STOCKHOLDERS INVESTMENT ACT OF 1974

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL MARKETS

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

ON

S. 2787

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO REVISE THE TAX TREATMENT OF GAINS AND LOSSES FROM THE SALE OR EXCHANGE OF CAPITAL ASSETS

S. 2842

AN ACT TO PROVIDE FOR THE CONTINUING AVAILABILITY OF CAPITAL FOR ECONOMIC GROWTH AND THE CREATION OF NEW JOBS AND TO PROVIDE FOR GREATER COMPETITIVENESS IN OUR ECONOMY BY AMENDING THE INTERNAL REVENUE CODE OF 1954 TO IMPOSE LIMITATIONS ON INSTITUTIONAL HOLDINGS OF SECURITIES AND TO ENCOURAGE INDIVIDUALS TO INVEST IN SECURITIES

FEBRUARY 5, AND 6, 1974

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STOCKHOLDERS INVESTMENT ACT OF 1974

TUESDAY, FEBRUARY 5, 1974

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

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2221 Dirksen Senate Office Building, Senator Lloyd Bentsen (chairman) presiding.

Present: Senators Bentsen and Bennett.

Senator BENTSEN. Ladies and gentlemen, the committee hearings will come to order.

We are obviously complying with the President's recommendations on temperature controls, saving some energy this morning.

Our first witnesses will be Mr. Roy Schotland and Dr. Edward Malca.

Mr. Schotland, Dr. Malca, would you gentlemen please come forward and be seated there?

This morning the Financial Markets Subcommittee is going to resume its hearings. We will receive testimony on S. 2842, the Stockholders Investment Act, which I introduced on December 20, 1973, as a result of the hearings that we had preceding that.

Now, this bill would place some limits through our tax laws on the degree to which managers of pension funds—and that is only totally discretionary funds—can concentrate their investments; and, in addition, this bill would provide tax incentives to the small investor, to hopefully encourage him to come into the stock market.

It is my feeling that this legislation is necessary for several reasons. First, the limitations on pension fund managers such as I propose would result in greater diversification of pension investments. It is my feeling that these are not onerous limitations. Subcommittee surveys indicate that the majority of pension fund managers already comply with limitations such as these. But there are aberrations on the part of some managers that could lead to abuse and to serious problems.

These kinds of limitations would spread available capital to a larger number of corporations and, in addition, provide safety to the future retirement benefits of more than 30 million Americans who participate in private pension plans.

Second, the tax incentives to encourage individual investment in the stock market I feel are very much needed these days to help industry raise the capital that is needed for business expansion for the future.

We have read the reports in the paper quite recently of many industries that are having a very difficult time in raising capital—the steel industry for one. The steel industry says, in effect, it is going to have to let part of the market go to foreign competitors because of the difficulty in raising capital for additional production.

Due to the lack of capital accumulation and investment in the past, our economy is therefore experiencing shortages in basic manufacturing capacity; and yet, at the same time this year we are seeing growing unemployment.

Our tax laws give direction to our free enterprise system. And I think it is essential to the economic well-being of every American that our tax system encourages adequate capital formation necessary for strong and continuous economic growth.

In addition to S. 2842, the subcommittee will receive testimony on other tax proposals to encourage individuals to invest in the stock market, for example, Senator Fannin's bill, S. 2787.

In conjunction with the resumption of these hearings, later this week I am releasing the details of a survey of the investments made by our Nation's leading bank trust departments. Last October I sent a questionnaire to the 25 largest bank trust departments; 21 of these banks have responded.

The results of this survey demonstrate the dramatic extent to which large banks sometimes concentrate their investments in a few securities. One bank, for example, has invested 14 percent of its discretionary assets in just one company, Avon.

I propose that no pension manager invest more than 5 percent of its aggregate discretionary pension assets in one stock.

The results of my bank trust survey also illustrate the potential exists for large institutions to control large portions of our economy. For example, the United States Trust Company holds more than 10 percent of the stock of five different companies. The Bank of New York holds more than 20 percent of the stock of two different companies.

I propose that no pension manager own more than 10 percent of the outstanding stock of a single large company with respect to the manager's aggregate discretionary pension assets. Obviously, we put a grandfather clause in there to protect against any wholesale dumping of stock where you have excesses already.

Many banks have voluntarily adopted limits of 10 percent or even lower. And I certainly congratulate them for doing so. I think it is prudent. I think it is wise management.

In previous hearings of the Financial Markets Subcommittee we learned that the number of individual stock investors, a group so essential to a healthy economy, has been declining; and the drop has been as much as 800,000 since early 1972.

Two of the provisions in S. 2842, the graduated capital gains proposal and the liberalized capital loss proposal, would help encourage greater individual investment in the stock market.

The ability of our economy to create new jobs and to provide the vast amounts of capital needed for economic expansion depends on a large number of individuals investing in the stock market—a multiplicity of decisionmakers, a free market.

We are fortunate to have this morning a wide variety of experts who will address themselves to these issues and comment on the legislation pending before the Subcommittee.

At this point I would like to insert a fact sheet and a statement describing S. 2842.

[The press release announcing these hearings, the material referred to by Senator Bentsen, and copies of S. 2787 and S. 2842, follow. Hearing commences on page 56.]

PRESS RELEASE

FOR IMMEDIATE RELEASE
January 10, 1974

COMMITTEE ON FINANCE
Subcommittee on Financial Markets
2227 Dirksen Senate Office Bldg.

SENATOR BENTSEN ANNOUNCES HEARINGS OF THE SUBCOMMITTEE ON FINANCIAL MARKETS, FEBRUARY 5 and 6, 1974

Senator Lloyd Bentsen (D-Texas), Chairman of the Subcommittee on Financial Markets, announced today that the Subcommittee will hold hearings February 5 and 6 on the Stockholders Investment Act.

The bill, S. 2842, would provide tax incentives to encourage small investors to invest in the stock market and would limit future acquisitions of stocks by managers of pension funds, through tax laws.

In addition to this legislation, introduced by Senator Bentsen, the Subcommittee will receive testimony on other proposals to encourage individuals to invest in the stock market, such as Senator Fannin's bill, S. 2787.

"Two series of Subcommittee hearings conducted last summer and fall clearly demonstrate the need for Congressional action to reverse several dangerous trends in our stock markets," Bentsen said in announcing the hearings.

Senator Bentsen cited three of these trends.

"First, there has been an increasing dominance of our securities markets by large institutional investors. In 1963, 35 percent of the trading on the New York Stock Exchange was attributable to institutions. Today that figure is 70 percent -- just double.

Second, institutional investments have become alarmingly concentrated in a small number of select stocks. As examples, one large bank trust has concentrated more than 20 percent of its discretionary stock market investments in just two issues. Another has concentrated more than 15 percent of its discretionary stock market investments in just two issues.

Third, the number of individual stock investors, who are so essential to a healthy economy, has been declining. It is estimated that the number of individual shareholders in the United States has declined by as many as 800,000 since early 1972."

Senator Bentsen stated that "these trends are having an adverse impact on the level of competition in our economy, and also on the ability of our economy to create new jobs and to provide the vast amounts of capital needed to meet such pressing challenges as our energy crisis."

Written requests to testify at the Subcommittee's hearings should be directed to Robert A. Best, Chief Economist, Senate Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D. C., before January 18.

Due to the shortness of time available for these hearings not all requests will be honored. However, those people who are not able to testify in person will be given an opportunity to submit wr en statements for the record.

FACT SHEET S. 2842
SENATOR LLOYD BENTSEN'S PROPOSED
"STOCKHOLDERS INVESTMENT
ACT OF 1973"

1. LIMITATIONS ON THE STOCK HOLDINGS OF PENSION MANAGERS -- No pension fund could qualify for favorable tax treatment unless the assets of the fund were placed in the hands of a manager who invests no more than 5% of its aggregate discretionary pension assets in any one equity security and, in addition, who acquires no more than 10% of any equity security of any one company with respect to the aggregate discretionary pension accounts. This limitation would not apply retroactively. Managers of pension accounts would not be forced to dispose of current stock holdings to meet these limitations, but they could not acquire additional shares of any security in which the pension manager had reached the limitation.

If any manager of tax-exempt pension funds exceeds these limitations (for example, by purchasing an additional 1% of the total equity securities of a company in which it already holds 10%), a penalty tax equal to 5% of the excess holdings would be imposed on the manager by the Internal Revenue Service. In the event that the manager fails to dispose of the excess holdings within 180 days, IRS will impose an additional penalty of 100% of the excess on the manager.

Excess holdings that result exclusively from fluctuations in market values will not be subject to a penalty tax. These limitations will not apply to investments in companies with a capital account of less than $25 million. These limitations apply only to pension plans and not profit-sharing plans.

Limits on institutional holdings are necessary to protect the more than 30 million private pension plan participants from excessive concentration of pension investments in only a few select stocks, and to encourage greater institutional interest in well-managed small and medium-size companies. In addition, these limits would help prevent a small number of large institutional investors from achieving too much control over our economy.

