporary correction is in the making for growth stocks. The mutual funds ran with the speculative torch for a decade, and now for the Seventies it is the banks' turn. . . . So the banks have all the tickets and, by concentrating on a handful of big capitalization securities, they can not only put an enormous amount of dollars to work, but they can almost achieve whatever performance goal they want per annum. No non-bank management organization can match this firepower, and the banks have finally hit upon a way to perform and keep all the money within the marble pillars. This trend may not change for years. . . . The institutionalization of speculation surely is unhealthy. Either the growth stocks will top out at some point in this cycle and the rest of the market will catch up, or the disparity will widen further and set the market up for a sizable correction comparable with 1962 or 1969."

The common thread running through all of these observations is that the so-called professional and supposedly prudent institutional investors are playing a dangerous, speculative game with other peoples' money. For years, bank trust departments were criticized for playing it "safe" with fixed income securities and blue chips. Now they are accused of being too speculative by investing in big ticket growth stocks selling at stratospheric price/earnings ratios. We share Mr. Sosnoff's concern over the unbecoming speculative tack of many bank investment managers. But we do NOT believe the banks will be able to achieve whatever performance goal they want per annum. On the contrary, we feel that eventually the banks are going to end up with a lot of high-priced, low-yielding growth stocks just like they ended up a few years ago with a lot of giant, slow-moving blue chips. In the case of the blue chips, the aftermath was a reduction in the prices of these stocks to sensible levels as it finally dawned on investors that these companies just weren't as invulnerable as the institutions had imagined them to be. We predict that the same fate awaits many of the cherished growth stocks of today which have been driven up to ridiculous prices and vanishing yields by the same kind of faulty but stubborn reasoning that these institutions applied to the blue chips a few years ago.

Senator BENTSEN. Mr. Hambleton. He is the President of the Harris Trust & Savings Bank, and president-elect, trust division of the American Bankers Association.

Mr. Hambleton, if this committee has hit an open nerve with you, you tell us about it.

I understand that you have a photographer, you want to take some pictures while you are testifying. If you do that is perfectly all right.

Mr. HAMBLETON. I do what I am told, sir.

Senator BENTSEN. If he wants some for your publication or something why you are certainly welcome to have him take it.

STATEMENT OF CHALKLEY J. HAMBLETON, PRESIDENT-ELECT OF THE TRUST DIVISION, THE AMERICAN BANKERS ASSOCIATION AND PRESIDENT OF THE HARRIS TRUST & SAVINGS BANK, CHICAGO; ACCOMPANIED BY WILLIAM W. GRAULTY, EXECUTIVE VICE PRESIDENT, THE CONNECTICUT BANK & TRUST CO., HARTFORD; PAUL J. COLLINS, SENIOR VICE PRESIDENT OF FIRST NATIONAL CITY BANK, NEW YORK CITY, AND ROBERT L. BEVAN, ASSISTANT FEDERAL LEGISLATIVE COUNSEL, ABA

Mr. Hambleton. Thank you very much, sir.

Mr. Chairman, as you mentioned, my name is Chalkley J. Hambleton, president-elect of the trust division, the American Bankers Association and president of the Harris Trust & Savings Bank, Chicago. I am accompanied by William W. Graulty, executive vice president, the Connecticut Bank & Trust Co., Hartford, who is vice president-elect of the trust division, Paul J. Collins, senior vice president of First National City Bank, New York City, and Robert L. Bevan, assistant federal legislative counsel, ABA.

The American Bankers Association has a membership of about 14,000 banks which represents approximately 96 percent of the commercial banks in the country. Over 3,800 of these banks exercise trust powers and are members of the trust division.

We appreciate this opportunity to appear before the subcommittee to discuss the role of institutional investors in the stock market and to discuss recommendations to restore the role of the individual investor in the stock market. We hope our comments will be of help in your consideration of this issue.

You will be happy to know that I do not intend to read the 40 pages of written testimony, sir, but I request that they be made a part of the record.

Senator Bentsen. It will be done.

Mr. Hambleton. The trust industry was somewhat surprised by articles and statements published this summer alleging that institutional investors were destroying Wall Street and the vitality of our capital markets.

Consequently we were pleased when the subcommittee undertook these hearings. We are convinced the hearings will help clarify the roles of institutions and individuals in the stock market, the causes of the two-tier market phenomenon and ways to help relieve this situation.

In discussing the current market situation some commentators have tended to overlook the fact that "institutions" are in reality "pools of savings" of many individuals. They also have tended to lump all institutions together as a giant monolithic investor. They have refused or failed to recognize that there are over 3,800 trust departments, over 800 mutual funds and uncounted thousands of insurance companies, endowments, pension funds and other separate institutional investors.

The association today would like to discuss trust departments, their operations and their investments in the equity market.

We also would like to suggest some ideas to help bring more individuals into the stock market.

Mr. Chairman, according to the latest figures we have seen, trust departments as of December 31, 1972, held, in over 1,200,000 accounts, assets totaling over $403 billion. These assets should not be viewed as one gigantic economic force since they are held by the 3,800 banks in many different capacities and with various degrees of authority. Most of our accounts involve numerous beneficiaries and over 167,000 of them are employee benefit accounts which serve millions of beneficiaries.

The fact that trust departments now hold over $400 billion in assets is evidence that they provide a needed service to the American people because these assets have come to the trust departments voluntarily and by best estimates 60 to 90 percent of them can be withdrawn by the customer at any time.

Bank trust departments serve as executors of estates, guardians of minors and incompetents, as trustees of revocable, irrevocable and testamentary trusts. They act as investment advisers and custodians.

A bank may serve alone or with a coexecutor or cotrustee. They may have sole investment discretion, may share investment discretion with others or may only provide investment advice.

They may have authority to vote stock under their management, they may share such authority or may possess no voting authority.

Even when the bank has sole investment discretion it is surrounded by legal restraints. When a bank accepts a trusteeship, it is under a duty to administer the trust according to its terms, and according to the law, solely in the interest of the beneficiaries of the trust. Consequently the investment portfolio of each trust must reflect the needs of its beneficiary or beneficiaries.

It should be emphasized that trust assets are not in a trust department's power but in its care.

Trust property belongs to the beneficiaries and any action that is taken to restrict trust departments restricts the rights of individuals. A good indication of the diversity of investment authority in personal trusts is the findings of the SEC institutional investor study that trust departments hold sole investment authority over less than 30 percent of personal trust assets and over less than 10 percent of agency accounts.

In contrast to this we readily acknowledge that banks hold sole investment authority over about 80 percent of the employee benefit assets in their accounts.

Employee benefit accounts held on December 31, 1972 about $110 billion worth of equity securities. Here again it should be kept in mind that these assets must be invested within the legal restraints imposed on trustees. And in addition the Senate has just approved a comprehensive pension bill that will prescribe in even more precise terms the obligations and responsibilities of pension trustees and other fiduciaries.

Now to turn to the question of how concentrated is bank investment activity. The American Bankers Association recently conducted a survey of trust department securities activities and securities holdings.

We sent questionnaires to all 3,800 banks with trust departments and received answers from about 800. One thing we learned is that

85.3 percent of the brokerage orders placed by trust departments with assets over $750 million between January 1 and June 30 this year were under $100,000.

We asked the total number of corporations in which the banks held equity securities on December 31, 1972. The average number for trust departments with assets under $50 million was 133 companies. For trust departments over $750 million, the average number of corporations in which equity securities were held was 2,543. We have only had time to feed into the computer the top 25 holdings of the top 52 reporting trust departments, all of which hold in excess of $1 billion in assets.

We found among the top 25 holdings a total of 29 corporations. We asked the trust departments to indicate where customers had discretion over 60 percent of more of a holding.

Senator BENTSEN. Mr. Hambleton, you are reading apparently from a summarized statement, is that correct?

Mr. HAMBLETON. Yes, sir.

Senator BENTSEN. I guess you sent one up to me. I am having trouble following your statement in the long document presented to me.

Mr. HAMBLETON. We just finished it this morning, sir, so I made some corrections on it.

Senator BENTSEN. We have run into a conflict here and I am going to have to run over and vote; that light up there means we have a vote on the floor. If you will wait I should be back in about 10 or 15 minutes unless we catch two votes back to back.

[Short recess.]

Senator BENTSEN. The committee will come to order.

Well, Mr. Hambleton, back on the record, if you will proceed with your testimony.

Mr. HAMBLETON. First, sir, I am sorry you did not get a copy of the condensed version.

Senator BENTSEN. That is all right.

Mr. HAMBLETON. We were working on it up to breakfast, as I mentioned. I shall continue reading.

We have only had time to feed into the computer the top 25 holdings of the top 52 reporting trust departments, all of which hold in excess of $1 billion in assets.

We found among the top 25 holdings a total of 299 corporations. We asked the trust departments to indicate where customers had discretion over 60 percent or more of a holding. We found that it is the customer in many instances that is partly responsible for the larger holdings of the growth stock by banks.

We will be glad to furnish the balance of this data as soon as it has come out of the computer.

Mr. Chairman, we included in our prepared statement considerable additional information on trust department investments. We believe the information presented indicates that bank trust departments are diversifying the portfolios of their beneficiaries and customers.

We do not deny that because of their investment quality certain stocks are held more often than others. But it seems clear that substantial holdings go far beyond the favorite 50 or 70 issues. The recent report of Morgan Guaranty shows that it holds over $10 million worth

of 223 securities and between $1 million and $10 million worth of 343 additional securities.

Senator BENTSEN. Let me understand, Mr. Hambleton, would you clarify that for me?

When it says over $10 million worth of 223 securities, that does mean, I suppose, over $10 million in each of these 223 securities?

Mr. HAMBLETON. Yes, sir.

If I may refer just briefly to my written testimony, there is one paragraph I would like to read there.

The First National City Bank of New York recently examined the 10 largest special situation funds managed by banks. These funds held $3.5 billion in total assets. Citibank found a total of 791 separate issues, 228 listed on the New York Stock Exchange, 142 listed on the American Stock Exchange, and 361 over-the-counter issues. Not one issue was held by all funds. One issue was held by 6 funds, and 587 issues were held by only 1 fund.

We realize, nevertheless, that despite this diversity there is concern over the recent gap between high and low multiple stocks. We agree with the comments of Mr. Samuel Calloway before this subcommittee as to the fundamental causes of the situation. We are convinced the problem is cyclical, not structural, and we are heartened by several signs that the situation is easing.

In the regard, Mr. Chairman, I request that an article which appeared in the Wall Street Journal on September 26 be printed at the conclusion of my statement.

Senator BENTSEN. It will be done.

Mr. HAMBLETON. I would like also to read one brief paragraph from the New York Times this morning:

> Wall Street analysts were impressed and some professed astonishment at the rotation of leadership among various groups that is often a classic indicator of market strength.

That is this morning's New York Times.

Nevertheless, despite this, the ABA does not advocate the Congress do nothing.

We believe the individuals who have left the market have done so for many reasons, including the following:

1. Many were burned in the 1969–70 market and continue to be reluctant to take another risk.
2. Overall uncertainty about the Nation's economy discourages equity investment.
3. Performance of the stock market in recent years has been weak.
4. There is more competition from high interest, fixed-income money instruments.
5. Changes in capital gains treatment has made stock investment less attractive.

Senator BENTSEN. Mr. Hambleton, I would not disagree with any of those. I think that all of those contribute to less individual investor participation. But obviously I do not think those are the only reasons.

Mr. HAMBLETON. Obviously; yes, sir.

We think certain steps can be taken that will increase individual participation and promote more healthy markets.

First, we support the early development of a central market system.

Second, we urge the Congress to enact an institutional investor disclosure act that would require bank trust departments to report securities holdings and transactions to the appropriate agency so long as it is limited to significant data and does not impose an undue cost burden on our customers.

We recognize that "confidence" is what is required to get individuals into the market and to promote healthy markets. If meaningful disclosure will help build consumer confidence in our securities markets, the ABA supports it.

A number of suggestions have been made for changes in our tax laws to provide incentives for individual investors trading. Most, if not all, of these suggestions have called for some change in the capital gains tax. These incentives would, however, be as favorable for investors in the high multiples as investors in the low multiples. While they would probably increase trading across the board, if we really want to achieve more buying in the low multiples, the tax incentive must be so directed and it must be significant.

We would suggest one approach which the subcommittee might wish to consider if it decides action in the tax area is necessary. Under this proposal the first year's cash dividends after the purchase of securities would not be subject to income tax but, rather, would be considered as a return of the taxpayer's basis. Thus ordinary income would be converted to capital gain.

To maximize the advantage of this tax incentive, a taxpayer would invest in low multiple high dividend stocks and would be encouraged to trade yearly. We realize this proposal has shortcomings and I hasten to repeat, the association does not advocate its enactment. However, the idea was developed by some of our people and we pass it on for whatever consideration the Congress wishes to give it.

In addition to disclosure and capital gains revision, a number of other suggestions have been made for regulation of institutional investors. We believe most of them would be counterproductive in that they would result in exactly the opposite effect than that desired.

The first suggestion is the imposition of a 5-percent cap on the amount of stock held by any institution in any one corporation.

While there is no specific limitation over the total holdings of a trust department in any one corporation at this time, there are two very realistic restaints. Good performance and fiduciary responsibility require real mobility.

Further, there are restraints in the 1933 and 1934 Securities Acts. The insider provisions, the controlling person provisions, and the corporate take-over provisions, and others serve as a real damper on the total position which a trust department may voluntarily take in a security.

Senator BENTSEN. Let me ask you, would a limitation on the amount of stock that you own in a corporation give you greater mobility? Would you not have less of a problem in selling that type of stock, and would you not run into less competition from other institutions that might want to get out at the same time?

Mr. HAMBLETON. Well, I think the point there, sir, is that it is sometimes easier to put together a block of trades if we get holdings of that size.

Senator BENTSEN. Well, of course that depends on 5 percent.

Mr. HAMBLETON. It depends on the security.

Senator BENTSEN. Five percent is a basis of how large a corporation you are dealing in.

Mr. HAMBLETON. I think some of the——

Senator BENTSEN. Five percent of IBM would be a pretty good-sized stock.

Mr. HAMBLETON. I think the subsequent paragraph gives some practical answers to this question really.

What would be the impact of a 5-percent limit?

In the growth stocks it would probably be nil. In the smaller second tier companies, it could be substantially adverse because 5 percent could represent a relatively small investment. If such a limit were established for trust departments, the Congress would have to decide whether the limitation would apply only to acquisitions where the bank had sole investment discretion or, in addition, to acquisitions where the bank shares investment discretion.

Would it apply to a guardianship coming to the bank?

Senator BENTSEN. I would say, I think we have touched on that, Mr. Hambleton, in previous statements. I think we are talking about situations where the bank has total discretion.

In addition to that, we have stated repeatedly, if such a limitation were put in we would assume the grandfather clause would be put in there to protect excess holdings.

Mr. HAMBLETON. Well, I think—it is my understanding that the grandfather clause would cover holdings currently held, but I mean in the future——

Senator BENTSEN. I think obviously you have to defer to any testator's limitations that he put in his will. Obviously you could have a situation where some man wanted ownership of a corporation to pass on to his family. Certainly we would not want to divest that sort of situation.

Mr. HAMBLETON. These are very important points in trust departments.

Senator BENTSEN. Of course they are, but to me they are so basic and axiomatic that you would not write legislation that would result in divestituture of such shares. We are only talking about the shares over which the bank has total discretion.

Mr. HAMBLETON. Then we will not spend any more time on that point and go on to the next one.

Another suggestion has been to limit the amount of a stock that can be sold during a certain period. One-quarter of 1 percent in a 30-day period was proposed. Under the prudent man rule, no fiduciary could possibly invest without a reasonable assurance of liquidity. Such a trading limitation would be devastating to smaller corporations. A limitation on trading would tend to peg maximum investment at that amount.

Similarly, the other suggestions which have been proposed for trading limitations would tend to limit the amount of stock acquired or held in smaller companies.

Also, if trading limitations were imposed, how would trust departments decide which account to sell from first?

This would result in tremendous problems and inequities in the liquidation of stock in a company in which we had lost confidence.

Chairman Ray Garrett of the SEC recently told the House Banking and Currency Committee that there is a lack of any hard data which

suggests that restrictions on trading are either wise or necessary. We agree completely with Chairman Garrett's observation and oppose trading restrictions as well as a limitation on the amount of stock of a corporation which can be held by any one person.

Mr. Chairman, the ABA appreciates this opportunity to appear and discuss these issues. If we can be of any assistance to the subcommittee or staff, we hope you will call on us.

Senator BENTSEN. Thank you, Mr. Hambleton.

Mr. Hambleton, in your statement you indicate that the 1933 and 1934 Securities Acts, through their insider provisions, serve as a real damper on the total position which a trust department may voluntarily take in a security. Would you elaborate on that?

Mr. HAMBLETON. May I ask Mr. Bevan if he would please answer that?

Mr. BEVAN. Yes, sir; the insider restrictions apply to a 10-percent holder of securities in a corporation, and this would be the concern. At the current time, we do not believe the law requires an aggregation of all accounts by a bank to determine whether it reaches that 10 percent. But there is always the possibility of a different construction being applied by the SEC. Also a suit may be brought against a bank and it would have to make the arguments to the court; that no aggregation is required. Therefore, the law sort of acts as a damper against exceeding the 10-percent holding.

Senator BENTSEN. Mr. Hambleton, I had previously stated that I personally, and I cannot speak for the subcommittee, do not believe that it is wise to put a limitation on institutional trading. I must say that the argument that you give for not imposing such a limit is not the same one I would use.

When you talk about whose accounts do you favor, you have that problem anyway. When you are ready to get out of a stock and it is in a number of your portfolios and you feel that the price is going down, you always have the problem, it seems to me, as to how you apportion that stock when you sell it. As the price keeps going down, obviously you must average it among these people so no one is discriminated against. I think you have that problem anyway.

Now one of the conclusions of the SEC institutional investor study of 1971 is that insider affiliate provisions of the Securities Act were not particularly effective on institutions because most of those provisions just deal with large holdings of shares which are beneficially owned. The study suggested in certain instances these rules be extended from beneficial ownership to holdings under common investment managements.

Would you consider that reasonable?

Mr. HAMBLETON. Sir, in reply to the first part of your comment, I think that the problem here is this 30-day delay in the sale of stock; in other words, that you can only do so much in a 30-day period.

Granted, you cannot always get rid of everything you own within 5 minutes, but you ordinarily under normal conditions can get rid of it within a reasonable period of time.

Senator BENTSEN. I would like to put in the record at this point a study showing institutional concentration of stocks where one bank held over 10 percent in three major corporations. So in this instance the so-called insider rule apparently had no effect.

[The document referred to by Senator Bentsen follows:]

PROLOGUE: Institutional investors have a vital stake in the continued viability of security markets as a national institution in our free enterprise economy. While institutionalization is certainly not the sole cause of the plethora of problems facing the security markets, and while institutional investors are themselves the victims of circumstance, their dominant position today is a mandate to take a leading role in security market revitalization. A broader understanding of the impact of institutionalization upon the public is necessary if the revitalization of our markets is to be achieved. These remarks attempt to contribute to that understanding.

The De-Institutionalization Of the Stock Market In American Society

A Question of National Economic Security

Hardly anyone in the investment community is unaware of the malaise affecting America's security markets today. However, because current discussions fail to span the full dimensions of this national problem, they can appropriately be likened to the proverbial "fiddling while Rome burns."

The public investor, the average U.S. corporation and the Wall Street community all seem to be sinking inexorably into the quagmire of distress surrounding our security markets. The public is disenchanted to a point where, for the first time, the U.S. shareholder population is actually declining. Numerous American corporations find their stocks selling at multiples of current earnings lower than we have seen for two decades, and so low as to subject them to the risk of control by foreign capital pools. Wall Street is immersed in red ink, with New York Stock Exchange member firms having reported an aggregate loss of $193 million in the first half of 1973.

The one group that has, until recently, emerged largely unscathed are the institutional investors.

This statement to the U.S. Senate subcommittee on financial markets expresses solely the views of David B. Bostian, Jr.

Despite the well known plight of the mutual funds, which comprise a relatively small part of the aggregate, institutional investors have, as a whole, increased their dominance even while other market interests were suffering. However, the institutions may soon find themselves faced with their own set of problems, stemming in no small part from the adverse public attitude toward our security markets. Commissioner John Evans of the S.E.C. recently noted in an address before the Utah Bankers Association, for example, that "some responsible parties" were recommending substantial restrictions on institutional trading and holdings, though he still remained opposed to such artificial impediments to the free market. Likewise, the Sixth Annual Institutional Investor Conference highlighted a panel on pending pension fund legislation noted to contain provisions that would make "the prudent man rule pale by comparison." Institutional investors would, therefore, seem to have as much a stake in the condition of the security markets as anyone, even though many of them have remained largely aloof to the distress of the broad lower tier of equity securities by steadfastly channeling their new funds into a favored few.

This writer is not suggesting, however, that institutionalization is the sole cause of the plethora of problems facing the security markets today. Indeed, in many respects, the institutional investors are themselves the victims of circumstance. On the other hand, with due regard for their col-

lective power and influence, institutional investors, on behalf of their self-interest, should be more than ready for a searching analysis of the problems facing the nation's markets.

On the Congressional front, significant legislation is now under consideration. It is of utmost importance that, in its final form, the legislation reflect a full appreciation of those basic truths which have been the very foundation of the economic superstructure, and which, heretofore, have engendered wide public support and enhanced the growth of both Corporate America and Wall Street, as well as the growth of institutional investors.

THE WRITER HOLDS THESE TRUTHS
TO BE SELF-EVIDENT:

(1) That the capitalistic form of economic society has been the vital foundation upon which America's past growth has been based and upon which future prosperity is dependent.

(2) That the individual American is the basic element in the capitalistic economic system, and only with the individual's faith in, and goodwill toward, the capitalistic system in America can it hope to prosper.

(3) That the broad body of Corporate America, upon which the majority of individual Americans depend to realize their entrepreneurial ambitions, is itself dependent on the goodwill of the broad population not only for capital, but also for the very mandate to operate profitably.

(4) Any serious impediment to the goodwill and faith of the average American in the capitalistic economic system should be viewed as alien and as a threat to the national economic security.

America's Security Markets — A Troubled Institution

In a 1972 address on "The Institutionalization of the Market" this writer summarized the many potential dangers accompanying the progressive institutionalization of the American security markets by noting that "the current institutionalization of the market seems to be resulting in the *de*-institutionalization of the stock market in our society at large".[1] Today, as institutional investors increasingly dominate dollar trading volume, research-information flows, and capital allocation decisions, while paying progressively less for their dominant market position, *individual* participation in our security markets, so vital to our capitalistic system, is suffering progressive and possibly permanent damage. The respect for equal opportunity to strive for success as an entrepreneur or an investor supplying capital to other entrepreneurs is being lost. The increasing dominance of institutional investors in the American stock market has probably done much to alienate the individual investor and possibly even to undermine the previously implicit mandate to Corporate America to earn a historically viable return on invested capital. When individual stock ownership, and the individual support of capitalistic goals implicit therein, begins to lose its place as an institution in American society, the private enterprise system is in grave danger. The assertion that this is a question of national economic security is not so difficult to accept when one considers in detail the following evidence:

(1) A recent Louis Harris survey reported on the degree of confidence in financial institutions.[2] The results were shocking and Harris concluded that the problem of solving the public's loss of confidence in the stock market was a challenge "of greater magnitude than some of the central problems on the agenda of today's securities industry leadership." Consider some of the Harris survey findings:

(A) Only 16 per cent of the population has confidence in the financial community (excepting banks).

(B) Only 19 per cent of all stockholders considered stocks to have a worthwhile degree of liquidity.

(C) 60 per cent of all stockholders now consider stocks to be a "luxury."

(D) 46 per cent of all stockholders now categorically say that owning stock is "*not* a good value for the money."

(2) A recent Arthur D. Little survey further confirmed the public's loss of confidence in the conduct of security markets.[3] The "most damning" finding of the report is that many investors think the market is "manipulated." Seventy per cent of investors and 64 per cent of non-investors shared this view regarding "manipulation." A key aspect of the "manipulation" charge centered upon "unfair advantages and access by institutions...".

(3) The New York Stock Exchange recently reported that the number of shareholders in the United States had declined 800,000 since the previous shareholder census, the first such decline on the records.

(4) Odd-lot investor transactions, also characteristic of small round-lot public (individual) transactions, reveal a steady stock liquidation trend for 36 consecutive months. Indeed, the last day on which these small investors made any net purchases was July 28, 1970, near the bottom of the 1969-1970 slide.

1. Footnotes appear at end of article.

(5) The consistent trend of net redemptions reported monthly by the fund industry dating back to 1971 reveals the same disenchantment evidenced by point 4 above.

(6) From the standpoint of the broad body of Corporate America, the market values of average companies have declined drastically in the recent past. For example, between April, 1972 and April, 1973 the price of an average share on the American Stock Exchange declined approximately 33 per cent and the price of an average share on the New York Stock Exchange declined approximately 20 per cent, on an equal weighting basis. These large declines occurred despite the fact that profits are up.

(7) Problems for the broad body of Corporate America created by limited market liquidity (and interest) in their shares run the gamut from reduced ability to garner new and additional capital for modernization to the threat of "raids" by foreign-held capital.[4]

(8) The combination of public investor disenchantment with the now heavily institutional stock market (points 1 and 2) and the declining share prices of the majority of American corporations (point 6) have created an atmosphere where the public at large has become increasingly skeptical about corporate goals as well as corporate profits. This skepticism is documented by surveys reported in leading business publications.

(9) Institutional investors dominate the dollar trading volume on the New York Stock Exchange today. Seventy per cent of non-member (or public) dollar volume is currently done by these large institutions as a group and the remaining 30 per cent is done by individuals.

(10) While institutional investors generate 70 per cent of the non-member dollar trading volume, they are paying increasingly lower commissions for the business done due to "negotiated" rates. While detailed current data on the allocation of commission revenues between institutional and individual sectors is not yet available, these institutions which dominate 70 per cent of the dollar volume on the NYSE may be paying less than half of NYSE commission revenues, leaving the individual investor paying more than half of the NYSE commission revenues.[5]

(11) While institutional investors dominate NYSE trading (as noted in points 9 and 10 above), they do not deal in all stocks equally. A group of 21 institutional "favorites" compiled by Wiesenberger Services advanced 90 per cent since December of 1968 and about 25 per cent between April of 1972 and April of 1973. An average stock on the NYSE (as reflected by unweighted market indicators) *declined* about 50 per cent since December of 1968 and about 20 per cent between April of 1972 and April of 1973. These divergent price trends resulted in the average multiple of the institutionally favored group rising to approximately four times the average level of the entire NYSE list, yet only five of the 21 "favorites" were able to rank among the top 100 companies on the NYSE in terms of highest five-year earnings growth! (See Exhibit A.)

(12) While many institutional investors (banks, pension funds and insurance companies for example) are not required to make a full disclosure of their portfolio holdings, tremendous concentration in the outstanding shares of certain companies was revealed as far back as 1969 by the Institutional Investor Study. Ownership percentages as high as 40 to 50 per cent of the outstanding shares in a limited list of "favorites" were reported then! Net buying by pension funds and banks, etc. over the past three-plus years has surely increased these concentrations. Recently *one* large bank was reported to own over 10 per cent of the outstanding shares of several large companies. (See Exhibit B and Exhibit C.)

(13) The institutional investors which dominate the NYSE dollar volume deal with an increasingly limited number of brokerage houses, according to the Arthur D. Little survey cited in point 2. This selectivity tends to allow institutions to "dictate" rather than negotiate commissions.[6]

(14) As many as "90 per cent of the companies listed in the *Wall Street Journal* stock pages do not appear to warrant research, not because their prospects are poor, but because they don't generate enough sales to reward brokerage houses in commissions."[7]

(15) The trend toward institutional "control" of research activities was noted by the Arthur D. Little report cited in points 2 and 13. Institutions, with research dollars drastically cut, "are planning internal expansion of their own research staffs."[8] Furthermore, the First Institutional Research Conference, being held in September of 1973, raises the question "Will institutions become independent of Wall Street research?".[9] Given the tendency to concentrate that institutions exhibit today, control of research, to any degree, would seem to be an ominous portent for the marketplace.

"Who, If Anyone, Is Gaining the Benefits?"

It is vital that the ultimate legislation on these matters surmount the myopic proposals from special interest groups and focus on the larger issues. The need for a national perspective was clearly stated by former SEC Chairman G. Bradford Cook in an address before the Economic Club of Chicago.

"The public character of the nation's securities markets is a unique national resource . . . one

Exhibit A: A GROUP OF 21 CURRENT INSTITUTIONAL FAVORITES

Wiesenberger's "21" Institutional Growth Favorites . . . . (Alpha order list)	Current Price to Earnings Multiple of Stock . . . . . . (as of 4/19/73)
American Home Products	38 X
AMP, Inc. "	40 X
Avon Products	56 X
Coca-Cola Company	44 X
Dr Pepper Company	58 X
Dun & Bradstreet	30 X
Eastman Kodak	41 X
Eli Lilly "	45 X
International Bus. Mach.	38 X
International Flavors & Frag.	77 X
Johnson & Johnson "	56 X
Lubrizol Corp.	31 X
Merck Company	46 X
Minnesota Mining & Mfg.	37 X
Pfizer Incorp.	25 X
Proctor & Gamble Company	29 X
Sears Roebuck & Co.	25 X
Schering-Plough Inc. "	51 X
Simplicity Pattern	44 X
Warner Lambert Company	31 X
Xerox Corporation "	48 X
MEAN MULTIPLE	42 X

that gives our population broad participation in companies and provides for a market pricing system that represents the effect of thousands of decisions made by individuals and institutions alike . . . The erosion of investor confidence and participation in the securities markets is national in scope, and so are the causes of the problem. The answers . . . can come only through a concerted effort on a national scale to preserve and strengthen the public character of the markets . . ."

In the short run, however, institutional investors appear to be dominating the scene at the expense of the other parties. Just what is the nature of this institutional dominance? How did it evolve? Is it viable? The July, 1973 *Fortune* magazine editorial dramatized the growing seriousness of the institutional domination. Noting the concentration of power in the pension fund sector, *Fortune* bluntly stated:

"Antitrust action to reduce the market share of the big banks' pension business might be appropriate."

Those are strong words. Hopefully, enlightened

Exhibit B: INSTITUTIONAL CONCENTRATION IN 1969 FOR SELECTED ISSUES

Institutional Favorite	Institutional Concentration
American Home Products	35% in 1969
Avon Products	47% in 1969
Eastman Kodak	41% in 1969
International Bus. Mach.	43% in 1969
Merck Company	50% in 1969
Minnesota Mining & Mfg.	33% in 1969
Proctor & Gamble	34% in 1969
Sears Roebuck	45% in 1969
Xerox Corporation	52% in 1969

This data was excerpted from the Institutional Investor Study Report.[11]

Exhibit C: INSTITUTIONAL CONCENTRATION IN 1972 — AN EXAMPLE

The table below reflects the portfolio holdings of just one major institution, a bank, as of 12/31/72. The right hand column indicates that one institution owns over 10 per cent of the outstanding stock of several major companies. It is noteworthy that this bank and nine other large banks manage $76 billion of pension assets, over half the total.[12]

Stock	Holdings on 12/31/72 Dollars (Mil)	Shares (Mil)	Shares Outstdg (Mil)	% of Total
IBM	$2,094	5.21	116.2	4.5
Eastman Kodak	1,188	7.69	161.5	4.8
Avon Products	651	4.75	57.8	8.2
Sears Roebuck	605	5.22	156.7	3.3
Xerox	596	4.00	79.3	5.0
Walt Disney	473	3.97	27.8	14.3
Polaroid	423	3.36	32.8	10.2
Proctor & Gamble	396	3.54	81.9	4.3
Schlumberger	390	4.29	36.5	11.8
General Motors	344	4.25	287.6	1.5
American Home Products	330	2.70	51.7	5.2
Coca-Cola	320	2.15	59.7	3.6
Exxon	309	3.51	224.2	1.6
American Express	306	4.71	48.6	9.7
Mobil	286	3.86	103.2	3.7
Kresge	285	5.82	117.2	5.0
J. C. Penney	279	3.10	57.1	5.4
Merck	274	3.08	74.2	4.2
Philip Morris	272	2.31	27.3	8.5
McDonald's	262	3.45	38.9	8.9
Texaco	212	5.58	272.0	2.1
First National City	210	2.73	116.1	2.4
Schering-Plough	207	1.51	26.3	5.7
Johnson & Johnson	206	1.57	56.4	2.8
MGIC Investment	203	2.11	21.1	10.0

(Table excerpted from *Barron's*, June 18, 1973)

self-interest will avoid government intervention. Likewise, a better understanding of the institutionalization phenomenon may lead the way to a more synergistic marketplace where regulation is not necessary. Though the following excerpts from the writer's address to the Tenth Annual Contrary Opinion Forum were delivered in 1972, subsequent events, especially the emergence of the "two-tier market," have made the question of viability less "contrary" today:

The Institutionalization of the Market — A Question of Viability

In a recent book on the subject, Charles Ellis has many pertinent observations on the relatively new phenomenon of institutional investing.[20]

> "Institutional investing has been a dramatic and powerful phenomenon. It is an exciting new kind of business. And it will surely change our nation's business and financial structure in the years ahead... It bears repeating that the full consequences of the impact (of institutional investing) have not yet been seen."

Ellis further points out that institutional investing is a relatively innovative business form that has evolved from a position of limited importance to a $200 billion asset position in just two decades. Indeed, its growth has become so rapid that today the institutional business is growing at twice the rate of the national economy. Yet despite the success implied by its rapid growth, the most pertinent and timely phrase from the above quotation may well be the final line: "It bears repeating that the full consequences of the impact of institutional investing have not yet been seen." Figure One provides important perspective by giving both historical and projected stock ownership for various categories of institutional investors as well as their cumulative market position. In the "Percentage of Total Market Value" columns in the middle of the table note the tremendous and still growing importance of "Noninsured Corporate Pension Funds." Total institutional holdings as a percentage of total market value of outstanding equity is currently around 30 per cent, half way between the 1968 figure of 23.2 per cent and the projected 1980 figure of 36.2 per cent. The New York Stock Exchange has recently estimated that institutional equity holdings may currently be as high as 45 per cent of the total market value of outstanding equity if "a number of institutional categories for which no basis exists for estimating holdings" are included.

The relative ownership positions of institutional investors and non-institutional investors does not mirror the full extent of today's institutionalization. While institutional investors currently own about 30 per cent — the conservative estimate — of total corporate stock outstanding, their trading activities, mainly in search of performance, encompasses approximately 70 per cent of NYSE dollar trading volume, excluding the activity of members. Figure Two clearly shows how institutions dominate the market on a total volume basis. The "turnover rate" graph reveals the dramatic increase in institutional trading that began in 1965 as institutional investors began to believe that better performance was directly related to portfolio trading. However, the 1969-1970 crash caused the first downturn in the turnover of holdings, and the rate has been basically flat in the 30 per cent area since then. The second graph shows that "block trading" as a percentage of NYSE volume is currently around 18 per cent and projected to reach 25 per cent by 1980. The third graph shows the relative volume trends of institutions and the public (individuals) and speaks for itself. If NYSE member trading is eliminated, the current institutional dollar volume runs at a 70 per cent rate.

The Institutional Investor Study[21]

The widely noted Institutional Investor Study concluded that institutional impacts on liquidity and stability were generally favorable. According to Lawrence D. Jones of the University of Pennsylvania, who spoke at the 13th annual meeting of the American Finance Association in his capacity as an Associate Director of the Institutional Investor Study:[22] "The Institutional Investor Study's results... have contributed to turning the focus of public attention away from the impact of institutions on the market structure and toward an appraisal of the markets themselves. Particularly significant are the negative findings produced by the Study's testing of the parallel trading hypothesis and the surprisingly limited evidence of institutional price impacts. The Study's analysis of market making indicates that the trading behavior of institutions that impinges upon market makers results from market fragmentation and a regulatory structure which has insulated markets and market makers from each other."

In the writer's opinion, these conclusions are subject to two important caveats:

(1) The Institutional Investor Study covered a limited time period in its search for evidence of serious institutional price impacts and, specifically, left out the final two devastating quarters of the 1969-1970 bear market when institutional nerves and market liquidity were really put to the test.

(2) The full nature of institutional impacts upon the public interest is a far broader question than whether or not institutional trading imbalances disrupt the stability of the market.

The Institutional Investor Study monitored "institutional trading imbalances . . . monthly for the period January 1968 to September 1969, for 229 institutions trading in 325 common stocks." (Journal of Finance, May, 1972, page 307). There is, however, the possibility that the favorable findings of the Study during that period may be less than valid because, in addition to the limited time frame, the high stress period of the bear market that included the final 1969 quarter through May of 1970 was not included. By contrast, the period of the Institutional Investor Study can be described in terms of the Dow Jones Industrial Average as a large trading range bounded by the high 900's on the upside and the 800 area on the downside. The critical time to measure institutional impacts was in the quarters following the Study when the DJIA plunged through 800. The prices of many institutional favorites dropped sharply following the close of the Study. Control Data, an institutional favorite of the period, had been trading calmly in the 140-160 range for many months before the Institutional Investor Study closed. However, in October of 1969, less than a month after termination of the Study's sample period, Control Data began a sudden decline that ended in the low 30's in May of 1970. While it did not rebound vigorously, other institutional favorites like Polaroid and International Business Machines also registered severe declines in the post-Study period followed by equally sharp advances when the new upswing in the market began. If the final months of the 1969-1970 bear market were included in the Institutional Investor Study Report the conclusions, which were relatively favorable to the institutionalized market, might have been altered significantly.

Noteworthy evidence of possibly disruptive institutional imbalances in the period following the close of the Institutional Investor Study is provided by the behavior of odd-lot balances relative to non-member round-lot balances, the latter being characterized by the SEC Statistical Bulletin as "institutionally dominated" trading balances (See Figure Three). Non-member round-lot balances, which, in the main, represent institutional activity, revealed heavy selling during the chaotic final months of the 1969-1970 decline, right at the lows! By contrast, Figure Three also shows that the public was a net seller right at the top of the bear market while institutions, on balance, were aggressive net buyers.

The Stock Market's New "Crowd"?

When unanimity of opinion develops, implying that the final participant has acted (bought or sold) on the opinion, price will have completed

FIGURE ONE: PAST AND PROJECTED STOCK OWNERSHIP BY INSTITUTIONS

HOW MUCH STOCK WILL INSTITUTIONS OWN?

	Market Value (in billions)			Percentage of Total Market Value			Growth Rates (percentage per year)	
	1968*	1980	2000	1968	1980	2000	1968-80	1981-2000
Noninsured Corporate Pension Funds	$ 56.0	$ 269	$2,362	7.3	13.7	25.8	14.0	11.5
Investment Companies	59.6	258	1,730	7.8	13.1	18.9	13.0	10.0
State and Local Pension Funds	4.8	37	357	0.6	1.9	3.9	17.0	12.0
Life Insurance Companies	12.8	46	171	1.7	2.3	1.8	13.5	6.8
Property and Casualty Insurance Companies	14.7	37	118	1.9	1.9	1.3	8.0	6.0
University and College Endowments	9.0	28	190	1.2	1.4	2.1	10.0	10.0
Foundations	15.8	28	74	2.1	1.4	0.8	5.0	5.0
Common Trust Funds	4.4	11	53	0.6	0.6	0.6	9.0	8.0
Total Institutional Holdings	$177.1	$ 714	$5,055	23.2	36.3	55.2	12.3	10.3
Market Value of All Outstanding Stock*	$761.3	$1,966	$9,161				8.0	8.0

*For widely held companies only includes both common and preferred stocks.

Source: Institutional Holdings of Common Stock, 1900-2000 by Robert M. Soldofsky.

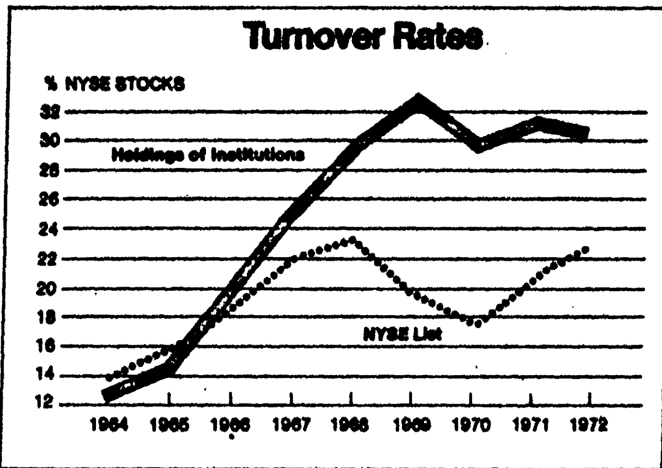
its current trend and will be ready to reverse direction. As public participation in the stock market has diminished, the institutions have become the primary active participants. Given their current dominance of the market in terms of dollar trading volume, it is entirely possible that, almost by default, institutions are becoming the new "crowd" in the market, predestined, as a group, to be wrong at major turning points.

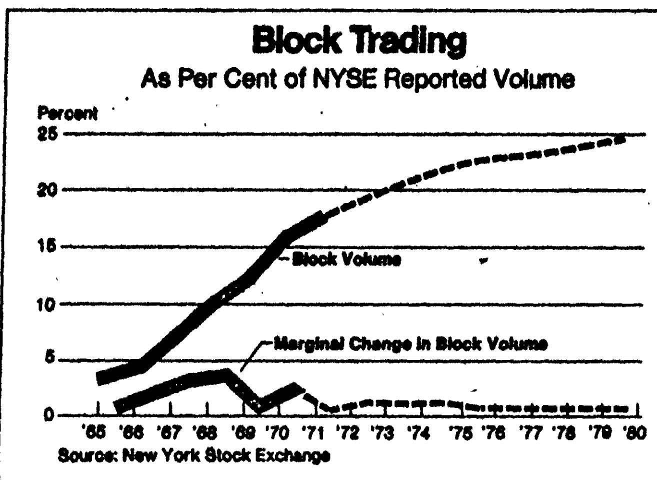
Evidence in support of this view is provided by a poll of money managers attending the Fifth Annual Institutional Investor Conference.[33] When asked to pick the group that would perform best for the duration of 1972, those surveyed picked the airlines as their first choice. At the time of this poll most major airline stocks were within one per cent of their 1972 highs and, as might be expected from such bullish unanimity, underwent severe declines immediately thereafter, plunging nearly 50 per cent as a group by the close of 1972 and about 75 per cent as a group by the spring of 1973 when they were voted as one of the groups to avoid at the 1973 Conference.

Has the New Crowd Oversold Performance?

An important factor underlying the dramatic growth of institutional investing—"an exciting new kind of business" as Ellis described it—appears to have been the selling of "performance," which has been broadly defined as doing better than certain market averages over a period of years. As the public found it increasingly difficult to make and keep money in the stock market as the last decade progressed, funds were turned over to professional money managers who not only could relieve the public of the burden of day-to-day decision making but also held forth the implicit promise of performance. In recent years, corporations burdened with the re-

FIGURE TWO: THREE VIEWS OF INSTITUTIONAL TRADING ACTIVITY ON THE NYSE





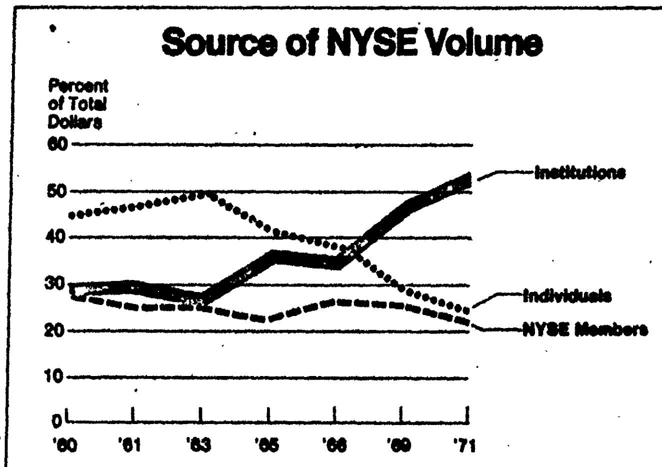
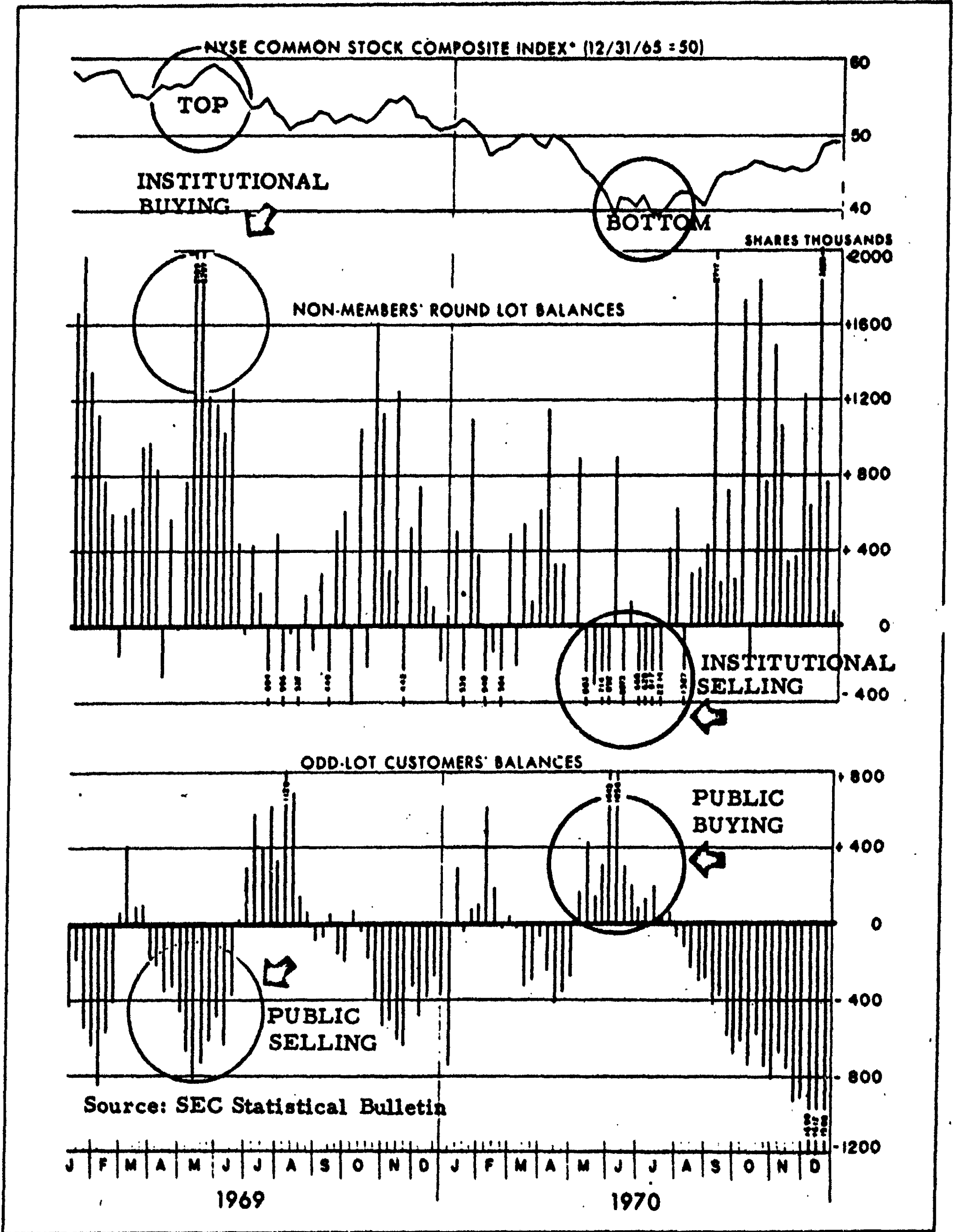


FIGURE THREE: ARE INSTITUTIONAL INVESTORS THE NEW "CROWD" IN THE MARKET?



sponsibility of corporate pension costs have been prodding their institutional money managers into a quarter-to-quarter performance race.

Institutional investors may have done themselves a serious disservice in selling performance. Many public investors have developed the attitude that performance is the primary goal of equity ownership. When performance was not forthcoming in recent years, they seem to have concluded there was little purpose in owning equities, much less paying someone else to buy and sell them. Could such a rationale not lie behind the tenacious trend in mutual fund net redemptions that stretches back to 1971?

There is a growing body of statistical evidence that institutions as a group cannot out-perform the "random walk" represented by the market averages. In March of 1972 *Fortune* magazine cited a key 1970 study sponsored by the Twentieth Century Fund and conducted by professors Irwin Friend, Marshall Blume and Jean Crockett of the Wharton Business School:

> "In a massive 1970 study, they — professors Friend, Blume and Crockett — showed that the investment performance of mutual funds as a group was no better than what an investor might have achieved by buying and selling at random."

Going on to review more recent studies, *Fortune* further observed:

> "The news about the rather poor overall performance of the pension funds and investment advisers parallels the (1970) findings . . . professor Friend also reached a similar conclusion about bank trust officers."

Summarizing the continuously growing body of evidence regarding the real limitations of widespread pursuit of performance, Joseph Spigelman and Dr. Julian Gumperz made the following observation:[24]

> "It is already notorious that the performances of professional money managers exhibit a more and more normal probability distribution. About half of them do better than the averages and about half do worse; and only a small minority perform consistently well over a period of years—probably by chance."

This evidence does not imply that institutional investors cannot make money for other people when the broad market is in a rising trend, but only that the gains achieved at such times are the result of aggregate appreciation influences and merely reflect the degree of that influence. The recent and growing popularity of the so-called "Index Funds" would appear to indicate increasing acceptance of merely duplicating the performance of leading market averages as a realistic investment goal. Indeed, one may conclude that the more institutions engage in the aggressive pursuit of performance, the greater any given institution's difficulty in achieving above average results.

However, the consequences of the pursuit of performance go beyond the frustrations that accompany the failure to achieve it. The volatile market action that appears to accompany the aggressive pursuit of performance may be further damaging the public psychology. Consider the following examples from a 1972 article entitled "Illiquidity: Is It Becoming a Problem Again?".[23] Noting that progressive institutionalization had "brought performance pressures to a pitch," specific stock price collapses were reviewed. In the case of Handleman Company stock, the public cancelled half of their orders to sell 10,000 shares when notified that the issue would open substantially lower, but "none of the institutions, whose total 'market' orders came to better than 350,000 shares, had second thoughts about bailing out." Likewise, Wang Laboratories' stock was dumped when interim earnings were lower than anticipated, even though the prospects for a new computerized typewriter — the cause of the issue's prior advance from 35 to 60 — remained unchanged.

An editorial in the August 21, 1972 *Barron's* highlighted how public confidence was being damaged by "a market already far too institutionalized and thin for its own good."

> "On the New York Stock Exchange, for example, since January, issues have been suspended from trading because of an 'order imbalance or influx' nearly 200 times, well over half again as often (not counting the upside bulges across-the-board on August 16, 1971, the day after the White House unveiled the New Economic Program) as a year ago. Unexpected adversity for one company after another . . . has triggered delayed openings and heavy overnight losses."

The erosion of public confidence did not happen suddenly. William McChesney Martin, Jr., speaking before a 1971 luncheon of the New

York Financial Writers Association, warned of the need "to re-establish the integrity of the stock markets" because "all sorts of people . . . don't want to buy stocks anymore." And former SBC Chairman William J. Casey noted in a 1971 interview:[illegible]

> "While it's easy to say that the little guy ought to get out of the market and into funds, I wouldn't like to see that happen. I think the challenge the whole investment community faces is how it can provide the kind of guidance and professionalism of information, advice and judgment which will keep the small guy in the investment markets."

Disenfranchising the Public

In focusing narrowly on the criterion of security price behavior, the Institutional Investor Study may have circumvented its mandate to determine the nature of institutional impacts upon "the interests of the public." To be sure, the selling of perfomance may have distorted the public's expectations of the rewards from equity ownership, and the pursuit of instant performance may have contributed to increases in price volatility which are frightening the public away. But there is an even deeper problem with the trend toward institutionalization. As financial intermediaries (institutional investors) have increasingly entered the

FIGURE FOUR: IS THE INDIVIDUAL INVESTOR IN U. S. CORPORATIONS BEING DISENFRANCHISED?

Are direct benefit flows increasing at the expense of shareholder benefit flows? Does the individual as voter think of himself more as employee-consumer than as shareholder-entrepreneur?

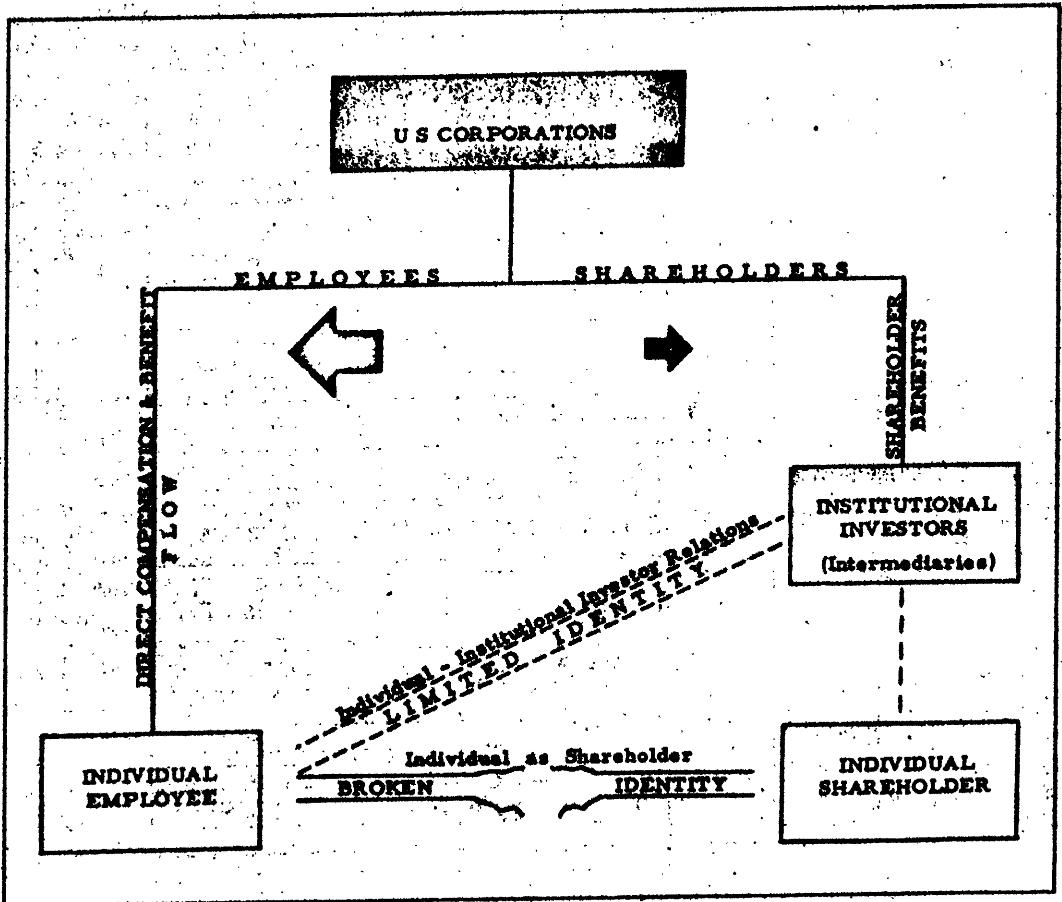
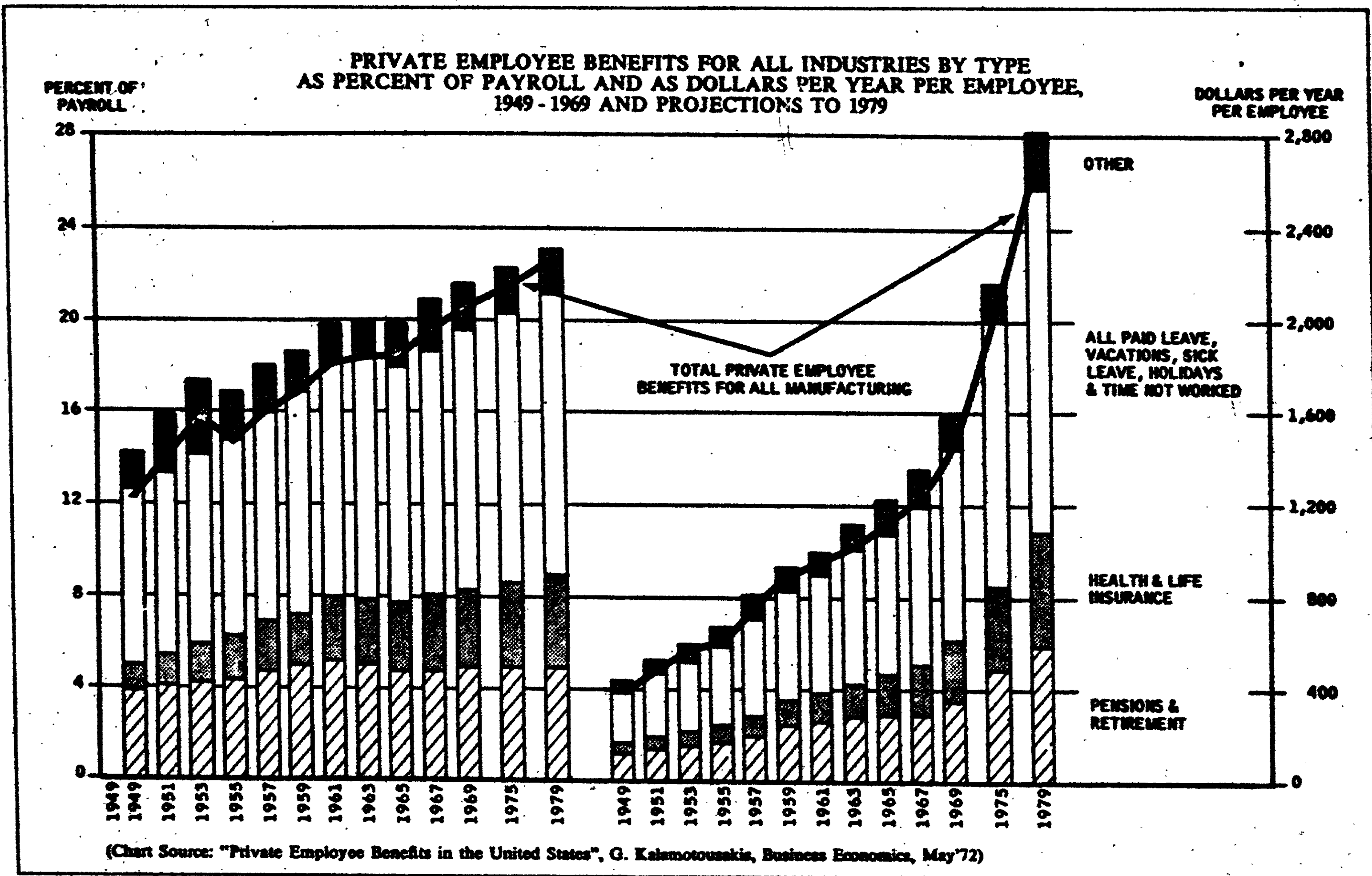


FIGURE FIVE: PENSION COSTS—THE UNDERLYING CAUSE OF THE RAPID GROWTH IN CORPORATE PENSION FUNDS



(Chart Source: "Private Employee Benefits in the United States", G. Kalamotousakis, Business Economics, May'72)

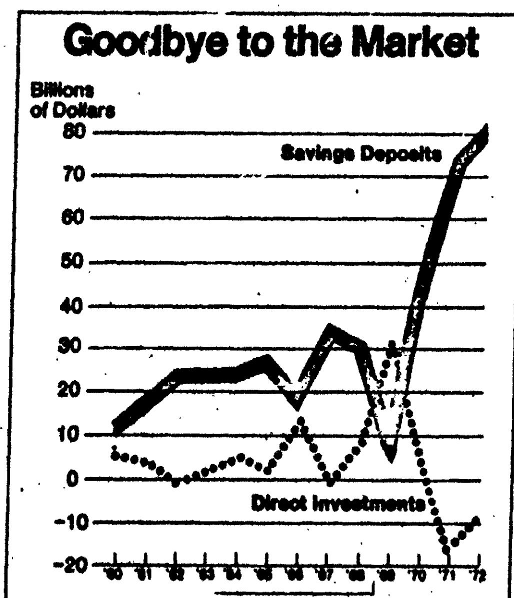
88-757 O - 73 - pt. 3 -- 13

corporate-shareholder relationship, the individual has had a progressive loss of identity with his shareholder role (see Figure Four and note the right side of the diagram). Even though the individual employee and the individual stockholder are often the same person, the role in which that person perceives himself will determine a great deal about how he conducts himself as a voter with respect to issues of importance to the private enterprise system. As the individual ceases to think of himself as a shareholder, he may have less concern for that system.

There are, of course, observers who believe that the public's direct interest in the market is no longer essential because the public has become an "involuntary" investor through the geometric growth of corporate pension funds. But there is something disquietingly myopic about such a view. Figure Five reveals that the growth of corporate pension funds is really nothing more than a reflection of the rapidly soaring *cost* of private employee benefits. American corporations have consequently turned to professional money managers in a desperate attempt to offset the potentially devastating impact of these costs on corporate profits.[27] This pressure for performance and the resultant concentration of institutional portfolios has allowed the equities of many corporations to drift downward to historically low levels. The so-called "two-tier" market has left many company executives as well as employees distressed when institutional cash flow from pension monies bypassed their own companies' equities. A recent *Fortune* article highlighted the "self-fulfilling prophecy" aspect of continuous channeling of cash flow into a narrow list of equities and questioned if this really represented performance.[28]

Ironically, the public still expects the financial intermediaries that manage its money to perform, even though its direct-compensation preferences may drastically narrow the number of corporations that are sufficiently unburdened by labor costs to produce earnings gains commensurate with aggressive performance goals. This, of course, leaves the institutional investors that have sold the public on their ability to perform caught in the middle .

FIGURE SIX
De-Institutionalization of the Market



Source: U. S. Savings and Loan League

Summary—The Risks

The depth of the public's disenchantment — which has been growing for some time — is revealed in this 1971 letter to the editor of *Barron's*.[29]

NEW KIND OF CASINO
To the Editor:

What Wall Street does not seem to understand as yet, is that millions of small investors are easing out of the stock market for good. They have become the smart guys. The market of tomorrow may well become a new kind of casino with the big investors trying to outsmart the other. Can a casino survive without the public?

If American industry is to survive, perhaps it would be well for each corporation to sell its own equities outright without a stock exchange, commissions and fees. Then, the small investor may return to purchase shares of those companies which he trusts will share in a bright future. The average small investor still has faith in industry. He has learned to distrust the machinations of clever people . . . those whose only motive is personal gain and who could care less about American industry.

Whatever the precise reason, the public departure documented in Figure Six is vivid evidence of the declining role of the stock market in our society. The current trend toward "institutionalization" of the market is resulting in the stock market's de-institutionalization in our society at large. It is doubtful whether this trend is beneficial to institutional investors, Wall Street, or our economic system. While institutional investors are certainly not inherently bad, the current nature of institutionalization is.

The Remedy — A Balance of Power

Our security markets are now at a truly critical juncture. Every party with a serious stake in their continued viability must be seriously concerned. We have argued that viability depends, at least in part, on a harmonious balance among the interests of the American public, American corporations, Wall Street and institutional investors.

Ultimate success in revitalizing our national security markets will depend on mutual respect on the part of each of the groups listed above for the interests of the other groups, and on the willingness of all to put the national economic security above the interest of any. In achieving the balance necessary to sustain a viable security market, it may seem that institutions are being asked to make a greater accommodation than the other interest groups. Given their stake in this market, however, and given their current power and influence, institutions must play a critical role. ♦

Footnotes

1. An address delivered on October 13, 1972 before the Tenth Annual Contrary Opinion Forum, Manchester, Vermont. The full text of addresses before that forum may be obtained from Mr. James L. Fraser, CFA, Fraser Management Associates, 309 South Willard Street, Burlington, Vermont, 05401, who is one of the sponsors of the annual forums. Excerpts from the "Institutionalization of the Market" address appeared in *Barron's* on November 6, 1972 (page five) and in *The New York Times* on November 8, 1972 ("Marketplace" column).
2. This Louis Harris survey was reported in the *Financial Analysts Journal*, March-April, 1973 issue.
3. This Arthur D. Little survey was reported in the *Wall Street Journal*, "Heard-on-the-Street" column, May 4, 1973.
4. The nature of the threat from foreign capital was discussed by NYSE Chairman, James J. Needham in a *Business Week* interview (4/14/73). Documented examples of foreign take-over attempts were cited in a *Barron's* editorial in the 6/25/73 issue.
5. The lower commission cost being paid by institutions (versus the public) was well illustrated in *The New York Times*, "Marketplace" column, (5/1/73).
6. See footnote (2) above.
7. This view of the institutional domination of research activities via the "power of the purse" is expressed by James L. Fraser, noted CFA and president of Fraser Management Associates.
8. See footnote (3) above.
9. The First Institutional Research Conference is sponsored by the *Institutional Investor* magazine.
10. See the annual review issue of *Forbes* magazine for January, 1973.
11. The Institutional Investor Study Report was authorized by Public Laws 90-438 and 91-410. It was released in 1970.
12. The 3/31/73 *Business Week* reported that the following ten banks now manage 76 billion dollars in pension assets.

Bank	Amount
1. Morgan Guaranty	$16.9 billion
2. Bankers Trust	15.1
3. First National City	9.3
4. Manufacturers Hanover	6.3
5. Chase	6.0
6. First Nat. Chicago	5.4
7. Nat. Bank, Detroit	5.0
8. Mellon	4.6
9. Continental Ill.	4.0
10. U.S. Trust	3.0
Total	$76.5 billion

20. *Institutional Investing* by Charles D. Ellis, Dow Jones-Irwin, Inc., 1971.
21. See footnote (11).
22. Excerpt from the remarks of Dr. Lawrence D. Jones before the 13th annual meeting of the American Finance Association (December 27-29, 1971) as reprinted in the May, 1972 *Journal of Finance*.
23. This poll of managers in attendance at the Fifth Annual Conference was reported in the *Wall Street Letter*, April 24, 1972.
24. "The Knowledge Revolution" appeared in the *Financial Analysts Journal*, July-August, 1972.
25. The article appeared in the September, 1972 issue of the *Institutional Investor*.
26. Interview with William J. Casey in *Forbes*, July 15, 1971.
27. "Sure as Death and Taxes" appeared in *Barron's*, August 28, 1972.
28. The article appeared in the July, 1973 *Fortune* and was entitled "Two-Tier Miseries."
29. See Letters-to-the-Editor section of *Barron's*, October 4, 1971.

Senator BENTSEN. Do you feel that banks should have a self-imposed limitation on how much of their discretionary assets should be invested in one particular stock?

Mr. HAMBLETON. Well, in the case of our bank, when we get over 5 percent of any what we call our working list stocks, it has to be reported to our directors once a month. They keep track of it. They are interested enough to know what is going on and to require a justification for it.

We are not one of the largest trust departments. Mr. Collins' bank might have a different problem there with the large holdings.

Senator BENTSEN. Do you feel there is a prudent limit on how much stock you should own in a major corporation, percentagewise?

Mr. HAMBLETON. Well, I would like to ask Mr. Collins to answer that question. He is an investments man, and may I ask him if he would answer it?

Senator BENTSEN. Yes; of course.

Mr. COLLINS. Thank you.

We follow somewhat the same procedure Mr. Hambleton does and, in general set an internal limit of 5 percent of the outstanding stock.

Senator BENTSEN. Generally set a limit of 5 percent?

Mr. COLLINS. We generally will not go over that.

In the event we do so, it is because of a relatively high level of confidence on our part in the outlook for the company.

Senator BENTSEN. Do you see any serious handicap to your investment policies if you had a 5-percent limit on what you could own in a major corporation when you had some 1,400 other choices just on the stock exchange?

Mr. COLLINS. To the extent that we would be forced to discriminate against new clients, yes.

Senator BENTSEN. This is the same kind of limitation that you see on insurance companies that operate in the State of New York.

Mr. COLLINS. But they are not managing funds for a series of individuals, corporations. The insurance situation tends to be a single pool as opposed to a number of individual accounts.

Senator BENTSEN. Well, they are beginning to, are they not?

Mr. COLLINS. They are as separate companies, but I have no feeling as to how large their business is.

Senator BENTSEN. And we have had no objections from them concerning such limitations. Mutual funds have a limitation. It is 10 percent of the stock of corporations, I recall, or 5 percent of the assets of the fund, making dual limitations; is that not the way it works?

Mr. COLLINS. I believe they have a kind of a basket provision that allows them to go over 5 percent in a single stock.

Mr. HAMBLETON. Senator, may I clarify one point here?

Senator BENTSEN. All right.

Mr. HAMBLETON. You are referring to 5 percent strictly on stocks, on holdings where the trustees might have full discretion?

Senator BENTSEN. That is correct.

Mr. HAMBLETON. You are not talking about cotrustees, you are not talking about any of that?

Senator BENTSEN. No.

Mr. HAMBLETON. All right.

Senator BENTSEN. That is my personal view at this time. And I might, like every economist, put a big hedge around it.

I say that is my personal view at this time.

Mr. HAMBLETON. Well, I could still see situations where a customer would come in and present certain securities to you, but I believe you have covered that.

Senator BENTSEN. Oh, yes. We would not want to negate the ability of a customer to do that at all.

Let me ask you how you vote your shares. Let's say that you are handling the pension fund money and you buy the stock for that account; I assume that you vote all those shares, do you not?

Mr. HAMBLETON. In our bank we vote all the shares we possibly can. If it is a routine proxy, we ordinarily vote with management. If there are any questions, if there are any serious questions, we have a subcommittee of our trust investment committee that reviews each one of them and makes recommendations as to how the shares should be voted.

I presume this is done differently in most banks.

Senator BENTSEN. Do you believe that a trust department should be allowed to buy and exercise control, and by that we acknowledge the control is not necessarily 51 percent; do you think a trust department should be allowed to do that?

Mr. HAMBLETON. Buy control of a company?

Senator BENTSEN. Yes.

Mr. HAMBLETON. I would not think so on its own. Maybe if it is outvoted, or is told to do so by a cotrustee, but I would think that would be a pretty high——

Senator BENTSEN. I am talking about totally discretionary accounts. You see, the situation we have in Germany today where you have one bank over there, that has 25 percent of 20 of the largest nonfinancial corporations; and one owns 25 percent of the largest shipping company.

Mr. HAMBLETON. That would be too high.

Senator BENTSEN. I frankly do not want to ever see that kind of situation ever develop in this country. I think that is a concentration of economic power that should not come to pass.

Mr. HAMBLETON. I would agree.

Senator BENTSEN. Obviously many companies can be controlled with less than 50 percent of the stock. You would agree with that, would you not?

Mr. HAMBLETON. Yes, sir, I would.

Senator BENTSEN. What would you think of the possibility of the beneficial owners of the shares voting them?

Let's say, for example, that you are holding shares in IBM for a pension fund. Would you have problems with the idea of letting the beneficial owners vote them?

Mr. HAMBLETON. You mean all the pensioners?

Senator BENTSEN. No; I do not mean that. I do not know whether it would be the pensioners' employer or whether it would be the trustees of the pension fund.

In other words, a diffusion of the concentration of voting.

Mr. HAMBLETON. My reaction to that would be that if a bank or trust department was acting as trustee, it should have the authority

to vote the shares. There is an intermediate step, most compnaies have pension committees that could be involved in voting in case of an agency type of arrangement, but if a trustee has sole investment authority and it is not written otherwise in the trust agreement it seems to me the trustee should have the full authority to vote the shares.

Senator BENTSEN. I assume you would agree that the market can only function efficiently if you have a multiplicity of judgments, a substantial number of buyers and sellers.

You would agree with that?

Mr. HAMBLETON. Yes, sir.

Senator BENTSEN. I assume you would also agree that it would be meritorious if stock prices actually reflected the true values of companies. I understand there would be varying judgments on that, particularly from management.

Mr. HAMBLETON. Well, I am inclined to think in many cases they represent the true value of the companies or certainly what the market thinks of it.

Senator BENTSEN. That is true; if you have true competition in the marketplace, then I would agree with you.

Ten years ago the dollar volume on the New York Stock Exchange attributed to institutions was 35 percent, and today it is 70 percent. If you extrapolate that kind of a trend curve and it went up to 90 percent, would that be a matter of concern to you?

Mr. HAMBLETON. May I ask Mr. Collins to answer that one?

Senator BENTSEN. All right.

Mr. COLLINS. Sir, I think the answer is yes, it would be of concern if by going to that number you did have an undue amount of concentration and you did end up with, as you stated previously, a relatively limited number of buyers and sellers who tend to act in similar fashion.

I am not sure that would be the result.

Senator BENTSEN. Well, let's take Morgan because they have apparently done a good job for their investors, from the record as I understand it, but they have $27.4 billion worth of assets, and we passed a pension bill that is going to accelerate the funding of pensions and probably accelerate the institutional management of them. Assuming they continue to do a good job and they continue to grow as they have, do you not see this continued concentration resulting in some problems?

In addition to the institutional volume there has been quite a substantial amount of corporate buying of their own stock, perhaps as much as 10 percent of that volume. So, when you finally get down to it, you really do not have a lot of individual trading in that stock by individual investors, and then you have board members who buy for their own accounts.

Mr. COLLINS. My response to that, sir, would be that I think we tend to lack enough good information on whether all of the institutions do, in fact, move at the same time as opposed to whether they, in fact, provide a fairly effective market among themselves as well as with individuals. And it certainly is for that reason that the ABA, and I speak also for Citibank, strongly supports disclosure in getting enough information so that we can make better judgments on the subject.

Senator BENTSEN. Mr. Hambleton, in supplying information for the record, after you have surveyed your 10 largest banks, we would like to have the percentage of funds managed by the 10 banks which are purely discretionary as opposed to cotrustee arrangements or other arrangements where the bank does not have discretionary authority.

Let me ask you as the investment counsel in this situation, if the number of participants in the market decreases, would you not anticipate larger fluctuations in prices because you did not have the leavening effect of a great number of judgments?

Mr. COLLINS. My view is that you would probably continue to have the leavening effect of a great number of judgments because I think that there would be a number of individual judgments expressed by the institutional investors as well as the individual investors.

Senator BENTSEN. Well, now, I understand that Morgan has an investment committee of eight.

Mr. COLLINS. I guess what I mean is that there will be considerable differences of opinion over time between what the Morgan feels and the Citibank feels and what the Harris feels and, as a result, you will get offsets that way instead of everybody doing the same thing.

Senator BENTSEN. We had information the other day of a foreign investor who stated that he was buying just the recommended lists of major banks and trust departments because he felt they would support the price of the stock.

Mr. COLLINS. I view that as a popular fiction, sir.

I realize that people attempt to do that. Certainly my experience would suggest that people who have been successful in the investment business have done so by doing good research and making their own independent decisions as opposed to second-guessing what other people's judgments are.

Senator BENTSEN. You do not believe in the follow-the-leader syndrome?

Mr. COLLINS. I do not, sir.

Mr. HAMBLETON. Senator, I sit on the finance committees of two charitable organizations in Chicago, one of which is at one bank and the other is at another competing bank, and I am amazed at the number of conflicting recommendations that go back and forth from those two banks, it is a source of constant amazement to me.

Senator BENTSEN. But there also is quite a concurrence of judgments from the holdings that we have seen concerning this top few.

Mr. HAMBLETON. Some, but it has always surprised me how little there is. Everybody is looking for a different—something different, to put in there.

Senator BENTSEN. You do not think that these five or six of these portfolio managers do not meet for lunch down at Delmonico's and decide, "You know, that is a pretty good idea, let's go back and buy it."

Mr. HAMBLETON. I could give no testimony on that subject.

Senator BENTSEN. In your statement you say that you think it is a popular fiction that the institutions can have self-fulfilling prophecies; I do not think it is a fiction that they can have self-filling prophecies because I think they can, and I think any institution that has a billion dollars of new money coming into it a year could support a

stock if the portfolio manager decided that that was necessary, to make his record look good for his investors, and he could do it for quite a period of time.

Now, whether he does it or not is something else. Again, you get into the subjective judgment and it is very difficult as to what should have motivated this man. I also understand that if he makes a decision to go into a company—of course, widgit manufacturers is usually used—and if he is wrong he could well be fired for it, but if he goes into one of the great corporations of this country that is supposedly accepted as having excellent management, and if it is wrong, why, it is just too bad if a lot of other people make the same mistake.

So again there is a pressure for him to go into that type of situation. I do not know how you manage that one. I wish I could figure it out.

Well, thank you very much for your contribution. I think it has been helpful.

You have brought up one new intriguing idea that I had not heard before insofar as possible tax treatment, and we will take a look at it.

[The prepared statement of Mr. Hambleton and an article from the Wall Street Journal follows:]

STATEMENT BY CHALKLEY J. HAMBLETON, PRESIDENT-ELECT, TRUST DIVISION, THE AMERICAN BANKERS ASSOCIATION

SUMMARY

According to the latest figures Trust Departments on December 31, 1972 held in over 1,200,000 accounts, assets totalling over $403 billion. Most of these accounts serve numerous beneficiaries and over 167,000 of them are employee benefit accounts some of which serve thousands of beneficiaries. In most Trust Departments somewhere between 60 and 90 percent of the assets can be withdrawn at any time by the customer.

Bank Trust Departments serve as executors, guardians, trustees, investment advisors and custodians. They may have sole investment discretion, may share investment discretion or only provide investment advice. Each trust is a separate entity and must be administered solely in the interest of its beneficiaries. This has resulted in a broad diversity of equity investments. Statistical data to support this is provided.

The American Banks Association supports the following which may help bring more individual investors in the market:

1. Development of a central market system.
2. Enactment of legislation which would require institutional investors to disclose significant securities holdings and transactions.

While not advocating its enactment, the American Bankers Association also suggests a tax proposal for Congressional consideration. Under the proposal, cash dividends received the first year after the purchase of securities would be treated as return of basis rather than ordinary income.

STATEMENT

Mr. Chairman: My name is Chalkley J. Hambleton, President-elect of the Trust Division, The American Bankers Association and President of the Harris Trust and Savings Bank, Chicago. I am accompanied by William W. Graulty, Executive Vice President, The Connecticut Bank and Trust Company, Hartford, who is Vice President-elect of the Trust Division, Paul J. Collins, Senior Vice President of First National City Bank, New York City, and Robert L. Bevan, Assistant Federal Legislative Counsel, ABA.

The American Bankers Association has a membership of about 14,000 banks which represents approximately 96% of the commercial banks in the country. Over 3,800 of these banks exercise trust powers and are members of the Trust Division.

The American Banks Association appreciates this opportunity to appear before the Subcommittee to discuss the role of institutional investors in the stock market and to discuss recommendations to restore the role of the individual investor in

the stock market. We hope our comments will be of help to the Subcommittee in its consideration of this important issue.

The trust industry was somewhat surprised by articles and statements published this summer alleging that institutional investors were destroying Wall Street and the vitality of our capital markets. Consequently we were pleased when the Subcommittee undertook these hearings. We are convinced the hearings will help clarify the roles of institutions and individuals in the stock market, the causes of two-tier market phenomenon and ways to help relieve this situation.

In discussing the current market situation some commentators have tended to overlook the fact that "institutions" are in reality "pools of savings" of many individuals. They also have tended to lump all institutions together as a giant monolithic investor. They have refused or failed to recognise that there are over 3,800 trust departments, over 800 mutual funds and uncounted thousands of insurance companies, endowments, pension funds and other separate institutional investors.

The Association today would like to discuss trust departments, their operations and their investments in the equity market. We also would like to suggest some ideas to help bring more individuals into the stock market.

The Association shares the Subcommittee's concern for a strong capital market and for a vital competitive brokerage industry. These things are not only essential to a growing economy but are a necessity if trust departments are to serve the public. For a number of years the Association has supported the extension of competitive broker fees. We have told the Congress on several occasions that banks have no interest in membership on stock exchanges to execute trades for trust accounts. We have urged a separation of brokerage and money management. And we have supported the development of a central market system composed of the two national exchanges, the regional exchanges, the third market and NASDAQ. We believe a central market will bring maximum liquidity to the market by giving maximum exposure to orders and maximum disclosure to transactions. This one development we believe is most important to bringing individuals into the market. When the individual investor knows he will be able to obtain the best price available in any market across the nation on his transactions we believe he will come into the market with a renewed confidence.

We are glad to see the SEC take steps to end fixed commissions but are somewhat apprehensive because it is tied to a temporary increase in fixed fees on transactions below $300,000. Further we are pleased that the Congress is continuing to move toward enactment of needed legislation in the securities area.

Mr. Chairman, according to the latest figures we have seen, trust departments as of December 31, 1972 held, in over 1,200,000 accounts, assets totalling over $403 billion. These assets should not be viewed as one gigantic economic force since they are held by the 3800 banks in many different capacities and with various degrees of authority.

I specifically mentioned the 1,200,000 accounts because this is an available statistic indicating the vast number of people the trust industry serves. Most of these accounts involve numerous beneficiaries and over 167,000 of them are employee benefit accounts some of which serve thousands of beneficiaries.

The fact that trust departments now hold over $400 billion in assets is evidence that they provide a needed service to the American people because these assets have come to the trust departments voluntarily and 60 to 90 percent of them can be withdrawn by the customer at any time.

Bank trust departments serve as executors of estates, guardians of minors and incompetents, as trustees of revocable, irrevocable and testamentary trusts, investment advisors and custodians. A bank may serve alone or with a co-executor or co-trustee. They may have sole investment discretion, may share investment discretion with others or may only provide investment advice. They may have authority to vote stock under their management, they may share such authority or may possess no voting authority.