2. VENTURE CAPITAL FROM PENSION FUNDS -- Pension managers would be given leeway to invest 1% of the assets of any pension plan in companies with capital accounts of less than $25 million. This would be an exemption from any prudent man rule for 1% of the pension assets. However, the "leeway clause" would not relieve fiduciaries from any prohibitions against self-dealing or fraudulent transactions. The "leeway clause" would relieve a fiduciary from liability with respect to the risk of an investment.

This provision would facilitate the flow of pension investments to new and expanding smaller companies that are in great need of equity capital and which present a higher than normal risk but offer the possibility of a higher than normal return.

3. GRADUATED CAPITAL GAINS TAX -- Under present law, the maximum capital gains rate is 35% without regard to the special minimum tax provisions or any other provision. This legislation would decrease the maximum rate annually over the holding period of a capital asset until the maximum rate was reduced to about 14% for assets held fifteen years. Capital losses would be provided comparable sliding-scale treatment over the holding period of the asset. The present six month holding period for capital gains treatment would be extended to twelve months. This would be phased in by one month per year.

This provision would help reduce the "lock-in" of long-term assets and provide greater liquidity in our capital markets. A graduated capital gains rate would also encourage the risk-taking spirit in America which has been so important to economic growth and the creation of new jobs.

4. LIBERALIZED CAPITAL LOSS TREATMENT -- Today, if an individual's capital losses exceed his capital gains, he can deduct up to $1,000 against his ordinary income each year. This hasn't changed since 1942, yet per capital disposable income has risen over 400% since then. This bill would allow the individual to deduct up to $4,000 of capital losses against ordinary income. It would also allow a three-year carryback of capital losses against capital gains.

Liberalized loss treatment would encourage more risk investment which is so important in starting new businesses and creating new jobs. It would also encourage investors to take their losses, thus providing greater liquidity in our capital markets.

FLOOR STATEMENT OF SENATOR LLOYD BENTSEN
December 20, 1973

S. 2842 -- STOCKHOLDERS INVESTMENT ACT OF 1973

Mr. President, one of the foundations of our competitive, free enterprise system has been the existence of broad-based stock markets which serve as a source of capital for persons striving to go into business or to expand an existing business.

Our securities markets have provided the capital that enabled companies like IBM and Xerox -- which at one time were very small -- to grow, provide thousands of jobs, offer innovative and competitive products and make a major contribution to our economic expansion.

The maintenance of strong and viable capital markets is essential to the economic well-being of every single American.

However, over the past several years we have been witnessing some very disturbing trends in our securities markets -- trends that have a major impact on our economy.

Mr. President, these trends are having an adverse impact on the level of competition in our economy, and also on the ability of our economy to create new jobs and to provide the vast amounts of capital needed to meet such pressing challenges as our energy crisis.

-- First, there has been an increasing dominance of our securities markets by large institutional investors. In 1963, 35% of the trading on the New York Stock Exchange was attributable to institutions. Today that figure is 70% -- just double. The eight-man investment committee of the largest bank trust department -- these eight men alone -- manage $21 billion worth of common stocks.

-- Furthermore, institutional investments have become alarmingly concentrated in a small number of select stocks. As examples, one large bank trust department has invested more than 60% of its total common stocks in just 20 issues. Another bank trust has concentrated more than 20% of its discretionary stock market investments in just two issues. Still another has concentrated more than 15% of its discretionary stock market investments in just two issues.

-- Meanwhile, the number of individual stock investors, who are so essential to a healthy economy, has been declining. It is estimated that the number of individual shareholders in the United States has declined by as many as 800,000 since early 1972.

Our stock markets have exhibited other disturbing characteristics in recent years.

A decade ago, few of us would have thought that America's securities markets would one day be compared to a well known bird named Jonathan Livingston Seagull.

Yet one member of the investment community has said: "If you want to understand the stock market, read Jonathan Livingston Seagull. It's all there. Just like the believers in high multiple stocks, Jonathan Livingston Seagull came to believe it was possible to fly as no gull ever had before. He schooled and disciplined himself to find ways to do it and he found them."

How similar to a small number of large institutional investors who came to believe that at one point the stock of a cosmetics firm was valued higher than the entire U.S. steel industry. The very actions of these institutions succeeded, at least for a while, in making these dreams come true--in short, a self-fulfilling prophecy, an act of will rather than a judgment value, just like Jonathan Livingston Seagull's.

Or compare today's institutional market activity to that old parlor game favorite, Monopoly. Once all of the pieces of property are taken up, there may be nobody to sell to, and the limited market on the Monopoly board loses its liquidity. The game ends. In the real investment world, we must assure that our capital markets maintain adequate liquidity--that there will always be a sufficient number of buyers and sellers--so that our markets will price securities in accordance with their true value.

To investigate these disturbing questions, the Subcommittee on Financial Markets, of which I am Chairman, has conducted two series of public hearings at which a broad spectrum of witnesses presented their views. Their testimony clearly demonstrated the need for Congressional action to reverse these dangerous trends.

As a result, I am today introducing tax legislation which would help reverse these trends by imposing reasonable limits on stock holdings of any single institution and by offering incentives to encourage individual investors to return to the market.

The problems our Subcommittee is studying are very difficult and complex. There are no easy solutions. My proposed legislation will not provide all of the answers to the many problems plaguing our financial markets. Further study may produce additional remedies. However, I hope that the introduction of this bill, followed by additional Subcommittee hearings early next year, will create a meaningful dialogue among all interested parties and lead to constructive solutions.

This legislation is a follow-up to the comprehensive pension reform bill, S. 1179, that I introduced last March, which was favorably reported by the Senate Finance Committee in July. That bill was merged with the Labor Committee's pension bill and was approved by the full Senate in September.

The pension reform bill focused on the impact of our private pension system on the individual American worker and established minimum standards of vesting, funding, eligibility and termination insurance to insure that every worker receives his earned retirement benefits. The bill I am now introducing focuses on the enormous impact that the more than $150 billion of assets in private retirement plans has on our entire economy.

The tax legislation I am introducing today contains four major provisions.

First, pension plans would be required to comply with a new qualification for favorable tax treatment. Tax-exempt pension funds would be required to be placed in the hands of a pension manager (either an outside management like an insurance company or bank trust department or "in house" management) that complied with reasonable limitations on the amount of shares in any one company that could be acquired. Acquisitions in excess of this limitation would subject the manager to a penalty tax.

This provision is necessary to protect the more than 30 million private pension plan participants from excessive concentration of pension investments in only a few select securities and to encourage greater institutional interest in well-managed small and medium-size companies.

In addition, these limits would help prevent a small number of large institutional investors from achieving too much control over our economy.

Second, investments of one percent of the assets in any pension fund would be exempt from the "prudent man rule." This would facilitate the flow of a limited amount of pension investments to new or expanding companies which present greater than normal risks but offer the opportunity for greater than normal returns.

Third, a graduated capital gains tax would be enacted to decrease the capital gains rate for an asset as the holding period increased. This provision would help reduce the present "lock-in" of long-term assets and provide greater liquidity in our capital markets. A graduated capital gains rate would also encourage the risk-taking spirit in America which has been so important to economic growth.

Fourth, the amount of ordinary income against which capital losses may be deducted would be increased. This would also encourage greater individual investment in our markets and result in greater turnover of securities.

Mr. President, I would now like to discuss these provisions in greater detail.

DIVERSIFICATION REQUIREMENTS FOR PENSION MANAGERS

A very disturbing trend in our economy is the extent to which tens of billions of dollars of pension investments are being concentrated in a small number of select stocks. Extensive data presented to the Financial Markets Subcommittee clearly demonstrates the tendency of large institutions to invest enormous amounts of money in a very few issues.

To help curb this excessive concentration, I am today proposing an amendment to the Internal Revenue Code which would impose reasonable limitations on the amount of shares in any company that a pension manager can hold. Under this legislation, a pension plan could not receive favorable tax treatment unless the assets of the plan were placed with a pension manager who invested no more than 5% of his total discretionary pension assets in one ~~stock~~ equity security, and, in addition, acquired no more than 10% of ~~the outstanding shares of a particular~~ any equity security of any one company with respect to his aggregate discretionary pension assets. However, this limitation would not apply retroactively. Managers of pension accounts would not be forced to dispose of current stock holdings to meet these limitations.

A number of our Nation's largest bank trust departments recognize the wisdom of these limits and, in fact, have already adopted these limits on a voluntary basis. The purpose of putting these limits into law is simply to insure that all pension managers follow the example that some of the best banks have established on their own.

Decades ago Congress enacted tax incentives to encourage the growth of pension plans. Under current tax laws, qualified pension plans receive three tax benefits. First, employers are given a tax deduction for all contributions made to a qualified plan. Second, the investment earnings of assets in the plan are tax exempt. Third, employer contributions are not taxable to the employee at the time of contribution. Rather, the income tax is deferred until the money is actually distributed to the employee after his retirement -- at which time he is usually in a much lower tax bracket.

Tax-qualified pension plans today receive an estimated tax subsidy of $4 billion annually. Inasmuch as the Federal Government encourages the creation of pension plans through our tax laws, these tax laws must include safeguards to prevent excessive concentration of pension investments.