Even when the bank has sole investment discretion it is surrounded by legal restraints. When a bank accepts a trusteeship, it is under a duty to administer the trust according to its terms, and according to the law, solely in the interest of the beneficiaries of the trust with unswerving loyalty, bringing to the trusteeship, and diligently exercising, all of the skills and abilities the trustee has. Justice Cardoso in 1928 said in *Meinhard* v. *Salmon* that the standards which must be met by fiduciaries are "not the morals of the market place but the punctilio of an honor the most sensitive." Much of the public and official misapprehension of the manner in which trust departments carry on their work arises from a

failure to comprehend that each trust is a separate entity, separate and apart from all others the trustee bank must administer. Also there is a failure to comprehend that banks actively compete with each other for trust business.

Consequently the investment portfolio of each trust must reflect the needs of its beneficiary or beneficiaries. If the beneficiary is an elderly widow with high or potentially high medical expenses the assets of the trust may well be invested all in fixed income debt securities. On the other hand if the beneficiary is in the middle years of life the assets will probably be split between equities and debt securities. If the beneficiary is a young adult with little need for additional income and with his or her earning years ahead the trust will probably be invested 100% in growth stocks. It is highly possible that the trustee at the same time could be selling a specific stock out of the first trust, holding the same stock in the second and buying it for the third.

An interesting reflection of how bank trustees may sometimes be selling a security out of one account to make distributions, to pay taxes, or for other trust purposes, and at the same time be buying the same security as an investment for another account is found in the 1972 Report of the Investment Management Group of First National City Bank of New York. The report lists the 25 largest equity purchases and sales during 1972. As examination shows that Citibank purchased $33 million of Xerox stock in 1972 but sold $61 million worth of the stock. It bought $53 million of IBM and sold $31 million. In the same way Citibank bought and sold in the top 25 four other securities, Avon, Eastman Kodak, Coca-Cola and Exxon.

Most personal trusts are established with securities already held by the grantor. As a result tax considerations may play an important part in investment decisions from the very first. As with individual investors a lock-in situation may prohibit certain investment activity in trusts. A further indication of the investment diversity of personal trusts is the findings of the SEC institutional investor study that trust departments hold sole investment authority over less than 30% of personal trust assets and over less than 10% of agency accounts.

In contrast to this we readily acknowledge that banks hold sole investment authority over about 80% of the employee benefit assets in their accounts. Employee benefit accounts held on December 31, 1972 about $110 billion worth of equity securities. Here again it should be kept in mind that these assets must be invested within the legal restraints imposed on trustees. And in addition the Senate has just approved a comprehensive pension bill that will prescribe in even more precise terms the obligations and responsibilities of pension trustees and other fiduciaries.

Another easily definable area in which banks exercise full investment discretion is the management of common trust funds. Here again the bank's discretion is subject to limitations. Common trust funds must be invested in accordance with a stated investment policy and are closely supervised by the banking agencies. Also a common trust fund must prepare and file an annual financial report which is sent to beneficiaries with an interest in the fund and is available to anyone else on request.

Just how are banks exercising their investment discretion? How concentrated is bank investment activity? How are investment decisions reached? To answer this last question first most bank trust departments have an investment committee that is composed of a number of senior officers. This committee decides which securities should be on the buy list, which should be on the sell list and which should be on the hold list. These decisions are made after the investment group in the trust department, which normally includes investment analysts, has made recommendations. Once the decisions are made it is the account portfolio managers who then make the day-to-day investment decisions based on the buy, hold and sell list and the needs of the account beneficiaries. The account portfolio manager, of course, must obtain the concurrence of co-fiduciaries when necessary and, as indicated before, this is 70% of the time in personal trusts. Except in rare instances buys and sells in a personal trust account occur only at the time of its periodic review.

The pattern of course is somewhat different in the employee benefit accounts where their size larger, their number smaller and there is no concern for tax consequences.

So there are many people involved in the investment decisions of bank trust departments—the analysts, the investment committee and the account portfolio managers. In some instances this latter duty may be performed as a joint effort of an investment officer and an administrative officer.

Before leaving the question of investments I would like to note that it is the goal of every analyst to find the next IBM. As a consequence there is always someone looking at the newcomers and at the lower tiers.

Now to turn to the question of how concentrated is bank investment activity. A number of sources provide answers to this question. Samuel Callaway testified before this committee as to some of the investment activities of Morgan Guaranty including its special situation funds.

James Wood, Vice President, Bank of New York, in addressing the ABA National Trust Conference in February of this year discussed his examination of twelve common trust funds managed by New York banks and banks represented on the Investment Committee of the Trust Division. He found 247 different issues in the 12 funds on December 31, 1972. Only 44 issues were held by 3 or more funds while only 15 issues were held commonly by 5 or more of the 12 funds. IBM was the only stock held in all 12 funds. The average p/e ratio of the stocks held in each fund varied from an average of 20.4 to 40.7 with 9 of the 12 funds being below 30.

In July of this year C. Roderick O'Neil, Executive Vice President of Manufacturers Hanover Trust Company, revealed a similar study by his bank which examined ten pooled funds managed by banks. Only one stock was held in all ten funds. In total 259 different stocks were held in the funds while only 12 stocks were owned by five or more funds.

The First National City Bank of New York recently examined the ten largest special situation funds managed by banks. These funds held $3.5 billion in total assets. Citibank found a total of 791 separate issues, 288 listed on the New York Stock Exchange, 142 listed on the American Stock Exchange and 361 over-the-counter issues. Not one issue was held by all funds. One issue was held by six funds, and 587 issues were held by only one fund.

The American Bankers Association also conducted a survey of trust department securities activities and securities holdings. We sent questionnaries to all 3,800 banks with trust departments and received answers from about 800. The first question we asked was the number of equity security orders they had placed with brokers druing the first 6 months of 1973, broken down by number below $100,000, the number between $100,000 and $300,000 and the number over $300,000. We tabulated the responses to provide figures for trust departments below $50 million in trust assets, $50 to $150 million in assets, $150 to $750 million and over $750 million. Thirty-seven thousand and eighty-one orders, or 98.6 percent, of the orders placed by trust departments under $50 million were under $100,000. Four hundred and thirty-three orders were placed between $100,000 and $300,000 by these small banks and 77 orders were placed over $300,000. Similar percentages are found for the larger banks. Of the banks from $50 to $150 million, 96.8 percent of their orders were under $100,000 and the $150 to $750 million banks reported 94.4 percent of their orders were under $100,000. The somewhat startling figure is that 85.3 percent of the orders placed by trust departments over $750 million were under $100,000. Eleven and six-tenths percent of the orders placed by these larger banks were between $100,000 and $300,000 and only 3 percent of the orders were over $300,000. This latter group consisted of 12,990 orders. Twenty of the top 25 banks responding provided figures indicating that 87 percent of their orders were under $100,000 and that 4 percent were over $300,000. All of these banks have trust assets in excess of $2 billion. It should be noted that this breakpoint of $300,000 is considerably below the block trade figure of $500,000.

The next question we asked was the total number of corporations in which the bank held equity securities on December 31, 1972. The average number for trust departments under $50 million was 133 companies. The number for trust departments from $50 to $150 million was 503, for trust departments from $150 to $750 million the number of corporations was 1,370 and for the trust departments over $750 million the number of corporations was 2,543.

We asked each bank to list their top 25 equity holdings and then asked what percentage these 25 constituted of their total equity assets. Sixty-eight percent of the trust departments over $750 million reported that the top 25 holdings represented less than 50 percent of their equity assets.

We have only had time to feed into the computer the top 25 holdings of the top 52 reporting trust departments all of which hold in excess of $1 billion in assets. We found among the top 25 holdings a total of 299 corporations. IBM again was the only security found on every list. Eastman Kodak and General Motors were next found on 51 lists. Exxon was on 49, G.E. on 48 and Sears on 41. Xerox

was on 38 lists, Texaco on 33 and 3M's on 32. By the time you reach the 31st stock in popularity it appears only on 10 lists. Only 87 stocks appear on 3 or more lists. We asked the trust departments to indicate where customers had discretion over 60 percent or more of a holding. In the case of IBM there were 10 banks where customers exercised discretion over more than 60 percentof the holding. In the case of Eastman Kodak customers exercised such discretion in 13 trust departments and for GM customer discretion over 60 percent of the holding was found in 14 instances. Exxon was subject to over 60 percent customer discretion in 13 cases and G.E. in 9 cases. The same was true for Sears in 11 cases and for Xerox in 5. So it is quitt clear that it is the customer in many instances that is partly responsible for the larger holdings of the growth stocks by banks.

Mr. Chairman, we believe the information presented indicates that bank trust departments are diversifying the portfolios of their beneficiaries and customers. We do not deny the popularity of certain stocks but it seems clear that substantial holdings go far beyond the favorite 50 or 70 issues. The recent report of Morgan Guaranty shows that it holds over $10 million worth of 223 securities and between $1 million and $10 million worth of 343 additional securities.

We realize nevertheless that despite this diversity there is a market problem when the gap between high and low multiple stocks is as it has been for the last several months. We are convinced the problem is cyclical, not structural, and we are heartened by several signs that the situation is easing. Nevertheless the ABA does not advocate the Congress do nothing.

We believe the individuals who have left the market have done so for the following reasons:

1. Many were burned in the 1969–70 market and continue to be reluctant to taken another risk.

2. Overall uncertainty about the nation's economy discourages equity investment.

3. Performance of the stock market in recent years has been weak.

4. Access to the buying and purchasing mechanism has been greatly reduced, particularly with brokerage firms across the country closing or reducing the number of retail offices.

5. There's more competition from high interest, fixed income money instruments.

6. Changes in capital gains treatment has made stock investment less attractive.

7. There's much disenchantment with the service and quality of advice offered by retail brokers.

We think certain steps can be taken that will increase individual participation and promote more healthy markets. First we would repeat our support for the early development of a central market system. Second we urge the Congress to enact an institutional investor disclosure act that would require bank trust departments to report significant securities holdings and transactions to the bank regulatory agencies with a copy to the SEC.

We recognize that "confidence" is what is required to get individuals into the market and to promote healthy markets. If disclosure will help build consumer confidence in our securities market we believe it is worth the administrative and economic costs to institutional investors so long as disclosure is limited to significant data.

If Congress should decide that all institutions should report to the SEC directly instead of trust departments reporting to the banking agencies we would not object. We would hope, however, that Congress would give some attention to centralizing reporting in one agency.

A number of suggestions have been made for changes in our tax laws to provide incentives for individual investors to begin trading. Most if not all of these suggestions have called for some change in the capital gains tax. These incentives would however be as favorable for investors in the high multiples as investors in the low multiples. While they would probably increase trading across the board, if we want to achieve more buying in the low multiples the tax incentive must be so directed and it must be significant. We would suggest one approach which the Subcommittee might wish to consider if it decides action in the tax area is necessary. Under this proposal the first year's cash dividends after the purchase of securities would not be subject to income tax but rather would be considered as a return of the taxpayer's basis. Thus ordinary income would be converted to capital gain. To maximize the advantage of this tax incentive a taxpayer would invest in low multiple high dividend stocks and would be encouraged to trade yearly. We realize this proposal has shortcomings and I hasten to repeat the Association does not advocate its enactment. However, the idea was developed by some of our people and we pass it on for whatever consideration the Congress wishes to give it.

In addition to disclosure and capital gains revision a number of other suggestions have been made for regulation of institutional investors. We believe most of them would be counterproductive in that they would result in exactly the opposite effect than that desired.

The first suggestion is the imposition of a 5% cap on the amount of stock held by any institution in any one corporation. A diversified mutual fund is subject to a 10% restriction. This limit along with others was placed in the Investment Company Act to protect mutual fund investors by assuring diversification. Accounts managed by trust departments as trustees or in other fiduciary capacities are protected by trust law against excessive investment in any one asset.

While there is no specific limitation over the total holding of a trust department in any one corporation there are two very realistic restraints. Good performance and fiduciary responsibility require real mobility. Further there are restraints in the 1933 & 1934 Securities Acts. The insider provisions, the controlling person provisions, and the corporate take-over provisions and others serve as a real damper on the total position which a trust department may voluntarily take in a security.

What would be the impact of a 5% limit? In the growth stocks it would probably be nil. In the smaller second tier companies it could be substantially adverse because 5% could represent a relatively small investment. If such a limit were established for trust departments the Congress would have to decide whether the limitation would apply only to acquisitions where the bank had sole investment discretion or, in addition, to acquisitions where the bank shares investment discretion. What about the case of 2 or more co-trustees when decisions are by majority vote and the bank opposes the acquisition? What about the cases where a life long customer of the bank dies and names the bank executor or trustee and his estate contains sufficient shares of a company to put the bank over the limit? Must this customer's testamentary wishes be denied? Must this customer be denied the protection of corporate trustee or executor? Also what about the various accounts of the trust department? Considering a bank's fiduciary responsibility how is it to determine which accounts are to hold what it believes may be the next IBM? Undoubtedly all these questions can be solved and our beneficiaries and customers can learn to live with the answers but I want to reiterate it will be our beneficiaries and customers including millions of employee benefit beneficiaries who may be affected by this limit. In our opinion a 5% limit could adversely affect our trust beneficiaries and customers and the medium and smaller size corporations who are the ones that are needing help.

Another suggestion has been to limit the amount of a stock that can be sold during a period. One quarter of 1% in a 30 day period was proposed. Such a limitation would be devastating to smaller corporations. No fiduciary can invest without a reasonable assurance of liquidity. A limitation on trading would tend to peg maximum investment at that amount. Similarly the other suggestions which have been proposed for trading limitations would tend to limit the amount of stock acquired or held in smaller companies. Also, if trading limitations were imposed how would trust departments decide which account to sell from first.

Chairman Ray Garrett Jr. of the SEC recently told the House Banking and Currency Committee that there is a lack of any hard data which suggests that restrictions on trading are either wise or necessary. We agree completely with Chairman Garrett's observation and oppose trading restrictions as well as a limitation on the amount of stock of a corporation which can be held by any one person.

In conclusion we would like to emphasize trust assets are not in our power but in our care. In most trust departments somewhere between 60 and 90 percent of the assets managed can be withdrawn at any time by the customer. One of the leaders of our industry has described our customers as follows and we believe this description is exceedingly important in explaining our role in the market. "Our customers (bless them) are a heterogeneous assemblage, a motley array which never marches in step. Among them are some who want a piece of the action, and many more who want only peace of mind. They are there for many reasons and their affairs have no common purpose and their investment activities no central tendency. What suits one will never suit another. It is a trustman's responsibility somehow to suit them all." I believe each member of the Subcommittee can appreciate this responsibility.

Mr. Chairman, the ABA appreciates this opportunity to appear and discuss these issues. If we can be of any assistance to the Subcommittee or staff we hope you will call on us.

APPENDIX A

Responsibility for Suitability—The Hand-Tailoring of Investments

(An Address by Charles W. Buek President United States Trust Co. of New York at the A.B.A. Seminar on Fiduciary Responsibility)

"Is now a good time to buy stocks?" This is a common question today and it is interesting how differently it will be answered by various investment managers. Many a broker will give you a straight answer, yes or no. Mutual fund managers may modify their replies a little, perhaps relating a cash reserve to the latest Dow Jones Averages. But in both cases you will get an answer.

Ask a trust man the same question, and he will reply with a barrage of questions in return. "Who are you? How's your health? Have you mortgaged your home? What is your annual salary? How old is your rich mother-in-law? How's she feeling?"

Ask a simple question and that is the kind of answer you will get from a trust man. But be patient, for he is preparing to give you a hand-tailored answer exactly suited to you and your circumstances. Hand-tailoring financial judgment is his way of life.

Solving a family financial problem is very much like studying a bridge hand at the card table. Those of you who play bridge will know that most hands have certain identifying characteristics. Sometimes you have all the cards, and you can make your bid without effort. At other times you may be short of trumps, or they may be in the wrong hand, and you will have to play carefully. All too often you are desperately short of strength and will have to take chances to make your contract.

The same is true of investment problems. A trust man asks himself such questions as, "Is there enough money here to do what must be done'? Do inescapable income requirements dictate investment policy? Will I have time enough to accomplish my customer's goals? Am I free to take risks, or must I avoid them?"

In studying trust investments from an industry-wide point of view, one all too often forgets the infinite variety of accounts which makes up those totals. A recent study of combined trust assets in all insured commercial banks showed the following diversification.

Trust asset distribution

All insured commercial banks:	Percent
Common stocks	65
Fixed income securities	30
All other [1]	5
Total	100

[1] Includes 9 percent cash on demand.

HAND-TAILORED INVESTMENT POLICIES

It would be an understandable mistake to think that this 65% holding of common stocks (more often referred to as the equity ratio) represents the collective market judgment of trust men under prevailing conditions. This ratio is then compared with similar ratios to be found in mutual funds, pension funds and the portfolios of other investment managers. The fact is that a trust department is a conglomeration of hundreds or even thousands of widely differing accounts. Equity ratios range all the way from 0% to 100%, and no two accounts are alike. The makeup of every account—the selection of bonds and stocks—is varied to suit its individual purpose and limitations.

Trust men must develop hand-tailored programs for savers and spenders, buyers and sellers, the old and the young, the rich and the rather poor, the timid and the brave. A 65% equity ratio for the industry is only an average from which individual accounts are free to range far and wide.

Simply to demonstrate the contrasts which we encounter, let me give you a thumbnail description of three types of customers having very different investment requirements. In each case I will assume that the trust department has $100,000 with which to work.

First consider the case of an elderly individual, perhaps a widow, 80 years of age and in poor health. Her medical expenses for nursing care are high. Her $100,000 trust might most wisely be invested entirely in 9% bonds. This would preclude almost all chance for growth, and yet be best for her. There is no time to build for the future, for her needs are immediate and urgent. (Resultant equity ratio 0%).

A younger woman, perhaps a spinster of 50, presents a very different problem. She still has some years of employment ahead of her. More importantly, she has 30 or 40 years to reckon with during which time inflation may impair the real value of her $100,000 fund. It might be more prudent to invest for her only 50% in high-yielding bonds and the remaining 50% in attractive long-term growth stocks. She clearly needs this hedge even though it reduces her current income to $6,000 a year from a maximum of $9,000. (Equity ratio 50%).

Another familiar trust customer is the young man who has inherited $100,000 at the age of 20. His entire career lies ahead of him. He has the God-given privilege of wealth at an early age. Over his lifetime an aggressive program of long-term growth should surely have time to succeed. His account might prudently be invested entirely in promising common stocks providing a very limited current return. (Equity ratio 100%).

All three of these utterly different programs seem to constitute prudent investment judgment under identical market conditions.

HAND-TAILORED TRUSTS

	Age	9-percent bonds	3-percent stocks	Overall return (percent)	Common stock ratio (percent)
Elderly individual	80	$100,000		9	0
Spinster	50	50,000	$50,000	6	50
Young man	20		100,000	3	100

These familiar examples of typical trust customers serve to demonstrate a significant aspect of the stock market activities of bank trust departments. Do you realize that the bank might buy IBM for the young man, hold it for the spinster, and sell it for the invalid! How different from the activities of other institutional investors. It is no wonder that trust departments have less market impact than one might expect.

THE CRUCIAL QUESTION OF TIME

Trust men work with aging individuals and ageless institutions, with accumulating trusts and with wasting trusts. Time is always a factor to be considered, and is often decisive.

In July of 1969, I talked to a group of life insurance men—The Million Dollar Round Table—about the risks involved in common stock investments. I told them of the market setback of the early 1960's, and stressed the need for time in all successful investment programs. In the light of recent market experience, my reference to the time element bears repeating.

The stock market reminded all of us recently of one of the basic facts about equity investment. It takes time to invest in equities and succeed. This is not the timing we talk so much about, but simply time. There are investors who don't have the time to own equities, and many more who do.

We may have lost track of this obvious fact in the Fabulous Fifties. Common stocks were a rewarding commitment for any or all periods of time. They appreciated in estates in process of liquidation, in building funds awaiting use, and even in the mail over the weekend. This was a stimulating period in which to live, but a deceptively misleading one in which to learn the business of equity investment.

That is not our usual way of life. Managers of investment funds must take the longer view. Our reasons for holding equities, and particularly for our selection of individual issues, all include the element of time.

We look for good management, but this is only evidenced by a long succession of wise decisions, day after day. Inevitably the well run company will emerge from its field and reward its stockholders, but this takes time.

We prefer companies which plow back a portion of earnings in research, or in new plant and labor saving equipment. This plowback has a cumulative effect, which is significant only over a period of years.

Research and inventiveness are frustratingly slow. Whether we are developing an antibiotic, a computer, or a spacecraft, the lead time is measured in years. Investors must wait for their faith in the resourcefulness of management to be rewarded.

We have no better way to choose stocks than by these standards. This being the case, we must have the time, and take the time, to make our method work. When we have done badly with equity investments, it has often been because we did not have time to do well.

The element of time always influences and sometimes determines the suitability of investment programs. Consider the following breakdown of those who may not have the time to make effective use of common stocks.

Have They the Time to Own Stocks? (And surely succeed.)

YES	NO
Young people.	Old people.
Profit sharing funds for young executives.	Profit sharing funds for elderly groups.
Pension funds.	Estates.
Endowment funds.	Building funds.
Insurance companies.	College tuition reserves.

On my list of those who have the time to own equities and succeed are college and university endowment funds. Unhappily some have the time but not the patience. They are ecstatic over the new total return concept which encourages the spending of all the endowment income and a portion of principal as well. Further appreciation to offset the inroad is assumed.

Burdened with deficits, many an institution has begun selling off the goose that lays the golden eggs. Understandably but also unhappily, they are trying to eat their cake and have it too. Furthermore, the practice of invading principal is likely to become habit forming. A little nip of principal today is like the student's first drink, first smoke or his first puff of marijuana. If a small invasion of principal will balance the budget today, how deep an inroad will be necessary when interest rates return to normal and costs have risen still higher? Time is on the side of colleges and universities, if they would only let it work for them.

Time is running out for another large group of trust customers. I am referring to doctors and lawyers and their so called Keogh-type trusts. A successful 45 year-old professional man may have 20 years before retirement in which to accumulate an adequate retirement fund for himself. The small amounts which he is permitted to set aside tax free for his retirement will be hopelessly inadequate to provide for him in his retirement unless they are very aggressively managed in the interim. For professional men who are not yet approaching retirement, I would expect Keogh trust investments very often to show 100% equity ratios.

SIZE AND ITS IMPORTANCE

Another factor having a strong and often decisive effect on investment decisions is the substantial size of trust accounts. The average market value of all personal trust accounts throughout the country is about $190,000. In the largest institutions this average size approaches $250,000. These are very substantial amounts, representing in many cases the sole support of the customer. By contrast, the average investment in a mutual fund is under $10,000, and very frequently under $5,000. Again by contrast, the average man carries less than $20,000 in life insurance in this country today.

When an individual invests a few thousand dollars in a mutual fund, he may say to himself, "Here goes nothing." His way of life will not be materially altered if the investment fails. On the other hand, when a customer brings a quarter of a million dollars to a trust company he very often may say, "Here goes everything I own." The large amount involved has a direct bearing on the dependable income which we must produce and the degree of risk which will be acceptable. As a result, our investment accounts tend to look more like an insurance company portfolio than the holdings of a mutual fund or a brokerage account.

BEST AVAILABLE COPY

The Largest Twenty Holdings of Common Stocks. (Two actual portfolios.)

A Major Trust Department [1]	*A Large Mutual Fund*
American Telephone & Telegraph.	Burroughs Corp.
Avon Products.	Career Academy, Inc.
Bristol Myers.	CNA Financial Corp.
Caterpillar Tractor.	Coca-Cola Co.
Eastman Kodak.	Continental Corp.
General Electric.	First Charter Financial Corp.
General Motors.	Ford Motor Co.
Gulf Oil.	GAC Corp.
International Business Machines.	Great Western Financial Corp.
International Flavors & Fragrances.	Imperial Corporation of America.
Merck & Co.	Kaufman & Broad, Inc.
Minnesota Mining & Manufacturing.	Kroger Co.
Chas. Pfizer & Co.	Polaroid Corp.
Polaroid Corp.	Saxon Industries, Inc.
Procter & Gamble.	Schlitz Brewing Co.
Sears Roebuck.	Trans Continental Investing Corp.
Standard Oil of California.	U.S. Fidelity & Guaranty Co.
Standard Oil of New Jersey.	U.S. Financial.
Texaco.	Xerox Corp.
Xerox Corp.	Zapata Norness Inc.

[1] Excluding family companies.

SUITABLE RISKS AND REWARDS

A trust man's responsibility for suitability is most evident in his calculation of acceptable investment risks. Because of the relatively large amounts of funds involved in our trust and agency accounts, principal tends to be precious and income indispensable.

On the other hand, in some cases our investment accounts do not represent all of the assets of an individual or a family. Sometimes a man's career or his family's business constitutes a full ration of risk already, and the account he opens with us represents his backlog and his anchor to windward. Here again suitable risks and no more are to be taken.

It is an old and commonly accepted rule that investment judgment involves the acceptance of calculated risks in anticipation of commensurate rewards. Trust men are expected to make this calculation with particular care. Many a man has brought his affairs to us simply to end the unacceptable risks which pervaded his own unskilled attempts at investment management.

Before closing I should mention that all investment activity of a trust department must suit the tax status and regulatory environment of the account. We use tax-exempt bonds for production of after-tax spendable income where appropriate, of course. We always weigh the relative advantage of dividend yield and common stock growth on an after-tax basis.

We have a very common problem with the capital gains tax liability attaching to old holdings of stocks, some of which have a nominal cost basis. Since accounts generally come to us fully invested rather than in cash, this is a very common problem and our investment activities are limited or even immobilized by these considerations.

SUITABILITY TO THE LIMIT OF CUSTOMER ACCEPTANCE

It is one thing to determine an investment program which exactly suits one of our customers. It is quite another thing to persuade him to accept it. Bear in mind our very limited authority to act on our own discretion.

COMMON STOCKS HELD UNDER SOLE DISCRETION

[In percent]

	Total assets	Average common stock proportion	Common stock, percent of total assets	Extent of bank discretion as to investment typical average	Common stocks under sole discretion, percent of total assets
Employee benefit accounts	33	60	20	75	15
Personal trusts and estates	49	67	33	25	8
Agency accounts	18	65	12	10	1
Total	100		64		24

Clearly our job has only begun when we have drawn an investment program for our customer. He may be a doctor, a lawyer, a businessman or an armchair quarterback, but one thing is certain; he will have strong views on investment matters. We must counsel, explain, persuade and amend. Our final action, when it comes, will often be a compromise between our views and his.

The assets of a trust department are truly the assets of our many customers, not only legally but emotionally as well. They shared in the choice. They hold their stocks at times with feelings of affection bordering on love, and will have to be completely satisfied by any reasons we may give for sale.

Our customers (bless them) are a heterogeneous assemblage, a willful and unruly group, a motley army which never marches in step. Among them are some who want a piece of the action, and many more who want only peace of mind. They are there for many reasons and their affairs have no common purpose and their investment activities no central tendency. What suits one will never suit another. It is a trust man's responsibility somehow to suit them all.

APPENDIX B

Responsibility of Fiduciaries

(An Address by Henry Harfield, Esquire, Shearman and Sterling, New York City, at the A.B.A. Seminar on Fiduciary Responsibility)

The best way to describe a person's responsibilities is to ascertain what he is supposed to do and for whom. That is as applicable to a fiduciary as it is to a day laborer. It is a pity that so many people take the easy way of reading labels rather than studying the operation of the labelled article. The sensible way to proceed is to examine the function and then decide what label should be applied.

Actually, just this often happens in the case of fiduciaries. There are a great many more fiduciaries in this world than ever applied for the job. For example, everyone is aware that a person wearing the label "trustee" is held to a very high standard of care and conscience. It may be said that this standard goes with the title. But consider the number of people who never aspired to the title of trustee but are held to that degree of responsibility through the device of resulting or constructive trusts. I'm reminded of the Frenchman who was convicted of treason and was carried to the guillotine in a tumbril surrounded by a jeering mob. He said "If it were not for the glory of the occasion, I would prefer to stay at home."

Probably the best single statement of fiduciary responsibility was made in a case that did not involve formal trust relationships nor indeed a voluntary assumption of the responsibilities that were imposed. That is the old New York case of Meinhard v. Salmon, 249 N.Y. 458; 164 N.E. 545 (1928) in which the complainant alleged that his partner had betrayed him. Justice Cardozo was moved to make his famous, if somewhat turgid, statement that where fiducaries are involved, the standards they must meet are "not the morals of the marketplace but the punctilio of an honor the most sensitive". In essence, then, a fiduciary is to be guided by the punctilio of an honor the most sensitive, in respect of his transactions with and on behalf of the person or persons who repose faith in him. This is the essence of the fiduciary relationship. It does not matter whether the relation is characterized as a formal trust under a will or other paper bedecked with red ribbons and seals, or as an agent or registrar.

Accordingly, I shall not waste your time or my own this morning by exploring in scholarly detail the sub-classes of the genus fiduciary. There is neither time, nor in my estimation, any good reason for rehearsing the subtleties of distinction between a testamentary trustee and a corporate trustee, or between a trustee and an executor or administrator, or among any of the other profusion of high-principled specialists that, in the aggregate, make up the holy band of fiduciaries. I should also say to you that the propositions of law which I shall state as general principles are derived from the American Law Institute Restatement of the Law of Trusts, and so it is possible, although I do not believe it likely, that State law may provide some exceptions.

At the outset, let us observe that a fiduciary cannot exist in a vacuum. Just as it has been said that no man can be a law unto himself, so no man is a fiduciary for himself except in certain ecclesiastical areas as to which I am not competent to speak. (cf. Romans, 4:15: "Where no law is, there is no transgression.") A fiduciary is one who acts in the interest and on behalf of another, whom we may loosely refer to as beneficiary. A person acting as fiduciary must be guided in his every act, or omission to act, by the exercise of his best judgment and the fullest employment of his talents and skills to the end of protecting and furthering the interest of his beneficiary. If, in any respect, he fails to discharge this duty, he will be held to account under the strictest principles of equity. Here, I believe, is one of the most significant distinctions between one who acts as a fiduciary, responsive to the punctilio of an honor the most sensitive, and one who acts as a principal, responsive only to the morals of the marketplace. The latter, Mr. Average Man, may be cast in damages and forced to pay, either by surrender of money or by surrender of liberty in extreme cases, for a default in the discharge of obligations that he has

undertaken. A fiduciary is much more strictly accountable for his deficiencies. The maxim "equity regards as done that which ought to be done" [1] has a special meaning for fiduciaries. Let me provide one illustration, borrowed from Section 206 of the Restatement:

"A transfers Blackacre and a sum of money to B in trust for C and directs him to develop oil wells on Blackaçre. B purchases adjoining land for himself and opens oil wells thereon which deplete the oil from the wells on Blackacre. B can be compelled to hold the adjoining land and any profit which he makes upon a constructive trust for C, on being reimbursed out of the trust estate for his expenditures."

Accordingly, it may be said that a fiduciary owes to his beneficiary a duty of perfect loyalty, such that no departure from it will be condoned and, to the extent possible, the beneficiary will be placed always in the same position as if the duty of perfect loyalty had been perfectly discharged.

It is clear, therefore,—at least it is clear to me,—that no one can can be a fiduciary because nobody is perfect. No one, corporation or individual, is capable of total subordination of all functions to the interests of another. When I say that, I recognize that a pregnant woman may be an exception. Absent the process of gestation, however, it is clear that a person who enters into the relationship of fiduciary also splits his personality. Stating this more practically the absolute standards of loyalty and selflessness are applied to the fiduciary only within the scope of his fiduciary relationship.

The legal fiction of selflessness is subject to additional practical footnotes. Even though certain acts by a fiduciary might clearly be advantageous to his beneficiary, the fiduciary is excused from performing them if to do so would constitute a violation of law or, indeed, conflict with a clearly defined or existing public policy.[2]

It is at this point that the differences among the various types of fiduciaries become of practical significance. The practical significance of the difference lies in the difference in the scope of the respective relationships. For example, an executor stands in the position of the representative in this world of the deceased testator. The scope of his responsibility is, accordingly, coexistent with the scope of the estate that he administers. Quite a different situation is presented where, for example, a person undertakes to act as trustee of a particular fund, the equitable interest in which may be only a small part of the settlor-beneficiary's total wealth. Let us go back to the Restatement illustration of a few moments ago, and assume that A and B are proprietors of adjoining oil properties. A dies, naming B as his executor and as trustee to operate his oil property. A question may arise as to whether B can properly accept this appointment, but it appears clear that if he does qualify he must prefer the operation of A's oil property over his own. Now assume that A, instead of dying, transfers a million dollars in cash to B, in trust to invest and reinvest the sum, paying the income to A during his life and thereafter to A's children, remainder in fee to the heirs of his body. There would appear to be no reason why B should hesitate to accept this appointment nor any reason why, if he does accept the appointment, he should be obliged to lessen the competition which exists between his oil property and A's oil property. Indeed, the Department of Justice might have something to say if he did elect cooperation over competition. The fiduciary's responsibility is congruent with his mandate. Thus, in our hypothetical case, B is a fiduciary with respect to the mass of assets he administers; he has assumed no responsibility with respect to the extraneous well-being of the beneficial owners of those assets. He must faithfully account to A for his stewardship of the trust assets, but if he alienates the affection of A's wife, that is not actionable—at least in the State of New York.

We deduce a rule. In determining the responsibility of a fiduciary, the scope of the relationship must first be ascertained. Once the scope of the fiduciary relationship is ascertained, the consequences of the fiduciary's conduct follow almost as a matter of course.

I do not suggest that controversies and indeed difficult lawsuits may not arise out of the definition of a fiduciary's duty in a particular case and out of the question as to whether he has adequately performed that duty. My point is only that the law provides formulae for the resolution of these questions and mechanisms by which the decisions may be implemented. Again, let me illustrate.

A trustee is directed by the terms of his governing instrument to invest and reinvest the corpus of the trust exclusively in railroad bonds. Pursuant to this mandate the trustee holds a portfolio of railroad bonds providing an average yield of 10%. At that point in time, the trustee sells the entire portfolio and reinvests in government bonds yielding on 5%. Accordingly to the Restatement

[1] 27 Am. Jur. 2d, Equity, § 126

[2] A trustee is under no duty to comply with the terms of a trust which are either illegal or against public policy, Restatement (2d), § 166.

(Section 227) this is a breach of trust by the trustee and the immediately foreseeable consequences is a diminution in the benefits to the income beneficiaries. It is clear, however, that the trustee is also under a duty to the beneficiary in administering the trust "to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property." (Restatement, Section 174). And what the trustee has done with the trust property int he hypothetical case parallels precisely what he has done with his own personal fortune. Does the so-called "prudent man" rule override the express terms of the trust? If the trustee had followed the express terms of the trust, would he be excused from the duty of prudence? Will the income beneficiary prevail? Will the settlor turn in his grave?

I do not attempt to answer any of these questions, but I emphasize again that the law provides procedures for their resolution as well as procedures by which the judgment, whatever it may be, may be enforced.

Let's try another hypothetical. Mr. John Q. Tycoon is the sole trustee of a charitable trust for the benefit of widows and crippled orphans. At the time the trust was created, it held and still holds a substantial block of stock in the Steadfast Glue Company, of which Mr. Tycoon is a director. Mr. Tycoon is summoned to an emergency meeting of the board of directors at which he is informed that the company is hopelessly insolvent and it must consider filing for bankruptcy within the next ten days. Mr. Tycoon leaves the meeting and, in his capacity as trustee for widows and orphans, telephones his broker to sell all of the company's stock held by that trust. Alternatively, Mr. Tycoon recognizes that he has received this information confidentially as an insider of the company, so he makes no phone calls to his broker and merely murmurs under his breath "there go the widows and orphans".

Once again, I make no attempt to predict what the consequences to Mr. Tycoon would be if he elected either of these courses of action, but again, I emphasize the fact that the law provides well-recognized procedures for determining his accountability as a fiduciary and for implementing whatever determination is made.

There is nothing new in any of the things that I have said to you. The concept of the requirement of absolute loyalty by a fiduciary and the concept of the accountability of a fiduciary, of the enforceability of fiduciary obligations, all are familiar doctrine to every law student. Their roots go back to the very development of the common law and concepts of equity in medieval England;[3] they are so much a part of the fabric of our society that they are no more worthy of remark than the rising of the sun and the obligation to pay taxes.

But there is a reason, I think, to discuss the legal responsibility of fiduciaries; indeed, there are two reasons. The first of these is that the concepts are so well known that they tend to be taken for granted and, therefore, perhaps, overlooked. The second is, as I mentioned at the outset, that we are developing in this country a whole new breed of what I may characterize as inadvertent fiduciaries. I am referring to corporate directors who act contrary to the interests of the corporation in which they hold the office of director. I am referring to investors who acquire or retain controlling stockholder positions in order to loot or otherwise abuse the company in which they hold stock. I am referring to persons who achieve a privileged position with respect to information and who reject the obligation of discretion that goes with that privilege. I am, in short, referring to scoundrels.

Now in the bad old days, these scoundrels may have gotten away with their rascality because they were wearing labels that said merchant, or industrialist, or entrepreneur, instead of labels that said trustee, or executor, or fiduciary. Today, they are not getting away with their misdeeds because the courts are adopting a functional approach in which they examine what the man did instead of what the man said, what the man did instead of what the man is, and the tool that they have used to achieve this result is the application of tried and true and well-established principles of law that have always been controlling for those who were professional and not inadvertent fiduciaries.

The use by courts and administrative agencies of equitable principles to correct inequitable conduct is wholesome. It always has been. It is the way our law works, and has worked since the beginning of equity, but you would think, from the uniformed public reaction, that the courts had just invented the wheel and so far as legislators are concerned, whether federal or state, the strutting and squawking is about what you would expect if a rooster had laid an egg.

---

[3] *Scott on Trusts*, 3rd. ed. § 170

You may ask whether I have any purpose in my remarks other than using this platform to insult the establishment of government and the public generally. I do. There is a moral. During the difficult days of World War II it was national policy to encourage efficiency and to discourage waste by promoting the full utilization of existing goods. You will remember, or some of you will, the ubiquitous signs saying "Use It Up", "Made It Last", and few years ago, during the recent water shortage in New York City, "Don't Flush for Everything".

The relevance of those policies to the responsibility of fiduciaries, here and now, is this. There is a comprehensive, detailed and time-tested body of law to protect those who deal with fiduciaries. The law requires a fiduciary to exercise his best efforts to further the interest of his beneficiary. "Best efforts" is a significant phrase in this connection because a fiduciary who is highly skilled may be held to a higher standard than one who is less skilled. The prudence of the reasonable man is a mandated minimum, but exercise of that degree of prudence which would characterize a reasonably stupid or ignorant man does not relieve a highly intelligent and expert fiduciary from the fullest devotion of all his talents.[4] Perhaps most important, the law not only makes substantive provision for the faithful performance by a fiduciary but provides effective means for rendering him accountable for all his actions, whether worthy of praise or censure.

This body of law or, if one prefers, this kit of legal tools applies and is available to any fiduciary relationship regardless of whether the particular relationship is given at the outset a particular label. Just as the concepts of equity have historically been applied, even in the absence of a formal fiduciary relationship, to achieve appropriate results by characterizing a relationship as a resulting trust or characterizing a person as a constructive trustee, so they are now available and are used, to characterize appropriate commercial or corporate practices as fiduciary relationships.

So, I conclude with these observations.

1. There is no deficiency in the law governing fiduciaries. That is a good and sufficient body of law. Let's not trade it in for a new model as long as it continues to serve.

2. The fact that the law governing fiduciaries is being applied more broadly confirms the vitality of that body of law; it negates any suggestion that fiduciaries require additional or different regulation.

3. If there are rascals abroad in the land whose excesses should be curbed by law, it may be appropriate to subject them to existing fiduciary law; it is not appropriate to alter the existing law. Don't flush for everything!

4. If the fiduciary concept is to be extended to relationships and transactions that have not traditionally been tested by fiduciary standards, then it is essential that the scope of the particular relationship be thoughtfully and realistically defined.

I end as I began, with a reference to Cardozo's dichotomy. The responsibility of a fiduciary is dictated by the punctilio of an honor the most sensitive. If the morals of the marketplace can be elevated to that standard, well and good. But so long as fiduciaries meet the exacting standards of their calling—and professional fiduciaries are required to do just that—they should not be caught up in prophylactic raids on the marketplace.

---

[4] "Ordinarily a trustee incurs no liability if he does not fall below the standard of a man of ordinary prudence. It may be, however, that a particular trustee has greater skill or more facilities than those of the ordinary prudent man. In such a case he is under a duty to exercise the skill." *Scott on Trusts*, § 174.

APPENDIX C

A DEFINITION AND ANALYSIS OF THE FIDUCIARY RESPONSIBILITIES OF BANKS

(An address by Richard P. Brown, First National Bank Denver, Colo. at the A. B. A. Seminar on Fiduciary Responsibility)

Mr. BROWN. Whenever I want to put my thoughts on anything in the trust field into order, I turn to the works of the master, Austin Wakeman Scott, the long-time professor of law in the field of trusts at Harvard Law School, and the reporter on trusts for the American Law Institute. In the first paragraph of the Introduction to his ABRIDGMENT OF THE LAW TRUSTS, Dr. Scott tells us that Professor Maitland was accustomed to tell his students in equity that "Of all the exploits of Equity the largest and the most important is the invention and development of the Trust. If we were asked what is the greatest and the most distinctive achievement performed by Englishmen in the field of jurisprudence I cannot think that we should have any better answer to give them than this, namely, the development from century to century of the trust idea." Dr. Scott goes on to compare the flexibility of the trust concept with that of the contract concept, then pointing out that while practically all legal systems embrace the contract concept, very few include the trust concept; Dr. Scott then says, "The trust, however, is a device for making dispositions of property. And no other system of law has for this purpose so flexible a tool. It is this that makes the trust unique."

Thus, the trust is a device conceived in the English system of equity jurisprudence which gives to the residents of the countries which have adopted that system of law a uniquely flexible way of making dispositions of property in the interest of the security and well-being of their families. We are fortunate in our United States to have the trust concept as a part of our legal system; and those of us who have chosen trust work as a career are privileged to work in a field where the opportunities to serve those who "place their trust" in us are unique.

My part of our program today is to delineate the responsibilities which a bank accepts, and must discharge, when it enters into the various relationships which exist in our trust departments between the bank and its customers; the extent of those responsibilities in terms of the number of such relationships and the dollar size of the relationships we have accepted; the fees which we charge; the manner in which we attract such business; the reasons that we seek such business; and, so far as we are able to ascertain, the reasons that our customers see fit to place such responsibilities upon us.

Until very recently there was a great deal of secrecy and mystery about trust figures. Banks, for one reason or another, were unwilling to reveal the size of their trust departments, the numbers of trusts which they handled, and the value of the trust assets contained in those trusts. Similarly, they were unwilling to reveal the amount of income which was derived from their trust business. No bank made any effort to report the value of its trust assets, and trust fees were almost always buried in the "other operating income" figure in the statements of income which were published in the banks' annual reports.

Beginning in 1967, however, several developments occurred which, for the first time, made trust department figures generally available. The staff of the subcommittee of the House Banking and Currency Committee initiated a study of the size of bank trust departments, and asked for and received from the major trust departments throughout the country information on their holdings of securities. The Comptroller of the Currency required that, for 1967 and succeeding years, trust department income be stated as a separate item in the income statement of the bank where trust department income constituted a significant portion of the bank's gross income. For the year 1968 for the first time the Board of Governors of the Federal Reserve System, the FDIC, and the Comptroller of the Currency all required the trust departments under their supervision to file statements of their condition on substantially identical forms and under substantially identical directions, so that the three sets of statistics could for the first time be collated and statistics which would include the assets of all of the banks in the trust business throughout the country produced. These statistics were released in

a booklet entitled "Trust Assets of Insured Commercial Banks—1968," and in that booklet we have literally for the first time a fair picture of the assets held by bank trustees throughout the country. These statistics are probably known to most of you, but they are impressive figures and, considered in gross, have led some to comment on the assumed economic power of "the trust industry."

As of the end of 1968, according to this booklet, insured banks throughout the United States handled a total of 962,880 trust department accounts. The rate of establishment of new trust department accounts permits us to state with confidence that the number of such accounts handled by the insured banks is now over one million. The value of assets held in those accounts in existence at the end of 1968 was $282,710,626,000. This is truly a tremendous figure, and the responsibilities assumed by our trust departments in the handling and management of assets of this value are of such magnitude as to be significant not only to our banks and to the beneficiaries of the trusts which we handle, but to our country as a whole. Thus, it is proper that we review here, for our own guidance in the continued discharge of those responsibilities, and for the benefit of those who are our guests today, the nature and extent of those responsibilities and the steps which we must take in order to assure that we will continue to discharge those responsibilities properly.

The key word in the relationship which exists between the trust department of a bank and its customers is the word "fiduciary"—a single word which summarizes the fact that our duties toward trust customers require us to subordinate any personal interest which our bank may have in their trusts, or in the securities and other properties which comprise the assets of the trust, to the interests of the beneficiaries, and to act solely in the best interest of the trust and of those entitled to share the benefits of the trust without regard for the bank's personal interest. Austin Scott, in speaking of the duty of loyalty which a trustee owes to the beneficiaries of the trust, states, "A trustee is in a fiduciary relation to the beneficiaries of the trust. There are other fiduciaries, such as guardian, executors or administrators, receivers, agents, attorneys, corporate directors or officers, partners, and joint adventurers. In some relations the fiduciary element is more intense than in others; it is peculiarly intense in the case of a trust."

I don't know that I have ever found the words "intense" and "fiduciary" used in conjunction in the way that Austin Scott has used them in this sentence, but I like the concept of "intensity" as a measurement of fiduciary duties; and I think that we can very properly classify the various relationships which exist between our trust departments and our customers in terms of the intensity of the fiduciary relationship which is involved, and I propose to do this—including in what I have to say about these separate categories of relationships, figures as to the number of such accounts, the total value of such accounts, and the average value of such accounts reported by insured commercial banks for 1968.

At the top of the list, as measured by the "intensity" of the fiduciary relationship, I would place the function of the executor or administrator of a decedent's estate. I place it there because the duties which are owed the beneficiaries of the estate—the devisees and legatees named in the will, or the heirs of the deceased person in absence of a will—are truly fiduciary duties of a high level. At the same time, however, the executor or the administrator owes other duties to persons who are not beneficiaries of the estate. He owes duties to the creditors of the decedent, and he owes duties to our Uncle Sam and to the state of the decedent's residence in connection with taxes which are imposed upon death. Quite frequently the interests of creditors and the interests of beneficiaries are adverse. Almost invariably the interest of the two tax-collecting entities on the one hand, and the interest of the beneficiaries on the other hand, may be considered to be adverse. A failure to discharge properly the duties owed to the government or the state may result in fines and penalties being assessed and, conceivably, in actual imprisonment of an executor or its agent. On the other hand, the failure to discharge properly the duties owed to the beneficiaries may result in substantial civil liability by way of surcharge. Thus, the executor or administrator in the administration of an estate is forced to walk a very careful, impartial line between his obligations to the benefícaries, the creditors, and the tax collectors. In addition to the presence of conflicting groups to whom the executor or administrator owes duties, there is the further very material fact that in his dealings with the members of the family of the deceased person, he is called upon to assist in times of critical stress, when it may properly be said that the abilities of the beneficiaries, particularly widows, to act in their own interest may be substantially impaired. Thus, I consider that the duties owed by the executor or administrator are of the highest type of responsibility.

In this same "most intense" area of fiduciary relationship, I am inclined to include the function of the guardian or conservator of the property of a person who is under legal disability. I do this because the duties bear a great resemblance to those of an executor or administrator, and because the fiduciary is acting with respect to the property of a person who, by legal definition, is unable properly to handle his own assets.

According to the joint compilation of the Fed, FDIC, and the Comptroller, to which I referred earlier, we find that the insured banks of the country as of the end of 1968 were handling 135,763 estates of persons who were deceased or were minors or mental incompetents, with total value of $18,564,317,000 or an average value of $136,700.[1]

One step down the ladder of the intensity of the fiduciary responsibility, and believe me, please, these steps are very small steps, I place the responsibility of banks in acting as trustees of testamentary trusts and of irrevocable living trusts. Under the heading of irrevocable living trusts I include those which were irrevocable from the time of their inception and those which, while originally revocable, became irrevocable at a later time due to the occurrence of some event such as the death of the settlor of the trust. I am a little hard put to explain why I place these two very substantial categories of trust business at a lower level of fiduciary responsibility than I have placed the administration of the estates of deceased persons or persons who are under legal disability. I think the reason is the feeling that the recency of death, in the case of an executor or an administrator, or the presence of a legal disability, in the case of a guardian or a conservator, raises the level of responsibility just a very little bit above that which is owed by the trustee of an irrevocable trust. This distinction is, perhaps, a little intangible, and is admittedly based, as far as I personally am concerned, upon a feeling which is more visceral than cerebral; nevertheless, I have that feeling.

Next in order in the "intensity" of fiduciary relationship I would place the revocable living trust; and, consistent with the definition of irrevocable trust which I used in the last category, I would define a revocable trust as being a trust which was at its inception, and still is, revocable. I place the revocable living trust below the irrevocable living trust and below the testamentary trust in the measure of fiduciary intensity, simply because in the revocable trust the person who holds the power to revoke can, at his own convenience, rid himself of the trustee if he sees fit to do so. In such cases, the trustee's services may be dispensed with very early in the game, if for any reason the trustee does not satisfy the settlor, and the settlor can ordinarily protect himself against any maladministration by the trustee before such maladministration becomes too great and results in substantial loss to the trust by the simple expedient of terminating the trust.

The combination of the testamentary trusts, irrevocable living trusts, and revocable living trusts is lumped together in the heading of Personal Trusts in the available statistics on the number and value of trust accounts, so that I cannot supply separate figures for these three categories. Taken together, however, they are by a very great margin the most widely used type of trust account, and the aggregate value of the assets held in these trusts exceeds by a substantial measure the next largest category, which is employee's trusts. At the end of 1968 under this combined category of personal trusts, the reporting banks throughout the country held a total of 614,927 such trusts with an aggregate valuation of $119, 808,688,000, or an average value of $194,800 per trust.

Philosophically at least, I think that employee benefit trusts should be included in the same general category as revocable living trusts in the assessment of the measure of fiduciary responsibility which the trustee bears. They are living trusts in the sense that they are entered into by written agreement rather than by will; and while they are not revocable in the ordinary sense that the creator of the trust may revoke it and bring back into his own ownership the funds and property which have been placed in the trust, nevertheless there is almost universally found in the employee benefit trust a provision whereby the trustee can be removed, either by the employer who has established the trust, or by an employees' committee.

[1] In order to simplify the reporting procedure for those banks where the breakdown between personal trusts and estates was not readily available, the supervising agencies permitted such banks to report personal trusts and estates under a single heading; where such a breakdown was readily available to the reporting bank, personal trusts and estates were reported in separate columns. For the purposes of this talk I have prorated the numbers of accounts and the value of property reported under the single heading "Personal Trusts and Estates" between the separate columns headed "Personal Trusts" and "Estates" respectively, in the same proportions as were found to exist in the case of those banks which were able to report those categories separately. I believe that this proration results in substantially, although perhaps not precisely, accurate figures.

It is because of this power of removal, which gives the person or the group which has the power to remove the trustee the opportunity to move quickly to put an end to any maladministration of the trust, that I say that the employee benefit trust fits into the same general category of responsibility as the revocable living trust. The statistics on the employee benefit trusts are, as you know, quite impos-imposing. They are certainly the most rapidly growing field of trust business. At the end of 1968 bank trustees administered 88,058 employee benefit trusts having a total value of $84,346,958,000. The average value of employee benefit trusts handled by bank trustees throughout the country is $957,900; this average figure is much higher than the average for the personal trusts and estates, almost five times as large as the average personal trust and about six times as large as the average estate. We must bear in mind here, that an employee benefit account is held for the overall benefit of a group of employees, with the total number of beneficiaries in some such accounts running-up into many, many thousands of individuals.

At the next lower level of the intensity of the fiduciary relationship I believe most of us place the agency account. The agent is deliberately selected by the principal, and he can be relieved of his duties at any time by the principal. Where the agency, as distinguished from the trust, relationship exists, the property remains the property of the principal and does not become the property of the agent; thus, the principal remains vested with all his legal rights in the property, and is not relegated to the enforcement of equitable rights against a trustee in order to protect himself. Since in the agency the powers and abilities of the principal to protect his own interests are substantially greater than is the case with a beneficiary of a trust or an estate, placement of an agency account at the lower end of the ranges of fiduciary responsibility appears to be proper; but again I would emphasize that once the basic fact of fiduciary responsibility is established, the gradations are very minor and the fundamental duties of the fiduciary are owed wherever the fiduciary relationship exists, regardless of the precise name which may be applied to that fiduciary relationship.

The 1968 report of the trust assets of insured commercial banks separates agencies from trusts and estates, and subdivides the agency field into the categories of employee benefit agencies and all other agencies. The aggregate of these figures is quite substantial—a total of 5,618 employee benefit agencies, holding a total of $8,496,489,000, and 118,514 other agencies holding a total of $51,491,-304,000. The total of all assets held by bank trust departments in agency accounts was $59,987,793,000.

Much of what I have had to say to this point might be described as a quantitative review of the aggregate of the trust responsibilities of bank trustees. Now I would like to discuss the matter of trustees' responsibilities in a qualitative sense—the duties owed, generally, by each trustee to the beneficiaries of each trust.

Once a bank accepts a trust, it is under a duty to administer it, according to its terms, and according to the law, in the interest solely of the beneficiaries of the trust with unswerving loyalty, bringing to the trusteeship, and diligently exercising all of the skills and abilities the trustees has, and, whether the trustee has them or not, all the abilities the trustee should have, or holds itself out as having.

Note that I have stated it is the trustee's duty to administer the trust according to its terms, and according to the law. Much public and official misapprehension of the manner in which trust departments carry on their work arises from failure to comprehend that each trust is a separate entity, separate and apart from all the other trusts the trustee bank administers, governed by the separate instrument which creates it, administered in the interest of the person or family entitled to its benefits, and invested in the manner best calculate to maximize those benefits.

The most fundamental responsibility of the trustee is the duty of loyalty owed to the beneficiaries of the trust. The trustee must deal with the trust property solely in the interest of the beneficiaries. The trustee may not deal as an individual with the trust property, may not acquire interests adverse to the trust, and may not avail itself for its own account of opportunities which would be advantageous to the trust, and may not derive profit, other than a reasonable trustee's fee, from the position of trusteeship.

It is the responsiblity of the trustee to protect the trust property, to take and maintain control over it, to defend any legal actions which may threaten the trust and its property, and, where necessary to the protection of the trust property, to initiate legal actions for that purpose.

Another of the major responsibilities of the trustee is to keep the trust property separate from its own property, and separate also from the property of other trusts which the trustee may be handling, in order that the trust property may always be identifiable as such. The trustee must keep and, at the times and in the manner required by law, render accurate accounting to the beneficiaries, and furnish to the beneficiaries, upon their reasonable request, information as to the status and administration of the trust.

It is a part of the responsibility of the trustee to deal equally and impartially with all the beneficiaries of the trust, and where the interests of separate beneficiaries or groups of beneficiaries are conflicting or potentially conflicting, to be most scrupulous in avoiding any preference of one beneficiary or group as against another.

When we consider the nature and the extent of the duties owed by a trustee to the beneficiaries of a trust, and the fact that the average trust department account has a worth of approximately $293,000, it is obvious that the decision to create a trust, and the selection of a trustee, are matters that are carefully considered, thoroughly discussed, and not arrived at lightly.

No one is obligated to create a trust, or to employ a bank as his trustee, executor, or agent. With very rare exceptions, every one of the more than one million trust department relationships handled by banks today is handled by the specific bank because the property owner who established the relationship wanted a bank, and wanted that specific bank, to undertake the fiduciary responsibilities which that relationship entails. Not only is no one obligated to create a trust or to utilize a bank as his trustee, but in a surprisingly large proportion of the trust department accounts which banks handle, they may be removed from their position of trust should their handling of the account fail to please.

Precise statistics as to the proportion of fiduciary accounts in which banks can be removed by their customers are not available, but from the very nature of the agency relationship they can be removed in all agency accounts; they can be removed in all revocable trusts where the settlor is still alive and competent; and they can be removed in a great majority of employee benefit trusts. Making some rough estimates, and saying that banks may be removed from their office in all agency accounts, 40 per cent of the "personal trusts," and 75 per cent of the employee benefit trusts, we find that we are subject to removal in 45 per cent of our trust department accounts, and that these accounts encompass 61 per cent of the total assets in our care. Thus, in this very substantial portion of our trust business, not only must our customers be convinced of our integrity and ability before they designate us, but they must remain so convinced by our handling of their trusts, or we will be without a job.

Trusts are established as the result of extensive discussion between customer and bank officer. The wills and agreements which establish trusts are carefully prepared, usually by, or with the collaboration of, the customer's attorney; and the customer's attorney is usually present when the effective document is signed. Each of the more than one million trust department accounts in existence represents a vote of confidence, by the owner of property of substantial worth, in the integrity, ability, and industry of the bank which has assumed the particular fiduciary responsibility.

A service which has led a million customers to entrust almost three hundred billions of assets to the trust departments of the nation's banks can exist only because of the combination of public need for the service and bank ability to supply it. The needs are many—in one case, management of a man's lifetime accumulation for the benefit of his widow, thoughtfully sheltered from business problems and worries by a devoted husband who is no longer able to supply that shelter; in another, the protection of a spendthrift from her own weakness, in order that the modest estate the father has accumulated may support the daughter for the greatest possible period of time; in yet another, the realization by an active professional man that the investment of the funds he is able to accumulate is a job calling for the same level of professional ability that he offers to his own patients or clients, and that he himself is not learned in the profession of investing.

The resources provided by bank trust departments to meet the needs of their customers and prospective customers are as many and varied as the needs they meet. We attract trust services by providing: administrative officers who are experienced and sympathetic in analyzing and solving the personal and family problems that the flexibility of the modern trust is designed to deal with; investment officers with proven ability to produce investment performance in today's

difficult investment climate; operations people who collect, account for, and remit with promptness and precision, relieving our customers of the burdens of bookkeeping and the like.

These abilities are our stock in trade—skill, training, experience, devotion ready availability, and an ability to meet our responsibility. These we supply to our customers to meet their needs; these we offer to those whose business we solicit. The growth in the number of trust accounts handled and the general upward trend in trust assets year by year are proof that our services please our customers.

What is the cost of our services? A part of the duty of a fiduciary is to derive no gain, other than reasonable compensation for its services, from its handling of trust accounts. Fees for services as executor, administrator, guardian, or conservator are either fixed by a court or approved by a court, within limitations contained in state laws. Fees of trustees under wills are fixed by law in many states. Fees of trustees under wills where not fixed by statute, and fees of trustees under agreements, are subject to the inherent requirement of equity that they be reasonable; and their reasonableness may be questioned in court at any time.

Bank trustees compete with other trustees, and with other types of institutions, in the various fields of trust work. Our fees must be, and are, reasonable in order to permit us to maintain and hold our business volume. Bank trustees' fees are usually calculated as a fraction of a percent of the value of the trust, starting at from one-half to three-quarters of one percent in the lower brackets of, say, up to one hundred or one hundred fifty thousand dollars, and dropping to about two-tenths of one percent in the areas above a million dollars. Fees in trusts under agreements, including employee benefit trusts, are subject to negotiation, and a potential trust customer is free to shop and negotiate the fee which may be charged. In my experience, and in the experience of other trustmen with whom we have talked, most trust customers, present and prospective, feel that "the laborer is worth his hire," and current fees for trust services are modest and no more than reasonable compensation for responsibility assumed and services performed.

For certain special services, such as discretionary distributions, the final distribution of the trust property, the tax involvements occasioned by the death of the creator of a revocable trust, and the like, there are reasonable additional fees.

The fact that our fees are based upon the current value of the trust property obviously supplies an added incentive to trustees to make the trusts under their administration grow and prosper.

It is also worth noting some of the things for which we do not charge. We do not charge commission on purchases and sales of securities; hence we have no incentive to "churn" trust accounts. Our common trust funds, in which many of our small and medium-sized trusts are invested, have no "load" charge and no redemption charge.

In summarizing this review of the nature and extent of the fiduciary responsibilities of banks, it seems fair to say:

"That the banks of our country have accepted responsibility for the fiduciary management of nearly 300 billions of dollars in assets;

"That these assets are encompassed in more than a million separate trust department accounts having in all probability several million individual beneficiaries;

"That the duties and responsibilities of the bank with respect to each separate fiduciary account are determined by the specific instrument establishing the relationship, read in the light of the applicable local law;

"That such duties and responsibilities therefore differ from one account to the next, and are owed in each individual account to the specific beneficiaries of that account, and are enforceable by those specific beneficiaries;

"That for these reasons, each fiduciary account must be administered separately, according to its own terms, in the interest of its own beneficiaries. While uniform practices and procedures for the handling of routine matters may be set up within our trust departments, discretionary matters such as the sale and purchase of investments, the making of discretionary distributions, meeting with and counseling beneficiaries and customers, and the like must remain matters of individual action and judgment by qualified experts within the trust departments;

"That in the separate handling of each separate fiduciary account the bank must act solely in the interest of the beneficiaries of that account, placing that interest above any personal interest of the bank, its officers, directors, or stockholders, and that the bank must derive no profit, other than its reasonable compensation, from its position as trustee."

We in trust work are proud of the ability and devotion of the staffs of our trust departments to the high standards of duty which these responsibilities impose upon us. We feel that the number of accounts handled by our trust departments, the high average size of those accounts, and the tremendous worth of the assets which have been entrusted to us, testify to the sincere and conscientious effort by trust people of both the present and past to meet and discharge these responsibilities, and that the continued growth in the number of fiduciary relationships established with our banks, demonstrates the trust and confidence which those who have studied our abilities, our principles, and our performance place in us. Those who know us best are our customers, and their favorable judgment of us is continually expressed by their placing in our care the funds and securities which they have been able to accumulate to provide for their futures and the futures of their families.

We intend so to conduct the business of our trust departments as to continue to merit this confidence.

[From the Wall Street Journal, Sept. 26, 1973]

HEARD ON THE STREET

(By Charles J. Elia)

It would have sounded like heresy a few months ago for dedicated backers of top-rung growth stocks to even suggest other stocks might be better investments.

It's happening, however, as a rallying stock market demonstrates that the broadening interest in depressed and cyclical stocks that appeared in the July rally wasn't any flash-in-the-pan.

Spencer Trask & Co., an influential brokerage firm closely identified with growth stocks, sent to its institutional clients yesterday a five-page memo outlining a modification in its investment policy. The gist of the advice: Growth stocks should still be best for the long run but a number of lesser-known, even traditionally cyclical, stocks are likely to show better relative performance and it's time to diversify.

The broadening market similarly is producing a switch of emphasis at such other major research firms as Baker, Weeks & Co., and a step-up of purchase decisions at such prestigious firms as Morgan, Stanley & Co.

The market's recent recovery hasn't quelled the fears of some bears who don't believe a new bull market has started. But the evidence is mounting that many issues, ignored during the past two years by institutions, are out performing the popular averages and some of the large portfolios so heavily committed to a small number of fashionable growth stocks.

The averages, in fact, are practically bringing up the rear in the performance derby, according to studies by Steven C. Leuthold, of Piper, Jaffray & Hopwood Inc. Through last week's close, the Dow Jones industrial average was up 9.3% from its 1973 low and Standard & Poor's 500-stock index was up 6.9%, after both were adjusted for dividends.

By comparison, one sector of the science-technology group tracked by Mr. Leuthold was nearly 56% above its low, and another was up 48%. The secondary petroleum sector was up 37%, primary metals 30%, cyclical manufacturing 21% and secondary chemicals 25%. In all, stocks in 25 industry groups advanced more from their 1973 lows than did the Dow Jones industrial average through last Friday.

Perhaps even more significantly, stocks in 15 of those groups rebounded better than did a special institutional index that Mr. Leuthold uses to measure the performance of 600 issues most widely held by pension, insurance and mutual funds. The institutional index was 4.9% above its low last Friday.

At Spencer Trask, the switch in approach was helped along by the psychological pall cast over high price-earnings-multiple stocks after International Business Machines lost a court decision in a civil antitrust suit to Telex.

The firm also cites a buildup of investible funds, anticipation of lower interest rates, increasing attention by Congress to wide gaps between valuations of "favorite few" growth stocks and the rest of the market, and a change in psychology, as reasons for switching its market strategy.

"At worst, in our opinion, high-quality growth stocks might simply underperform in a generally rising market in the near or intermediate term," says Spencer Trask. Most portfolios needn't disturb "core" holdings in these stocks but, the

firm adds, investors might consider "using a portion of 'excessive' holdings of high p-e stocks including, for example, certain drug stocks," cash reserves and new money inflows to diversify.

Among the examples of groups and stocks it likes, Spencer Trask includes lesser-known growth stocks, such as Chubb Corp. (over the counter), Disston, AMP, Sambo's Restaurants and several oil issues; stocks in capacity-short process industries, such as Monsanto, Dow Chemical, Du Pont and Kimberly-Clark; asset-rich companies, such as Weyerhaeuser and Louisiana Land; and issues likely to improve as interest rates ease, such as Federal National Mortgage Association, Household Finance, Beneficial Finance, bank stocks and selected utilities, such as American Telephone & Telegraph.

At Baker Weeks, which has been recommending such cyclicals as airlines, papers and selected chemicals for some time, in addition to growth stocks, there has been a switch in emphasis. Among other things, the brokerage concern in recent weeks suggested its clients reduce consumer-oriented stock holdings to 17% of the portfolio, from 22% several months ago (and 31% a year ago); increase energy-related stocks to 15% of holdings (they were 7% a year ago); and increase basic manufacturing to 20%, from 19% recently (and 15% a year ago).

The securities firm has 44 companies on its list of recommended cyclicals or "turn-around" situations, recently adding such issues as Clark Equipment, Sperry Rand, Mission Equities and several airlines.

Morgan Stanley's stock research department believes an expected change in market leadership "and the correction of so-called religious growth stocks" have begun. Barton M. Biggs, research director, adds: "The portfolio manager who doesn't recognize the importance of this and position himself accordingly will have to accept the anguish of below-average performance."

Morgan Stnaley is urging portfolios be 90% invested, and is recommending 25% of holdings be in paper, metals and other resource-oriented cyclicals; 10% in bank and utility stocks; 20% in what he calls "second-tier, emerging growth" companies; 10% to 12% in companies affected by capital spending, including Burroughs and Digital Equipment, and about 15% in energy-related stocks.

Senator BENTSEN. We will meet again at 10 o'clock tommorow morning.

Thank you very much.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 10:00 a.m., Friday, September 28, 1973.]

FINANCIAL MARKETS

FRIDAY, SEPTEMBER 28, 1973

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:10 a.m., in room 2228, Dirksen Senate Office Building, Senator Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senators Long (chairman of the full committee), Bentsen, and Bennett.

Senator BENTSEN. The committee will come to order.

We have a conflict in that the full committee is now meeting discussing other legislation. That is where I have been.

We will proceed with the hearing at this time.

Mr. Corcoran, you are the first witness; if you would come forward and take the witness stand. We are pleased to have you.

Today is the last day of our second round of hearings on the role of the institutional investor in the marketplace. We will be hearing from two witnesses who believe very strongly in the importance of maintaining a stock market where millions of individual investors buy and sell shares in American business, where multiplicity of investment decisions and goals provide a ready source of equity capital for the new and expanding businesses which must provide our Nation's growth in the years ahead.

I must say the chairman of this committee agrees with the importance of that market.

Mr. Corcoran.

STATEMENT OF THOMAS G. CORCORAN, ATTORNEY

Mr. CORCORAN. Thank you; thank you, Senator. My name is Thomas Corcoran. I am a lawyer at 1511 K Street.

For this appearance I am not on a retainer for any particular client. To qualify the witness, I am deeply interested in your investigation because, as a lawyer with Mr. Jesse Jones' Reconstruction Finance Corp. and as assistant to the Secretary of the Treasury, I was a White House participant in congressional deliberations during its attempt to meet the capital markets crisis from 1932 until the outbreak of the war.

Under Mr. Rayburn's direction I was a participant in the drafting of the Securities Act of 1933, the Securities and Exchange Act of 1934, the Public Utilities Holding Company Act of 1935, and the congressional examination of the effects of concentration of economic power in the so-called Temporary National Economic Committee examination for the Congress in 1938.

With respect to the effect on the U.S. economy of the activity of foreign nations, I participated in the formation by Executive order of the first Export-Import Bank in 1934; I sat at the feet of Milo Perkins in the Board of Economic Warfare during the war.

I have for 30 years represented fully American-owned companies doing business in every continent where I have been able to see the intensity of the competitive position in which U.S. industry will increasingly find itself in the years ahead.

The burden of this statement, relies on the fact that ultimately, if we are going to have a balance of payments without a deficit, we have to recreate the capacity of the U.S. technology to export manufactured goods from the United States as well as technology.

One of my old chiefs was Justice Holmes. He opined: "An advocate would well assume that the court knows some law."

As the last witness in these hearings, having read most of the testimony before your committee and the public comment on it in the press and in the magazines, I appreciate and will assume the depth of your understanding of an unprecedently complicated economic situation in relation to the supreme importance of the only internationally competitive asset the U.S. has not already given away—its once remarkable equity capital market.

Therefore, not repeating what others have said, I confine myself only to the help I consider might be given to your many-fronted economic problem by one idea which I think can at least tangentially assist in many phases of your problem. That problem, as the preparation material of your staff shows in the green book, is so entangled with provisions of our own tax law and the politics of the international money market that no one observer could honestly suggest a comprehensive solution of all facets of the problem.

We are all like the blindfolded Hindus who generalized about the anatomy of an elephant by feeling either just its trunk or its tail.

The idea I offer as a tool in helping some facets of this problem is an old idea already once embodied in our tax laws—a tool which, I have been given to understand by press reports, Congressman Mills, chairman of the House Ways and Means Committee, and the chairman of this committee, Senator Bentsen, approve in principle. It is the adaptation to today's circumstances of an idea which was embodied in the Federal tax law prior to the needs of World War II financing:

(a) The taxation of gains in capital assets on a graduated scale downward, graduated in relationship to time such capital asset has been held dated back to the time of acquisition, and

(b) A corresponding proportional offset of capital losses against such capital gains.

You have heard from more qualified witnesses of the value of this capital gains tax treatment in relationship to the provision of equity investment in the kind of large business enterprises listed on the stock exchanges and solicited in public offerings.

I think Mr. Reagan of Merrill, Lynch, Mr. Whitehead and Mr. Needham have already previously testified to that.

Beyond that kind of equity capital, I testified last March before the House Ways and Means Committee about the application of the graduated concept to spur the even more individual entrepreneur equity economy that has not only been, but still is, the backbone of our economic growth.

I am talking, for instance, about capital gains in farmlands developed over a lifetime by farm owners, homes developed and improved over a lifetime which have to be disposed of with the progress of familes and growing old, the ultimate disposal of employee stock ownership in Tenneco, the realization of a lifetime's work in self-employed and self-financed business operations.

I request that there be received for the record the full text of my March statement before the House Ways and Means Committee in which I developed this approach in full.

Senator BENTSEN. It will be so included.[1]

Mr. CORCORAN. I hope there will also be incorporated in the record:

(a) The testimony in such March hearings of Mr. James Needham, chairman of the board of directors, and chief executive officer of the New York Stock Exchange, and

(b) Of Mr. John C. Whitehead, chairman on behalf of the Securities Industry Association, and his colleagues.[2]

The research in their testimony supported the generalizations in my own.

I do not say this idea is the complete answer to cut through the tangled web of interrelated problems you are examining, but I propose that it might help a lot in many directions.

If I may digress a moment to fundamental background:

Part of the problem of the U.S. balance of payments is that American business has been accustomed to the management simplicity of serving an ever-expanding domestic market without bothersome problems of paper and currency details involved in managing foreign trade. Our trade deficit is to a considerable degree due to the fact that except for the providential assistance of agricultural exporters—which is only temporarily saving us—American businessmen have not wanted to, because they have not had to, engage in aggressive export promotion of American-made products like other countries, which until the last 10 years could not match on our technical superiority—a supperiority which is dangerously nearly over.

For Americans, up to date, it was easier for management to export capital rather than goods. Since most of my business life has been spent serving truly enterpreneuring ventures abroad, I have seen this firsthand.

Only very lately on a trip to Asia were there signs of a significant interest in a general export of made-in-America industrial products rather than the export of American capital to produce in foreign countries. That instance was where RCA, despite the competition of Sony, was deliberately putting a color television set for sale in Taiwan in competition with the Japanese almost monopoly of television sets that have so far run around the world. An incidental piece of that, Senator, that was very interesting was that the Taiwan Foreign Minister told me that he was perfectly willing to enter into an understanding with the United States that Taiwan would buy from the United States American technical goods equal to the amount of any export from Taiwan to the United States.

There are exceptions, of course—airplanes, but the Concorde is flying around Washington now and we have licensed the Phantom to

---

[1] See p. 225.

[2] See House Ways and Means hearings entitled "General Tax Reform," Mar. 21, 1973, pp. 2400 ff., and 2465 ff.

Japan, computers, but we are harassing our leader in that field, IBM, and Japan and Europe are licensed to catch up fast.

Since we will have indefinitely to import raw materials for industry, the only possible permanent answer to the balance-of-payments problem must be continuing export of a continuing superior industrial technology. That as I shall suggest later is dependent on a resumption and sustaining of a research and technological supremacy which in turn will require an enthusiastic equity market.

The answer again to our balance-of-payments problem, I submit, is technological development, and again I insist that there is related to this the ability that is given in the tax law for the new invention and the new company to acquire equity capital.

Now, only for a moment I generalize on some of these causes of the total U.S. economic problem as seen from the viewpoint of one who has spent all his professional life in helping build from the bottom truly entrepreneurial equity enterprise. My own experience has confirmed a generalization, I hope you will not object, I learned from Justice Holmes, exposing me to the prophecies of Brooks Adams, the Democratic brother of Henry Adams. And subsequent events are certainly corroborating Brooks Adams.

No people as such are fundamentally eternally superior. Economic, and eventually political power, are related to the availability of adequate natural resources useful in the technology of the time and adequate supplies of productive labor. Depleting American material resources of essential kinds during the wars, we in that competitive respect have passed from a have to a have-not Nation, for just one instance in the quality of our iron ore supplies in the Great Lakes region.

In the ultimate simplicities of the material and productive-labor equation, unless we use our better educated brains to do something about it in regaining our technological superiority, power will certainly pass in our children's lifetime to the comparatively undepleted resources and cheap labor productivity across the Pacific.

Further, paying an understandable gambling price to buttress the political security of Europe against a Russian threat, we have, in our political support of the European Economic Community, created a competitive colossus ultimately more threatening to our political and economic power than even, to date, the Japanese.

For the moment this ultimate competitive difficulty is masked in the international balance of accounts by the need by other nations for our agricultural production—what my friend Eliot Janeway called yesterday before the Banking Committee America's "agripower" in cotton and grains. It is a providential respite for us, but obviously that advantage will not long hold.

Nations with governments which can by force direct their economics, like China and Russia, will make it their first goal, by importing and copying our agricultural technology and technique on low-cost loans, to avoid dependence on food from America as we now seek to avoid dependence on foreign energy. It may take them 5 or even 10 years to succeed but, barring governmental upheavals, succeed they will—ultimately.

All this is to point up the tremendous importance to the United States, in order to preserve a now vanishing industrial technology

supremacy, of revitalizing its unique equity capital market which is an uncopiable consequence of the free development tradition in which a brand new Nation grew up a brand new continent and whose export technology is our best and only hope for a permanent solution to our balance-of-payments problem.

Your committee faces the most crucial necessity of concentrating on the resuscitation of that equity capital market as the most important economic instrument we have to have for our technological survival and technological export as the strongest and most socially secure Nation in the world.

In a perhaps laudable and justifiable search for a world of peace and compassion, we have already given away almost every other advantage we once had. In hindsight, after the devaluation of our currency we find we have already distributed in excess every other component of our one-time technological superiority. In overabundance we have given away our accumulated capital and, along with it, the supremacy of our dollar and the elasticity of our Government's power to borrow and tax.

To reconstruct Europe, to provide a source of production close to the action of our wars against the double forces of ideology and nationalism in the Far East; to meet our deficit of raw materials in Latin America and Africa (engendering political repercussions of "imperialistic exploitation"), we have distributed on soft credit our machinery capital and freely licensed our engineering know-how. All we really have left is an open capital market in which the public as well as financial institutions participate, which again is an uncopiable consequence of the free development tradition in which a brandnew nation grew up a brandnew continent.

In retrospect we might have distributed our partly used machinery instead of giving away to our competitors our newest, leaving our own industrial complex trying to compete against our new machinery abroad with machinery at home for which we did not provide adequate depreciation for replacement because we feared the loss of tax revenue.

All that is over the dam. The hopeful significant fact is that we did not, yet, export one asset so subtle and so dependent upon American public habit, developed out of the original entrepreneurial American spirit, that the world has not yet been able to copy it in entirety; that is the U.S. equity capital market.

For, although the mixed financial syndicates you every day note in the financial pages are teaching the Japanese and the Europeans fast, no country in the world has yet developed so subtle and as varied a mechanism as our own capital market. When it works properly, it can draw willing, not enforced, public savings into the continued unmatchable equity support of a nation's economic development.

But, as has been pointed out to you by others, the way things are going, there could be a possibility that before they become like us, we will become like our competitors, not a free capital market but a Government-bank-directed financial monopoly.

For that reason, with priority over every other economic problem in the country, the readaptation of the machinery of the American capital market and the related readaptation to it of the American tax laws is the most important economic matter before the country.

Furthermore, as is clear to all perceptive people in political life, we are in a period where (a) a rising demand for social services, and (b) a rising level of assumed understanding of economic forces emanating from college teaching of so-called political and economic science is fueling a growing passion, domestically and internationally, for what is called the "redistribution of wealth and power."

For those trying to keep political forces of a heterogeneous nation on an even keel, this could create a challenge the like of which we have never faced since 1929. Without offering a judgment what should be done about facing it—because I honestly do not know—I mention only incidentally the political potentiality of a concentration of power in the so-called two-tier capital market.

If, due to unforeseen circumstances, we should have a stock market crash even less than that of 1929, it will now as it did not in 1929 affect the economic security of hundreds of thousands of pension holders. It might engender a vicious public reaction such as in the famous 100 days of Franklin Roosevelt almost swept away the possibility of keeping the financial market in privaté control. Against this background, it seems important to look at the averages of the use of a graduated capital-gains tax on several fronts of your interrelated marketing-taxing problem.

First of all, such use should be looked at in the light of a most significant fact. In the last few years there has been an appreciable closing in the tax laws of the gap between the highest tax on earned income and the highest tax on capital gains. Excluding the variation in additional State taxes on both earned income and capital gains now on the Federal basis, making allowance for the new preference tax, the rates of such taxes are startlingly close.

On the Federal basis, 50 percent is the top tax on earned income. Allowing for the preference tax, the capital gains tax in any substantial situation is already 37½ percent instead of the traditional 25 percent, and in particular situations I am informed it can exceed 50 percent. In the important capital-providing State of New York, with which I am very familiar, allowing for both Federal and State taxes, the earned income tax and the capital gains tax are generally considered as substantially equal.

On such a basis, what financial inducement is there for a future true self-financing genius like the Bill Lear or David Packard of the present to hold on and develop to its fullest development a headaching equity situation for the long-term good of the country, compared to taking an opportunity for a quick profit by selling out to a domestic conglomerate or an exchange-fat foreigner.

You have heard able testimony about the advantage to the renewal of the capital market of a graduated capital gains tax as an incentive for investors "locked in" to long-term holdings to sell during their lifetime by the inducement of a gradually reducing capital gains tax, rather than stay "locked in" for a lifetime to wait for a lower estate tax. This is important and true. But in honesty, it should not be stretched to assume it will meet all the hopes of those concerned with the economy of bringing the small investor with additional capital into the market.

The coming back of the small investor, burned in losses since the market began to turn in 1958, or disillusioned by a conviction that

he is at an information disadvantage with big institutions, will have to be achieved by much more reorganization of the capital market than a graduated capital gains tax only.

But as the figures shown by the witnesses before you representing the stock exchanges and the securities business, the inducement to sell of such a gradually reducing capital gains tax can result in a large redistribution of the capital already in the market to make it available for investment in different and newer enterprises than it is already locked into.

It was also testified by representatives of the stock exchanges and investment industry before the House committee that demonstrably it would result in a higher tax return to the Federal Government.

Conversely, however, it can also have the beneficent effect of keeping capital locked in in situations where it is to the advantage of the American economy and continuity of American management that capital shall stay locked in. When, as now, sound equity investment is selling at an unprecedentedly low price (particularly in depreciated American money as compared with appreciated European or Japanese money) an offer of takeover can tempt an American investor to take a quick profit rather than stick with his company for long term unless he has the counterbenefit of a decreasing capital gains tax. This is a matter of no little concern to the American economy right now, and to American political thought.

While hoping for the infusion of foreign buying to buoy the stock market and make equities competitive with fixed income investments, the Nation is as apprehensive of foreign control of American companies as a few years ago Europe and Britain were protesting American takeover of British and other foreign companies.

Furthermore, a capital gains tax decreasing with years of investment-holding will stimulate the risk-taking entrepreneurial spirit of the individual risk-taker like Bill Lear of Lear Jet or David Packard of Hewlett Packard.

On the daring and self-confident originating genius of such men has depended much of American technological advance despite the organized technological research of long-established companies. When our "agripower" advantage is gone, we will have needed in time the encouragement of such beginning entrepreneurs. They are indispensable to reestablish our technological supremacy with which we have been blessed for 30 years by the brain drain of scientists from all over the world, attracted by our organization in war and daring breakthroughs in atom power, airplanes, electronics, and space.