Our tax laws already include investment limitations for foundations and mutual funds as well as pension plans. The Internal

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Revenue Service has had years of experience administering these tax restrictions, particularly with respect to the prohibited transactions and investments of pension assets.

For example, under present tax law, the assets of a tax-exempt pension fund may be used only for the exclusive benefit of the employees or their beneficiaries. Under I.R.S. rulings, an investment generally complies with the "exclusive benefit" requirement if it meets the following standards: the cost of the investment does not exceed fair market value, a fair return commensurate with the prevailing rate is provided, sufficient liquidity is maintained to permit distributions, and the safeguards and diversity to which a prudent investor would adhere are present.

Tax restrictions on excessive concentration of pension investment would simply be an extension of existing tax rulings on diversity and liquidity for pension assets.

There is substantial precedent under both state and Federal law for limitations on the amount of stock in one company that an institutional investor can hold. Insurance companies are so limited in practically every state. Mutual funds are subject to holding limits established by Federal law. Yet no such limits apply to banks wich are the largest institutional investors and also the biggest managers of pension assets.

Insurance statutes in almost every state impose limitations on the investments of insurance company assets. Although the rules and the percentages vary from state to state, many states restrict insurance companies from holding more than 10% of the outstanding stock of a company or from investing more than 5% of the insurance company's separate or general accounts in one stock. These percentages are often applied to all of the accounts of an insurance company, in the aggregate.

Under Federal law, diversified mutual funds are restricted from holding more than 10% of the outstanding shares of any company or from investing more than 5% of the assets of the mutual fund in one security. (However, this limitation applies only to 75% of the total assets in a mutual fund.)

There are five essential reasons for imposing these limitations:

First, the extent to which institutions concentrate their pension investments in a few select stocks raises disturbing questions with respect to the safety of the enormous amounts of pension money that these institutions manage. In testimony before our Committee, one trust department argued that those of us who advocate limits on their holdings are ignoring their fiduciary responsibility for these funds. Quite the contrary. Prior to coming to the Senate, I was involved in the management of an insurance company, a mutual fund, and a savings and loan association, as well as several banks--all of which involved fiduciary relationships. It is precisely because of the fiduciary responsibility that limitations are needed.

Today more than 30 million Americans participate in our private retirement system. The retirement incomes of these Americans depend directly upon the safety of the pension investments. Excessive concentration of investments in only a few stocks jeopardizes the safety of these assets since a major decline in value of only two or three of these select stocks will substantially reduce the value of the pension assets.

This was dramatically illustrated by a recent anti-trust decision against IBM. Some of our largest bank trust departments are concentrating close to 10% of their total assets in this stock which lost $5.5 billion in two days of trading. Another of our largest bank trust departments has concentrated more than twenty percent of the assets over which it has complete investment discretion in just two securities--IBM and Avon. Little do the pension plan participants, who depend on this bank to manage their pension funds, realize that their future retirement benefits are so closely tied to the fate of one cosmetics firm and one manufacturer of computers. A high degree of concentration in any stock severely limits the ability of the manager to protect individual accounts in the event the stock gets into serious trouble. A pension fund manager simply is in no position to protect his individual accounts through orderly selling if he has a large percentage of his total assets in a stock or if his assets represent a large percentage of the company's outstanding shares.

Second, limitations on the investments of pension managers will prevent a small number of large institutions from achieving too much control over our entire economy.

We must never allow our institutions to control American business to the extent that institutions control German business. One of Germany's banks owns 25% of no less than 20 non-financial companies. The largest German bank owns one-quarter of the country's largest shipping company. Even these impressive shares of direct ownership do not reflect the true power of German financial institutions. Some observers estimate that as much as 60% of German industry is now effectively controlled by banks.

The Financial Markets Subcommittee has obtained data indicating the frequency with which American institutions hold large portions of the outstanding shares of a company. Earlier this year, one bank trust department held more than 14% of the outstanding shares of Walt Disney, almost 12% of Schlumberger, and over 10% of Polaroid. The aggregate discretionary accounts of another large bank include more than 18% of one company, close to 18% of the outstanding shares of a second company, and over 10% of a third.

When a single institution owns more than 10% of a company, it no longer is just an investor--it is an owner. Continued institutional acquisition of large portions of American corporations will lead to too few individuals possessing too much economic control over the entire economy. Limitations on institutional holdings will halt this trend.

Third, limits on the stock that <u>one</u> pension manager can hold in <u>one</u> company will limit the money this manager can pour into the market to bolster the price of any particular stocks. This will limit the ability to create self-fulfilling prophecies. The ability of pension managers to channel billions of dollars of new pension money every year into a few select stocks can have a very distorting effect on our stock market and our economy. The Morgan Guaranty Trust Company alone receives over $800 million of new pension money each year, and over 70% of Morgan's pension assets are invested in stocks. The Committee has received reports of foreign institutions purchasing only those stocks found on a few New York banks' investment lists because they believed those stocks would be supported.

Fourth, holding limitations could help provide greater liquidity in the market. Thousands of individual investment decisions, occurring hour after hour, are necessary to allow our capital markets to price securities in a manner which reflects their true value and to provide the liquidity that has made our capital markets unique in the world. One of the factors that detracts from liquidity of the markets is the holding by a few institutions of a substantial amount of the stock of a limited number of companies.

Finally, these limitations on concentration will encourage greater institutional interest in the many well-managed small and medium-size companies that have strong historical earnings records, good growth prospects, and whose current access to our nation's capital markets is seriously limited. Diversification of pension investments into these smaller companies will substantially increase competition in our economy at the same time the diversity provides greater safety for the funds.

Under the legislation I am introducing today, no pension fund could qualify for favorable tax treatment unless the assets of the fund were placed in the hands of a manager who invests no more than 5% of its aggregate discretionary pension assets in just one equity security and, in addition, who acquires no more than 10% of ~~the outstanding shares~~ any equity security of any one company with respect to the aggregate discretionary pension accounts.

If any manager of tax-exempt pension funds exceeds these limitations--for example, by purchasing an additional 1% of the total outstanding shares of a company in which it already holds 10%--, a penalty tax equal to 5% of the excess holdings would be imposed on the manager by the Internal Revenue Service. Then if the manager fails to dispose of the excess holdings within a specified time period, IRS will impose an additional penalty tax of 100% of the excess.

Excess holdings that result exclusively from fluctuations in market values will not be subject to a penalty tax.

These limitations will not apply to investments in companies with a capital account of less than $25 million. To limit investments in small companies would discourage institutional investors from looking for opportunities among smaller companies. The institutional investor wants a position large enough to have a real efffect upon the portfolio. In addition, the cost of analyzing a company relative to the potential dollar investment must be recognized. By excluding smaller companies from these restrictions, institutions would be encouraged to take the time to analyze the smaller companies.

In addition, the holding limitations would apply only to pension plans and not to profit-sharing plans.

Before drafting this legislation, I sent detailed questionnaires to the twenty-five largest bank trust departments. Their replies enabled me to select the most reasonable percentage limits for holdings.

Many of the leading bank trust officers, themselves, indicated that no more than 5% of the aggregate discretionary assets should be invested in any one security. It is estimated that as much as two-thirds of the aggregate discretionary assets of our nation's leading bank trust departments are represented by pension assets.

One bank executive said, "In no case do we hold more than 5% of our aggregate discretionary accounts in one security . . . It would be unusual to make an initial investment in a security with a market value in excess of 5% of the value of a portfolio and I would be inclined to feel that this might be a prudent limit on an original investment. However, in the event that over a period of time, the value of the investment in relation to the size of the portfolio grows to a percentage in excess (possibly substantially in excess) of 5%, which is relatively common, I would be opposed to a policy that would require selling off a portion of a good investment for no other reason than to bring it within a percentage limitation."

Still another bank trust executive said, "While we do not have a limit on how much of aggregate discretionary accounts will be allowed in one security, in order to insure liquidity for the individual accounts we would prefer not to have significantly more than 5% in any one common stock."

Many of the Nation's leading banks said that it would not be prudent for a trust department to hold more than 10% of the outstanding shares of one company.

In fact, some banks have indicated that a bank should hold no more than 5% of a company's shares.

Last year, Mr. Thomas C. Theobald, Executive Vice President of the First National City Bank, stated: "If we held more than 5% of a company's stock, we'd be concerned that we could become locked in. That 5% limit is our working rule for good market liquidity."

Another bank has stated, "In the event that our total trust department holdings approach 5% of the aggregate market value of the individual company's common shares outstanding, we review the company and the nature of our holdings quite closely to determine whether any further purchases should be allowed. Only in rare instances do we permit additional acquisitions, and in no cases do our purely discretionary holdings exceed this limit."

Another bank said that as a general rule, it does not want its aggregate discretionary holdings to represent more than 5% of a company's outstanding shares. This bank pointed out that if a trust department holds more than 10% of a company's outstanding shares, the Comptroller of the Currency will routinely raise questions of "appropriateness."

Some argue that holding limits cannot be applied to the aggregate holdings of bank trust departments since banks -- unlike mutual funds -- do not deal with a common pool of funds but instead deal with many different individual accounts which must be treated separately.

However, a great number of state insurance statutes already impose holding limits on the aggregate of the insurance company's separate accounts. In testimony before the Financial Markets Subcommittee, representatives of insurance companies clearly stated that aggregate holding limits do not impose additional problems.

One must remember that bank trust departments presently must make allocations between the various accounts held by the bank. As examples, large banks must allocate purchases of the shares of small and new companies among the various accounts.

In addition, bank trusts now must allocate promising new issues among their various accounts.

Several banks have indicated that they have one investment committee which makes the final decision as to what stocks to buy or sell. Clearly, such a system requires an allocation of the purchases and sales among accounts with the same investment goals.

There is no reason why banks cannot adopt an allocation policy to comply with aggregate holding limitations since they now must have an allocation policy anyway.

VENTURE CAPITAL FROM PENSION TRUSTS

The second major provision of my bill would facilitate the flow of institutional money to small and medium-size companies.

A great deal of the recent growth of institutional investments has been due to the inflow of private pension funds. The assets in private pension funds currently exceed $150 billion, and the figure is rising by over $14 billion a year, most of it invested in common stocks. This year the Senate enacted a major pension reform measure and this bill is expected to promote the additional flow of funds into professional management. Judging from past performance, most of it will go into bank trust departments.

The pension bill includes a "prudent man" rule which exposes the managers and trustees of pension plans to liability for losses resulting from unreasonable investments. Certainly, this is necessary to protect pension assets against highly risky investments but it could also have an undesirable effect. It might lead to even greater concentration of investments in companies which have been thoroughly analyzed and stamped with the approval of giant bank trust departments. Trustees will be very reluctant to reach out beyond successful, solid, well-researched companies toward those which are newer, attractive but less completely tried. Yet we must not forget that at one time IBM, Xerox, and Polaroid were new and untried companies.

Legislation is desirable to provide pension managers with leeway to invest 1% of the assets of any pension plan in companies with paid-in capital of less than $25 million. This would be an exemption from any prudent man rule for 1% of the pension assets. However, the "leeway clause" would in absolutely no way relieve fiduciaries from any prohibitions against self-dealing or fraudulent transactions. The "leeway clause" would relieve a fiduciary from liability only with respect to the riskiness of an investment. Nor would the "leeway clause" imply that investment in all companies of less than $25 million are high risk investment. Many are not. This provision would allow a limited amount of pension assets to be invested in a small company which presents a higher than normal risk but offers what might be a higher than normal return.

The exit of the individual investor from the market has denied new businesses a traditional source of equity capital. New businesses have had a particularly difficult time raising equity capital this year. New Issue Outlook, Inc., which publishes weekly reports of the new issue market, reports that in the first ten months of 1973, only 96 initial offerings began trading compared to 491 in the comparable period of 1972.

Even if individual investments in the market increase, institutions should be given the opportunity to make greater investments in unseasoned companies so as to insure an adequate source of equity capital for good new business ventures. A "leeway clause" which allows the investment of a small portion of the assets of each pension plan in new issues of somewhat higher risk would help maintain a viable equity market for these new issues.

A "leeway clause" would be similar to the so-called "basket clauses" found in a great many state insurance laws.

Many states permit life insurance companies to invest a small portion of their assets in companies which otherwise would not qualify as acceptable investments. A "leeway clause" for pension funds would be an exemption from any state or Federal "prudent man rule". It would help assure a ready source of risk capital for the new Xerox and the new IBM. The vitality of capitalism in this country demands an easier flow of capital into good, growing concerns which may not yet be as big or as familiar to investors as the institutional favorites.

An exemption from the prudent man rule for only 1% of the assets of a pension trust would certainly not jeopardize the safety of the pension assets. The "leeway clause" applies only to 1% of the assets of a pension trust and investments in unseasoned companies can be very profitable.

GRADUATED CAPITAL GAINS TAX

Now let's turn to an equally important need: How do we get greater investment by individuals in the market? For the first time since 1952, when record-keeping began, we find a decline in the actual number of individual stockholders in the U. S. Unfortunately, the decline of the individual investors active participation in the market has been going on for some time. The individual investor has been selling more than he has been purchasing for the last 10 years. That selling has been accelerating since 1967.

This decline is alarming because individuals contribute the great variety of opinions and judgements that make a free market place. It is the individual investor who has traditionally invested in the new and smaller companies, and the exit of the individual investor from the market poses some very serious problems.

If well-managed companies with good growth prospects cannot raise equity capital, these companies may have to sell out to ones that can raise money. The smaller companies will be confronted with the choice of merging voluntarily or becoming the target of a takeover. If smaller companies can't raise the capital required to grow, and if new companies lack the capital to get started, how are we going to generate the employment opportunities we need to create in the years ahead? I think we can do it by reasonable incentives to encourage more individual investment in securities.

Encouraging new investment in the stock market is not only important to investors and brokerage firms, it is important to the economic well-being of all Americans.

A healthy securities market not only provides the capital for new jobs, it makes it possible for new firms with new products to raise the capital necessary to get started.

The entry of new businesses and products into our economy is what has kept our system efficient and competitive. As one of the witnesses before our Subcommittee testified, a healthy stock market, where millions of investors participate and provide the ready pools of capital for new ventures, is one of the very few economic advantages which our Nation has not exported.

But unless steps are taken to increase participation in that market by individuals, I am afraid we will lose that advantage as well.

The provisions of our tax laws have a tremendous impact upon the direction of investment in our Nation. And I believe it is essential that those provisions give adequate recognition to the importance of risk investment.

Our present tax provisions may have been adequate for our Nation's economic needs in the 1950's but they do not meet the needs of the 1970's.

Since the late '50's our economy's capital needs have increased dramatically. Yet during this same period the growing inflation bias of our economy has discouraged capital investment. And the higher interest rates which have accompanied that inflation have improved the return on fixed income investments relative to common stocks which involve far greater risk. Changes in our tax laws have further reduced the after-tax return on higher risk investments. I believe that it is important to all Americans that sufficient incentive be provided to insure a reasonable amount of risk-taking -- even if some of those Americans never take advantage of those provisions directly.

I am today proposing a graduated capital gains tax which would decrease the capital gains rate for an asset as the holding period increases.

A graduated capital gains rate would serve at least four major purposes.

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First, it would reduce the so-called "lock-in" of assets held for a longer period of time and provide for a more efficient allocation of capital resources. Under our present tax laws, individuals are discouraged from selling securities that have been held for longer periods of time.

These persons would be much more prone to dispose of long-term assets if the rate of tax on the gain realized on the sale of these assets were less than it is today. If "locked-in" assets were sold, then, a great deal of additional tax revenue would be collected.

A graduated capital gains rate would help avoid tying an investor to investments that may not be the most suitable use of his resources. With millions of investors making tax decisions, rather than investment decisions, a substantial amount of available capital is being put to less than optimum use. We do not live in a static economy. The capital needs of different sectors of our economy change. One function of the stock market is to direct capital where it is needed most and thus earns the greatest return. The present tax provisions hinder the flow of that capital.

While the "locked-in" investors lose, the greater damage is to the U. S. economy, which is falling short of its potential at a time when it must use all of its resources to their fullest to respond adequately to the challenges ahead.

Second, a reduction in the "lock-in" would provide a greater liquidity in our capital markets which is so important to insuring that the price of stocks accurately reflects the value of the companies being bought and sold.

Relative stock prices play an important role in the allocation of capital in our economy. Valuations -- reflected in stock prices -- govern the allocation of resources that produce the millions of different products and services turned out by the American economy. Whether a company is able to issue new stock or obtain additional debt to finance a new expansion frequently depends upon what its stock is selling for. It is essential to the health of the company that its stock be accurately priced.

In order to achieve the most efficient evaluation of stock prices and hence the most efficient allocation of resources -- the securities market must have a multiplicity of decision-makers -- a large number of individual as well as institutional buyers and sellers.

Third, a reduction in "lock-in" would aid individuals in providing for their retirement years. Many middle income Americans invest in "growth stocks" when their children are grown and they are in their late forties or fifties. By the time they reach retirement they would like to sell those stocks and invest in income producing stocks. Under present law they can do so only at a substantial tax penalty. My proposal would allow them to transfer their assets without incurring such a significant loss in their savings.

Fourth, a graduated capital gains tax would encourage the risk-taking spirit in America. We must provide potential investors with the incentives to take the risks inherent in equity investing if our economy is to continue expanding to provide more jobs and opportunities and a larger tax base for our Government. Venture capital must be available so that new and promising companies can 10, 20, or 30 years from now become the "new IBM."

Let's look at an example.

Let's suppose that two individuals each have the same income. One spends his income. The other is the adventurer who, by investing in his own or someone else's business, takes risks for the benefit of the whole economy through the creation of new businesses or the expansion of existing ones. If tax laws do not differentiate between these two, an important force for the creation of jobs will have been lost.

Our Nation currently faces great new challenges. For example, in developing new sources of energy, in financing our housing needs and overcoming environmental and transportation problems. These challenges will require a great deal more capital from a great many more people.

Under present law, the maximum capital gains rate is 35% without regard to the special minimum tax preference provisions or any other provisions. Under the legislation I am introducing today, this maximum rate would decrease annually during the holding period of an asset until the maximum rate was approximately 14% for assets held fifteen years.