Bill Lear's incredibly persistent attempts to break through to a new way to produce an antipollution engine are a natural resource of the country. If our principal industry, the automobile industry, is going to regain its power to resist the inroads of products from countries with cheaper materials and cheaper productive labor, to some large degree its success will depend upon the inventive genius of the thousands of parts suppliers, running their own businesses on the equity contributions of themselves and a few friends who supply the bulk of the ideas from which the technology of the U.S. automobile business advances.

The point need not be labored. The instinct of the small entrepreneur bred of the American experience is a plus for the regaining of American technological supremacy, which no Asiatic or European country has

in its bones. Every witness before your committee has put his finger on the desperate necessity that the capital market once more provide a means of equity assistance to these small beginners and the risks they undertake.

A fabulously successful investor once described to me his investment technique. In a single frontier technique of science, he invested heavily in 10 small companies in which individual genius was working its ferment, gambling that at least 1 of the 10 would turn out magnificently whatever the risk that the other 9 might fail.

But when comparative tax rates reach a point where there is no advantage to the individual entrepreneur to hang on year after year rather than take a quick sellout to a merger opportunity, combined with the temptation of an earned income salary for his continued management, the country loses the essential driving power of owner-management. The cure for it can in some degree be to induce him to hold on to his ownership with the expectation that the longer he maintains his capital risk position, the more the tax law will favor him rather than the fellow who gives up too easily.

Again, I am not trying to overstate what this particular change in the tax law will do. Changes far more reaching than this are going to be needed to avoid a concentration of power in the Japanese- or German-type-bank-capitalized economy, with a danger of popular political resentment peculiar to the opportunities of our political system.

It is not easy to be specific about how the capital market has to be reorganized. It is hard to deny the results produced by the successful experts in economic prophecy that has produced the two-tier system. No matter what the effect has been on the rest of the economy, it seems good for those who have profited and seems to argue that all we need is simply more and better "experts" of that kind.

A capacity for selecting the businesses and the companies that in the complicated situations of today can constantly produce growth is not an inconsiderable national asset, even if it resists the interference with its way of operating involved in proposed periodic disclosure so that the average investor will not feel he will be jockeyed into losses by insiders running pools such as destroyed the market in 1929.

A component of an adequate reorganization of the equity market may require a reexamination as discussed in the preparatroy material of your committee staff of certain tax advantages given large aggregations of capital and their managers under provisions of the present tax laws which hitherto have seemed, and may still seem, based on sound considerations of public policy. Possibly easier treatment of dividends may redress the balance between equities and fixed income investment.

Certainly the survival of an equity market requires a reorganization of the securities trading market that will not make the rescue of the securities industry from its present nonprofitable operation depend on putting the burden of its revitalization on the small investor least able to bear the burden.

The combination of these remedies is for wiser and younger men.

But for the reasons stated, a most useful tool, and a tool that appeals to the American sense of justice, would be a graduated capital gains tax, graduated downward according to the length of time an asset is held, related back to the time of acquisition of such capital

asset, with a corresponding proportional application of capital losses against capital gains.

My testimony before the House committee tried to develop this thesis in specific application to that equity investment of average America which is larger in totality than all listed stocks, although it does not appear in stock exchange quotations or public offerings—for instance, the farmer's land, the houseowner's residence, the employee's carried stock, the individual entrepreneur's business.

There is still a driving power of thrift in the American success story.

Suppose two men each with the same amount of income; one spends his money or is content with investment at high-interest rates. The other is the adventurer who, in the form of equity investment in his own or someone else's business, saves his money to take risks for the benefit of the whole economy, however unintentionally. If there is not a differentiation between these two in the tax laws, a driving power will go out of American life that we need to stay on top for the peace of the whole world.

If the golden goose is to continue to provide the good life for all Americans while they go on taking care of the world, this is more than economic justice; this is economic commonsense.

Senator BENTSEN. Mr. Corcoran, I appreciate that statement. I think probably you and Ben Cohen are uniquely in a position to judge the issues before this subcommittee because of the driving force that the two of you were in drafting some of the far-reaching laws back in the thirties that helped this economy get moving again.

Mr. CORCORAN. May I suggest Mr. Ben Cohen is in this room, sir.

Senator BENTSEN. I know he is. I want to thank you for your excellent statement. I appreciate its candor, and I think it is an excellent contribution and we think that the experience that you bring to this committee is something that is very helpful to us.

I do not know where we are going to get those wiser men you are talking about, but we think we are beginning to understand the problem. I certainly agree with you that a graduated capital gains tax for a period of time helps, but by no means is a total solution to the problem. We have to find other and more innovative ways to bring the individual investor back into the marketplace.

I would like to ask Senator Bennett if he has some questions at this time.

Senator BENNETT. Only one comment: I think in the process we have to find a way to solve the problem hinted at in this statement to give credit to the individual investor and make him feel that he is making a contribution, instead of participating in an evil function which is destroying our society. This business of downgrading the process of production and saying that profit itself is evil and that we would be better off to take care of all of the people out of the tax money of the United States is a serious psychological problem that we face in considering this problem of equity investment, either in the exchanges, through the exchanges, or through the direct application of individual savings to a single man's business.

Senator BENTSEN. Did you have anything further?

Senator BENNETT. No.

Senator BENTSEN. I, too, believe we must give credit to the fellow who starts out and builds a business from scratch and takes the risk

because he is the type of fellow who has made a major contribution to the growth of this country, and there is a very direct correlation between his success and the creation of new jobs for people across this country. We know for every new job in manufacturing, you are talking about a capital investment of something like $25,000.

Now if we are going to avoid the continued concentration of economic power, then these new small companies have to be able to go to the equity market.

We have had some witnesses who testified that a very minimal percentage of money was raised on the equity market but he was relating to the overall corporate structure. It is true that a major corporation has a history behind it so that it can sell bonds or finance much of its expansion out of its cash flow and its appreciable assets. But the young corporation does not have that kind of a history, and they cannot sell those bonds and they have to sell equity on the market. They have to be able to go to the equity market and find risk-takers who are willing to buy those kinds of stocks on the chance that maybe they will hit the Xerox of the future or the Polaroid of the future.

So I share with you your very deep concern, and we will be working very hard to try to come up with some solutions that we think are responsible to keep the investor acting like an investor and yet to bring the multiplicity of judgments and decisions to the marketplace that give you a free market.

Let me ask you what you think about the possibility of a limitation placed on institutions so far as how much stock they could own in major corporations? Such is done now with mutual funds and it is done now with insurance companies that operate in States like New York. This has not been true of bank trust departments other than self-imposed limitations that they might put on, and you have a variable there so far as the judgment of different trust departments are concerned.

What would you think of a limitation, say, a percentage of stock that an institution could own in IBM or Avon or Disney?

Mr. CORCORAN. I favor it very much, and I think in their own wisdom they should do it, too. I also think we ought to be careful no matter how much resistance there is to it, to the secret operation, I think we ought to have more disclosure so that we do not have this feeling that the big fellow on the inside swaps information within his own group and lets the little fellow go down the drain.

I think that is essential to the restoration of confidence.

If you really believe that the small investor is really coming back into the market, I think these things have to be done to take the chance that maybe he is going to, I think we have to go an awful long way to bring the small investor back into the market.

Senator BENTSEN. Mr. Corcoran, I do not know that we can. I think that the figures that we have related—which indicate that 10 years ago the institutions had 35 percent of the dollar volume on the New York Stock Exchange and today they have 70 percent—really do not tell how far it has gone because I am confident that since January 1 that probably 10 percent of that dollar volume has been by corporations buying their own stock.

Mr. CORCORAN. That is right.

Senator BENTSEN. Because it was selling at such a very low multiple that they could sell their own stock and have a greater impact on their earnings per share than trying to spend it on some productive capacity. That is kind of self-defeating when you are trying to create new jobs in this country, that is a pretty sad situation.

Mr. CORCORAN. That is right.

Senator BENTSEN. In addition to that, you have had a number of firms on the exchange buying for their own accounts. So when you get down to the individual investor who is making an investment in that market, it is a pretty small percentage. There are a number of long-range things we have to do to deal with the problems of inflation. But then I think we can come up, perhaps taxwise, with some legislative contributions that will create an incentive for this man to come back into the market, and that is what we are studying very hard to see if we cannot do as our contribution.

Senator Bennett?

Senator BENNETT. Mr. Chairman; the chief theme in your testimony, Mr. Corcoran, was the importance of a declining rate of capital gains tax over time.

Do you have any ideas for us as to the pattern in which that rate might decline. Do you favor a slowly declining rate each year or a series of steps every 5, 10, 15 years or a series of broad steps?

Can you give us any comment about this pattern?

Mr. CORCORAN. Well, I think, first of all, it would be politically necessary, if you are going to be able to do this at all, to increase the 6 months' holding period. Now starting with that, the reason I asked for the reference to it in my testimony to the testimony in the House, I worked out my own series of suggested drafts, which cut us down to 20 percent after 15 years and maybe nothing after 20.

The stock exchange—and I jump that in 5-year jumps to avoid administrative difficulties when people were trying to fool the Treasury by saying they had held for 5 years instead of 4 years.

Then the stock exchange and Mr. Needham had much more—I made it every 5 years, and I have that in my testimony, which I have referred to here, in the House thing, all spelled out in statistical form. The stock exchange wanted to make it every year or every 2 years. I wanted to make it every 5 years because I have been in the Treasury and I know these administrative difficulties.

The securities industry, I think, was even more—they worked it out on an even more of a quick scale, I mean every year or something like that.

I would rather do it in 5-year jumps because of the administrative difficulty of making decisions as between 1975 and 1976. But allowing for the rate of inflation, which has already been taken into account, I should certainly think that after the first—suppose we start, and I have an assumption in which I may be wrong. I think that before we are through with the reorganization of the tax laws, public opinion is going to force a beginning top rate for both earned income and capital gains, I am afraid of it. I do not think it is right, but I am afraid it will happen.

Working on that assumption that both will be 50 percent, then I say the fellow who saves his money and keeps it saved for 5 years should at least have 10 percent taken off for the first 5 years, and then lesser amounts, or even maybe greater amounts as you go on from 10 to 15 to 20.

Now the Stock Exchange wants to do it at a much faster immediate rate and, sir, I would only suggest, I have the stock exchange position here in the statement by Mr. Whitehead of last March, how he wants to do it, and I have the securities industries suggest as to how they want to do it, and I had in my own testimony my own suggestion as to how I wanted to do it, and they are all set out comparatively in my own March testimony.

Senator BENTSEN. Well, of course we have not had time to read that.

Mr. CORCORAN., I know that, sir.

What I thought we ought to do with it is, we take off 10 percent for the first 5 years, then we begin to take it off until we get down to, say, 20 percent and maybe at 20 years we stop at 20 percent, or maybe at 20 years we stop at nothing. But considering the inflation and considering the inducements both to get out and get in on that strange combination of lockedins, I told you, sometimes it is good to get them out, sometimes it is good to get them in.

I think you have to take then what to do about that as to the way you fix these rates, but I would say for myself that I would start, I would take 10 percent off for the first 5 years and I would take another 20 percent off for the next 10 years, although it is hard to say you should have no tax, I do not know whether it will politically sell but I think if a fellow holds it that long, he should pay no tax at all.

I kept talking about three instances that really bother me. You take a fellow who inherits a piece of land from his father and farms it and improves it as we improve it over the years with all the new things we put into the land and all the machinery we buy, and it comes to the point where the son does not want to take over the business and wants to go to the city. By this time the value of the land has gone up because of the pressure on land prices.

It seems outrageous that after having contributed to the economy and worked his heart out and taken his risk for 20 years—that he should pay almost no capital gains tax at all.

I do not think that will sell, but that is what I think.

I am thinking of something else. All right, if you own a home and you improve your home and you grow your children up in your home, and you invest in your home, as I who have had six children have invested in my home, and then all the children go away; now the tax law says,

> You will not pay any capital gains tax if you reinvest that money to that degree in another home.

I do not need another home. I need to be able to pay rent on an apartment and be taken care of, and I do not think the present situation, the present tax law, helps one damn bit in the amount of capital appreciation that has been plowed into that home over 20 years.

Now you take another situation, many an employee has, as I call it, a carry stock situation in a company. One of the ways to make an employee, make an employee feel like the Japanese feel that the company cares for him, is to go into a thrift plan where the employee buys stock and the company contributes to the purchase of the stock. At the end of it, this is a common stock, the fellow has the common stock but now maybe when he retires at 65 he would rather sell that

stock and buy a fixed income or buy an annuity to take care of him in a different way of life. I think it is outrageous that after he has held on to that stock for 20 years he should pay a regular capital gains tax.

I think as he has to sell it in order to meet his change in life, he ought to be given the benefit of a graduated tax downward, and I would say if he had stayed with the company 20 years, he pays no tax at all.

Or you take the case of a fellow like my friend Bill Lear or my friend Packard, who build a company up, as they have, with tremendous consequences for the technological development of the country, and then they become 70 and they have all this stock. Now I do not think that after having done that and having lived through this that they should have to pay the same capital gain as a fellow who goes into the market and speculates on a 6-month or a 1-month term. Because I do not—because I understand that, it is a long time before that I have thought of concretions on this.

I have very honestly put in my testimony on March 20 and I have suggested that there be put in the record in connection with my testimony today the tables of reduction year-by-year which are suggested by other people than me.

Senator BENNETT. That is what I wanted to get into the record.

Mr. CORCORAN. It is all in the record, in my testimony which I have had, you have already accepted for the record, the comparative tables are there, and I also ask that the record now refer to this earlier testimony of Needham and of Whitehead, which explains why they rationalize the particular rate of decline for the tax which they recommended.

Senator BENNETT. Well, if the committee should decide that a diminishing rate is a sound program, then we can worry about the numbers——

Mr. CORCORAN. That is right.

Senator BENNETT [continuing.] Afterwards.

Mr. CORCORAN. Then, sir, may I say you have another correlative relationship.

I was in the Treasury before Mr. Morgenthau kicked me out, I was in the Treasury when we were worried about the offset of capital losses against capital gains.

Now, the reason we did not treat capital losses at that time as a complete setoff against capital gains, you know we only allowed it was that the losses in the 1929 market were so big that we were afraid of the public reaction if some of the big operators in the market paid no tax at all at that time.

Now that situation has gone by, and I think there is a relation between the offset of capital losses and the right tax on capital gains and I think this is a time when we can consider it without having the apprehensions we had after the break of 1929.

Senator BENNETT. The committee is considering that proposition also.

I have no further questions, Mr. Chairman.

Senator BENTSEN. Thank you, Senator Bennett.

I have one other concern about the graduated capital gains tax.

I would not agree with the stock exchange members who feel that the holding period for capital gains treatment should be shortened.

However, if we extended the holding period to one year, it would seem to me that you would have a hiatus there of 6 months wherein you might very drastically affect the stock market because of those persons who wait until the 6-month period has passed, and therefore you have a period of time in which you would depress the trading. Perhaps that could be handled by phasing in the 1-year holding period for capital gains over a period of, say, 6 years and to put it out to 7 months at the end of a year, 8 months at the end of another year, and therefore not have that kind of a serious effect of the impact on the market.

Would something like that appear reasonable to you?

Mr. CORCORAN. Senator, sometime you are going to have to race up to this short period, capital gains 6 months, 1 year, sometime you have to face up to it. Whether you can ease it out as you are saying over a period, maybe that would be a wise thing to do, but inevitably we are going to have to do it and, as I have always understood the politics of this situation, the labor power will not permit you to make any reductions in capital gains taxes unless you do lengthen the period. I have, unfortuantely, had to take that into my computer, too.

Senator BENTSEN. I think you may have a good argument on that point.

Mr. Corcoran, we appreciate your testimony, and it has been a real contribution.

Thank you very much.

Mr. CORCORAN. Thank you.

[Mr. Corcoran's prepared statement and his statement before the Ways and Means Committee, follow:]

STATEMENT OF THOMAS G. CORCORAN, BEFORE THE SUBCOMMITTEE ON FINANCIAL MARKETS OF THE SENATE COMMITTEE ON FINANCE

For this appearance I am not on retainer for any particular client. To qualify the witness, I am deeply interested in your investigation because, as a lawyer with Mr. Jessee Jones' Reconstruction Finance Corporation and as Assistant to the Secretary of the Treasury, I was a White House participant in Congressional deliberations during its attempt to meet the capital markets crisis from 1932 until the outbreak of the War.

Under Mr. Rayburn's direction I was a participant in the drafting of the Securities Act of 1933, the Securities and Exchange Act of 1934, the Public Utilities Holding Company Act of 1935 and the Congressional examination of the effects of concentration of economic power in the so-called Temporary National Economic Committee examination for the Congress in 1938.

With respect to the effect on the U.S. economy of the activity of foreign nations I participated in the formation by Executive Order of the first Export-Import Bank in 1934: I sat at the feet of Milo Perkins in the Board of Economic Warfare during the War. I have for 30 years represented fully American owned companies doing business in every continent where I have been able to see the intensity of the competitive position in which U.S. industry will increasingly find itself in the years ahead.

One of my old chiefs was Justice Holmes. He opined: "An advocate would well assume that the court knows some law." As the last witness in these hearings, having read most of the testimony before your Committee and the public comment on it in the press and in the magazines, I appreciate and will assume the depth of your understanding of an unprecedently complicated economic situation in relation to the supreme importance of the only internationally competitive asset the U.S. has not already given away—its once remarkable equity capital market.

Therefore not repeating what others have said I confine myself only to the help I consider might be given to your many fronted economic problem by one idea which I think can at least tangentially assist in many phases of your problem. That problem, as the preparation material of your staff shows, is so entangled with provisions of our own tax law and the politics of the international money market that no one observer could honestly suggest a comprehensive solution of all facets

of the problem. We are all like the blindfolded Hindus who generalized about the anatomy of an elephant by feeling either just its trunk or its tail.

The idea I offer as a tool in helping some facets of this problem is an old idea already once embodied in our tax laws—a tool which, I have been given to understand by press reports, Congressman Mills, Chairman of the House Ways and Means Committee, and the Chairman of this Committee, Senator Bentsen, approve in principle. It is the adaptation to today's circumstances of an idea which was embodied in the federal tax law prior to the needs of World War II financing: (a) the taxation of gains in capital assets on a graduated scale downward, graduated in relationship to time such capital asset has been held dated back to the time of acquisition, and (b) a corresponding proportional offset of capital losses against such capital gains.

You have heard from more qualified witnesses of the value of this capital gains tax treatment in relationship to the provision of equity investment in the kind of large business enterprises listed on the stock exchanges and solicited in public offerings.

Beyond that kind of equity capital, I testified last March before the House Ways and Means Committee about the application of the graduated concept to spur the even more individual entrepreneur equity economy that has not only been but still is the backbone of our economic growth. I am talking for instance about capital gains in farm lands developed over a lifetime by farm owners, homes developed and improved over a lifetime which have to be disposed of with the progress of families and growing old, the ultimate disposal of employee stock ownership, the realization of a lifetime's work in self-employed and self-financed business operations.

I request that there be received for the record the full text of my March statement before the House Ways and Means Committee in which I developed this approach in full. I hope there will also be incorporated in the record (a) the testimony in such March hearings of Mr. James Needham, Chairman of the Board of Directors and Chief Executive Officer of the New York Stock Exchange, and (b) of Mr. John C. Whitehead, Chairman on behalf of the Securities Industry Association and his colleagues.

The research in their testimony supported the generalizations in my own.

I do not say this idea is the complete answer to cut through the tangled web of interrelated problems you are examining but I propose that it might help a lot in many directions.

If I may digress a moment to background. Part of the problem of the United States balance of payments is that American business has been accustomed to the management simplicity of serving an ever expanding domestic market without bothersome problems of paper and currency details involved in managing foreign trade. Our trade deficit is to a considerable degree due to the fact that except for the providential assistance of agricultural exporters—which is only temporarily saving us—American business men have not wanted to, because they have not had to, engage in aggressive export promotion of American-made products like other countries which until the last 10 years could not match on our technical superiority—a superiority which is dangerously nearly over. For Americans, up to date, it was easier for management to export capital rather than goods. Since most of my business life has been spent serving truly entrepreneuring ventures abroad I have seen this first hand.

Only very lately on a trip to Asia were there signs of a significant interest in a general export of made-in-America industrial products rather than the export of American capital to produce in foreign countries. There are exceptions of course—airplanes (but the Concorde is flying around Washington now and we have licensed the Phantom); computers, but we are harassing our leader in that field and Japan and Europe are licensed to catch up fast.

Since we will have indefinitely to import raw materials for industry, the only possible permanent answer to the balance of payments problem must be continuing export of a continuing superior industrial technology. That as I shall suggest later is dependent on a resumption and sustaining of a research and technological supremacy which in turn will require an enthusiastic equity market.

Only for a moment I generalize on some of the causes of the total U.S. economic problem as seen from the viewpoint of one who has spent all his professional life in helping build from the bottom truly entrepreneurial equity enterprise. My own experience has confirmed a generalization I learned from Justice Holmes exposing me to the prophecies of Brooks Adams, the Democratic brother of Henry Adams. And subsequent events are certainly corroborating Brooks Adams. No people as such are fundamentally enternally superior. Economic and eventually political power are related to the availability of adequate natural resources useful in the

technology of the time and adequate supplies of productive labor. Depleting American material resources of essential kinds during the wars we in that competitive respect have passed from a have to a have not nation, for just one instance in the quality of our iron ore supplies in the Great Lakes region. In the ultimate simplicities of the materials-and-productive-labor-equation, unless we use our better educated brains to do something about it, power will pass in our children's lifetime to the comparatively undepleted resources and cheap labor productivity across the Pacific.

Further, paying an understandable gambling price to buttress the political security of Europe against a Russian threat, we have, in our support of the European Economic Community, created a competitive colossus ultimately more threatening to our political and economic power than even to date the Japanese.

For the moment this ultimate competitive difficulty is masked in the international balance of accounts by the need by other nations for our agricultural production—what my friend Eliot Janeway called yesterday before the Banking Committee America's "agripower" in cotton and grains. It is a providential respite for us, but obviously that advantage will not long hold. Nations with governments which can by force direct their economics like China and Russia will make it their first goal, by importing and copying our agricultural technology and technique on low cost loans, to avoid dependence on food from America as we now seek to avoid dependence on foreign energy. It may take them five or even ten years to succeed but, barring governmental upheavals, succeed they will—ultimately.

All this is to point up the tremendous importance to the United States, in order to preserve a now vanishing industrial technology supremacy, of revitalizing its unique equity capital market which is an uncopiable consequence of the free development tradition in which a brand new nation grew up a brand new continent and whose export technology is our best and only hope for a permanent solution to our balance of payments problem. Your Committee faces a crucial necessity of concentrating on the resuscitation of that equity capital market as the most important economic instrument we have to have for our technological survival and technological export as the strongest and most socially secure nation in the world.

In a perhaps laudable and justifiable search for a world of peace and compassion, we have already given away almost every other advantage we once had. In hindsight after the devaluation of our currency we find we have already distributed in excess every other component of our one-time technological superiority. In over-abundance we have given away our accumulated capital and along with it the supremacy of our dollar and the elasticity of our government's power to borrow and tax. To reconstruct Europe, to provide a source of production close to the action of our wars against the double forces of ideology and nationalism in the Far East: to meet our deficit of raw materials in Latin America and Africa (engendering political repercussions of imperialistic exploitation), we have distributed on soft credit our machinery capital and freely licensed our engineering knowhow. All we really have left is an open market capital in which the public as well as financial institutions participate which again is an uncopiable consequence of the free development tradition in which a brand new nation grew up a brand new continent.

In retrospect we might have distributed our partly used machinery instead of giving away to our competitors our newest leaving our own industrial complex trying to compete against our new machinery abroad with machinery at home for which we did not provide adequate depreciation for replacement because we feared the loss of tax revenue.

All that's over the dam. The hopeful significant fact is that we did not—yet—export one asset so subtle and so dependent upon American public habit, developed out of the original entrepreneurial American spirit, that the world has not yet been able to copy it in entirety. That is the U.S. equity capital market. For although the mixed financial syndicates you every day note in the financial pages are teaching the Japanese and the Europeans fast, no country in the world has yet developed so subtle and as varied a mechanism as our own capital market. When it works properly, it can draw *willing* not *enforced* public savings into the continued unmatchable equity support of a nation's economic development. But as has been pointed out to you by others, the way things are going there could be a possibility that before they become like us—we will become like our competitors. not a free capital market but a government-bank-directed financial monopoly.

For that reason, with priority over every other economic problem in the country, the re-adaptation of the machinery of the American capital market and

the related re-adaptation to it of the American tax laws is the most important economic matter before the country. Furthermore as is clear to all perceptive people in political life we are in a period where (a) a rising demand for social services and (b) a rising level of assumed understanding of economic forces emanating from college teaching of so-called political and economic science, fuels a growing passion, domestically and internationally, for what is called the "redistribution of wealth and power." For those trying to keep political forces of a heterogeneous nation on an even keel this could create a challenge the like of which we have never faced since 1929. Without offering a judgment what should be done about facing it—because I honestly do not know—I mention only incidentally the political potentiality of a concentration of power in the so-called "two-tier" capital market. If due to unforeseen circumstances we should have a stock market crash even less than that of 1929, it will now as it did not in 1929 affect the economic security of hundreds of thousands of pension holders. It might engender a vicious public reaction such as in the famous 100 days of Franklin Roosevelt almost swept away the possibility of keeping the financial market in private control.

This prolix background seems important to look at the advantages of the use of a graduated capital gains tax on several fronts of your inter-related marketing-taxing problem.

First of all, such use should be looked at in the light of a most significant fact. In the last few years there has been an appreciable closing in the tax laws of the gap between the highest tax on earned income and the highest tax on capital gains. Excluding the variation in additional state taxes on earned income and capital gains now on the Federal basis, making allowance for the new preference tax the rates of such taxes are startlingly close.

On the Federal basis 50% is the top tax on earned income. Allowing for the preference tax the capital gains tax in any substantial situation is already 37½% instead of the traditional 25% and in particular situations I am informed it can exceed 50%. In the important capital-providing state of New York, allowing for both federal and state taxes, the earned income tax and the capital gains tax are generally considered as substantially equal.

On such a basis what financial inducement is there for a future true self-financing genius like the Bill Lear or David Packard of the present, to hold on and develop to its fullest development a headaching equity situation for the longtime good of the country—compared to taking an opportunity for a quick profit by selling out to a domestic conglomerate or an exchange-fat foreigner.

You have heard able testimony about the advantage to the renewal of the capital market of a graduated capital gains tax as an incentive for investors "locked in" to long term holdings to sell during their lifetime by the inducement of a gradually reducing capital gains tax, rather than stay "locked in" for a lifetime to wait for a lower estate tax. This is important and true. But in honesty it should not be stretched to assume it will meet all the hopes of those concerned with the economy of bringing the small investor with additional capital into the market. The coming back of the small investor, burned in losses since the market began to turn in 1958, or disillusioned by a conviction that he is at an information disadvantage with big institutions will have to be achieved by much more reorganization of the capital market than a graduated capital gains tax only. But as the figures shown by the witnesses before you representing the stock exchanges and the securities business the inducement to sell of such a gradually reducing capital gains tax can result in a large *redistribution of the capital already in the market* to make it available for investment in different and newer enterprises than it is already locked into. It was also testified by representatives of the stock exchanges and investment industry before the House Committee that demonstrably it would result in a higher tax return to the Federal Government.

Conversely, however, it can also have the beneficient effect of keeping capital *locked in* in situations where it is to the advantage of the American economy and continuity of American management that capital shall stay "locked in." When as now sound equity investment is selling at an unprecedently low price (particularly in depreciated American money as compared with appreciated European or Japanese money) an offer of takeover can tempt an American investor to take a quick profit rather than stick with his company for long term unless he has the counter-benefit of a decreasing capital gains tax. This is a matter of no little concern to the American economy right now. While hoping for the infusion of foreign buying to buoy the stock market and make equities competitive with fixed income investments, the nation is as apprehensive of foreign control of American companies as a few years ago Europe and Britain were protesting American takeover of British and other foreign companies.

Furthermore, a capital gains tax decreasing with years of investment-holding will stimulate the risk-taking entrepreneurial spirit of the individual risk-taker like Bill Lear of Lear Jet or David Packard of Hewlett Packard. On the daring and self-confident originating genius of such men has depended much of American technological advance despite the organized technological research of long established companies. When our "agripower" advantage is gone we will have needed *in time* the encouragement of such beginning entrepreneurs. They are indispensable to re-establish our technological supremacy with which we have been blessed for 30 years by the brain drain of scientists from all over the world attracted by our organization in war and daring breakthroughs in atom power, airplanes, electronics and space. Bill Lear's incredibly persistent attempts to break through to a new way to produce an anti-pollution engine are a natural resource of the country. If our principal industry, the automobile industry, is going to regain its power to resist the inroads of products from countries with cheaper materials and cheaper productive labor, to some large degree its success will depend upon the inventive genius of the thousands of parts suppliers, running their own businesses on the equity contributions of themselves and a few friends who provide the bulk of the ideas from which the technology of the U.S. automobile business advances.

The point need not be labored. The instinct of the small entrepreneur bred of the American experience is a plus for the regaining of American technological supremacy which no Asiatic or European country has in its bones. Every witness before your Committee has put his finger on the desperate necessity that the capital market once more provide a means of equity assistance to these small beginners and the risks they undertake. A fabulously successful investor once described to me his investment technique. In a single frontier technique of science he invested heavily in ten small companies in which individual genius was working its ferment, gambling that at least one of the ten would turn out magnificently whatever the risk that the other nine might fail.

But when comparative tax rates reach a point where there is no advantage to the individual entrepreneur to hang on year after year rather than take a quick sell-out to a merger opportunity combined with the temptation of an earned income salary for his continued management, the country loses the essential driving power of owner-management. The cure for it can in some degree be to induce him to hold on to his ownership with the expectation that the longer he maintains his capital risk position the more the tax law will favor him rather than the fellow who gives up too easily.

Again I am not trying to overstate what this particular change in the tax law will do. Changes far more reaching than this are going to be needed to avoid a concentration of power in the Japanese—or German-type-bank-capitalized economy with a danger of popular political resentment peculiar to the opportunities of our political system.

It is not easy to be specific about how the capital market has got to be reorganized. It is hard to deny the results produced by the successful experts in economic prophecy that has produced the two-tier system. No matter what the effect has been on the rest of the economy, it seems good for those who have profited and seems to argue that all we need is simply more and better "experts" of that kind. A capacity for selecting the businesses and the companies that in the complicated situations of today can constantly produce growth is a not inconsiderable national asset—even if the top tier investment fraternity naturally resists the interference with its way of operating involved in proposed periodic disclosure so that the average investor will not feel he will be jockeyed into losses by insiders running pools such as destroyed the market in 1929.

A component of an adequate reorganization of the equity market may require a re-examination as discussed in the preparatory material of your Committee staff of certain tax advantages given large aggregations of capital and their managers under provisions of the present tax laws which hitherto have seemed (and may still seem) based on sound considerations of public policy. Possibly easier treatment of dividends may redress the balance between equities and fixed income investment. Certainly the survival of an equity market requires a reorganization of the securities trading market that will not make the rescue of the securities industry from its present non-profitable operation depend on putting the burden of its revitalization on the small investor least able to bear the burden

The combination of these remedies is for wiser and younger men.

But for the reasons stated, a most useful tool and a tool that appeals to the American sense of justice would be a graduated capital gains tax graduated according to the length of time an asset is held, related back to the time of acqui-

sition of such capital asset, with a corresponding and proportional application of capital losses against capital gains. My testimony before the House Committee tried to develop this thesis in specific application to that equity investment of average America which is larger in totality than all listed stocks, although it does not appear in stock exchange quotations or public offerings—for instance, the farmer's land, the house owner's residence, the employee's carried stock, the individual entrepreneur's business.

There is still a driving power of thrift in the American success story. Suppose two men each with the same amount of income. One spends his money or is content with investment at high interest rates. The other is the adventurer who in the form of equity investment in his own or someone else's business saves his money to take risks for the benefit of the whole economy, however unintentionally. If there is not a differentiation between these two in the tax laws a driving power will go out of American life which we need to stay on top for the peace of the whole world. If the golden goose is to continue to provide the good life for all Americans while they go on talking care of the world, this is more than economic justice; this is economic common sense.

Statement of Thomas G. Corcoran Before the House Ways and Means Committee

(Included are excerpts from Stock Exchange and Securities Industry Association statements)

This statement before the Ways and Means Committee is a realistic, consciously *political* approach recognizing that (a) the Committee has a *political* more than an *economic* problem, (b) the capital gains problem is emotionally involved with every other problem before the Committee and the nation, and (c) perfection aside, the best approach to accomplish anything in the near future is to be technically as simple as possible and appeal from many points of view to the widest possible approval of a public that generalizes only that it is against (1) taxes on itself, (2) favor to the "rich," and (3) the concentration of wealth.

Therefore, note these emphases in this statement, e.g.—

1. Not a *new* idea; it is only the reconsideration and extension of an *old* idea adopted in 1934 to meet an investment freeze, resulting from '29–'32, similar to what we have now.

2. Simple—it requires only a simple change in the tax *base*—it is not involved in the tangle over the earned income *rate* as such and the "loopholes." It leaves unrecommended the length of the short term gain and the rate of write-off of capital losses against earned income. It is also administratively *simple* as would not be a year-by-year sliding rate. The Committee can therefore consider this now without making hard decisions on more complicated matters that may have to be laid over.

3. Ties the arithmetic of taxation into the existing political *real* situation let loose by Wallace-McGovern by emphasizing the *average man's* investment position after twenty years, involving far more other property-capital than securities-capital—the "what to do" is a corollary to a main concern for the average man, his job, and his country. *Without* disagreeing on the more complicated positions of the Securities Industry or the Stock Exchange, it asks *now* for *less*.

4. Therefore, ties into (a) the balance of payments situation, (b) reversal of the de-industrialization of the U.S., (c) reattainment of the U.S. supremacy in *technology*, (d) social contentment, and (e) avoidance of a concentration of power with inevitable ultimate results in McGovern-type political radicalism.

I

The views I express here are my own, deliberately without retainer from others—n interest deriving from my own *work* in the Government since 1932 in the Treasury, the RFC, the organization of the SEC, the wartime Board of Economic Warfare, and the subsequent experience of myself and associates in provate practice in the problems of financing *new* enterprise.

I am familiar with the work on tax bills and although I would go along with much of what the preceding witness for the Securities Industry has said my suggestion is to make the simplest change possible in the present law for pragmatic political simplicity. My purpose is—not to propose a *new* idea that will politically or administratively complicate the present system—but only to suggest that the Committee re-examine and re-develop an *old* idea that easily fits within the

system—an *old* idea of this Committee's predecessors in the 1934 Act. Then as now the Committee was vitally concerned about the economy. The country was frightened by the '32 crash and by our first devaluation of the dollar and wasn't investing. The 1934 Committee, therefore, sought to fashion the capital gains tax to get savings out of hiding into investments in new enterprise and new employment.

The idea of the 1934 Act was to tax capital gains on a scale graduating downward to *more than ten years*. It would be hopeful if now that idea could be re-examined and extended to tax capital gains on property on a downward graduating scale when the property has been held for a very long period of time, e.g., 20 years.

Until 1942, when the War forced many expediences in the tax law—among other reasons to keep the stock exchanges open—the tax law considered equitable, as well as economically and socially most desirable, this general idea of graduation of capital gain tax according to periods of time.

1972 is somewhat like 1934. Witnesses before me have shown that the again-devalued dollar, the doubts about the economy, and shunning of the capital market by the non-institutional equity investor, all are suggesting clearly that today's tax law isn't working to help a U.S. economy just waking up that it is newly competing for its very life with competitors bigger, richer and more productive than before we have ever met. There is fire behind the Burke-Hartke smoke and the energy crisis smoke. And it is also waking up to the capital costs of the pollution and energy technology it demands and *that our only ultimate answer to the balance of payments problem is the re-creation of our supremacy in new technology.*

In conditions of the '70s, the Ways and Means Committee's direction in the '30s is significant. To expand investments and jobs with the help of the American capital market in the international competition and the technological necessities of the '70s, the graduation-rationale of the 1934 Act needs re-examination and extension. It will include, it is to be hoped, encouragement of the creation of a new category of *very long* capital gains.

In the now additional 30 years since the 1934 idea was dropped in the War conditions of 1942, many new factors have been added to make a re-adoption of the 1934 graduation principle needed to stimulate new venture investment we must have if today's U.S. economy is going to be competitively capable of maintaining national employment at U.S. labor rates and national independence in raw materials.

Certainly, a first important factor is our new European and Asiatic competitors themselves. We have already equipped them against ourselves with our technology, our education, our marketing skills, our credit, and much of our accumulated capital.

But certainly, a second important factor is the creeping rise in the capital gain rate itself relative to the earned income rate. The earned income tax top is 50%. On the alternative tax basis, not only has the capital gains tax gone up from 25% to 35% but with the minimum preference tax added, it can go up to 37%.

Further, when there is taken into account the effect on interaction of capital gains with the earned income limitation of 50%, the seemingly effective tax on certain amounts of capital gain can go up to 45%. Add new state and city taxes on capital gains and it is now assumed, as rule of thumb, in a capital market as important as New York City, that for an equity investor the effective long-term capital gain rate will average out to *at least 50%*.

And a third important factor is that it now takes at least $10,000 of new capital to create the opportunity for one new earned income job.

II

Herewith for comparison are the relevant part of the law of 1934 and a suggestion for this Committee's thought about a new category of *very long capital gains;*

1934

Sec.
117(a) SEC. 117. CAPITAL GAINS AND LOSSES.

(a) General Rule. In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 percentum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

Notice this 1934 Act stopped graduating at 10 years. Wouldn't it be more appropriate to extend the graduation to the 20th year—i.e., the average man's investment lifetime. Because the capital gains tax in so far as it affects longer term capital gains is a retroactive tax on gains on capital assets purchased many years ago when the rates on capital gains were much lower and on gains which accrued in years past long before the new rates became effective. The *longer* the time of holding the more inequitable and more discouraging is the situation of a *very long* investor in respect of new rates.

Suggested new schedule graduated downward for "very long" capital holdings (including existing holdings):

If the capital asset has been held for not less than 20 years—10 per cent;

If the capital asset has been held for not less than 10 nor more than 19 years—20 per cent;

If the capital asset has been held for not less than 5 nor more than 9 years—30 per cent;

If the capital asset has been held for not less than 4 years but more than ———40 per cent;

If the capital asset has been held for more than ——— but not more than ——————— per cent;

If the capital asset has been held for more than ——— but not more than ——————— per cent;

If the capital asset has been held for less than ——————— per cent.

The maximum rate of tax should not be higher than the highest applicable tax on taxpayer's other income, in no event higher than 50%, and there should be an appropriate reduction of percentage for gains and losses under a stated amount like $50,000.

Capital losses should be graduated in the same proportion when used against capital gains. Capital losses not offset by capital gains might be offset against ordinary income to the extent allowed under the present law. (See next page showing comparable proposals of the New York Stock Exchange and the Securities Industry Association.)

The New York Stock Exchange suggested—

Holding period	*Inclusion rate (percent)*
6 months to under 5 years	50
5 to under 10 years	45
10 to under 15 years	40
15 to under 20 years	35
20 to under 25 years	30
25 to under 30 years	25
30 years or more	20

The Securities Industry Association proposal is—

PROPOSED LONG TERM CAPITAL GAINS TAX REVISION

[In percent]

Holding period	Percent inclusion	Effective maximum tax rate [1]
0 to 3 mo	100	70.0
3 to 12 mo	50	35.0
1 yr to 5 yr	40	28.0
5 yr to 10 yr	30	21.0
10 yr to 15 yr	20	14.0
15 yr to 20 yr	15	10.5
Over 20 yr	10	7.0

[1] Does not give effect to State and local income taxes, minimum tax on tax preferences or maximum tax on earned income

Special emphasis should be placed on the *over* 20 years category. Because that is the real investment lifetime of the investing American. It brackets (a) the time when he has paid the costs of his children's education and the setting up of their new families and (b) the time when he retires or his earned income otherwise diminishes and he has to begin to depend on his accumulated capital nest egg if he's lucky enough to have it and possibly shift out of a low income growth holding holding into an investment with a higher income yield like the Sears, Roebuck pension situation described to you by the witnesses for the Stock Exchange.

For that reason it would seem more realistically equitable to consider first the 20-year investor and work backwards to shorter periods.

This suggested schedule for *very long* capital gains tries to make due allowance, in accordance with other testimony before this Committee, for the normal secular inflation of the dollar which reduces purchasing power compared to the real value of the dollar with the capital investment was normally made. Furthermore, with little spread between long holdings and short holding, deliberate attempts are made to twist either short term trading or earned income into the long-term category. With longer time spreads, this twisting out of the short term tax can be avoided.

Would this schedule mean a measurable loss or more unstable flow of revenue to the Treasury? The holder of property, large or small, of course, has his option when he chooses to sell or hold and incur or not incur capital gains tax. The very long-term holding approach, however, tends to avoid erratic liquidation by booms and busts.