Capital losses would be provided comparable sliding-scale treatment over the holding period of the asset.

The present six month holding period for capital gains treatment would be extended to twelve months. This would be phased in by one month per year.

Enactment of a sliding-scale capital gains tax could very well result in a net revenue gain due to the revenue generated by the trading of "unlocked" assets.

For every billion dollars of gains unlocked, it has been estimated that as much as $200 million in new tax revenues might be gained. One analyst has estimated that there are $233 billion of unrealized capital gain in equities and that 90% of these assets have been held for more than 7 years. Another analyst put the figure at $558 billion. Unlocking even one-half of the $233 billion and taxing them at, say, a 20% rate would produce over $20 billion in revenues for the Government that it is unlikely to receive otherwise.

LIBERALIZED TAX TREATMENT OF CAPITAL LOSSES

A second tax proposal which I am including in my bill would liberalize the tax treatment of capital losses. Today, if an individual's capital losses exceed his capital gains, he can deduct up to $1,000 against his ordinary income each year. This hasn't changed since 1942, yet per capita disposable income has risen over 400% since then. Taking into account this increase in income, my proposal would allow$4,000 in capital losses to be deductible against ordinary income. This provision would, in effect, allow the same tax treatment the investor received in 1942.

However, prior to off-setting capital losses against ordinary income my proposal would require that the taxpayer carry back the loss against any capital gains which had been realized during the previous three years. This is the same carry back provision which is available to ~~business~~. corporations.

The opportunities for reward on the stock market are balanced by the risk that values will decline as well as rise. From the point of view of the investor, realizing a loss on assets hurts just as much as a loss in business or a loss from casualty or theft. We need to encourage investors to take their losses and re-invest their remaining capital.

Mr. President, for the reasons I have outlined, a graduated capital gains tax and liberalized capital loss treatment would have a very positive effect on our economy and would be of substantial benefit to all Americans by the creation of new jobs.

INSTITUTIONAL DISCLOSURE

A related issue which requires prompt legislative attention is the need for greater disclosure of institutional holdings and transactions.

Although the legislation I am introducing today contains no provisions relating to disclosure, I will most certainly support legislation to require increased institutional disclosure of meaningful information. My bill only contains provisions that amend the Internal Revenue Code or closely related pension laws.

There is a clear need for increased disclosure of the activities of bank trust departments.

Since 1940, mutual funds have been required to disclose on a quarterly basis their substantial holdings and transactions. Under state statutes, insurance companies face similar requirements. However, the biggest institutional investors of them all -- the bank trust departments with investments in tens of billions of dollars -- are free from any public scrutiny.

Disclosure would serve two very important functions.

First, it would increase the confidence of the individual investor that the markets are not being manipulated. The importance of disclosure has perhaps been best expressed by the Chairman of the Board of the Morgan Guaranty Trust Company who recently commented: "The resulting greater availability of information would enhance public understanding of, and confidence in, the investment mechanism.

It would contribute to the efficiency of the securities markets. And it would be a useful input to the formulation of public policy."

Second disclosure would provide meaningful information necessary for the formulation of sound public policy so that Congress and Federal regulatory bodies can more effectively safeguard the public interest.

93D CONGRESS
1ST SESSION

S. 2787

IN THE SENATE OF THE UNITED STATES

DECEMBER 6, 1973

Mr. FANNIN introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to revise the tax treatment of gains and losses from the sale or exchange of capital assets.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraphs (1) and (2) of section 1222 of the Internal Revenue Code of 1954 (relating to other terms relating to capital gains and losses) are each amended by striking out "6 months" and inserting in lieu thereof "90 days".

(b) Paragraph (3) of such section (relating to long-term capital gain) is amended to read as follows:

"(3) LONG-TERM CAPITAL GAIN.—The term 'long-

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term capital gain' means the percentage, determined under the following table, of gain from the sale or exchange of a capital asset held for more than 90 days, to the extent that such gain is taken into account in computing gross income.

"If the asset was held for—	The percentage is—
More than 90 days, but less than 366 days	50
More than 365 days, but less than 60 months and a day	40
More than 60 months, but less than 120 months and a day	30
More than 120 months, but less than 180 months and a day	20
More than 180 months, but less than 240 months and a day	15
More than 240 months	10.".

(c) Paragraph (4) of such section (relating to long-term capital loss) is amended to read as follows:

"(4) LONG-TERM CAPITAL LOSS.—The term 'long-term capital loss' means the percentage, determined under the following table, of the loss from the sale or exchange of a capital asset held for more than 90 days, to the extent that such loss is taken into account in computing taxable income.

"If the asset was held for—	The percentage is—
More than 90 days, but less than 366 days	50
More than 365 days, but less than 60 months and a day	40
More than 60 months, but less than 120 months and a day	30
More than 120 months, but less than 180 months and a day	20
More than 180 months, but less than 240 months and a day	15
More than 240 months	10.".

(d) (1) Section 1211 (b) (1) of such Code (relating to capital losses of individuals) is amended to read as follows:

"(b) (1) In General.—In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges plus (if such losses exceed such gains) the taxable income of the taxpayer or $4,000, whichever is smaller.".

(2) Section 1211 (b) is amended by striking out paragraph (2) and by redesignating paragraph (3) as paragraph (1).

(e) (1) The following sections of the Internal Revenue Code of 1954 are each amended by striking out "6 months" each place it appears and inserting in lieu thereof "90 days": 166 (d) (1) (B), 341 (a), 342 (a), 402 (a) (2), 403 (a) (2), 582 (c) (2), 584 (c) (1), 642 (c) (3) and (4), 702 (a) (1) and (2), 852 (b) (3) (B), 852 (b) (4) (B), 857 (b) (3) (B), 1231 (a), 1232 (a) (2) (A) and (B), 1233 (b), (d), and (e) (4) (A) (i), 1234 (c) (1), 1235 (a), 1240, 1247 (i), and 1248 (b).

(2) The caption of section 1247 (i) of such Code is amended by striking out "6 Months" and inserting in lieu thereof "90 Days".

(3) The Secretary of the Treasury or his delegate shall, as soon as practicable but in any event not later than 90 days

after the date of enactment of this Act, submit to the Committee on Ways and Means of the House of Representatives a draft of any technical and conforming changes in the Internal Revenue Code of 1954 which are necessary to reflect throughout such Code the changes in the substantive provisions of law made by this Act.

SEC. 2. The amendments made by this Act shall apply with respect to taxable years beginning after December 31, 1974.

93D CONGRESS
1ST SESSION

S. 2842

IN THE SENATE OF THE UNITED STATES

DECEMBER 20, 1973

Mr. BENTSEN introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To provide for the continuing availability of capital for economic growth and the creation of new jobs and to provide for greater competitiveness in our economy by amending the Internal Revenue Code of 1954 to impose limitations on institutional holdings of securities and to encourage individuals to invest in securities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) this Act may be cited as the "Stockholders Investment Act of 1973".

(b) CONFORMING CHANGES.—The Secretary of the Treasury or his delegate shall, as soon as practicable but in any event not later than 90 days after the date of enactment of this Act, submit to the Committee on Ways and

Means of the House of Representatives a draft of any technical and conforming changes in the Internal Revenue Code of 1954 which are necessary to reflect throughout such Code the changes in the substantive provisions of law made by this Act.

SEC. 2. LIMITATIONS ON INSTITUTIONAL INVESTORS.

(a) IN GENERAL.—Part I of subchapter D of chapter 1 of the Internal Revenue Code of 1954 (relating to pension, profit-sharing, stock bonus plans, etc.) is amended by adding at the end thereof the following new section:

"SEC. 408. LIMITATION ON INVESTMENT OF PENSION TRUST ASSETS.

"(a) IN GENERAL.—A trust which is part of a pension plan (other than a profit-sharing plan) is not a qualified trust under section 401 (a) unless that plan requires that the assets of the trust be held by a pension manager and provides that those assets may not be invested in violation of the limitations contained in subsection (b).

"(b) LIMITATIONS ON PENSION TRUST ASSET INVESTMENT.—No pension manager shall invest or sell any of the pension trust assets over which he has discretionary investment authority in the securities of any corporation with a capital account of more than $25,000,000 if that investment or sale would result in the investment of—

"(1) more than 5 percent of the value of all pension trust assets managed by him in the securities of any corporation, or

"(2) such assets in more than 10 percent of any class of security of any corporation.

"(c) DIVESTITURE NOT REQUIRED IN CERTAIN CASES.—It is not a violation of the limitations contained in subsection (b) for a pension manager to retain a security held by a trust managed by him which he may not acquire for the trust under subsection (b) if—

"(1) the acquisition of that security by the trust was not in violation of the requirements of subsection (b) when the security was acquired, and

"(2) the only reason the security cannot be acquired by the trust is that the market value of that security has increased since it was acquired by the trust, or that the market value of other securities held by the trust has decreased since that security was acquired by the trust.

"(d) DEFINITIONS.—For purposes of this section—

"(1) PENSION MANAGER.—The term 'pension manager' means any person who is authorized to invest the assets (or any part thereof) of a trust which is part of a pension plan.

"(2) DISCRETIONARY INVESTMENT AUTHORITY.—The term 'discretionary investment authority' means the power to invest the assets (or any part thereof) of a trust which is part of a pension plan without prior approval of any other person.

"(3) SECURITY.—The term 'security' means any share of common stock in any corporation, any security other than a common stock which is convertible into common stock, any other class of stock in any corporation whose owners are entitled regularly to vote, and any other security determined by the Secretary or his delegate to constitute a security for purposes of this section.

"(c) RULES.—For purposes of this section—

"(1) CAPITAL ACCOUNT.—The capital account of a corporation is more than $25,000,000 if, as reported to the shareholders of the corporation in the annual report reflecting the most recently ended fiscal year of the corporation, the paid-in capital and earned surplus of the corporation exceed $25,000,000.

"(2) APPLICATION OF SECTION.—The limitations contained in subsection (b) apply with respect to securities acquired after December 31, 1974, but in applying those limitations to the acquisition of securities after that date all securities held by pension trusts managed by a pension manager shall be taken into account without regard to the date on which the securities were acquired.

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"(f) WAIVER AUTHORITY; REGULATIONS.—The Secretary or his delegate is authorized to waive the provisions of this section with respect to any proposed investment, or with respect to the investment of the assets of any trust which is part of a pension plan, upon application made by a pension manager who demonstrates to the satisfaction of the Secretary or his delegate that the requested waiver is not inconsistent with the purposes of this section and is not inconsistent with the best interest of the trust with respect to which the waiver is requested. The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this section.

"(g) CROSS REFERENCE.—For excise tax where requirements of this section are not met, see section 4950.".

(b) CLERICAL AMENDMENT.—The table of sections for such part is amended by adding at the end thereof the following new section:

"Sec. 408. Limitation on investment of pension trust assets.".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1975.

SEC. 3. EXCISE TAX ON PROHIBITED INVESTMENTS.

(a) IN GENERAL.—Subtitle D of the Internal Revenue Code of 1954 (relating to miscellaneous excise taxes) is amended by adding at the end thereof the following new chapter:

"CHAPTER 43—PENSION TRUST ASSETS

"SEC. 4950. EXCISE TAX BASED ON PROHIBITED INVESTMENT.

"(a) INITIAL TAX.—There is imposed on each pension manager (as defined in section 408(d)(1)) a tax of 5 percent of the amount of each investment made by him during his taxable year in violation of the provisions of section 408(b) (relating to limitations on pension trust asset investment).

"(b) ADDITIONAL TAX.—If a pension manager who is liable for the payment of a tax under subsection (a) for any taxable year fails to correct the violation of section 408(b) which resulted in that liability within the correction period, there is imposed on that pension manager a tax of 100 percent of the amount of that investment to the extent that, on the last date of that correction period, that investment is still in violation of the provisions of section 408(b).

"(c) CORRECTION PERIOD.—For purposes of this section, the term 'correction period' means the 180-day period beginning on the date on which an investment is made by a pension manager in violation of the provisions of section 408(b).".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on January 1, 1975.

SEC. 4. VENTURE CAPITAL FROM PENSION TRUST ASSETS.

(a) GENERAL RULE.—A trust which is part of a pension plan (other than a profit-sharing plan) and which meets the applicable requirements of subchapter D of chapter 1 of the Internal Revenue Code of 1954 (relating to pension, profit-sharing, stock bonus plans, etc.) shall not be held to fail to meet the requirements of section 401 (a) (2) of such Code, or to fail to meet the requirements, or to violate the provisions, of any other Federal or State law restricting or limiting the investment of the assets of such a trust (other than provisions of law prohibiting self-dealing or establishing prohibited transactions for persons investing such assets) on account of any investment of such assets by a fiduciary of the trust after careful scrutiny of the investment (taking into account the need for diversification within the trust with respect to the type of security, the type of industry, the degree of risk, and the potential for return) in the securities of any corporation with a capital account of less than $25,000,000 if the market value of such securities, when added to the market value of all other such securities held by that trust, does not exceed 1 percent of the market value of all assets of the trust. The provisions of this subsection shall be applied without regard to any increase in the market value of securities of a corporation with a capital account of less than $25,000,000 which occurs after the securities were acquired by the trust, and without regard to any decrease in the market value of other securities held by the trust which occurs after the securities of that corporation were acquired by the trust.

(b) WAIVER.—For purposes of this section trust assets invested in the securities of a corporation described in subsection (a) shall be treated as having been invested in a corporation not described in subsection (a) if the pension manager of a trust demonstrates to the satisfaction of the Secretary of the Treasury, under such regulations and procedures as he may prescribe, that the securities of that corporation should be treated as the securities of a corporation not described in this section.

(c) LAWS NOT AFFECTED.—For purposes of this section, the Secretary of the Treasury shall determine and publish by regulation the provisions of law referred to in subsection (a) as "provisions of law prohibiting self-dealing or establishing prohibited transactions for persons investing such assets".

(d) DEFINITION OF SECURITY; CAPITAL ACCOUNT RULE.—For purposes of this section, the term "security" has the meaning given it in section 408 of the Internal Revenue Code of 1954; and a corporation shall be treated as having a capital account of less than $25,000,000 if it would be so treated under that section.

(e) EFFECTIVE DATE.—The provisions of this section apply to securities of a corporation with a capital account of less than $25,000,000 acquired after December 31, 1974, but all other securities held by a trust shall be taken into account in applying such provisions to the acquisition of securities of that corporation after that date without regard to when such other securities were acquired.

SEC. 5. GRADUATED TAXATION OF CAPITAL GAINS AND LIBERALIZED CAPITAL LOSS TREATMENT.

(a) (1) CHANGE IN HOLDING PERIOD.—Section 1222 is amended by—

(A) striking out "For purposes of this title.—" and inserting in lieu thereof "(a) DEFINITIONS.—";

(B) striking out "6 months" each place it appears in paragraphs (1), (2), (3), and (4) and inserting in lieu thereof "12 months"; and

(C) adding at the end of such section the following:

"(b) SPECIAL RULE FOR TAXABLE YEARS ENDING BEFORE JANUARY 1, 1980.—For required holding period of capital assets necessary for long-term capital gain or loss treatment for taxable years ending before January 1, 1980, see section 5(f) of the Stockholders Investment Act of 1973.".

(2) The following sections of the Internal Revenue Code of 1954 are each amended by striking out "6 months"

each place it appears and inserting in lieu thereof "12 months": 166 (d) (1) (B), 341 (a), 342 (a), 402 (a) (2), 403 (a) (2), 582 (c) (2), 584 (c) (1), 642 (c) (3) and (4), 702 (a) (1) and (2), 852 (b) (3) (B), 852 (b) (4) (B), 857 (b) (3) (B), 1231 (a), 1232 (a) (2) (A) and (B), 1233 (b), (d) and (e) (4) (A) (i), 1234 (c) (1), 1235 (a), 1240, 1247 (i), and 1248 (b).

(3) The caption of section 1247 (i) of such Code is amended by striking out "6 Months" and inserting in lieu thereof "12 Months".

(b) Repeal of Alternative Tax for Individuals.—Section 1201 of such Code (relating to alternative tax) is amended by—

(1) striking out subsections (b) and (c);

(2) striking out "subsection (d) gain" in subsection (a) (1) (A) (i) and (B) and inserting in lieu thereof "subsection (b) gain";

(3) redesignating subsection (d) as (b), and striking out "(d)" each place it appears in such subsection (including the subsection caption) and inserting in lieu thereof "(b)";

(4) inserting "and" after "section 453 (a) (1)," in paragraph (1) of subsection (b) (as redesignated by this section);

(5) striking out "1969, and" in paragraph (2) of

such subsection and inserting in lieu thereof "1969."; and

(6) striking out paragraph (3) of such subsection.

(c) Repeal of Deduction for Capital Gains; Graduated Taxation of Capital Gains.—(1) Section 1202 of such Code (relating to deduction for capital gains) is amended to read as follows:

"SEC. 1202. NONRECOGNITION OF CERTAIN GAINS AND LOSSES.

"(a) Long-Term Capital Gains.—In the case of a taxpayer other than a corporation, a percentage (determined under subsection (c)) of the gain from the sale or exchange of a capital asset held for more than 12 months shall be excluded from gross income.

"(b) Long-Term Capital Losses.—In the case of a taxpayer other than a corporation, a percentage (determined under subsection (c)) of the loss from the sale or exchange of a capital asset held for more than 12 months shall not be taken into account for purposes of this title.

"(c) Determination of Percentage.—The percentage referred to in subsections (a) and (b) is 50 percent, increased (but not to more than 80 percent) by 2 percent for each 12-month period in excess of 12 months the capital asset with respect to which the gain was derived, or the loss was incurred, was held by the taxpayer.

"(d) ESTATES AND TRUSTS.—In the case of an estate or trust the provisions of this section shall be applied by excluding the portion of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includable by the income beneficiary as gains derived from the sale or exchange of capital assets.".

(2) The table of sections for part I of subchapter P of chapter 1 of such Code is amended by striking out the item relating to section 1202 and inserting in lieu thereof the following:

"Sec. 1202. Nonrecognition of certain gains and losses.".