There is probably no better evidence on this point than that in considering the 1934 Bill, your predecessor Committee studying the matter concluded: ". . . the adoption of this plan will result in much greater stability in revenue, will give all taxpayers equal treatment, will encourage normal business transactions, and will yield substantially greater revenue." [1]

The testimony here given by representatives of the Stock Exchange and the Securities industry backs up this estimate of the Committee of 1934 with figures from modern Treasury experts.

As I've said before, special emphasis should be placed on the *over* 20 years category. Because that is the real investment lifetime of the investing American. It brackets (a) the time when he has paid the costs of his children's education and the setting up of their new families and (b) the time when he has to begin to depend on his accumulated capital nest egg if he's lucky enough to have it and possibly shift out of a low income growth holding into an investment with a higher income yield. In the case of a man who starts and lives with his new business, it usually takes him 20 years of steady work to bring his work to steady fruition.

Excerpt from Statement of John C. Whitehead, Chairman, on behalf of the Securities Industry Association, before the House Ways and Means Committee

"*Revenue Benefits of Unlocked Gains*

"In these days of federal budget stringency, a liberalization of capital gains tax treatment offers this Congress a unique opportunity to increase tax receipts and at the same time help to regenerate the national wealth. For every billion dollars of gains unlocked, as much as $200 million in new tax revenues might be gained. Tax Analyst Nelson McClung, while a U.S. Treasury Analyst in 1966, estimated that there were $233 billion of unrealized capital gain in equities and that 90% of these assets had been held for more than 7 years. (Martin J. Bailey in an earlier study put the figure at $558 billion.) Unlocking even one-half the dollars noted by McClung's research and taxing them at, say, a 20% rate would produce over $20 billion in revenues for the government that it is unlikely to otherwise receive. Furthermore, there are likely to be even greater tax gains from locked-in real estate holdings, mineral resources and other forms of wealth."

III

Consider such a continuous holding for 20 years—in substance, the average man's entire active investment life. There the distinction is clearest between short-term trading and very long-term investment both in consequences for the economy, administrative workability and in individual justice. (However, the same approach can justify comparable treatment for holdings for 15, 10 or 5 years with appro-

[1] Attached hereto are excerpts from the Committee reports on the legislation of 1934 as compiled in Seidman's Legislative History. So far as inflation is concerned so much evidence has already been given the Committee that I will not attempt to repeat its significance.

priate graduations, i.e., a downward graduation of the tax with the length of the holding period.)

The previous witnesses have told you of the problems of attracting capital for aggregation in big enterprises. To some of the public whose political opinion has to be taken into account, capital gains relate only to high flyers on the Stock Exchange seeking tax shelters and loopholes. To mitigate I'd like to emphasize that far more capital is invested in simpler activities of the average American than is represented by the Stock Exchange lists and it is equally entitled to your attention. Vital as are the organized exchanges and investment mechanisms to the momentum of industry and furnishing jobs, it clears emotional prejudices to think first of the kind of capital property outside of the exchanges in which the average American invests and keeps his savings for most of his life (after, of course, he has first paid taxes on his earned income to acquire capital for the investment).

A few types cover the majority of properties in which the quiet American has always invested his savings in the hope that the investment of his already taxed earned income will ultimately near the end of his life produce a lump sum of capital.

Looking at them first should disabuse any presumption that consideration for *very long* term investors is only to help the rich. In each case, ask first whether it seems "just" to those investors that they should for 20 years of risk have to give up as much as a possible half of the 20-year appreciation of the value of their asset, whether including or excluding the factor of unprecedented inflation—would it seem "just" enough so they would invest again? (So far as inflation is concerned so much evidence has already been given the Committee that I will not attempt to repeat its significance.)

Then ask whether being "locked-in" as they say and hesitant to pay such a large tax to liquidate investment such an investor will feel free to change his investment as he should change it in the changing circumstances of his later life when he needs higher income return.

More importantly for the sale of the whole economy of the whole country, then ask whether a 50% rate, a 35% rate or even a 25% rate would be an adequate inducement for another new investor to start today, investing in the same kind of property, to undertake a similar 20-year service to the community and creation of jobs for others each one of his predecessor investors has undoubtedly performed. Remember investors now near completion of 20 years of investment started commonly assuming a capital gains tax rate lower than today's.

Case one.—Fifteen years ago a farmer bought his farm out of his own pre-tax earnings or from an inheritance which had to originate from tax paid earned income or from estate tax paid. We have tried hard to maintain this individual farmer for the social value of rural population. He holds on and adds to his farm. Now he can hardly farm it himself; his sons go to the city; he can't find young labor. Costs rise through taxes and inflation of equipment and materials to compete with commercial farming. Five years from now he will give up and sell to a commercial farmer.

After twenty years of risking his time and his only asset do you think it seems fair to him to take away half the value of the land he improved with his labor over so many years? Would you think his paying half his inflated gain in taxes an inducement for others to buy another farm to work alone?

Case two.—Fifteen years ago a family buys a home on the 20 year FHA mortgage. Five years from now the children will leave home; the mortgage will be paid off and the parents retired, with little nest egg after paying the children's way through college. For any reason the parents will then want to sell. Without capital gains taxation a young family shifting homes every three or four years could reinvest in *ownership* of a new home. But old parents can't afford to sell their 20 year investment in their home and buy and keep another home. Instead, they need to turn their 20-year mortgage free capital asset into income to pay rent on an apartment and to make up the reduction of their earned income. With all your allowances for the aged in such a case do you think it seems fair to them to take away a substantial part of the value of the house they maintained for 20 years?

Case three.—Fifteen years ago that national hero, a venturesome man, bet all his savings to date, already tax-paid as earned income, on his burning idea—like David Packard and Bill Lear of our time or Henry Ford and Orville Wright when there were no taxes. For further capital he took the debtor's risk of borrowing from friends or a bank. Few of these individual venturers make good on their risk without joining with them other risk-takers. But the nation's job-giving lifeblood depends on their keeping coming. It takes at least $10,000 worth of such

investment to create each significant new earning job. But hundreds of venturers take the risk—the big technological industries like the automobile and the airplane are really assemblers from small suppliers of such investors. And from their experiments come a large part of the ideas to improve American technology.

For fifteen years such a risk-taking enterpriser beats the ups-and-downs of the business cycle and better capitalized competition and creates something new for the economy to make jobs in new industries when old industries rot off.

Five years from now, after 20 years of persistence he may realize a capital gain bunched in one year by selling to another business or "going public." The significance of this case is that we're beyond whether he thinks it "just" that he give up 50% or even 25% of a capital gain a goodly portion of which may be due to the reduction in the purchasing power of the dollar. The important question about this kind of indispensable man is whether you think that at a 50%, 35% or even a 25% rate in an inflating world, there will be enough new men like him to begin now to risk 20 years of ulcers to provide new jobs for old?

Case four.—Fifteen years ago a doctor or a lawyer had saved from tax-paid earned income or a tax-paid inheritance $1,000, $10,000, or $50,000. Against an old age, for which a professional usually has little or no retirement income, he invests in *equities*, i.e., stocks not bonds. Possibly he stakes the one-man venturer we just talked about, and he holds on at a lower rate of annual return than he could get from bonds or savings banks in the hope of an ultimate better capital gain. On the average, he has an even chance not to lose; but if five years later he has to sell out at a loss there probably won't be enough years left in his life to take up his full deduction of $1,000 a year against his capital loss. In the meantime, however, his risk money with that of others is creating jobs.

This is exactly how most new and competitive American grassroot businesses start before big capital becomes interested. At increasing capital tax rates do you think from now on there will be more small investors taking the chance that they took until three years ago? The market isn't saying so. If anything, the small investor is only lending on debt securities not buying stock equities. The mutual funds market redeeming investors in stocks is now successfully interesting investors in bonds.

Case five.—On this last example you have already finally given some relief in seven-year averaging but the principle still holds for a 20 year investment. An employee buys stock of a forward-looking corporation under a plan to hold to retirement in 20 years. To ensure itself loyalty and morale the employer helped and subtly encouraged the employee's investment. Sears, Roebuck is an example—it is in large part owned by its employees. If it is a growth company like Sears, Roebuck, the employee will on 20-year retirement probably sell his stock to get income. If the company prospers, among other reasons because of the loyal productiveness of similarly situated employee-stockholders, the employee's realization can be a substantial capital gain. In the Sears case, it is very substantial.

If an employee retiring after 20 years has to give up even his partly averaged property gain at 50, 35, or 25% of his appreciation—are such socially desirable plans going to attract *new* employees to stick on the job down the long road of 20 years like his Japanese employee-competitor rather than keep their wages *un*invested in the equity and stability of the business they stick with?

Of course, we finally meet the kind of big investment needed to build steel mills, industrial plants and mines. Since their earnings cyclically fluctuate too heavy fixed charges can be dangerous to the big ones as to the little man starting a parts business. They too need *equity* money. It used to come to them through the small individual investor into the stock market. Then, when he was told he needed professional management, the average American contributed his equity through mutual stock funds.

But he isn't doing that today. There may be many reasons why. But certainly one reason is that a rising capital gain rate in an uncertain economy does not make equity investment attractive.

In the stock market, it has been estimated there are now comparatively few very long term investors. One good guess is that 70%, not 50%, of today's exchange volume is trading by so-call institutional investors, pension funds, charitable endowments and insurance companies, some of whom pay no capital gains taxes for good reasons of public policy. Being shrewd investors, they are seldom 20, 15, or 10 year continuous holders. They trade in and out on certainly shorter than five-year market swings and establish a useful *new tax base*. Among them, there will be fewer 20 year, 10 year, or 15 year large investors than smaller investors to benefit from *very long gain* tax modification.

But it is the readiness of *all* these kinds of Americans to risk their savings as equity capital investment that has, along with superior natural resources we are just beginning to understand we no longer possess, developed this country's economy under a free economic system to our past state of social content and stability and competitive effectiveness against the foreigner. Home ownership, individual farm ownership, owner-management of business, employee participation in business ownership, and long time holdings by investors of any kind are the real producers of the earned income jobs at superior American wages on which our workers live and from which all our advanced social services are funded.

As past Chairman Casey of the SEC has been saying, now that we have given away all our other competitive assets, the only superior competitive asset we have left for international competition is our capital market, i.e., the willingness of our people to invest in long term equities while the Japanese and German investment is still owned and directed by their banks not their public and the Frenchman may still be keeping his savings in gold under his mattress.

Having looked at the problem of the small very long term investor let us now fact squarely a possible feeling that although you want to help the small long term investor, you don't want similarly to help the big *very long term* investor or maybe your public does not want to. This although he performs perhaps more significantly the same service to the economy in the provision of jobs; and although it will be self-defeating economy-wise and administratively to try to distinguish between small and large.

But it may make you feel *less worse* to treat them all the same if you think about the stability of the economy.

Long time small investors usually reach a point where they have to liquidate at some point in their lifetime; large investors are usually not under such compulsion and liquidate only after long consideration.

As the Treasury's tax experience shows, with a broad, diversified portfolio professionally managed, a very wealthy individual or a wealthy institution, foundation, pension fund, or mutual public fund, has opportunities for great timing advantages in offsetting against capital gains contributions, shelters, and above all capital losses taken in different years from capital gains. A taxpayer of moderate means who has to use his time and attention to live does not have these opportunities. His capital assets are in a few properties, his farm, his business his home, his savings bank, a few securities; he can neither offset capital losses against his earned income nor sit before the ticker to give investments hour-by-hour attention.

For both its stability and mobility therefore the economy needs a *very long time* capital gains tax encouragement to induce the large investor both to hold on at the right time and to liquidate at the right time.

IV

Beyond immediate capital contribution, *very long term* investment by small or large investors meets a serious need in our economy at this stage of concentrating economic power.

It meets a need to encourage continuing owner-management and substantial stability of stock ownership in both owners and employees to ensure businesses reasonable stability of management and employee marale. By and large, business is run more efficiently and employment is more stable the closer ownership is tied to both management and employees—rather than to street-name stock, prey for proxy houses hunting mergers. The best protection for successful American businesses to avoid the jarring experiences of year-by-year attempts at takeover mergers is substantial *very long term* investment by owner-management and employees. Employee long-holding stockholders have the production incentive of feeling that in working for secure employers, they are working securely for themselves.

Another social problem of no little significance related to the treatment of capital gains to justify encouraging the average investor to invest his capital long term in equities, is the threat of disappearance of the so-called free-auction market on the stock exchanges. It is estimated that perhpas 70% of the New York Stock Exchange volume today is the concentrated activity of so-called institutional investors, e.i., mutual funds, pension funds, charitable endowments, insurance companies seeking mainly at the same time the same kind of opportunities and thus tending to buy and sell together on "good" or "bad" news.

In the next 10 years under continuing conditions, you could project that 70% into nearly *100%* of such concentration. That could bring the financial and therefore the industrial decisions of the entire country under the potential total control of a few decision makers—that would, in turn, bring *certain political radicalism.*

Apart from such concentrated power over broader economic decisions, concentrated buying and selling huge amounts of already accumulated capital could be far more dangerous to the economy than the stock exchange pools that were outlawed by the securities legislation creating the SEC. It could have the same depression effect as happened in 1931 and 1932 on individual enterprises and employment, bank loans for industry, and on banks themselves lending on securities collateral.

V

Suming up to apply taxation "principles" to economic and political realities:

The capital gains tax is a tax on the net gains realized by the taxpayer from the sales of capital assets in a taxable year. The capital assets sold may have been bought many years earlier. The net realized capital gains in any year does not measure the increase in the taxpayer's net worth, but only the net gain on the capital assets sold during the year. It is possible that the taxpayer may have a substantial decrease in his net worth in a year in which he has taken net capital gains, and conversely that he may have a substantial increase in his net worth in a year in which he has taken net capital losses.

When a gain is approximately only the length of the present short term gain, it is politically understandable why the public cannot appreciate the difference and why administrators have difficulty.

But when we come to truly longer term capital gains, i.e., 20, 15, 10, 5 years old, factors are involved that have little bearing on short term capital gains. There is the secular trend towards inflation and the depreciation of the purchasing power of the dollar over the long term. For all but a few exceptional cases, there is bunching in one taxable year of capital gains gradually built up over many years.

There is the problem of not penalizing the investor and the nation for the investor's willingness to accept smaller current yields on his investments than he could secure on triple A bonds and for his willingness to accept the risks of staying with a good investment through periods of declining as well as rising earnings.

Depriving the investor of a substantial part of capital gains built up over the years may cause the investor to prefer bonds over stocks and make equity financing by American business increasingly difficult: The strength and resourcefulness of American business enterprise may be seriously impaired by having to finance growth and expansion by an excessive reliance on debt financing.

High taxes on long term gains may cause many long term investors to become short term traders in their effort to ride up but not down with the market. This will increase the floating supply of stocks overhanging the market in periods of decline thereby accentuating and prolonging market declines and their effect on business and employment. Certainly, this has been the case with many mutual funds excessively concerned with their short term performance.

Although corporate management of both our great and small business enterprises must have a sense of responsibility to all stockholders and employees, management in turn needs the support of a substantial body of long term stockholders and employees concerned with the long term standing, strength and success of the company.

It should also be remembered that the capital gains tax affects not only those who invest in the list securities of our larger corporations but many more moderate-sized and small corporations which are owned and run by a few individuals who started their businesses by leaving most of their profits in them. As stated by Richard D. Turner in the July 1971 issue of the *American Bar Journal:* ". . . small business represents a livelihood for approximately 60% of the population and accounts for more than 40% of the business activity in the United States."

While a capital gains tax may operate more or less harshly in particular situations, the tax obviously cannot be tailored to each individual case. But the various considerations referred to, however, do suggest that the tax on *very long*

term capital gains should be graduated downward. That is, the longer the capital asset has been held, the less should be the applicable effective rate of the capital gains tax.

It is therefore suggested the Committee consider the schedule herein earlier sketched out as an idea for an extension, fitted to the needs of the United States in 1973, of the 1934 Committee's pre-War appreciation of the economic and social benefits of a *very long capital gain* tax category.

In relation to other parts and purposes of the tax law, the idea may take much technical working out in detail. But fundamentally its approach seems the sound principle for the new economy ahead.

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) General Rule.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more 10 years.

COMMITTEE REPORTS

Report—Ways and Means Subcommittee (73d Cong., 2d Sess., H. Rept. Dec. 4, 1933).—Substantially as reported by Ways and Means Committee. (p. 5–6)

Report—Ways and Means Committee (73d Cong., 2d Sess., H. Rept. 704).—Existing law provides in section 101 for a special treatment of the gains and losses resulting from the sale of capital assets held over 2 years. The tax on gains on such sales is limited to 12½ percent, with a corresponding limitation in case of losses. In the case of assets held less than 2 years, the gains are taxed in full and the losses allowed in full except in the case of stocks and bonds, losses from which are limited under section 23(r).

Our present system has the following defects:

First. It produces an unstable revenue—large receipts in prosperous years, low receipts in depression years.

Second. In many instances, the capital-gains tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of on a real increase in value.

Third. Taxpayers take their loss within the 2-year period and get the benefit therefrom, and delay taking gains until the 2-year period has expired thereby reducing their taxes.

Fourth. The relief afforded in the case of transactions of more than 2 years is inequitable. It gives relief only to the larger taxpayers with net incomes of over $16,000.

Fifth. In some instances, normal business transactions are still prevented on account of the tax.

Your committee has examined the British system, which disregards the gains and losses for income-tax purposes. The stability of the British revenue over the last 11 years is in marked contrast to the instability of our own. In that period the maximum British revenue was only 35 percent above the minimum, while in our own case the percentage of variation was 280 percent.

Your committee, however, has been unable to reach the conclusion that we should adopt the British system. It is deemed wiser to attempt a step in this direction without letting capital gains go entirely untaxed. Your committee recommends the following plan:

First. To measure the gain or loss from the sale of property by an individual according to the length of time he has held the property, only the following percentages of the recognized gain or loss are taken into account for tax purposes:

One hundred percent if the capital asset has been held for not more than 1 year;

Eighty percent if the capital asset has been held for more than 1 year but not more than 2 years;

Sixty percent if the capital asset has been held for more than 2 years but not more than 5 years; and

Forty percent if the capital asset has been held for more than 5 years. (p. 9–10).

It is believed that the adoption of this plan (see sec. 117 of the bill) will result in much greater stability in revenue, will give all taxpayers equal treatment, will encourage normal business transactions, and will yield substantially greater revenue. The method proposed is safe from a revenue standpoint, inasmuch as capital losses cannot be used to reduce ordinary income, while gains are taxed in full or in part in proportion to the time for which the property has been held. The existing method which has been in force since 1921 can be defended only on the ground of expediency. (p. 10).

Section 117. Capital gains and losses: This section provides for the new treatment of capital gains and losses already described in general terms under item (3) of the first part of this report. It should be borne in mind that this new treatment supersedes the 12½ percent capital gain and loss system of present law, as well as the system of limiting short-term losses to the amount of short-term gains as provided for under section 23 (r), (s), and (t) of the Revenue Act of 1932.

The following propositions are essential to the consideration of the new treatment:

1. The determination of the amount of gain or loss from each sale or exchange of property, the recognition of such gain or loss, and the basis for determining gain and loss, are all provided for in sections 111, 112, and 113 of the bill. These sections correspond to the same numbered sections of existing law.

2. Section 117 of the bill deals with the manner of taking into account in computing net income these gains and losses which have been determined under section 111 and have been recognized under section 112.

3. Subsection (a) provides for all taxpayers, other than corporations, a series of percentages which must be used in arriving at the amount of the recognized gain or loss which shall be taken into account in computing net income. The theory is that the gain or loss should be somewhat reduced in proportion to the time for which the capital asset has been held. (p. 30–31).

To illustrate the application of the new capital gain-and-loss system in the case of an individual, the following example is given:

Item	Gain recognized under sec. 112	Loss recognized under sec. 112	Time held	Percent applicable	Gain taken into account under sec. 117	Loss taken into account under sec. 117
Corporate stock	$5,000		9 mo.	100	$5,000	
Bonds		$4,000	1½ yrs.	80		$3,200
Government bonds	1,000		2½ yrs.	60	600	
Real estate		3,000	6 yrs.	40		1,200
Short sales	2,000			100	2,000	
Total					7,600	4,400

In the above case, the taxpayer would include in gross income subject to tax $7,600 in gains and be allowed to deduct $1,400 of losses. The net increase in his income will, therefore, be $3,200. If, however, in another case, the total shown in the last column of the example had been $7,600 (loss) and the total in the preceding column, $4,400 (gain), then the taxpayer would be allowed to deduct from his gross income only $4,400 out of his $7,600 of losses. Practically speaking, in such a case the gains and losses would, therefore, have no effect on the tax paid by the taxpayer. (p. 31–32).

Report—Senate Finance Committee (73d Cong., 2d Sess., S. Rept. 553).—Your committee concurs in the general features of the plan proposed by the House bill, but believes a few modifications should be made therein. Reference to section 117 of the bill dealing with capital gains and losses will reveal the following changes in respect to the House bill.

First, and additional bracket is added to the schedule providing for the percentages of gains or losses to be taken into account in computing net income. This additional bracket provides for taking into account 30 percent of the gain or loss if the asset has been held for over 10 years. Under the House bill 40 percent of the gain or loss was taken into account in the case of assets held for more than 5 years. It is believed this change is proper in order that normal business transactions may not be prevented and in order that long-term losses may not eliminate from tax speculative short-term gains. Moreover, as far as the 30-percent rate on gains is concerned, the use of this rate cannot reduce the tax by more than 70 percent. Under existing law the 12½-percent rate may bring about a tax reduction as great as 80 percent. (p. 12)

Substantially increased revenues are expected from this new system of treating capital gains and losses. The changes made are either to prevent tax avoidance or to bring about greater equity. No consequential amount of revenue is lost by these changes. It should be noted that all persons other than corporations are affected by the percentage brackets, including individuals, partnerships, and trusts. (p. 13).

Report—Congerence Committee (73d Cong., 2d Sess., H. Rept. 1335). Amendment no. 65: The House bill provided that (except in the case of corporations) only 40 percent of the recognized gain or loss from the sale or exchange of a capital asset should be taken into account in computing net income if the asset had been held for more than 5 years. The Senate amendment provides for 30 percent if the asset has been held for more than 10 years. The House recedes. (p. 22)

CONGRESSIONAL DISCUSSION

Discussion—House (Cong. Rec. Vol. 78).—On capital gains and losses, in general. (p. 2510, 2512, 2789)

MR. SAMUEL B. HILL. * * * what we have aimed at and what we think we have succeeded in accomplishing is a smoother gradation in the matter of recognized gains and losses on capital investment, so that there is not that great jump from taxing 100 percent of such gain if held for 2 years or less and only 12½ percent of such gain if it is held for more than 2 years. * * * (p. 2663)

Mr. COOPER of Tennessee. * * * Under existing law there are only two types of capital gains and losses treated under the income tax law. We will consider for a moment a capital gain-or-loss transaction. If the asset has been held for less than 2 years it is treated in full as ordinary income. The full amount is taken by way of tax on the gain and a full amount given by way of loss on the loss sustained. But it the asset is held over 2 years there is a rate of 12½ percent applied to the capital gain or the capital loss. This simply means that many wealthy taxpayers of this country dispose of their capital assets in order to get the benefit of the loss by selling just before the 2-year period expires and the gain by selling just over the 2-year period. Your committee, after giving most thoughtful attention to the subject, decided that there should be a further extension or division of the period of time within which treatment should be given to these capital gains or losses. (p. 2789)

Discussion—Senate (Cong. Rec. Vol. 76).—Rejected amendment to tax gains or loss on basis of five times additional tax from one-fifth of profit in case of property held for five years, etc. (p. 6099–103, 6170–87)

MR. HARRISON. * * * Profits from sales of property cannot fairly be subjected to the same graduated rates which are applicable to other types of income, because of the fact that the gain realized by a sale in a particular year often represents a profit which has accrued over a number of years. The bill represents a great advance over the existing law in providing that the amount of capital gains or capital losses to be taken into account shall depend upon the length of time that the property sold has been held. For example, if the property sold has been held for 2 to 5 years, 60 percent of the gain or loss is to be taken into account in computing net income. Senators will recall that now the period is 2 years. If the property has been held for more than 10 years, 30 percent of the gain or loss is to be taken into account. These provisions give a proper recognition to the length of time during which the profit or loss has accrued, while at the same time the capital gain or loss which is taken into account is subjected to the graduated surtax rates. In our opinion these provisions are a notable improvement over existing law, which subjects any gain from the sale of property held over 2 years to a flat 12½ percent tax. We estimate that $30,000,000 additional revenue will be secured by these provisions. They are certainly a simplification. I may say, in that connection, that while there is no capital gain and loss tax in England, while we retain these provisions, they have a tendency toward simplification. (p. 5846)

Mr. Black. Then what is the reason advanced as to why the entire gain should not be taxed if the asset has been held more than 2 years?

Mr. Reed. Because presumably the entire profit has not been realized in the last year; presumably the asset increased or decreased in value at a fairly uniform rate while it was being held. That is the theory.

* * * * * * *

Mr. Reed. I do not think it is a question so much of encouraging or discouraging the transaction in the case of the short-term profit, but the philosophy is that a speculative profit from a purchase last week and a sale this week is not in any sense an investment transaction. A man engaged in that kind of dealing is trading in property in order to obtain a speculative income out of it, just as dealers on the New York Stock Exchange will buy and sell thousands of shares in a day and wind up all even, so far as shares go, but with a money profit. That is income in every sense of the word, whereas in the case of a man who bought a dwelling house to live in 20 years ago, who sells it now for some reason—perhaps because he has to—if he makes a gain, he is not making a speculative gain in any sense. The transaction was not entered into for profit at all. To clap on that man a very high surtax rate, as if that were a constant investment income coming to him, would be the height of injustice. (p. 6171–2)

Mr. George. * * * Now we have this proposition, and this is the philosophy and the reasoning under this provision. If we are not going to allow the taxpayers the benefit of capital losses, how may we in equity tax his capital gain? The bill undertakes to soften the tax on the capital gain. Bear in mind, we have taken away from him his losses, we have disallowed his losses except for the one year upon the same business in whcih he had the gain, and yet we hold him to his capital gain for the first year, 100 percent of the gain, and then we graduate it downward depending upon the length of time he has held the particular asset. (p. 6174)

Senator Bentsen. Our next witness is Mr. Harry Kahn. Come forward, please.

STATEMENT OF HARRY KAHN, NEUBERGER & BERMAN

Mr. Kahn. Mr. Chairman, Senator Bennett, my name is Harry Kahn; I am a partner of Neuberger and Berman, a member firm of the New York Stock Exchange. The views I express today are my own and my own only and are not intended to represent the views of my 29 other partners. In spite of the number, we are a strong small firm without branch offices and confine ourselves to a relatively small range of activities; that is, no underwriting nor commodity business.

As background of my own qualifications, I have handled funds on a discretionary basis for many years; from 1960 into 1963 I was research partner of a major retail brokerage house, Bache and Co., and in the days of Presidents Roosevelt and Truman, I served as an economist in a number of Government departments; State, Treasury, the Marshall Plan, among others.

I do not wish to repeat what you have already read and heard. The articles in both Fortune and Business Week, the testimony you have already received from the heads of the exchanges, the speech of James Roche, and much of the other testimony you have already received certainly illuminates the problems of maintaining a broad free market and the maintenance of a system designed to permit the raising of risk capital by the small and the middle-sized firms.

Parenthetically, I should say that I wrote a short piece along the same lines which was printed in the NYSE magazine exchange back in May. I submit a copy of it as more background.

Senator Bentsen. It will be included in the record.

Mr. KAHN. But to get right to the point, what can be done to make things better?

I do not believe that things will right themselves by the passage of time and I am not sure that the remedies already suggested to you go far enough to resolve these problems. The remedies already submitted to you include:

(1) Full disclosure of the activities of major banks and other institutions handling the billions of dollars of pension, institutional, and individual accounts;

(2) Limitations on the size of their holdings and limitations on the pace of their selling decisions;

(3) Changes in the tax structure to help the small investor.

I would support and second all of these useful and timely suggestions, particularly the second one.

Full disclosure is an important and useful first step. If the public could see from quarter-to-quarter what each bank and other financial institution is doing in the handling of the funds under its control, it would be most helpful. Publicity instead of secrecy, results instead of guessing, would be most desirable.

But I believe disclosure is only a first step. I would favor putting limitations on the size of the money handled and the percentage in any one company that any one investor can hold as two necessary second steps.

What seems of primary importance is to prevent too few people from making too many giant financial decisions. Investors should be given two cutoff points—both the amount of money they can handle (safeguarding this in every way against holding company devices that might be created), and the amount of money and/or the percentage of total stock outstanding that any institution can put into any one stock.

In the tax field, I would like to second a proposal made by Henry Kohn, a New York lawyer, which appeared in the New York Times on August 27 of this year. The gist of it applying to small companies is: To change the Federal tax law so that a person buying and selling a publicly traded stock issue would receive material tax benefits on the sale if the stock either appreciated in value or if it declines.

I should say here, he was concentrating, and I am concentrating here, on small companies, not the huge ones, and while I append his entire remarks and enclose the letter, I would like to point out that he is referring to publicly traded companies with stock selling below 20 at the time of purchase, and with gross revenues under $15 million.

Congress could provide that if a person buys and sells a stock in that category within a 5-year period beginning, say, January 1, 1974, any realized long-term capital gains would be divided by five instead of by two before applying the regular tax rate, and in the case of short-term gains, consider only one-half of the gains before adding them to other income.

In the event of a loss, permit losses to be deducted from ordinary income limited to $25,000 in any one stock issue, and a maximum of $100,000 over the 5-year period.

Now, clearly this is simply illustrative, and it is a suggestion, and you are going to hear many more suggestions, but it does illuminate an area which I think could be explored and refined.

I would like to develop——

Senator BENTSEN. Tell me again, as you read your prepared statement, what was the categorization of the company?

Mr. KAHN. A company which would be selling below 20 at the time of purchase.

Senator BENTSEN. You mean the price would be below 20?

Mr. KAHN. A price, a small company selling at a low price.

Senator BENTSEN. What difference does that make?

Mr. KAHN. With gross revenues under $15 million.

Senator BENTSEN. I understand that kind of limitation, but what differences does it make about selling below a price?

Mr. KAHN. I think you are right, I think that is out. It should be the gross revenues and not the price, I agree.

I would like to develop the second theme and one other which I believe the committee should explore as perhaps more significant ways of getting at these difficult maladjustments in our financial society.

The problem remains that major institutions—banks, insurance, et cetera—by the various nature of their operations, concentrate their purchasing into too few companies with too few people making investment decisions.

A recent list sent out by a major company to its portfolio executives consisted of stocks to be recommended to their clients; it was a good list of fine companes. But there were only 32 names on it. Now institutional portfolio executives are required to confine, for the most part, their suggestions to an approved list and institutions, for purposes of convenience, ease of handling, supervision of portfolios, prevention of major investment blunders, et cetera, will try to limit such lists. The result is that by the very nature of their operations, large institutions tend to freeze out of investment consideration the many, many middle and small companies which may be worthy of investment but are a nuisance or bother or statistical anomaly for the institution's investment operation. The impact of this knowledge is very serious in its repercussions.

We, for example, as a small brokerage house trying to do our best for our individual clients, have to follow, to a large degree, the same formula. The old saying "If you can't lick them, join them" holds.

Once in a while a situation becomes so overwhelmingly attractive that a chance can be taken but now, for the first time in my investment experience, I must say to myself each time I buy a stock for a client not only "Has this investment merit?" but "Is it likely that major institutional investors will be interested in this investment?" That is why so many good companies with good prospects are selling at such low multiples, and this is why the underwriting of new issues has come to such a halt.

I would say there, departing from my statement, that I handle upwards of $60 million of individual clients, and I have learned that it is extremely difficult for me these days to buy small companies for them because they have become so sensitive about being stuck with the so-called small company that if you make a mistake in a small, purchase of a small company, the client really is most concerned. If you buy Exxon or IBM and it goes down, everyone is perfectly satisfied.

Senator BENTSEN. It is the Government's fault then.

[Laughter.]

Mr. KAHN. Or whatever. But it really is, this is a big change, and it is a big change in the last 10 years.

I simply say that by the very size of the money to be disposed of and the necessity to control such operations properly, diversity in investment judgment, individuality in investment decisionmaking, and decisionmaking for the right reasons are hampered or prevented.

Perhaps institutions can find ways to break down their own operations into segments, completely decentralized, with separate analysts and separate investment decisions by many more individuals. This might include research on the number of people in institutions who make final decisions as to security selection and how these people go about getting their information.

To what degree do institutions automatically exclude investing in companies of small size? And what is defined as small? $300 million in sales, or more?

I cannot answer these questions, but I believe the committee will discover that the trend toward untoward concentration in our financial society continues.

My other recommendation is to consider creating a new Government agency to purchase securities both of corporations seeking more equity capital for expansion purposes through underwriting and of corporations whose stocks are now so low in our current two-tier market that without new major sources of investment they are currently prevented from expanding or developing their activities.

This recommendation is designed to fill the gap which now exists because the private underwriters are either unable or unwilling to help small- and middle-size firms to raise sufficient equity capital.

Again departing from my statement, obviously that is not politically feasible or attractive at the moment when the stock market is rising and people are less worried and so forth. Nevertheless, I think it should be considered now as something which could be a standby or a plan at future bad times.

Precedent for such activity would be the Japanese effort in the 1960's to bolster their securities markets after a great downturn and our own effort to help business in the early 1930's—the Reconstruction Finance Corporation. The success, too of the Comsat Corp. as a mixed Government-private operation is also another most successful example of how Government can help business to help itself.

Since the Japanese experience is the most relevant, let me say a few words about it.

There was a boom in Japanese securities in the 1959–61 period. This was followed by a long decline which lasted for several years into 1964. It was serious and there was at least one major securities company liquidation.

In 1964, a mixed group of private and public institutions consisting of 12 Japanese city banks, the Industrial Bank, the Long Term Credit Bank, and four large securities companies, founded the Japan Joint Securities Co. Later on this company also borrowed funds from the Bank of Japan. The Japan Joint Securities Co.'s main purpose was to buy depressed securities. It was not permitted to buy more than 10

percent of any one single issue. During 1964 and 1965, it bought 189 billion yens' worth of stocks—190 different issues.

These stocks were held and gradually sold over the next several years. By 1969, the Japan Joint Securities Co. was virtually out of business. In 1970 it was dissolved after distributing modest profits on its operation.

Senator BENTSEN. I would have to say that with respect to a government agency that dissolves itself, the East is different from the West. I have always heard that the nearest thing to immortality on Earth was a temporary government agency.

Mr. KAHN. As one who worked for the Marshall Plan, I am aware of that.

Senator BENNETT. Mr. Chairman, the witness has mentioned the RFC. As a member of the Banking Committee, I participated in the dismemberment of the final elimination of the RFC.

Mr. KAHN. Perhaps if we had more of them and more clearly planned that they would be temporary, it could be done more often.

At any rate, part of these were used for public purposes connected with banking and securities, but in its hour of crisis in part of 1964, the Japan Joint Securities Co. was virtually the only buyer.

Now, let us assume, for example, that Congress were to pass an act creating a $2 billion corporation designed to help small and middle-sized firms raise equity capital. Such a corporation could be required either to purchase on its own, were no private investors willing to do so, or to operate on a matching or some equivalent basis with private underwriters and private capital.

Without having done extensive research on the subject, it seems clear to me that many well-run companies now unable to tap the capital markets would find the way much easier. The result on the success side would be a sharply higher degree of new underwriting now almost nonexistent and perhaps a major break or turn in the current trend toward concentration in American corporate life and American decisionmaking.

I point out that my firm has no underwriting so I have no personal ax to grind here.

With the strong shoulder of a Government corporation and major funds available, many small, middle-sized, and even large investors would be more venturesome and more willing to risk capital in equity projects.

Naturally, there are major risks and major pitfalls in such a project. Unless done with great safeguards, excellent security, and excellent, very carefully chosen personnel, such a corporation would be open to graft, corruption, and scandal. But if we wish to make capitalism more open and to seek more innovative companies doing new things, and finding new ways of developing independent of the giants, this would be a way which has already been tried in limited ways both here and abroad and has had more success than failure.

In suggesting such a corporation, I am not recommending another permanent agency but, rather, a new temporary one with a limited life designed to end as soon as the underwriting markets return to a more normal life and as soon as ways are found to diminish the results of institutional pervasiveness over the current capital markets.

Since Senator Bentsen's very recent address to the New York Society of Securities Analysts, the *IBM-Telex* case has broken and the market has returned to the upside with vim and vigor. Many will, therefore, say and feel that these problems are self-correcting and, in reading the testimony, I see that several people anticipated this and said that this is what would happen.

I do not feel that way. I think the programs suggested are still vital and that all should be either instituted now or made ready. Thus, future emergencies could be avoided by advance planning and forward-thinking legislation.

Senator BENTSEN. Well, it is an intriguing idea you have offered and it is excellent testimony.

We are pleased to have the chairman of the full committee here this morning and I would ask the chairman if he has any questions?

The CHAIRMAN. I think it is a good statement. Thank you.

M. KAHN. Thank you, Senator Long.

Senator BENTSEN. Mr. Kahn, I would like to explore one idea with you which involves the so-called splinter groups of analysts, analysts that might specialize as metal analysts or energy analysts, who cover the same industry for different institutions.

It is my understanding that from time to time these men gather periodically at places like the city, Midday Club or the Recess Club. Are you aware of such splinter groups of analysts?

Mr. KAHN. Yes.

Senator BENTSEN. Could you give us examples of such splinter groups other than the metal analysts or the energy analysts?

Mr. KAHN. Well, I am not an authority on the workings of the splinter groups, but it is my impression and understanding that most major industries have groups of analysts, specializing in an industry, who have been doing this for some years for their institution or their brokerage house, and who are authoritative in this field. The field could be retail trade, the metals industry, the oil industry, the chemical industry, and so forth, right down the whole list of different industries, and they have a group of such people who meet, and they will get a top official of a corporation in their field and they will have a special meeting, dinner or afternoon or what, and they will hear him.

Now, they will be very careful that no inside information is given which would not be available to everybody else, no new information would be given, and I think that is handled carefully. But obviously they are going to get a flavor, an impression, which is going to be advantageous to their understanding of the company.

Senator BENTSEN. There is a distinct possibility, if not probability, that the participating analysts will arrive at, as you say, a flavor or idea that might be transmitted back with some unanimity to their respective financial institutions and therefore influence the investment decisions?

Mr. KAHN I think there is a tendency in that direction. I think that the analyst is more likely to want to go along with his peers than to be independent because if he tells his institution to get rid of a major drug company, for example, and he thinks the others are not going to do that, he is really stepping way out.

Senator BENTSEN. It is much easier to conform?

Mr. KAHN. Much easier.

Senator BENTSEN. If they are all wrong, why there is some solace in that and he can point to the others making the same mistakes?

Mr. KAHN. Same mistakes and the stock will drop a great deal the day they decide they are all wrong.

Senator BENTSEN. Do you believe there should be a limitation on what institutions own in a single corporation?

Mr. KAHN. I do.

I also believe that the limitation should be not only in the percentage of the stock, but also in the actual value, the number of dollars the institution should have in any one corporation so that if, for example, an institution has an investment which has gone up to a tremendous degree, so that from the institution's point of view it has become a larger percentage of its own equity holdings, perhaps there should be restrictions or suggestions that they would be automatically forced to sell a certain percentage.

Senator BENTSEN. Are you thinking that because of the fiduciary responsibility of the institution——

Mr. KAHN. Yes.

Senator BENTSEN. If they had a higher percentage of their assets in one particular situation?

Mr. KAHN. Yes, I think it would be helpful both ways.

Senator BENTSEN. Do you think we have cause for concern, do you think we are on a subject that is of great concern to the equity market, the continuing concentration of economic decisions in smaller and smaller groups of people?

Mr. KAHN. I think that is a matter of very grave concern because I do feel very strongly that there are too few people making these decisions.

Senator BENTSEN. Mr. Kahn, I, too, am concerned about the smaller companies not being able to go to the equity market to raise capital to expand.

Senator Bennett?

Senator BENNETT. Mr. Chairman, there is in Mr. Kahn's statement something that intrigues me and I cannot quite understand what it means. In his statement he says:

> Investors should be given two cut-off points—both the amount of money they can handle (safeguarding this in every way against holding company devices that might be created) and the amount of money and/or the percentage of total stock outstanding that any institution can put into any one stock.

We have been talking about the second and I understand it, but I am puzzled as to how you can say to a man that "if you have a million dollars to invest, that is too much, you cannot invest it."

Mr. KAHN. No, no, that should be amended to say institutional investors, institutions.

Senator BENNETT. Well, how do you mean that an institutiona investor should be told,

> You can handle up to $100 million worth of stock and then you get to be that big, you have to stop?

Mr. KAHN. I think, I would like to suggest that that is an area that should be looked at. That at a certain point any one bank or institution should be limited in the amount of money that they can or should handle.

Senator BENNETT. Then you say to the bank trust department——
Mr. KAHN. Right.
Senator BENNETT [continuing]. You can get so big and then you have to stop.
Mr. KAHN. Then you have to stop and it should go to other banks or other trust departments.
Senator BENNETT. So a client has to be told,

You have to divide your business. I cannot take any more of your business?