(d) LIMITATION ON AMOUNT OF LOSSES WHICH MAY BE SET OFF AGAINST ORDINARY INCOME.—(1) Section 1211 (b) (1) of such Code (relating to capital losses of individuals) is amended to read as follows:

"(b) (1) IN GENERAL.—In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges plus (if such losses exceed such gains) the taxable income of the taxpayer or $4,000 ($2,000 in the case of a married individual filing separately), whichever is smaller.".

(2) Section 1211 (b) of such Code is amended by

striking out paragraph (2) and by redesignating paragraph (3) as paragraph (2).

(e) CARRYBACK OF LOSSES INCURRED BY INDIVIDUALS.—Section 1212(b) of such Code (relating to capital loss carrybacks and carryovers for noncorporate taxpayers) is amended to read as follows:

"(b) OTHER TAXPAYERS.—If a taxpayer other than a corporation has a net capital loss for any taxable year (referred to in this subsection as the 'loss year'), the amount of that loss shall be a capital loss carryback to each of the 3 taxable years preceding the loss year, and a capital loss carryover to the succeeding taxable year. The entire amount of the net capital loss for any taxable year shall be carried to the earliest of the taxable years to which such loss may be carried, and the portion of such loss which shall be carried to each of the other taxable years to which such loss may be carried shall be the excess, if any, of such loss over the total of the net capital gains for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the net capital gain for any such prior taxable year shall be computed without regard to the net capital loss for the loss year or for any taxable year thereafter.".

(f) PHASE-IN OF INCREASE IN HOLDING PERIOD.—Notwithstanding the amendments made by this section, whenever reference is made in the Internal Revenue Code of 1954 (as amended by this section) to the sale or exchange of a capital asset held for not more than 12 months, or held for more than 12 months, the term "12 months" means—

(1) 7 months, with respect to taxable years beginning after December 31, 1974, and ending before January 1, 1975;

(2) 8 months, with respect to taxable years beginning after December 31, 1975, and ending before January 1, 1976;

(3) 9 months, with respect to taxable years beginning after December 31, 1976. and ending before January 1, 1977;

(4) 10 months, with respect to taxable years beginning after December 31, 1977, and ending before January 1, 1978;

(5) 11 months, with respect to taxable years beginning after December 31, 1978, and ending before January 1, 1979; and

(6) 12 months, with respect to taxable years beginning after December 31, 1979.

(g) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1974.

Senator BENTSEN. Now, Mr. Schotland, I am going to ask that each witness, because of the number of witnesses we have, limit his oral presentation to 10 minutes. Then we will have some questions subsequent to that; and any additional testimony you have we would like for the record.

I have found from the great amount of correspondence I have received that there has been extensive reading of the written testimony that has been submitted for the record.

Mr. Schotland.

STATEMENTS OF ROY SCHOTLAND, PROFESSOR, GEORGETOWN UNIVERSITY LAW CENTER, AND DR. EDWARD MALCA, ASSISTANT PROFESSOR OF ECONOMICS, CITY UNIVERSITY OF NEW YORK

Mr. SCHOTLAND. Thank you, Senator.

At the outset I wish to make clear, in light of the subcommittee's press release, that although I served as Chief Counsel of the SEC's Institutional Investor Study until 1970, I did not serve as such throughout the study; that is, until the culmination. I left to take the opportunity to become associate dean of Georgetown Law School.

I commend the subcommittee for conducting its hearings of last summer and now on this bill. It says much about your hearings that by merely calling attention to these problems a most interesting series of events has occurred. That the events came after you does not say they all occurred because of you; and I will have to refrain from the details of the sequence and the praise for your hearings in the interest of brevity.

I would like to speak of real problems, myth problems, and the real impacts of myths.

Senator BENTSEN. If you talk about praise for the hearings, I might give you a little more time, Professor. [General laughter.]

Mr. SCHOTLAND. It is set forth in full detail, Senator, at the very outset of the statement. I think it is frankly a rather unusual story, and one which says a great deal both about the value of the hearings and the nature of the problems.

Your witnesses and the impressive appendices assembled by your able staff make it unnecessary to repeat here how little information we have about the holdings of employee benefit plan funds, by far the biggest and even further the fastest growing segment of our market.

Since 1933 the cornerstone and policy of all securities and security market legislation has been disclosure. It is a paradox that we know least about the largest force in the markets.

For 40 years we have acted on the commitment that the stock markets will remain efficient and fair only if they are open and informed. Your hearings have helped make clear what serious problems develop when the concern for full disclosure gets lost in the trees of tombstone ads and prospectus boilerplate, and when those responsible for assuring disclosure fail to see that the whole forest has been moving.

I will summarize my statement of the problems or impact provoking these hearings. First are impacts on employee beneficiaries of funds, who are in many ways more in need of protection than are shareholders themselves. Second are impacts on portfolio corporations. This is merely one of the problems which have provoked so much public attention in such terms of institutional dominance of the stock markets, giants wrecking Wall Street, bank trust departments controlling operating corporations, the two-tier market, and other battle cries. The battle cries are not all accurate descriptions of the actual problems, as battle cries never are, and although they may be colorful oversimplifications of the problems, the fact remains that there are acute problems, or there would be no battle cries.

There is thought, for one thing, to be a serious problem of institutional investors' control of portfolio corporations. This may well become a substantial problem, but today this is mostly myth. Episodes of such control occur, as seems to have happened in Cleveland. But in large measure, the myth seems to be promoted by those justifiably trying to draw public attention to the more subtle but still so important real problem, institutional influence on portfolio company management.

Next are impacts on other stockholders in portfolio corporations. There is the inevitable, mostly legal, difference in access to information. There is an inevitable, largely desirable, difference in ability to use information. There is also the fact that institutional presence in the stockholder family is likely to lead to less continuity in stock prices. As your opening witness Donald Regan said in July, we know too little for certain about the impacts of institutional trading, and I hope you will call for a study of the trading in a number of airpocket situations. I will later offer a proposal on this.

Next are impacts on stock markets generally. For decades, we have talked of the importance of public confidence in the markets. Myths and realities undermining that confidence demand correction. Institutions know they have obligations to their own beneficiaries; they know they also have obligations to the markets, such as not to manipulate and not to trade on inside information. But their new gargantuan size commands that their obligations to the markets rise above merely avoiding fraud.

Last are impacts on the economy, which your hearings have developed so well. Those impacts finally culminate in the economy's becoming more subject to the views and interests of lenders and money managers, and less subject to the views and interests—and greater diversity, in terms of kinds of people, geography, backgrounds, skills, ages and so forth—of operating managements.

As noted earlier, these hearings have both directly and indirectly developed new information. But much remains to be done on the information front, and even if the disclosure bill is enacted this session, this work would remain valuable for several years. I have tried in my statement to compile a beginning of an inventory of relevant available information. If others agree with me about the value of pulling together the picture, I hope they will add to this outline.

Information tells us little that is important to remember unless we have a sense of trends. If we know that the Morgan manages $27 billion, that information is almost useless if we do not know also whether the figure is a drop of x billion dollars from the prior year or—as it was—a rise of $5 billion, or over 20 percent in 1 year.

Trends show what the problems may be and how consequential they may be. For example, in the ABA survey of trust departments last summer, one cannot know, let alone evaluate, the meaning of information given unless one knows something about the direction and pace of movement.

Is concentration dropping slowly or rising sharply?

Their data leaves us in limbo for purposes of action, although I applaud the survey's being done and hope it will be repeated regularly.

Every survey faces problems of definition and responsiveness. For example, in Senator Bentsen's October letter survey the banks were asked for holdings of over 5 percent of outstanding stock in discretionary accounts.

The Morgan did not answer the question as you asked it. The First National City, managing $10.4 billion in discretionary funds, answered listing seven stocks, and the U.S. Trust, managing $4.4 billion less in discretionary funds, listed 38 stocks. Perhaps those two completely cooperative respondents had the same understanding of "discretionary," but one cannot help wondering.

Until we have systematic disclosure, we run too great a risk of learning only what the people with the information think we should learn. The ABA survey of last summer may be 100 percent valid on all points, but until one is certain of that it should be used with care.

Let me give three examples. The survey report gives information on the size of equity orders. The trust departments have, right or wrong, long followed a practice of making separate orders for separate accounts, and so of course they will have a very large number of orders.

Also, we need to know how many orders are entered on the same day for the same stock. We need to know more about the dollar size of the orders. We need to know whether there is a tendency toward larger orders, because of bunching or for other reasons. We need a distribution of sizes of trust departments much more informative than the ABA's absurd classification of three categories below $750 million total assets, but only one category above. Without more such information, we cannot give much weight to the report's arguments.

For a second example, the survey shows that the average number of common stocks held by all trust departments was 507. Only a fool would think that the favorite 50 are the only stocks held. The report is arguing against a strawman. Once again we need much more detailed information.

For a last example, they give the 25 largest holdings as a percentage of total equity held. Again, without data on how this compares to prior years, without separate data on the matter under consideration of your subcommittee—employees benefit funds—without as much data on the bigger banks as on the little, the ABA tells us only that we need not be worried by strawmen.