Mr. KAHN. I would favor that.
Senator BENNETT. Does that not fly in the face of the American idea that we should all do so well that we continue to grow, we continue to expand our services?
Mr. KAHN. Well, my answer to you is, if one institution was here and indicated that they handled about $30 billion equity capital, do you want them to handle $60 billion? Or more?
Senator BENNETT. Well, I can see when you get out to that extreme case, you have something to give you pause but are you going to say $20 billion is the limit? Are you going to say to the Salt Lake Bank, "You are small and you live in a small community so $100 million is your limit"?
Mr. KAHN. No, I would not do that. I would say there should be a maximum for any one institution so there would be a cutoff point at a certain size because I fear that you otherwise are going to have a small group of giants and your smaller Salt Lake bank may have great trouble in having continued investors interested in them if they think that huge banks, because of their power and knowledge and the fact that they can keep buying one-way stocks, are going to do so much better for you than that smaller bank, they are not going to give you any more money.
Senator BENNETT. Do you have any idea where you would put that limit?
Would you chop any bank down to $1 billion, $5 billion, or would you, if you are not going to chop them down and you say $22 billion is the limit, then actually you have only put a limit on one bank. All the rest of them are free to grow as they please.
Mr. KAHN. I would say that a cutoff point perhaps of 25 percent higher than the present peak level would seem to me a fair maximum, and I would think that any one institution should have a maximum amount in that area. It would have to be determined rather thoughtfully, and not off the top of my head, but I favor a limitation, yes.
Senator BENNETT. This would be very difficult to write into law, I think; it would be very difficult to write into law.
That is the only question I have.
Senator BENTSEN. Mr. Kahn, Mr. Kennedy of the Ford Foundation, in talking to us about the prudent man rule and the responsibilities of trustees and their exposure to personal liabilities, stated that the prudent man rule could be inhibiting for risk situations.
He suggested that it might be wise if a small percentage—1 percent or 2 percent of the discretionary funds of an institution—could have a different criterion of investment apart from the prudent man rule.
I know that some State insurance laws have that kind of a basket clause. Do you think that would be a progressive step or not?

Mr. KAHN. I think it would, I would agree with that.

Senator BENNETT. It is a built-in go-go fund.

Mr. KAHN. Not quite, Senator.

Senator BENTSEN. Well, when you start putting parameters around investments there are new companies that often fall into that classification.

I am sure that at one time Xerox must have been a rather risky investment.

Well, thank you very much, Mr. Kahn, for your contribution. We appreciate it.

Mr. KAHN. Thank you, Senator.

[Attachments to Mr. Kahn's statement follows:]

APPENDIX A—AS APPEARED IN "THE EXCHANGE", MAY 1973

The stock market is suffering, in part, today because of an increasing concentration of money and financial interest in a steadily smaller group of securities. There have been a number of studies showing that the rise in the stock market last year was primarily in a very small number of major corporations—a favored 50, so to speak. In contrast to these, there has been a decline in interest in hundred perhaps thousands of secondary companies listed on the New York and the American stock exchanges and traded over the counter.

The large institutions handling huge sums of money and concerned about the welfare of their investors naturally take the position that they must consider their clients first. The other side of the coin is by overconcentration in a smaller and smaller number of investment choices, the institutions have created a situation harmful to the American markets, the American economy and, in the long run, to the very clients they wish to protect.

Institutions that continue this trend create an atmosphere where far too much may be paid for a few stock market leaders while no interest is shown in the many other companies in our society selling at far more reasonable prices, with far greater income, and thus, perhaps, a far greater total return. In consequence of this trend, many secondary companies have trouble in interesting their employes in stock option programs and, more important, have liquidity problems in depressed markets. This in turn limits their opportunities to raise equity money.

It is easy to go over the list of big companies that have been stock market favorites and to see where money has been concentrated. These would be companies such as IBM, Merck, Xerox, Procter & Gamble, Disney and Eastman Kodak. Each of these companies are excellent companies and it is not my intent to disparage their competence, quality, or potential. At the same time, many are now selling at multiples of 40 or 50 or even 70 times earnings. In an earlier era, this would have been regarded as dangerous. In each case, the dividend income is minuscule. Yet because of the leadership of major institutions in buying these few large holdings, they have led the way to an overconcentration and, in consequence, to an unfortunate trend away from the rest of the nation's securities.

It is hard to understand why institutions controlling so much money don't branch out and study the many, many companies selling at eight to twenty times earnings, with good prospects, good quality and decent yields. There are an enormous number of such companies. If institutions were to lead the way in putting a slightly increased percent of money into such companies, it would have major effects. These would be a reversal of the overconcentration clearly apparent in current institutional practices and a greater ability of many small and middle-size companied to obtain capital for both expansion and handling their corporate relations with stockholders, employees and larger competitors. In turn, this would probably help to turn the tide in the withdrawal of the individual investor from the securities markets and perhaps even help offset the redemption rate in the mutual fund industry.

History shows the danger of following just one securities policy fashion with too much enthusiasm. Forty years ago, major financial institutions followed a very different investment policy than many do today. Fresh in their minds was the grim memory of the Depression and what has happened to the growth stocks of the Twenties—they were caught in the speculative frenzy that led to the market debacle of 1929. Intending to avoid a repetition of that catastrophe and to seek security for their clients, the institutions overreacted against stocks and were

guilty again and again of overconcentration in corporate or government bonds of the highest quality but paying meager returns of three percent or less. At this turn of the investment cycle, there were innumerable stocks of fine quality and good earnings paying out dividends of five and six percent. These tended to be avoided as too risky. If used at all, they tended to be minor percentages of the total portfolio.

And just as this strategy led to a poor overall return because of excessive emphasis on conservation of principal, so 10 and 20 years later the institutions concentrated in the blue chips—the steels, chemicals, autos and utilities. These worked fine for the early iivestors. But those who held many of them into the Sixties saw the wheel turn again—this time to companies in younger industries such as electronics, drugs, computers and copying. As a result, the blue-chip portfolios stagnated at best.

The multiples in these new glamor stocks have been going up in these ever since. I believe institutions should change their approach to take advantage of existing good values rather than play a style too long and too hard.

Is it too harsh to compare the "well-run" conservative financial institution with the fashion business? A new style sells well and then is exploited to death. Aren't institutions now overconcentrating on one style—companies with a seeming constant predictability of steady earnings growth—and stressing it too much? By doing so, stocks are bid to such false values so that very slight disappointments are taken as overwhelming defeats and then the rush for liquidity is like the rush of the lemmings over the cliff. Everyone at once and price disaster.

This is not to suggest that institutions should become more speculative or less quality-minded. On the contrary, many quality companies doing well are currently undervalued and that this trend has been going on to such an extent that it is time for some fresh thinking about true value in investments. The health of the American business economy depends upon diversity rather than overconcentration.

A society in which all investment decisions tend to go more and more into too few places may become a dangerous economic society. It implies monopoly power. It also creates the danger of terrible price reversals in which competitive institutions all seek liquidity at the same time. But liquidity for everybody is impossible, as economist John Maynard Keynes has pointed out. And to use his metaphor, the game of musical chairs in which someone is left standing is not a proper game for big institutions. On the contrary, they should be more concerned with finding hidden values in the many big but not giant companies that currently exist.

In early 1962, the then president of the New York Stock Exchange made a speech warning investors against too much speculation in unseasoned, inexperienced companies. Eleven years later, the situation is 180 degrees different. The time has come to warn against overinvestment in the small number of extremely well-run American corporations at the expense of indifference to so many alternative and cheaper investments. It would be a healthy thing for the United States and a measure of the social responsibility and maturity of major institutional investors if they could show the leadership required by changing their approach from the select few to the neglected many.

Appendix B

To Bolster Stock-Market Underdogs

To the Editor: The crisis that paralyzes a significant part of the stock market calls for legislative action. It hardly makes sense to continue only to wring our hands and bemoan depressed prices of so many securities, and to deplore the rapid demise of many stockbrokers, when constructive steps are within our reach. Everyone recognizes that raising capital by selling stocks has almost dried up. The established corporations can weather the storm, but tens of thousands of small companies are imperiled because there is virtually no interest in stocks of small companies. A healthy securities industry is a vital prerequisite of our system. We can and should make it more attractive to buy the securities of relatively small companies.

While there is more than one way to bring life back into the securities markets, here is an approach which is simple and requires no appropriation of funds. The stimulus is to change the Federal tax law so that a person buying and selling a publicly traded stock issue would receive material tax benefits on the sale if the stock either appreciated in value or if it declined.

It would work this way: Determine a category of stocks, which may be called "small companies"; any publicly traded company with its stock selling below 20 at the time of purchase with gross revenues under $15 million, would qualify. The Congress could provide that if a person buys and sells a stock in that category within a five-year period beginning, say, Jan. 1, 1974, any realized long-term capital gains would be divided by five instead of by two before applying the regular tax rate, and in the case of short-term gains, consider only one-half of the gains before adding them to other income. In the event of a loss, permit losses to be deducted from ordinary income, limited to $25,000 in any one stock issue and a maximum of $100,000 over the five-year period.

Tax incentives in the field of small business have been helpful in the past. We need something now which has a broader scope in order to lift so many thousands of companies out of their stagnancy and help assure the continued viability of a capital market which is so essential to our economic system.

This suggestion, which can of course be altered in many different ways, is not a substitute for the exercise of prudence in investing in smaller companies but should go a long way to get our capital markets off dead center.

HENRY KAHN.

New York, Aug. 27, 1973.

Senator BENTSEN. Thank you, gentlemen. That will conclude the hearings at this time.

[Whereupon, at 11:30 a.m., the committee adjourned.]

Appendix

Communications Received by the Committee

248

STATEMENT OF GEORGE KLINE SMITH, REPRESENTING THE AMERICAN COUNCIL ON CAPITAL GAINS AND ESTATE TAXATION

My name is George Cline Smith. I have been an economic and business consultant for many years. I am past president of the National Association of Business Economists and I am a member of the Board of Directors and Executive Committee of the American Council on Capital Gains and Estate Taxation. This statement has been prepared and is submitted on behalf of the American Council and its members.

The United States is currently facing two major economic crises: inflation and severe shortages. Both have been well publicized, and need no documentation here. While the causes of these crises have independent elements, there is considerable interrelation between them. Increasing productivity and production could go a long way toward curing both shortages and inflation.

Since Biblical times, it has been recognized that an economy cannot consume all its production, something has to be held aside for investment. If a society eats all its corn, there is nothing left to seed next year's crop. The United States, through its tax policy, seems to be deliberately ignoring this fundamental economic truth, encouraging maximum consumption and placing one roadblock after another in the path of investment.

Tax policy can be used to stimulate productivity and production, productivity meaning efficient use of economic inputs such as labor and material, and production meaning total output with or without changes in productivity. The investment tax credit has demonstrated its effectiveness in stimulating capital investment, which is the principal source of improved productivity.

What is generally overlooked is that the basic structure of our tax system is designed to encourage consumption at the expense of investment, and there is even the real danger that prospective changes in tax law will increase the bias against investment.

It should be obvious that the progressive income tax eats into potential investment by absorbing funds from those who would not spend all their income on consumption. It is not my purpose to debate the progressive income tax, since it is so thoroughly established as a part of national policy, but merely to point out that it exists as a factor.

But on top of this tax, we have the unnecessary burden of the capital gains tax. Some expert semanticists have managed to convey the impression that long-term capital gains get "preferential treatment" since they are taxed at lower rates than ordinary income. The truth is that capital gains get detrimental treatment, in the sense that they are taxed at all. Most industrialized nations have recognized that capital gains are not income, and should not be taxed as such; the United States stands almost alone in its policy of syphoning off private investment capital through the gains tax.

It should therefore not surprise anyone that other industrialized nations are outstripping the United States in economic growth. As I pointed out in testimony before the House Ways and Means Committee on March 21 of this year, there is an almost perfect correlation between high rates of fixed investment and high growth rates. Germany, Japan stand at the top of the list in both factors; Britain and the United States are at the bottom.

The fact that we share this dubious distinction with the British is somewhat alarming. We are both low-investment and high-consumption economies; the main difference is that our absolute consumption per capita is higher than the British, because we are richer. But Britain once occupied our enviable position, with high absolute consumption per capita relative to all other nations; today it does not. I shudder to think that we may be following the British in this as in so many other things. But there are signs to be read as Americans are forced to cut back on consumption of electricity, gasoline, heating fuels, paper bags and a host of other things once taken for granted.

In my earlier testimony for the Ways and Means Committee, I said that material growth had become a dirty word in the minds of many people. Obviously, there are many problems caused by excessive growth rates to which we have not made proper adjustments. But as I pointed out then, no-growth can be

an even dirtier word. In the six months since that statement was made, we have been forced to face up to the problem of no-growth. The paper industry is one example; uncertainty as to the rules and costs of pollution control, among other factors, has almost stopped the addition of new capacity, with present and prospective shortages of bags, boxes and printing paper. Some 40 million acres of agricultural land have been released for crop use, but production of fertilizer and farm equipment is at capacity ceilings already—resulting in continued inflationary pressure in the sensitive food sector. Many other examples could be cited. The important point is that many of our current problems could be cured, or at least eased, by increased capacity.

In our economy, private fixed investment is critical to capacity growth, and the tax structure is critical to such investment. Our present tax structure, with its combination of progressive income tax rates, double taxation of distributed profits, and "preferential" treatment of capital gains gives considerable encouragement to the retention of corporate earnings.

How important are retained earnings? According to the Federal Trade Commission figures, retained earnings of manufacturing corporations in the period 1966–1971 totalled $99 billion. Over the same period, net property, plant and equipment of these corporations increased by $103 billion, or almost the same amount. I would not argue that every dollar of retained earings goes into fixed investment; during the same period, inventory investment amounted to $50 billion.

The important thing is that the $99 billion of retained earnings supplied a major portion of investment needs. What would happen with less retained earnings? Corporations would face two choices: reduce investment by the same amount, or tap the lending institutions for the difference—in which case the additional demand would certainly drive up interest rates. In actual practice, the result would probably be somewhere in between: lower investment and higher interest rates.

During the first phase of these hearings, Dr. Norman B. Ture described the importance to the economy of the efficient performance of financial markets in the allocation of saving. He noted that these markets were being hampered by the thin participation which has prevailed in recent years, and illustrated the anti-saving bias of our present tax laws. The lackluster performance of the stock markets in spite of the current boom in business certainly presents some awkward questions. Tax policy furnishes some answers.

It is popular to talk of the capital gains tax as a haven for the rich. But to the extent that it affects the stock markets, it is hitting at a broad cross-section of Americans of all degrees. In 1970, some 30 million people owned stock. Of these, about 58% were in households with total incomes of under $15,000 a year. Many of these would be retirees; some 17% of the household heads reporting stock ownership were 65 years of age or over. Any increase in the capital gains tax rates would most certainly have an adverse effect on the market and on these 30 million individuals. Conversely, a reduction of present rates would have a favorable effect.

There is another stock market effect which touches particularly middle and lower income families who do not themselves own stock. Pension funds are more and more involved in equities. And pension funds are being called on to perform much larger functions through legislation and labor contracts. Again, pension funds can be hurt or helped, depending on whether capital gains rates are raised or lowered.

Inflation has been called the most cruel tax of all. To the extent that the capita gains tax hinders investment, it must bear some responsibility for inflation. The best way to fight inflation—and certainly the most satisfactory for both consumers and management—is improved productivity. And productivity improvement depends more on plant and equipment investment than on any other factor. Any tax change which shifts emphasis from investment toward consumption simply intensifies inflation by increasing demand pull and decreasing the capability of productivity improvement.

There has been debate over equity ever since taxes began, and there will never be universal agreement. There is also total disagreement among tax experts as to the effects of changes in the capital gains tax. Certainly an increase in the gains tax rates would open a Pandora's box, radically altering a complex structure to which our laws, our courts and our economy have long been adjusted. At the very least, the tax should not be made more burdensome. At best, it should be eliminated completely, for the good of the economy and all the people—not just a favored few. Such a development is probably unrealistic, but consideration should at least be given to changes in the direction of lessening the gains tax burden.

[From the Japan Stock Journal, Sept. 17, 1973]

Vanishing Individual Investors

The Tokyo Stock Exchange is very much concerned by the sharp decline in the proportion of shares held by individual investors. A study by the TSE's Research Department finds that the figure dropped from 61.3% in 1950 to 32.2% in March, 1972 and further down to 29.8% in March, 1973. The figures are based on the proportions of the market values of shares of the 1,631 companies listed on the TSE's First and Second sections.

When the Tokyo market reopened in 1949, the Japanese government under directives of the Allied occupation had broken up the old zaibatsu combines and some of their larger companies. Various measures were taken to sell or otherwise transfer the shares formerly owned by the zaibatsu central holding companies. The banks and other financial institutions were prohibited from owning more than 10% of the shares in other firms. By and large, the shares thus forcibly liquidated wound up in the hands of individual investors. Again, inflation was still severe, and the market offered a hedge against it. The securities trade got itself an assured position, particularly with the banks barred by law from the securities business, and there was much talk well into the early 1960's of "people's capitalism." The launching of investment trusts also offered an easy and fairly safe method of investment in stocks by the general public.

Business Takes Over

The relative decline of the individual investor, however, has been steady and one-way. Most Japanese still prefer to put their savings in the bank. As inflationary pressures eased, the life insurance companies came back into business to write new policies, collect premiums, and put part of the proceeds into stocks. Business firms got back on their feet and started to acquire shares in other companies to build up or cement business ties. Interlocking share-holding arrangements grew, and the old zaibatsu banks and firms revived old ties featured by such arrangements. Savings, as has been said, flowed into the banks and through them into the hands of business. Those with control of money naturally tended to increase their share of ownership of the major sectors of the economy.

In recent years, this trend toward business owning business has been spurred by "stable stockholder" operations. Originally fearful that the lifting of controls on entry of foreign direct investment would lead to takeover attempts, management of Japanese firms, painfully aware that their notoriously small equities made them vulnerable to takeover, sought to get the bulk of their shares into the hands of banks, other financial institutions, subsidiaries, and companies with which they did business and which could be reasonably relied on to hang on to their shares, assure the issuing firm of a solid pro-management majority, and protect it against foreign takeover. This strategy was later expanded to protect firms against domestic takeover as well. The majority of large Japanese firms now aim at stable stockholder levels of 79% to 80% and in many cases have already achieved their targets. The result has been that financial institutions and non-financial business firms now hold 69.7% of all shares—the balance not owned by individual shareholders is in the hands of securities houses, the government (in a few firms only of a public interest character like Japan Air Lines), and miscellaneous groups as mutual aid societies.

The financial institutions and business firms are lumped by the securities trade under the term of "hojin" (incorporated bodies). The easy credit situation in 1972 made it possible for the hojin to step up their buying of shares sharply and to increase their total proportion of all shares outstanding by 4.6% during the year. The big trading firms bought shares in manufacturing companies to get more leverage in pressuring them to do business with them. Auto manufacturers bought shares in parts companies to secure closer control or to prevent rivals from doing so.

The Decline in Trading

The hojin and other stable stockholders tend to keep their shares. This has in turn reduced the number of floating shares in the market and also quite markedly, particularly in the current uncertain market, the volume of trading. On two occasions—in December last year and January this year—daily volume in the TSE's First Section went over a billion shares. The market is now limping along on daily turnover of about 100,000,000 shares. The hojin, having bought, are not selling, and with money becoming increasingly tight, they are not doing much

buying. In Wall Street, the institutionals are reported to be accounting for most of the trading. In Tokyo's Kabutocho, individual traders now do most of the buying and selling. The overall trend is for individual investors to sell and the hojin to buy. Again, the still high level of the market and high prices of individual issues make it difficult for the small investor to buy. The old days when they could pick up bank shares for ¥50 or ¥60 each and buy power company shares that paid a higher yield than bonds are over.

The TSE and the securities houses are finally acting to examine the situation and to search for remedies. The exchange's Policy Committee has set up a special working group which is due to report before the end of the year. The problem is a complex one and of vital concern to the securities trade. By going strongly after hojin business, expediting stable stockholder operations, and handling such matters as the direct allocation of new issues to designated parties, the houses have in a sense been working to put themselves out of business. Unless shares are held more widely by individual investors, the secondary or trading function of the market will atrophy. Daily volume must be gotten up to the 200-million-share level in the TSE if the houses are at least to break even. The market in too many issues is already far too thin and prices rise or drop sharply on small-scale buying or selling. Again, if the credit squeeze gets so tight that the hojin are forced to start selling to raise needed operating funds, the market will be in serious trouble. The prevalent belief, however, is that this will not happen and any shares that the hojin wanted to dispose of have already been sold.

The securities houses themselves are now maintaining a low profile in the market. They used to account for a substantial part of total volume as dealers buying and selling for their own account, but under their new code of ethics, they can no longer do so. The houses long made the market and they will have to find ways of reassuring a more active role.

There are various proposals for getting the individual investor back into the market. One way would be to adopt tax measures that would encourage higher dividends. The present corporation tax on earnings is 36.75% but on that part paid out as dividends the rate is 26%. One suggestion is to lower the latter rate to the West German level of 15%. It has even been urged that earnings paid out as dividends be made tax-free as a business cost in the same way as interest paid on bonds and money borrowed from the banks. While the need is recognized to build up equities and strengthen corporation financial structures, there is considerable criticism that the payout rate among Japanese firms of dividends against earnings and yields are far too low compared with those of the West. With foreign companies due to be listed on the TSE shortly, Japanese investors will be comparing domestic firms with them and this also could lead to changes.

Basically, however, Japanese management may find it advisable to change its line of thinking as embodied in the stable stockholder idea and regard with more favor wide holding of its company's shares. Stockholders, for example, can also be customers for its goods or services. Closed holdings of capital may in its way be as bad as closed trading blocs or controlled product markets. An environment needs to be created in which the individual can make a choice among wider options, based on reliable information, on where to invest his money.

STEINER, ROUSE & CO., INC.,
New York, N.Y.

HON. LLOYD BENTSEN,
Russell Office Building,
Washington, D.C.

DEAR SENATOR BENTSEN: I am writing in my capacity as the Chief Executive Officer of a forty-nine year old retail oriented stock and bond brokerage firm. Our operations are mostly in the New York area, but we have also maintained branches for many years in Alabama and Louisiana and more recently in Florida. We have over 300 employees.

I congratulate the Committee in the forthright and constructive way it has approached the problems of the securities industry. As you know only too well, the health of our industry has a direct relationship to the general public interest. "Wall Street" is the leading money market of the world. The efficiency of this market in raising capital is unparalleled, and capital is the fuel of a free enterprise system which supports the very society in which we live.

I do not have to tell you about the seriousness of the condition of the financial community. The problem stems from the fact that the public has turned its back

on traditional financial markets. This has affected both the brokerage and the underwriting sectors of our business.

If our industry does not recover its health and if the trend toward concentration of financial resources into fewer and fewer hands continues, our marvelous system of distribution will no longer be available to American business. I am sure the giant corporation will find ways to raise capital, but what will happen to medium sized and small firms?

The key to the problem is the individual investor. In order to regain his participation we must restore his confidence in financial markets and provide him with new incentives for risk taking. With this in mind, I would like to present to the Committee a summary of my views.

1. The free enterprise system, which is the foundation of our industrial economy, should be given a climate in which it can perform for the general good.

2. While not without imperfections, the Stock Exchanges have served this nation well in that they have fulfilled their role in the capital raising process. In so doing, the Exchanges were historically organized to be responsive primarily to the investment needs of the public.

3. Our national philosophy should be to encourage direct ownership of shares of United States industry by as many individuals as possible. Securities markets should be designed to serve the public. Government and industry policy should be directed toward encouraging public participation.

4. The Exchanges and the public were not prepared for the institutional dominance of the equity market. This dominance, a recent phenomenon, has had a profound effect on the system of orderly determination of value. Opinion surveys have shown conclusively, that individual investors feel overwhelmed and frightened by this new situation. The number of individual U.S. shareholders declined by 800,000 in 1972. This is the first time a decline has ever been recorded. If this trend is allowed to continue, it could create serious long-term economic and political problems.

5. The individual investor needs encouragement. He must be reassured that our system works for him. A program must be developed to further the concept of broad based direct participation in American business. Such a program must combine new legislative initiatives as well as new self-regulatory rules. It could include the following:

(a) that exchange membership implies on obligation to do a public business

(b) that the commission structure be fair both to the small investor and the institution

(c) that the institutions be required to reveal their holdings and disclose their trading activities

(d) that new rules be established to require institutions to follow orderly trading procedures

(e) that capital gains and dividend treatment for small investors be liberalized as one means of equalizing the relationship between individuals and institutions.

It is difficult to cover a complex subject in a brief letter, but I have tried to touch upon the major points. I would be happy to assist the Committee if further information is desired.

Very truly yours,

LEON J. WEIL,
Chairman of the Executive Committee.

AMERICAN INSURANCE ASSOCIATION,
GOVERNMENT AFFAIRS DEPARTMENT,
Washington, D.C.

Hon. LLOYD BENTSEN,
Chairman, Subcommittee on Financial Markets, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BENTSEN: We have recently polled the property-casualty insurers in this Association to determine what percentage of their assets are invested in so-called "upper tier" common stocks.

As you know, an article by Carol J. Loomis in the July 1973 issue of *Fortune* called attention to the existence of a "two-tier market" in common stocks, particularly regarding investments by bank trust departments. We have taken the top twenty common stocks used by Ms. Loomis, plus seven others from the com-

mon stocks which she found repeatedly in bank trust departments which also appear in our company portfolios. The remaining stocks in Mr. Loomis' analysis are not held with frequency by our members. The twenty-seven securities selected constitute the most frequent investments by our membership in the upper tier of common stocks. They are: IBM; AT&T; Eastman Kodak; General Motors; Exxon; Sears Roebuck; General Electric, Xerox; Texaco; Minnesota Mining; Procter and Gamble; Coca-Cola; duPont; Ford; Avon; Mobil; Johnson & Johnson; Standard of California; Merck; American Home Products; Burroughs; Catepillar; Dow; Disney; ITT; Kresge; and McDonald's.

Five portfolios have been selected as representative of our property-casualty membership. Each is broken down on the attached chart to show the amount of assets invested in bonds (including both corporate and tax free), preferred stock; and common stocks. Common stocks are further divided into public utilities banks, trusts and insurance companies; and industrial—miscellaneous.

Because bonds are such an important part of property-casualty investments, we have stated the amount of assets invested in upper tier stocks as a percentage of the total portfolio including bonds, and as a percentage of common stocks. It, is important to remember that in many property-casualty companies, over half of the portfolio is invested in bonds, whereas Ms. Loomis found "bonds today are about as unpopular as low p–e stocks with the big banks," *Fortune* 89.

I hope this information will be helpful, and that you will let us know if other data would be useful.

Sincerely yours,

WALTER D. VINYARD, Jr.,
Counsel.

Insurance company	Total portfolio (thousands)	Total bonds	Total common stocks	Total preferred stocks	Public utility common stock	Banks, trusts, and insurance common stock	Industrial and miscellaneous common stocks	Upper-tier common stocks as per cent of portfolio	Upper-tier common stocks as per cent of common stock
A	$941,587	[1] $390,352	$535,043	$16,192	$139,198	$58,568	$377,277	8.2	14.5
B	404,969	169,480	212,710	22,779	15,398	15,874	181,438	7.1	13.4
C	593,919	398,487	183,023	12,409	26,485	11,267	145,271	5.6	18.3
D	2,490,256	1,301,463	1,171,559	17,234	215,294	138,292	817,973	17.4	37.0
E	1,082,771	582,711	500,060	....	47,933	34,956	417,171	10.5	42.7

[1] Book value.

STATEMENT SUBMITTED BY B. KENNETH SANDEN, PRICE WATERHOUSE & CO.

SUMMARY

It appears there will be a limitless need for capital investment in the foreseeable future. To insure an orderly flow of investment and viability in the capital markets, the tax system applicable to realized capital gains must continue to be founded on equitable and rational rules, preferably simple in application and administration. On this basis it is respectfully recommended that the system taxing long-term capital gains include the following general principles:

1. Continue to distinguish long-term capital gains from ordinary income.
2. Continue to tax only realized gains.
3. Adopt a sliding scale for the inclusion of realized gains in taxable income based on the holding period of assets sold.
4. Eliminate the higher tax on capital gains caused by considering capital gains a preference that reduces "earned income" subject to the maximum tax.

Other major countries generally tax capital gains more favorably and, in addition, encouragement is given to investors through imputation of the corporate tax or in reduction of such taxes on profits distributed.

STATEMENT

One of the most important assets of the United States is its capital market system with tremendous capacity to generate capital accumulation and its viable mobility to provide shifts in investment as the needs of the economy change. As accounting consultants to a broad cross section of American business we believe there will be virtually a limitless need for capital investment in the foreseeable

future. This need is rapidly expanding as the social and environmental issues come into greater focus. For example, it has been estimated that some 300 billion dollars might well be needed for pollution control facilities *alone* in the next decade. To ensure an orderly flow of investment and viability in the capital markets, the tax system applicable to realized capital gains must continue to be founded on equitable and rational rules, preferably simple in application and administration. We believe there is real danger to our long-term economy in some of the recent proposals for greater taxation of capital gains. It appears that these proposals have been built on the shifting sands of emotion and expedience.

The proper method of taxing long-term capital gains has been a complex question for over half a century. Since 1922 such gains have been distinguished from ordinary income and the "tree" and its "fruit," with their important distinctions, have become part of the income tax jargon. Although there are those who believe capital appreciation should not be taxed at all under an income tax system, the more accepted view in the United States is that so long as the toll charge is reasonable the concept is acceptable. Of the major industrial countries, however, only England and Canada tax capital gains at rates comparable to those of the United States. The other industrial countries tax such gains at relatively nominal rates or not at all.[1] (Summaries of how certain countries tax capital gains are attached as Exhibit I.) Moreover, most of the industrial countries give investment in equities an additional boost by using either the imputation or the split-rate system of taxing corporate dividends. Both of these systems give the stockholder a degree of relief from the double taxation inherent in the U.S. "classical" system.

However, the reasonableness of the current taxation of long-term capital gains may well be questioned. In the last ten years the maximum tax rate on other income, and particularly earned income, has been drastically reduced. (Congress should be commended in this regard inasmuch as any tax system which takes half or more of one's income should be viewed as having reached economic and social limitations except for national emergency periods.) But, in the meantime there has been a steady erosion of the capital gains base in addition to increases in the effective tax rate on long-term capital gains. It must be recognized that an individual taxpayer is enticed to put his personal wealth into securities or other investment because the potential for profit *after taxes* makes them attractive even in the face of losses. However, as the waters of favorable tax treatment recede the rocks of risk and loss appear more formidable to investors. Further shifts in reducing the differential between the taxation of long-term capital gains and ordinary income do not appear equitable and should be avoided.

It is respectfully recommended that the system taxing long-term capital gains include the following general principles:

1. Continue to distinguish long-term capital gains from ordinary income.
2. Continue to tax only realized gains.
3. Adopt a sliding scale for the inclusion of realized gains in taxable income based on the holding period of assets sold.
4. Eliminate the higher tax on capital gains caused by considering capital gains a preference that reduces "earned income" subject to the maximum tax.

The reasoning behind the foregoing suggestions is set forth as briefly as possible.

1. Continue to distinguish long-term capital gains from ordinary income

There are many substantial reasons for taxing long-term capital gains at a rate different from that applied to ordinary income. Not all of these, of course, are equally applicable to each type of capital investment, but they generally encompass the basic rationale of encouraging the flow of capital to the securities market. Among the primary reasons for taxing capital gains more favorably are:

(a) Capital losses are limited in deductibility
(b) Reinvested capital gains are taxed
(c) Partial double taxation on corporate investments
(d) Taxable gain reflects price level changes and not economic gain
(e) Capital gains, aside from price level changes, often represent accumulation of income of many years which would be bunched in one year except for the averaging effect of the preferential rate.

(a) The tax law generally limits the deductibility of capital losses to prevent taxpayers from passing on their financial wounds to the Treasury. Therefore, without encouragement through a favorable differential when capital gains are realized, investors would be placed in the same category for tax purposes as

[1] It is interesting to note that foreigners can trade in the U.S. stock market tax-free during any year in which they are in the United States less than 183 days. This is obvious recognition of the fact that favorable tax rates attract investment capital.

gamblers—hardly the public policy appropriate to the times. It is essential to our economy that business "risk-takers" exist in substantial numbers and recognition of this fact occurs in the capital gains area and in other special provisions of the Internal Revenue Code.

(b) Mobility of capital is desirable in a free economy. Taxation of capital transactions naturally has its adverse effects on mobility through the so-called "lock in." In addition, to the extent capital proceeds are reinvested, there is no net economic gains and any tax imposed on the transaction reduces total capital available for reinvestment. This repetitive tax impost should be at a lesser rate than applied to ordinary realized income so as not to unduly inhibit mobility and create a frozen investment climate. The ready ability to divest is elemental to public investment. The greater supply of capital—the lower its cost—with benefit to the entire economy.

(c) With respect to corporate investments, there is a substantial element of double taxation when earnings are taxed at the corporate level and again at the shareholder level on gains which represent capitalized earnings. The minor adjustment allowed on dividends received cannot be considered adequate relief in this area and accordingly there is additional justification for a tax differential when taxing realized long-term capital gains.

(d) The primary basis today for a tax differential attributable to long-term capital gains is the recognition that such gains are largely the effect of inflationary price level adjustments and are not economic gains. Tax publications and business periodicals have devoted considerable space in recent years to the problems of compensating for inflation in the tax and financial area.[3] It should be clear to all of us that a taxing system which ignores the economic effects of the tremendous decrease in the purchasing power of the dollar may create inequities and hardship of substantial magnitude.

The dramatic shrinking of the dollar is illustrated by the following table of the Consumer Price Index in five-year intervals using the 1967 base and a rounded-off CPI computed on a 1971 base from 1931 to 1971:

Year	(CPI 1967 base)	(CPI 1971 base)
1931	45.6	38
1936	41.5	34
1941	44.1	36
1946	58.5	48
1951	77.8	64
1956	81.4	67
1961	89.6	74
1966	97.2	80
1971	121.3	100

Based on the above index, if an investment made 15 years ago is presently sold for a dollar increase of 50% there would be no economic gain on the transaction. On this basis taxing the illusory gain at a more favorable rate is hardly preferential treatment, but merely an equitable realization of economic fact.

2. Continue to tax only realized gains

The income tax statutes appropriately tax only realized gains under the method of reporting adopted by a taxpayer. This principle should be adhered to in the taxation of long-term capital gains under the income tax laws. Taxation of unrealized appreciation at death is not an income tax problem and it appears that once the "fruit" is taxed, under the income tax provisions, and the "tree" as capital, under the estate tax provisions, it is irrational to suggest that the branches be pruned to somehow produce more taxable "fruit" and less "tree."

The solution may lie in the integration of the estate and gift tax provisions with proper recognition of inter-family transfers, adjustment of total exemption, etc. In the meantime neither of the solutions frequently mentioned appear to be helpful in the capital accumulation and mobility area. If additional taxes are imposed at death, there is simply less personal investment. If a carry-over of the decedent's basis is adopted, the problem of "lock-in" is greatly exaggerated and carried over into succeeding generations.

[3] Of particular interest is the report of the Committee on Sales, Exchanges and Basis of the Section of Taxation of the American Bar Association. The report "Price-Level Basis Adjustment—A Modest Proposal" is reproduced in *The Tax Lawyer*, Winter 1973.

3. Adopt a sliding scale for the inclusion of realized gains in taxable income based on the holding period of assets sold

Present law differentiates short and long-term capital transactions on the basis of a six months holding period. The reasons previously set forth for continuing to distinguish long-term capital gains from ordinary income do not appear generally applicable to assets held for a period as short as six months and apply with more force to assets held considerably longer. In recognition of these factors a sliding scale for inclusion in taxable income of capital gains would create greater equity and would appear to be less cumbersome than a price level adjustment mechanism designed to accomplish the same purpose.

Short-term gains and losses should be reflected as trading transactions fully includible in income or offset against other income if a net loss. This treatment would create a clearer distinction between traders and investors. A suitable short-term cut off might be one year, with a phase in of the extended period by one or two month intervals over a number of years to avoid complications in the securities market. The extension of the short-term holding period should help to restore confidence in the fairness of the capital gains tax system.

Gains on assets held beyond the short-term trading period could be included on an annual sliding scale at reductions of say 10% per year (but to not less than perhaps 20%) or alternatively by brackets of years and percentages. However, too large a reduction for holding assets slightly longer may create temporary "lock-in" disadvantages. On a consistent basis, long-term losses should be allowed to offset long-term gains on the same scale.

It might well be that the sliding scale approach would also encourage more public offerings of securities in closely held companies as contrasted with present law which gives encouragement to tax-free mergers with larger corporations to overcome the "lock-in" and secure diversification.

4. Eliminate the reduction in "earned income" attributable to the 50% capital gains deduction for maximum tax purposes

One of the most important provisions in the Revenue Act of 1969 was that pertaining to the maximum tax on "earned income." Now that the 50% rate has been phased in, greater equity applies in taxing salaries and profits attributable to personal services, and the incentive to engage in planning to defer taxation has been greatly diminished. However, the inclusion of the 50% capital gains deduction as an item of "tax preference" that reduces "earned income" to which the maximum tax may be applied appears completely inequitable.

The inclusion of only 50% of long-term capital gains in income is not a true preference, but is in reality a measurement of maximum tax on such gains. Mechanically, the entire gain could just as well be included with a 35% top rate made applicable and, in fact, this is the way the tax is generally understood. The 50% deduction is not a "tax shelter" as it cannot offset independently generated income which would otherwise be taxed as ordinary income. The net effect of including the capital gain deduction as a tax preference is that people who work for a living pay higher capital gains taxes than those who merely live off their wealth. The public policy aspect of this treatment escapes logic.

5. (a) Allow corporations to recoup currently capital losses at the same rate as capital gains are taxed, or (b) In any event, extend the capital loss carryover provisions without limitation

Capital losses are deductible by corporations under present law only to the extent of capital gains. Any excess losses are entitled to a three-year carryback and a five-year carryforward. These provisions appear unduly restrictive and should be modified.

Generally the business of a corporation is "business" and not the generation of capital gains. There are many instances, however, in which it is desirable that temporarily idle funds be invested in other enterprises or direct investments. The non-business risk elements and time factors involved justify treating resulting gains in a category different from ordinary income. The restrictive provisions relating to the deduction of losses, however, may create adverse "lock-in" effects at the corporate level. In the meantime the special punitive provisions of the Internal Revenue Code relating to unreasonable accumulations of surplus and personal holding companies are safeguards against the improper use of corporations as tax haven pocketbooks.

It is suggested, accordingly, that an economic loss sustained by a corporation on capital transactions should be recognized at the same tax rate as would be applied if a net gain were realized.

In any event, the current limitation on the length of the carryforward of a capital loss should be eliminated. Present law creates a "lock-in" which discourages disposition of loss assets, and encourages the use of forced measures to create capital gains. Neither of these alternatives appear desirable to the economy as a whole.

Comments on alternative suggestions for taxing long-term capital gains

The responsible proponents of eliminating the tax distinction between capital gains and ordinary income generally concede that further refinements would then be required in the interest of equity. Price level adjustments should be recognized in order to minimize taxing the non-economic gain. Capital losses should also be allowed consistent with the taxation of gains. In order to avoid the taking of losses, but deferring of gains, a periodic determination and taxation of unrealized appreciation is frequently advocated. If these alternative principles of taxing long-term capital gains and losses were adopted the result might well approximate the present system of taxation coupled with the sliding scale approach. They would, however, introduce into the tax laws complexities in application and administration of perhaps unmanageable proportions.

Valuation as a problem

The specter of periodically valuing every closely-held business in the United States is mind boggling (let alone art work, jewels, silverware, farm land, etc.). The proponents of taxing unrealized gain, recognizing the valuation problem, start a steady retreat; exception after exception is added to the list of items which will not be taxed until the gain is actually realized. Some proponents of taxing unrealized gains have compromised to the point of suggesting that only the gain on publicly traded securities be recognized. However, such a policy would surely discourage investing in public companies vis-a-vis other investments, such as real estate. It would also act as a strong impetus to keeping privately held companies from going public; can you imagine taking a successful company public if it would subject all its stock to taxation at the next valuation date?

Liquidity as a problem

The taxation of unrealized gains also presents a liquidity problem; where will the money come from to pay the tax? Some, recognizing liquidity (but not valuation) as a problem, would tax all gains, but defer the tax due on closely-held businesses until (1) the closely-held stock is disposed of by sale or gift, (2) the stock becomes a liquid asset (e.g., the company goes public), or (3) the owner dies. Others have suggested that, pending payment, the tax would merely be a debt which would draw interest or that the government should receive an immediate equity interest in the property in question. The creation of a debt might well involve the usual security devices the government imposes when a taxpayer owes money—posting of bonds, jeopardy assessments, attachments, etc. The implications to private borrowings and mobility of capital of such procedures could well be enormous.

It appears we would be well advised to steer clear of such a tangled web approach to the taxation of long-term capital gains and retain the basic distinguishment inherent in the present law which has worked so well for half a century.

EXHIBIT I

There follow summaries of how several major industrial countries tax individuals on capital gains from portfolio securities held for investment:

CANADA

Canada has taxed capital gains only since 1972. Marketable securities take as their cost basis their fair market value on December 22, 1971 (or original cost, if less, if sold as a loss).

The Canadian taxation of capital gains of individuals is similar to that of the U.S. One half of net long-term capital gain on securities hold for investment is included in income. If transactions for a year are a net loss, an individual may deduct the lesser of $1,000 or 50 percent of the loss. Unlike the U.S., there is no holding period requirement for capital gains treatment.

FRANCE

France does not tax capital gains of individuals on portfolio securities held for investment.

Gain on stock is subject to tax at a flat rate of eight percent where (1) the seller or a close relative was the director or manager of the company during the previous five years, (2) the seller's share of the company profits was greater than 25 percent during the previous five years, *and* (3) the gain exceeds F 1,000 (approximately $240).

WEST GERMANY

West Germany does not tax individuals on long-term capital gains from portfolio securities held for investment. Short-term gains (six months or less) are taxed in full.

Gain from the disposition of stock held by a "substantial investor" is taxed at half the regular rate. A "substantial investor" is one who during the five year period preceding the date of transfer owned directly more than 25 percent of the outstanding stock. Losses can be offset against income or gain from other sources.

ITALY

Italy does not tax individuals on capital gains from securities held for investment.

JAPAN

Japan does not tax capital gains of individuals on securities held for investment if his trading activity during a year is less than 50 trades and 200,000 shares. Trading in excess of these limits subjects all security transactions to taxation.

If the limit is passed 100 percent of net short-term gains (5 year holding period) and 50 percent of long-term gains are included in taxable income (after a statutory capital gains deduction of ¥400,000—approximately $1,500).

Net capital loss for a year offsets other income without limitation.

THE NETHERLANDS

The Netherlands does not tax individuals on capital gains from portfolio securities held for investment. However, if the seller has a substantial interest in the corporation the gain is taxed at the lesser of (1) the ordinary rates or (2) a flat 20 percent.

An interest is deemed to be substantial of (1) the seller and his family own one-third or more of the outstanding shares *and* (2) the seller's direct interest amounts to seven percent or more of the outstanding shares.

UNITED KINGDOM

The U.K. did not tax capital gains until 1965. Marketable securities take as their cost basis their fair market value on April 6, 1965.

Net annual capital gains of individuals from securities held for investment are taxed at the *lesser* of the following:

1. A flat 30 percent; or
2. Half of the first £5,000 of gain and all in excess of £5,000 included in ordinary income. An investment income surcharge of 15% on investment income over £2,000 is added to the tax initially computed. Investment income, for this purpose, includes capital gains.

REMARKS OF JEFFREY M. BUCHER, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM TO THE CONFERENCE OF THE WESTERN SECTION OF THE TRUST DIVISION OF THE AMERICAN BANKERS ASSOCIATION HONOLULU, SEPTEMBER 21, 1973

For the past 21 months the Report of the Presidential Commission on Financial Structure and Regulation, headed by Reed O. Hunt, has been a leading element in the climate of change stirring throughout the financial community of this country. Both the existing structural configurations and the practices of financial institutions have been embroiled in controversy in some respects reminiscent of the 1930's era of reform. The Hunt Commission was not the sole source of this atmosphere, as we can see changes initiated from other parts of the government as well as the private sector. The environment appears to augur a substantial probability that some changes will come to pass and that among them the trust activities of banks will not be overlooked.

On the regulatory—or to put it more broadly, the governmental-side of these events, there have been a number of first approximation responses to the Hunt Commission Report and the climate of change. The most notable was a Presidential message to the Congress early in August suggesting seven major legislative proposals "designed to strengthen and revitalize our financial institutions" so as to allow them "to adapt to the changing needs of borrowers and lenders (and) make full use of technological innovations." To date there have been no Administration proposals directly affecting trust activities, but given the Hunt Commission and Congressional proposals, some legislative reactions should probably be anticipated.

In the Congress the stirrings have been varied. The House Banking and Currency Committee chaired by Representative Wright Patman just last week began hearings which in part focus on reforming the nation's financial institutions and their regulation. The staff of the House Banking and Currency Committee has issued a Staff Report titled "Financial Institutions: Reform and the Public Interest" in which recommendations for general banking reform at least as comprehensive as those of the Hunt Commission are outlined.

Whether any of these recommendations, reports, or legislative proposals will appear in the near future in the form of new law, is an open question. However, taken comprehensively they indicate a rather general questioning of the present structure and operations of financial institutions and of the form and nature of governmental regulation of the financial world. In this connection, the greatest present significance of the questioning may lie in what appears to be widespread hospitality for the idea of the need for substantial changes that would affect the financial community both broadly and deeply.

Recently, one can also sense some ferment in the private sector. Changes arising from this unrest have both governmental and private origins, but banks, particularly trust departments, have responded voluntarily to some of these forces. For example, recent public concern about the voting of stock held in trust portfolios—when issues of social responsibility or when management-shareholder disagreements were present—has resulted in the development of recommended guidelines by the American Bankers Association. In another case, the Justice Department criticized as an alleged "restraint of trade" the interest of banks in the deposits of those stockbrokers who receive commissions for carrying out the securities transactions of thir trust departments.

The mere threat of Justice Department action, along with some journalistic criticism of the practice, has led to the voluntary elimination of "tie-in" practices of this type by most institutions. For various reasons, we also are seeing the creation of investment advisory company subsidiaries in bank holding companies, which in effect constitute a spinning-off of investment research and portfolio management services from the bank trust department to a semiautonomous subsidiary. The establishment of these companies constitutes one example of how banks on their own initiative are effecting significant structural and operational change in their trust activities.

I hope these observations will help us to place the remainder of our discussion in the context of a changing environment to which we must be perceptive and responsive. Trust activities are by no means the only focus of public attention, or perhaps even the most likely area where change will occur first. Nonetheless, I feel the proposals for change merit close scrutiny.

PROPOSALS FOR CHANGE IN TRUST DEPARTMENT OPERATION

Specific proposals concerning the future of trust operations are of particular interest. In part, the Hunt Commission recommended:

That banks with total trust assets of greater than $200 million should be required to build a wall between their trust and commercial banking operations, denying to trust department investment personnel access to credit information accumulated by the commercial banking division of the bank.

That no director, officer or employee of a corporate fiduciary recommend or initiate any purchase or sale of securities on the basis of insider information.

That the "prudent man rule" should become a universal requirement by making it a part of Federal bank law.

That bank holding companies be permitted to set up a single affiliate to carry on the trust activities of all the banks in the holding company.

That, state law permitting, bank holding companies be allowed to operate system-wide common trust funds among all affiliate banks with trust powers.

The section on trust operations of the study by the staff of the House Banking and Currency Committee included these principal observations and recommenda-

tions—intended to generate debate—and I would emphasize that this was a staff, not a Committee product:

There exists a potential conflict of interest when commercial banks extend credit to corporations while holding enormous corporate assets in their trust departments; moreover, trust department operations in securities markets pose a potential threat of circumvention of the Glass-Steagall Act's requirements.

Such circumstances "argue strongly for separation of commercial and trust departments of commercial banks."

As an alternative to present arrangements, there is proposed the creation of a Federal Trust Management Commission "to regulate and supervise the management of all foundation funds, charitable trusts and pension funds."

Provision could be made for the licensing of "special investment advisory corporations, devoted solely to the management of all pension, foundation and charitable trust investments" and qualifying "for management of private trusts as well." All officers and employees of these corporations would be prohibited from having business relationships with any other corporate entity.

That trust companies resulting from the proposed complete separation of trust departments from commercial banks could qualify as such "special investment advisory corporations."

Finally, that "the required separation should not, perhaps, apply to banks which hold trust assets of $200 million or less."

THE BACKGROUND

There is an evident malaise about bank trust operations, too broad to be attributed solely to suspicion of the commercial banking system. In particular the Hunt Commission, if it is judged by its leadership, personnel, and its Report, was an advocate of change in banking structure because it believed in the system and wanted to preserve banking's legitimate role in the United States economy. Yet it suggested that information and operational barriers be put up between trust departments and other commercial bank functions, while the House Banking Committee staff has gone so far as to recommend not just a "wall" between trust and commercial banking but complete separation.

I am uneasy about these matters, because I feel that the banking system as it operates in the United States is too important an economic factor to be permitted to lose public confidence. In looking at all of these proposed reforms together, it seems to me that the concerns stimulating them are rooted in several aspects of commercial bank trust operations. These include the tremendous size of commercial bank trust department holdings; evident possibilities for conflict of interest between trust and other bank operations; and, very importantly, the impact of trust operations on the economy as a whole, particularly in the equities and bond markets.

The Federal Reserve Bank of New York recently published a two-part study of commercial bank trust operations which gave some analytical clarity to these misgivings. Let me cite the following findings:

Commercial banks are administrators of a large part of the nation's intangible wealth. Personal trust departments of the banks administer, either as trustee or agent, the largest aggregate of investment funds in the country—$292 billion at the end of 1970 and $343 billion at the end of 1971—equivalent at the end of 1970 to almost two-thirds of the commercial banking assets held by the same banks and almost half again as large as the pool of fiduciary funds administered by life insurance companies. The 1970 total was an increase of 50 per cent in six years. In 1971 alone, the increase was 17.5 per cent, 70 per cent of the increase being appreciation of assets. That is to say—if I may comment at this point—that this is an aggregate which, given even moderately competent handling, cannot help but grow with a rapidity which, in turn, cannot help but provide further evidence for those who voice concern over such concentration of resources.

Approximately one quarter of personal trust funds held by commercial banks in 1970 was concentrated in just five banks, and half in 21 banks.

Employee benefit trust funds accounted for approximately a third of the personal trust-fund totals in both 1970 and 1971, and has been the fastest growing principal component of commercial bank trust holdings since the early 1960's.

Certain categories of commercial banks' fiduciary assets are impressive not only in absolute terms but also as percentages of the total of such securities outstanding. This is particularly striking with regard to equities and corporate bonds, with trust department fiduciary holdings accounting in 1971 for 22.4 per cent and 20 per cent, respectively, of the outstanding totals.

Banks have maintained their position into the seventies as far and away the largest public traders in the equities markets.

The sheer size of financial assets held by commercial banks as fiduciaries has awakened strong public interest and even fears.

Concern has been expressed, too, about the potential for conflicts of interest. At many banks the funds deposited by trust departments in their own bank are larger than those of the bank's largest outside depositor.

The staff study of the House Banking and Currency Committee is much more explicit on the subject of possible conflicts of interest, asserting that:

Trust department officials can take unfair advantage of loan activity information available in the commercial bank.

Trust department investments can be used to help *bail out* an ailing corporation which is heavily indebted to the commercial bank; or, the opposite case, in which the bank lends to help a badly managed company in which the trust department has invested.

Loans can be withheld from competitors of corporations that are heavily represented in the investment portfolios of trust accounts, thereby diminishing the ability to compete.

In view of such indications of accumulating concern about the operations of trust departments of commercial banks, the author of a recent article in the *Yale Law Review* suggests, as one viable alternative, "separate incorporation of the trust department outside the bank complex." However, this author points out that separation could have its abuses also, in the form of "sweetheart" arrangements between the bank and the trust department separated from it. Further, one could point out that the mere separation by creation of a subsidiary company, does not substantially alleviate the problems of concentration or regulation.

ONE REGULATOR'S VIEWS

From the foregoing discussion, we see an underlying ferment with respect to the future shape and operation of the nation's financial system as well as with regard to the role and structure of governmental regulation of financial institutions. The trust departments of commercial banks appear to be contributing significantly to the general uneasiness. I want to state very clearly that while I can see an understandable basis for misgivings about commercial bank trust departments, current criticisms and assertions appear to relate to potential or possible abuses. Few emperical studies have been made of these alleged conflicts of interest. There has been no litigation in the area of the magnitude of, for example, the *Texas Gulf Sulphur* case on the question of improper use of insider information. This, along with personal observations and experiences, leads me to believe trust activities to be very largely operated by honorable men who do their best to keep possibly conflicting interests at arm's length. I feel as did Justice Cardozo in the famous old New York case of *Meinhard* v. *Salmon*, there Cardozo remarked that the fiduciary responsibility, like that demanded in operating trust activities, is a very high standard of conduct "not the morals of the market place but the punctilio of an honor the most sensitive." I think this would continue to be the case in the future without structural change or additional governmental regulation.

However, the problem is not one of whether or not we must regulate more stringently the conduct of honorable men, but the trust department's public image. What then is the issue with which we are confronted at this time? Increasingly it appears to me that the problem is one of recognizing that our banks, because of their unique pivotal economic role and enormous economic power, must not only avoid actual abuse of their powers but, like our judicial system, even the appearance of such insofar as they are capable of performing their duties. As William J. Copeland, Vice Chairman of Pittsburgh National Bank, said recently, the trust department's "problem with the public is not what we *are* but what we *appear* to be." If the public perceives, and to some extent believes these problems exist, their confidence will decline, regardless of the objectively viewed reality. The "wall" must take a form such that the public will be assured that it is a sufficient barrier to abuse. The reinforcement of the "wall" can be initiated by the government, or by the banking industry. I would prefer to see the latter.

Now is the time for action because the assets of commercial bank trust departments have grown so great, their operations can have such an impact on critical markets, and the potential for conflict of interest has become so pervasive. Therefore, I confess I must be counted among those hospitable to the idea that change

must be given serious consideration. The separation of trust and commercial banking activities in a holding company would relieve the risk of the dangers associated with these potentials for abuse and could bring positive benefits to the whole banking enterprise as well. I feel that in many respects a trust subsidiary or affiliate, as opposed to a trust department or division, would be a far smaller liability to the nation's banking system in the public's eyes.

Here I speak only for myself, as the Federal Reserve Board has not taken a position on the future of trust departments. I do not even know the thinking of my colleagues on this subject, as a body or as individuals. To that, I would add that my position, so far as specifics of change go, is not yet final in all of its details. However, it is my view that there are good arguments in favor of change in the relationship of commercial bank trust operations to the rest of commercial banking.

What shape should this change take? I do not want to be dogmatic here, because I think there are probably several possible solutions ranging from Vice Chairman Copeland's suggestions about improved public relations to the House Banking and Currency Committee staff's ideas for a major restructuring of the industry. At this time, I am inclined to say that the bank holding company offers a solution that could go far toward solving both the banking and the regulatory problems involved.

Mr. Copeland's emphasis on the image of trust department's is the correct focus, but fails to attack the separation problem. The proposals in the study by the staff of the House committee have not been fully developed yet, so I will reserve any evaluation until later. However, their general thrust suggests that additional regulatory organizations need to be established specifically for trust operations. Although there could be improvements, I feel the present framework is adequate.

As a practical matter, I think banks that are in bank holding companies present virtually the whole problem, because they include nearly all the large banks with large trust departments. You will recall that the study published by the New York Federal Reserve Bank noted that half of personal trust funds administered by commercial banks was in 21 banks. This study also found that in 1971 nearly nine-tenths of the employee benefit trust fund assets at banks was lodged at 59 banks with trust assets of more than $1 billion each. Since holding company groups mid-way in 1972 included banks with 60 per cent of all commercial bank assets in the United States, few of the larger banks remain outside the holding company format.

Wherever the line is drawn for a required break-off of trust from commercial bank activities, I do not think this would cause an exodus of large banks with large trust departments from holding companies. If the rationale for the suggested $200 million boundary is the potential conflicts of interest arising from trust department's holdings in securities of companies to which the bank is extending credit, then I think the barrier could be raised substantially and still be effective. I feel this asset level should be more extensively researched to provide an optimum point where additional regulation attaches. Actually line-drawing is largely irrelevant as these banks have many other interests in remaining within the holding company format. Further, from what I know of the current operating rules. particularly in the larger institutions, bankers and trust men follow rules that, for all practical purposes, already accomplish the total separation of commercial banking and trust activities.

I should add that one of the basic statutory rules governing banks is a bar to tie-in arrangements with their affiliates. Another basic rule is that affiliation with a holding company should carry with it a positive public benefit. Assuming the legal separation of trust departments as entities in bank holding companies, these statutory requirements would strengthen the Board's hand in promulgating rules to avoid conflicts of interest, or other anticompetitive effects, between banks and trust companies in a bank holding company.

This regulatory framework would be built upon the existing foundation of Board regulation for trust departments which has as its primary purpose the avoidance of trust activities placing undue liability upon the bank, or disadvantaging trust beneficiaries. Since, as a practical matter, the insulation of the bank from the liabilities of a holding company subsidiary might be difficult, the avoidance of liability would still be a very important aspect of regulation, as would also the protection of trust beneficiaries.

The separation of trust departments of banks in a bank holding company, as distinct corporate entities, would, I believe, solve most of the objectionable aspects that are gathering in the public's view around bank operated trust depart-

ments. Problems of supervision and regulation would remain as before the separation and additional safeguards to insure independent operation would have to be employed, but these would be the regulators' problems.

I think there might be other benefits as well. These benefits come from greater attention to cost accounting as related to the trust function and certain economies of scale derived from the consolidation of duplicative activities within the holding company. I would expect a further swing from a reliance on "balance credits" as a crutch to support trust department earnings to a "fee basis" measurement of profitability for the separate trust company. This would, I hope, establish the trust subsidiary as an "earner" so that capital could be more efficiently allocated based on expected rate of return. Presently bank managers seem to have real difficulty in deciding how to allocate funds to the trust department. Profit planning and performance should be enhanced through the creation of a subsidiary which must compete for capital with the other holding company affiliates. Thus, the separated trust operation could be viewed as a separate whole, and decisions would be made to continue or discontinue services because they do or do not add, directly or indirectly, to the profitability of the trust company. Furthermore, the commercial bankers could no longer be heard to complain about the trust department's drag on institutional profits.

Consolidation of the individual trust operations of bank holding company banks into one unit is likely to produce efficiencies of scale which can also contribute to holding company earnings. By eliminating duplications among the banks, the administrative advantage of uniformity could lower operating costs and control problems without impairing the overall level of services rendered to the public.

From the bank management point of view, the creation of a trust subsidiary might have several additional advantages. In recent years the investment advisory activities of trust departments have been subjected to increased competition. The trust department "product" could be marketed more effectively, perhaps, by removing it from the unromantic image of the stodgy bank trust department. A further advantage could be the achievements of trust managers, since the subsidiary would not be subordinate to the bank, and management would become more goal oriented.

However, it is my view that the largest and most enduring benefit would inure to the nation's banking system as a whole, by lifting from it a growing burden of public doubt. As a matter of public perception, regardless of what is believed by trustmen, the "Chinese Wall" lacks sufficient strength to resist the abuses of economic power and conflicts of interest. I see no evidence to suggest that the issues of trust operations or holdings will disappear from public attention. The only reasonably expectable reaction is a public outcry for the breakup of the agglomerations of money and economic power represented by commercial banks.

It is my opinion that by moving the trust department a definitive step away from the commercial bank, in a bank holding company, we would accomplish most of the good that could come from simple breakup, and avoid the ills that beset any economic violence in the form of highly restrictive legislation. This is a worthy objective indeed.

NEW YORK, N.Y.

Senator LLOYD BENTSEN,
Chairman of the Subcommittee on Financial Markets,
U.S. Senate.

THE IMPACT ON INSTITUTIONAL INVESTORS IN THE STOCK MARKET

For the record, my name is Andrew G. Racz. I am Chairman of a research division of a New York Stock Exchange Member Firm. My department deals with institutional as well as private clients. For the purpose of illustration, we prepare lengthy reports, anywhere between 10 and 40 pages, for dissemination to our clients. Our compensation is generated from the commissions generated by our customers' transactions.

The purpose of my testimony is to illustrate certain aspects of the disequilibrium of the equity markets in the United States. I approached Sen. Lloyd Bentsen to point out that unlike many other people in Wall Street who recognized the problems which had been described in countless number of articles, my research group has come forward with a number of suggestions to help correct the major imbalance on the marketplace.

By way of personal background, I was born in Budapest, Hungary, in 1938, and left during the Hungarian uprising. I was educated in the U.K. at the Universities of London and Cambridge and was a visiting student at the University of Munich, Germany. During each summer vacation I visited and worked in Switzerland and South Africa, having received my first introduction to the stock markets in Johannesburg, S.A. My research thesis at Cambridge University dealt with the computerised analysis of portfolio management. During the past 12 years I have worked as a security analyst in England, and later in the U.S.

The so-called two-tier market and its consequences first came to our attention around the middle of 1972. By the early part of 1973 we had seen the establishment of subsidiaries of various European merchant banks in the U.S., some of which today are well known such as Slater Walker of America, L d., Triumph America, Ralli America, and the Vavassour Group of America. I trust there are many other similar subsidiaries; and, in fact, several brokerage houses from London such as Casanova have recently opened an office in New York. The two-tier market has created many opportunities for foreign investors, including takeovers. The first major one which we have witnessed in close proximity was the tender offer by Triumph America, Inc., an 82%-owned subsidiary of Triumph Investment Trust, Ltd., from London. Triumph offered $18.50 per share for 51% of the common stock of General Host, a half-billion dollar meat packing, food distributing and bakery company, which is listed on the New York Stock Exchange. General Host had large cash reserves, as well as substantial operating tax loss carry forwards and capital loss carry forwards. At the time of the tender offer, the corporation had a net working capital of close to $90 million. The tender offer was unsuccessful. At that time, March 20, 1973, we prepared a report where we tried to describe the significance of this event:

"The entry of Great Britain into the Common Market opens the possibility that Throgmorton Street ('The City'), with its unique merchant-banking capability, might again become the center of European finance. London, the traditional headquarters of the growing $90 billion Eurodollar market, might introduce to 'The Street' what J. J. Servan-Schreiber would describe as 'The European Challenge.'

In this unusual international corporate drama only the opening chapters have been written; the story has yet to unfold. Regardless of the outcome of the Triumph-General Host tender offer it represents a noval episode in the history of international high finance.

The alliance of Thomas Whyte, a self-made imaginative, Hungarian-born, empire builder and Alan Gruber, an unassuming, successful, thoroughly professional, modern American businessman could prove to the world that the *Transatlantic merger movement will never again be a one-way street.*"

Having been educated in England and thus gaining an understanding of the freewheeling atmosphere within which British merchant banks are permitted to operate in the City of London, the take-over was no surprise to me. The rapid growth of Triumph Investment Trust, Ltd., while admirable was by no means totally unique among its competitors. Pre-tax profit has increased from £49,000 in 1965 to £4,427,000 in fiscal 1972 (year ends March 31). Triumph Investment Trust today controls well over a billion dollars in assets. Obviously, it was not lacking in cash to take advantage of the deeply depressed price of General Host which at $13.00 was truly representative of the U.S. market. Making a tender offer at $18.50, Triumph would have acquired a major American company on the New York Stock Exchange.

HISTORICAL RECORD OF TRIUMPH INVESTMENT TRUST

[Expressed in pound sterling]

	Profits pretax (thousands)	Earnings per share (percent)	Dividend per share (percent)
Fiscal year ended Mar. 31:			
1965	49	0.56	0.47
1966	168	1.39	.94
1967	221	1.82	.94
1968	344	2.58	1.67
1969	1,296	5.63	1.73
1970	2,154	7.98	5.42
1971	3,374	11.21	6.88
1972	4,427	14.38	8.25

The profit before parent company overhead stated above is earned in the following areas of the world:

[In thousands of pounds]

	1972		1971	
	Amount	Percent	Amount	Percent
United Kingdom	3,450	68.7	2,384	62.4
North America	718	14.3	1,225	32.1
Other countries	853	17.0	210	5.5
Profit before parent overhead	5,021	100.0	3,819	100.0

Since Mr. G. T. Whyte, an internationally known financier, took control in 1964, the company has posted a 63% znnual compound rate of growth in earnings per share. This growth was generated both internally and through acquisition.

Furthermore, we have tried to illustrate that Triumph's offer for 51% of General Host marked only the beginning of similar tenders for depressed U.S. equities. There have been distinct reasons why such tender offers suddenly became popular, and in the report we have given detailed reasons for the sudden change of climate, for the sudden attraction of such corporate maneuvers:

"The international monetary crisis has created unusual opportunities for asset rich European companies to expand in the U.S.A.

(*a*) A series of devaluations rendered European purchases of U.S. securities approximately 15%-20% cheaper than, say, two years ago.

(*b*) The $90 billion Eurodollar market is highly receptive to dollar loans. The recent flight from the U.S. currency has become an international problem. The recent monetary agreement in Paris refers to rising U.S. short term interest rates and the possible issuance of long term U.S. government securities to absorb the unwanted dollars deposited abroad. (Yet, according to some expert opinions the Eurodollar market might grow as large as $200 billion by 1980–82.)

(*c*) The American stock market, excluding a few selected high-grade securities, is basically in a four-year downtrend. Secondary securities even large cash-rich companies are selling at historically low multiples. Price/earnings ratios among cyclicals and conglomerates appear especially depressed. Some of these large companies sell at 40–70% of their reported book values.

Obviously, in this market climate it is very difficult to generate interest for portfolio investments among overseas investors. At the same time the very U.S. companies that are disregarded for short or medium term investments have become interesting candidates for acquisitions.

In retrospect our prognosis has been totally correct. In the Subcommittee's report in Part 1 covering hearings of July 24, 25, and 26, 1973, on page 183 a number of successful tender offers have been listed which were all subsequent to the Triumph/General Host tender. (See table from page 183.) While it may sound repetitive, let me quote again:

"The entry of Great Britain into the Common Market opens the possibility that Throgmorton Street ('The City'), with its unique merchant banking capability, might again become the center of European finance. London, the traditional headquarters of the growing Eurodollar market, could introduce to 'The Street' what J. J. Servan-Schreiber might describe as 'The European Challenge.' "

During the summer, of course, we have witnessed perhaps the worst bear market since 1929. Brokerage houses as well as their clientele suffered major losses. The two-tier market has reached its zenith and it was impossible to approach institutions with anything except the highest quality, so-called "one decision" stocks for equity investment. Private investors by the summer of 1973 were almost completely out of the market.

Having recognized the problem, we tried to come up with an answer. Approximately in June, 1973, we addressed letters to several dozen corporate chairmen, a process which still continues. Let me quote:

"DEAR MR. CHAIRMAN: Our recent research among stocks listed on the major stock exchanges indicates to us that your company's shares, along with hundreds of others, are selling at a relatively modest price/earnings multiple. At present, your shares are not represented in institutional portfolios . . .

. . . Our organization very rarely recommends high flyers for the simple reason that we believe they are often yesterday's heroes and the downside risk on a high-multiple stock does not lend itself to a proper investment recommendation.

You and many of your friends are probably frustrated . . . and you must also be disillusioned by the four-year old bear market that has been battering securities such as yours.

Now let me ask you a straightforward question.

Have you ever done anything about it? *Waiting for regulatory changes may be proper but you know as well as I that today our country is beset with political problems and the fact that stocks are selling at or near historically low price/earnings multiples is of little consequence to most people in Washington.* I wonder if you realize that it is in fact you who are supporting the current distortion in the American equity markets through a curious oversight.

Let me explain to you a very simple and interesting fact. The institutions, just like the Government of the United States, have no money. You support the Federal Government through your tax dollars and they are accountable to you periodically through your ballot.

In the same fashion, you also provide the money for institutions through:

a. Your pension plan;
b. Your group insurance policy;
c. Your profit sharing plan;
d. Your executive retirement plan.

With this in mind, why not call in your Treasurer and request an immediate rundown on the various portfolios that you have handed out to money management concerns? Then break down the percentage of your money that is invested in the selected 300 and how much is held in respectable, decent, well-run corporations such as yours. *I venture to suggest that you are supporting a system that is penalizing you as well as your stockholders* because you will not find many low multiple *stocks in the above-mentioned portfolios.*

Racz-Rooney Research feels that the individuals who could best do something about this situation are those who are directly affected by it! Accordingly, why not evaluate the progress that your investment management firm has made during the last several years. Perhaps an organization possessing some original thought and new ideas instead of the old, unimaginative way of following the crowd would better suit the investment goals of your company's profit sharing, pension and retirement plans.

If executives like yourself in American Industry are more critical of the results achieved by their money managers, I firmly believe that these professionals will become more creative and thus explore many diverse avenues of investment. This will eventually bring the public investor back into the marketplace and concomitantly broaden the base of our equity markets and stem the tide of rapidly deteriorating liquidity on the nation's stock exchanges."

Among the many constructive answers the most encouraging response we have received was from Mr. Walter Kissinger, Chairman of the Board and Chief Executive Officer of The Allen Group, Inc., listed on the NYSE. The letter reads as follows:

"DEAR ANDREW: Your letter regarding the disproportionate interest among large institutional investors in a limited number of high multiple stocks struck a very responsive chord. I believe that this dislocation in the equity market is one that could lead to a greater concentration of foreign ownership and control of some domestic industries."

Encouraged from the various responses, we have started a newsletter called "Fundamentals Revisted" (Undervalued and Overlooked Securities). We have tried to focus attention on companies satisfying the following criteria:

1. The company should be well capitalized;
2. The stock should have a low price/earnings multiple;
3. We could with reasonable certainty point to earnings gains for the next two to three years.

These selected securities had been totally out of favor for several years. Our recommendations in the last three editions included seven securities. The date of the recommendation and the current price are listed in the table below. (See Table 1.)

	Date recommended	Price recommended	Current price
AZE—American Maize Products	July 27	7¼	7
ALN—The Allen Group	May 28	11	11
ARW—Arrow Electronics	July 27	6⅝	6¾
ITP—Interpool Ltd	Aug. 27	14⅝	16¾
WII—Wolverine Industries	do	6	6⅜
CHNL—Channel Cos	do	5⅝	7¾
MG—Monogram Industries	Sept. 21	7⅛	7⅛

Simultaneously, we have started to recommend corporate securities which have a wide representation in the energy field. The disproportionate performance between these two groups is wide and quite interesting. (See Energy List.)

During the month of August and prior to the Labor Day Weekend, the stock market was in such a depressed state that merger negotiations between various investment banking firms was commonplace. The Exchange in the early part of August, 1973 published on the Dow Jones ticker tape that approximately 65 firms were on the strict surveillance list; meaning that their ratio of debt to equity was close to the dangerous 10:1 figure. Wall Street itself seemed ripe for a takeover! In the third edition of our newsletter we published an article called "Pearl Harbour Revisited", which dealt with the Japanese purchases of 500,000 shares of the common stock of Merrill, Lynch.

PEARL HARBOUR REVISITED

On August 27, 1973, it was announced that Japanese financial interests have accumulated an estimated 500,000 shares of the common stock of Merrill, Lynch. As the nation's largest security dealer, Merrill accounts for approximately 10% of the trading volume on the New York Stock Exchange.

Practically speaking, the Japanese have the same chance to take over Merrill, Lynch as they had to win the Second World War. To put in perspective just how remote that possibility actually was, one has only to go back to the late Sir Winston Churchill's reminder to the war time Japanese Foreign Minister when he pointed out that in 1941 U.S. Steel production was 75 million tons compared to the Japanese 7 million tons. Laws exist or could be easily legislated which could terminate any control of Merrill, Lynch by foreign interests. From a practical standpoint, with approximately 32.4 million shares outstanding, any threat appears remote. Yet, it would be foolish to disregard this transaction and not weigh the circumstances which have brought about the possible specture of a certain amount of Japanese control over Merrill, Lynch. It is an event of historical significance.

Perhaps the starting point was the guns and butter policy of the Johnson administration which set the stage for unprecendented inflation by the late 1960's and led to the accumulation of approximately $120 billion Eurodollars in foreign hands. This was theoretically backed by the frozen $10 billion worth of gold in the U.S. Treasury. At current market prices that gold, would no doubt, be perhaps three-fold its earlier value. In our opinion, both Presidents Johnson and Nixon dealth with foreign policy with a certain amount of disregard of U.S. economic affairs. During the last 2-1/2 years foreign policy was conducted at the risk of both politically and economically alienating some of our former allies.

The internal economic problems of the U.S. have created the second largest stock market slump in the century. Watergate did not help either. While it is difficult to point out direct correlations between stock prices and the nation's greatest constitutional crisis, Watergate undoubtedly helped lead to the apathy which is one of the biggest dangers for the stock market. Monetary factors aside, stock market enthusiasm is built largely on the psychological outlook. Has anybody heard recently the words "The American Dream"?

The institutions have not helped. By 1973, approximately 70% of the trading on the New York Stock Exchange was conducted by institutions. Many of these have concentrated their interest on a narrow list of about 100 issues. This has helped to create the lowest price/earnings multiple structure for most stocks in recent history.

The devaluations and the floating exchange rates have made the U.S. equity market approximately 30% cheaper than the Japanese was about two years ago. Merrill Lynch is owned by many people. It had some 130 partners before incorporation. While we do not seriously expect the Japanese to try to assume

control of Merrill Lynch, their recent action is another cause to sit up and take notice of what has been happening in the world.

While the U.S. has been preoccupied with political controversy, inflation, and "phaseology", the Japanese have buckled down to hard work and an intelligent application of their resources and manpower. The result is apparent throughout the world today. Japanese industry has risen from the ashes to challenge once dominant American products in almost every aspect of international competition.

Nowhere is this reality more vividly demonstrated than in the comparative figures for steel production. Remember when Sir Winston pointed to the overwhelming dominance of American steel? At that point our production was over 10 times the Japanese total; today they have pulled nearly abreast. Japanese steel output is expected to reach 132 million tons this year, within striking distance of estimated U.S. production on the order of 150 million tons. From all indications it won't be long before they pass us.

It seems we have come full circle in thirty years; Pearl Harbor is being revisited!

While in the article we emphasized that we simply do not see the possibility of the U.S. government permitting a foreign control over the largest security house of the nation, it was also equally clear to us that the only way to stop such a takeover, if ever attempted, was through legislative action. The utilization of legislative power against foreign takeovers is equivalent to torpedos and flying bombers in military warfare.

I want to emphasize that we do not wish to stop at this level. We plan to continue publishing our newsletter. Fundamentals Revisited, simply because we feel we bring attention to deserving companies and thereby fulfilling a useful social function. We realize that our time would be better rewarded by following larger securities but we feel that we have a great duty towards the American system that permits us to function as entrepreneurs.

Personally speaking, as an immigrant to the United States, I have always been a great believer in the American Dream. I have noticed with great regret that this expression has almost disappeared from our vocabulary and fewer numbers of young people contemplate a career in Wall Street.

Furthermore, we are regularly approaching union pension funds. The leaders of unions, just as corporate executives, have a responsibility to help the pension fund to be properly utilized. Union leadership in my opinion is elected to create more jobs, higher wages and better working conditions for their members and their prospective members. This cannot happen unless the American industry is healthy. Instead of trying to generalize, let me pick up a particular example upon which I have some pertinent statistics and knowledge.

In 1971 the United Mine Workers union won a major concession from the mine owners to install new and modern equipment to protect the miners from the vicissitudes of their profession. This was, in my opinion, a just and honorable settlement. At the same time, the amount of money that was required to modernize the mines could only be supplied by the largest and most powerful coal mines.

The two-tier market has rendered most of the coal stocks into the second tier. Accordingly, most of the smaller coal mine owners have found themselves unable to cope with the requirements. An article published by Barron's in December, 1972 stated that in calendar 1972, 850 coal mines had to shut down their operations. Even today the equities of leading coal mining corporations such as Pittston, Eastern Gas & Fuel and North American Coal sell at a price/earnings multiple of 15 or less. Yet, in order to expand their mining activities, to open up new mines, to modernize existing mines, to install the so-called long wall mining rechniques, to train the people, they require hundreds of millions of dollars. Now, let me ask the following question? If these coal mines were valuated based on the reserves that they have (the U.S. has 48% of the entire world's coal reserves!!) these stocks should be selling not at 10 or 15 but probably at 30, 35 multiples. At that price they could raise from the public the necessary amount of capital, expand their operations and create many thousands of jobs that are badly needed for the industry. I am not sure but I suspect that similar conditions exist among corporate as well as union pension funds!! As we have emphasized in our article "Pearl Harbour Revisited", today American steel production is hardly larger than that of the Japanese (150 million tons vs. 132 million), whereas 30 years ago it was in favor of the USA in a ten-fold magnitude. Steel stocks have been in a downtrend for the last 10 years. I wonder if the stock holdings of the pension funds of the steel workers union should not be submitted for examination!! I trust it is not necessary to explain to the honorable members of the Subcommittee the importance for the U.S. to have a healthy and growing steel and coal industry, particularly in the background of the current Middle East war.

While I fully appreciate that my name and achievements cannot be considered with the eminent members that have been representing the financial community at the first public hearing by the Subcommittee on financial markets. Nevertheless, I would like to assure the Subcommittee that our research group is fully committed to bring about more sense, and balance in selecting good investment values for our clients. Our aim is to correct this basic imbalance in the U.S. equity markets.

It is my firm personal belief that the strength of America is a free capitalistic society. The liquidity of the U.S. equity market serves as a base for the welfare of every citizen of the U.S.A. To be neglectful about this issue is a greater danger than permitting isolationism, and almost equivalent to rendering the U.S. to a second rate power. America will only flourish if its equity market and its currency remain strong.

It is my strong belief that if the legislative arm of our government, as well as our corporate and labor leadership, will recognize the common danger, then the current view that the '70's are likely to be dull and uneventful days in the equity markets will be dispelled forever. This nation has learned from the events of 1929, and so it will of 1973. The activities of your Subcommittee's hearings is one of the best testimonies to that effect.

Respectfully submitted,

ANDREW G. RACZ.

LIST OF ENERGY RELATED STOCKS

Company	Price, Aug. 17, 1973	Fully diluted			P/E ratio	Comment
		1971	1972	1973 (estimate)		
Alaska Interstate (AKI-NYSE).	26⅞	$1.31	$1.51	$1.20	22.4	Highly leveraged Indonesian oil and gas play and major participant in Trans Alaska pipeline project.
Atwood Oceanics (ATWD-OTC).	15¾	1.03	1.26	1.50	10.5	One of the fastest growing offshore drilling companies having demonstrated impressive growth during its 1st 2½ years of existence.
Banister Continental (BAN-ASE)[2].	21	1.15	1.93	1.20	17.5	Leader in Artic pipeline building technology. The most leveraged participant in building of Trans Alaska and other Artic pipelines.
Dresser Industries (DI-NYSE).[3]	44	2.23	2.62	3.00	14.7	Dresser will be a major benefactor of increasing oil and gas exploration and drilling activity. All major segments of the company are ready for sustained growth.
Eastern Gas & Fuel (EFU-NYSE).	16	1.58	1.75	1.55	10.3	When coal productivity picks up, good earnings advances are expected. Barge business should continue strong.
Helmerich & Payne (HP-NYSE).[1]	27½	1.05	1.25	1.55	17.7	Oil producer and driller. Will benefit from rising oil and gas prices, expanding production and higher drilling rates.
Overseas Shipholding (OSG-NYSE).	35⅝	1.95	2.40	3.00	11.9	Increasing worldwide demand for energy and expanding international trade indicates a strong demand for the company's tankers. Long-term chartering contracts give the company substantial sales and earnings visibility.
Pittston Co. (PCO-NYSE)...	22½	2.17	1.43	1.75-1.90	12.3	Largest capitalization coal stock. Should benefit with energy conscious investors taking new look at coal.
Raymond International, Inc. (RII-NYSE).	10⅞	.44	.76	1.10	9.9	A worldwide engineering company with substantial potential. The company is involved in various projects related to the exploration for oil and gas. Large potential from Trans Alaska and port construction.
SEDCO, Inc. (SED-NYSE)[4].	44⅝	1.42	1.75	2.45	18.2	Planned addition of about $150,000,000 of "state of the art" semisubmersible drilling rigs by early 1974 coupled with prospects for additional pipeline contracts creates substantial potential increase in company earnings.
Smith International (SII-NYSE).	21⅝	.71	.90	1.05	20.4	Broad based supplier of oil well drilling equipment. Recent equity financing should allow approximately 30 percent gains in net income over next few years. Being compared to Hughes Tool by some analysts.

See footnotes at end of table p. 271.

LIST OF ENERGY RELATED STOCKS—Continued

Company	Price, Aug. 17, 1973	Fully diluted 1971	Fully diluted 1972	Fully diluted 1973 (estimate)	P/E ratio	Comment
Trinity Indust.ies[2] (TRN-NYSE).	18⅞	1.67	1.72	2.80	6.7	Company is a metals fabricator with expertise in building con.ainers for the storage and transportation of LPG and other liquids, a market that continues to grow substantially. Likely to become factor in LNG containers. First quarter: reported $0.62 versus $0.19.
Williams Cos. (WMB-NYSE).	44⅝	3.13	3.62	4.10	10.1	Largest contributor to 1973 earnings will be fertilizer. Fertilizer was insignificant to earnings as recently as 1971. A prime contractor for Trans Alaska pipeline.

[1] Fiscal year ending Sept. 30, 1973.
[2] Fiscal year ending Mar. 31, 1973.
[3] Fiscal year ending Oct. 31, 1973.
[4] Fiscal year ending June 30, 1974.

O