All are for disclosure of institutional investors' holdings and tradings. Just what is to be disclosed, how often and so forth, are issues of important details, but not pertinent here.

Inevitably, some suggest, however, there should be legal barriers restricting the amount of stock any one or all institutions can sell or buy in any one day. The cure would be worse than the disease. Such trading limits seem feasible in the commodities markets and for control persons. But there are so many distinctions and so many reasons not to hinder institutional investor trading. I think the unwisdom of the limits was made clear by your first witness—quoting again Donald

Regan—who said he had once supported such a notion, but now believed it needed at least much more study.

In addition to disclosure, a sure improvement for market liquidity and the other concerns before you is to make sure that no single institution can hold too great a portion of the stock of any one company. I say "make sure," because according to what I had always heard—and on which we now have firm information from your letter survey—virtually all of these money managers follow flat limitations rules, or give at least great weight to avoiding unduly large positions, as the Senator made clear in his opening statement this morning.

Therefore, the Bentsen bill's proposal to make percentage limitations legally binding is merely an incorporation of the best banks' best practice, an assurance that these practices will not weaken as enormous money flows continue to pour into these trust departments, and a further assurance that all pension managers will follow the practices of the best managers.

The public will come back when the market rises. But while some forces are functioning to correct the other problems, massive trends are under way to worsen many of them.

I refer particularly to the continued enormous growth of pension plan funds and the continued flow of such enormous portions of those funds to bank trust departments. Taking New York-listed stocks alone, private noninsured funds held just under $20 billion in 1961. By 10 years later, they had gone up $57 billion to a total of $77 billion.

That kind of growth can be dwarfed quickly by only two figures, the U.S. budget and the projected growth for such funds in the current decade. The official New York Stock Exchange projection of June 1972 is for another $120 billion by 1980 in New York-listed stocks alone, and in total equity holding the SEC projects $269 billion in 1980.

So in the current decade such funds are expected to grow in New York-listed stocks alone nearly twice as fast as in the 1960's. This does not count growth of pension moneys managed by insurance companies. While I have no data showing just how much of the new pension funds goes to self-managed plans, how much to investment advisers and how much to bank trust departments, I am confident the data would show flatly that the trust departments have always had and continue to hold the vast bulk of these funds. I hope your other witnesses will provide data on this, either today or pursuant to a request I urge the subcommittee to make.

Of the enormous flow into bank trust departments, the largest banks are getting under their management both an enormous and a constant portion. From 1968 through 1972, the top five trust departments have held their share of the market for trust asset management, where of course the main growth is in pension moneys, at 23 to 25 percent. The top 10 have held at 31 to 36 percent. Banks in New York State alone have held at 46 to 50 percent.

This morning's New York Times column of Robert Metz, which at the end I will ask to be put into the record, suggests that people should go to other States.

I have assembled the figures on growth in my statement.

With respect to the precise language of the Bentsen bill, seven points:

I am troubled first about the legal differences the bill will introduce between self-managed pension plans, like United States Steel, and plans managed by outsiders like your witnesses later this morning.

Why should United States Steel pension funds be able to hold up to 10 percent of the stock of any one company, whereas Exxon pension funds managed by trust departments would be limited by law to holding only a tiny fraction of 10 percent of most appropriate stocks, since their funds would have to share the percentage limit with other funds under the same money manager?

Many people believe, as this committee is surely aware, that self-managed pension funds present particularly sharp problems. Legislation should not encourage self-management. This new discrimination in favor of self-management warrants serious consideration. I hope your other witnesses will address themselves to it constructively, and not merely use it as a stick for standing pat against this wise bill.

I am not sure what the answer is, but suggest lines such as this. First, perhaps existing self-managed plans are entitled to move favorable treatment in these regards than new ones. Second, if the 5- and 10-percent limits are sound for large aggregations of pension funds, as in a trust department, then for a self-managed plan lower figures seem in order, scaled still lower according to the plan's size.

In points 2, 3, and 4, I raise relatively small, but I think important questions. In point 5, I want to underline the importance of the "discretionary investment authority" definition. An unduly legalistic definition will fail to embrace many accounts which ought to be included. Consideration ought to be given to amending the definition to conform with that in the bill on disclosure, S. 2234. The definition there is realistic. Conformity is desirable in terms of policy, case of compliance and administration, and for sound understanding of what will flow from the disclosures and limits.

Next I am—Senator, shall I stop?

Senator BENTSEN. Why don't you summarize in a couple of minutes, and then we will ask some questions?

Mr. SCHOTLAND. I am troubled about the application of the new percentage limits to existing securities positions, and would suggest a phase-in period for large positions.

With respect to capital gains treatment, I have six points alone on which I will rely on the statement. Most of them are affirmative. One one two raise questions.

I then suggest that what is needed in addition to disclosure and in addition to holding limits——

Senator BENTSEN. Professor, I would like to hear your six points. Would you touch upon your six points?

Mr. SCHOTLAND. Yes, sir. I would be happy to do so, sir, especially since the first one is applause, period. Second, applause in particular for resisting the Wall Street promoters of speculation—Senator—the Wall Street promoters of speculation who want to reduce the holding period to 3 months. The irresponsibility and selfishness of their position on most matters can be summed up, I believe, by the general evaluation stated last June on the Senate floor by Senator Williams.

Third, I think it is worth repeating that the proposal you have put forth to raise the capital gains exclusion was put forward just a decade ago by the Kennedy administration, and there was substantial writing about its value at that time.

Fourth, with no intention to criticize, I suggest the problem of lockin caused by capital gains treatment is dealt with only partially by changing the exclusion and ignoring the long-criticized stepped-up basis upon death. Whether or not the step-up should be wholly eliminated, at least the amount of step-up might be reduced in relationship to the length of holding period.

Also, there may be some who would think that reducing the capital gains tax while preserving intact the stepped-up basis is wanting to have the cake and still eat it.

Fifth, may I urge reconsideration for special capital gains treatment in the case of reinvestment in publicly traded securities. Donald Regan urged this, suggesting treatment parallel to that given upon the sale of a residence and timely repurchase. At very least, if the capital gains tax is not postponed upon timely reinvestment, a substantial increase in the percentage exclusion should be considered.

The next part of my statement proposes what I call an antigambling tax, which would inhibit speculative trading without interfering with sound investment trading, the differential line being the turnover of the particular portfolios. Somebody with a 100-percent turnover going in and out within a month would pay a very heavy tax. For somebody with a relatively low turnover, say 20 percent, going in and out in a month would be an unusual situation and probably would rest on sound reasons and should be allowed.

The last part of my statement draws attention to the fact that we terribly need to promote savings in this country. We save as a proportion of after-tax income at a rate lower than Britain's, two-thirds of the rate in France, just over half the rate in Germany, and would you believe only 40 percent of the rate in Japan.

The figures come from a Department of Commerce publication. There may be some flaws, for example, in close comparisons like the British. But any economist who knows about these figures will stand behind the fact that France, Germany, and Japan are saving greatly more than we are.

Now, there are many reasons why that should occur, some of them bad, some of them are good. We have a fine pension system. We have much more consumer debt. Whether that is bad or good is another question. Perhaps we have much more security.

But I submit that we are saving much too little in this country, and I want to applaud at this point our leading banks for their aggressive new monthly stock investment plans, which do bring in more savings. It is unfortunate but true that the securities industry cannot do the same thing as efficiently. Their cries of anguish seem to come down, apart from fear of losing their monopoly, to the claim that the banks are limiting the plan to too few stocks.

We need more equity capital. We need more venture capital. We also need to redirect capital flows. Equity market improvement, combined with tax and other revisions, can help meet the great challenges before us.

One of our finest businessmen, J. Irwin Miller, 2 years ago wrote an article called "Can We Afford Tomorrow?" I believe we would be rather in trouble if the answer to that question were "No." I believe the question before us is whether we will meet our challenges well enough to keep reasonable the costs of getting to tomorrow and the value of getting there.

Senator, I would like to submit, if it is acceptable, for inclusion in the hearing record a number of articles from the "New York Times" and some from the "Wall Street Journal," including an article from this morning's "New York Times" by Robert Metz on bank commingled equity fund performance.[1]

Thank you, Senator.

Senator BENTSEN. Thank you. That is a very interesting statement. I would like to add to your quote of Mr. Miller's "Can We Afford Tomorrow?" and I remember "this like all times can be the best of all times if we but know what to do with it." That is what we are working on.

Well, you have touched all of us. You have touched me, you have touched bankers, you have touched brokers. It has been a very thoughtful statement. I am going to take it home and read it again tonight. You spent a lot of time on it.

You make an interesting point there about our excluding profit-sharing trusts from the holding limitations. I did this because one of the principles of profit sharing plans is to try to have participation by the employees and the owners of a company. We have so many profit sharing plans, like Sears and Penney's, that work very well.

But you make what seems to me a valid criticism of my bill in saying, why should we exclude the rest of the investment from——

Mr. SCHOTLAND. Sears, for example, would be almost totally excluded because they are so heavily in Sears. But if, for example, a fund were, let us say, 20 percent in other stocks, why ought not the same limits apply?

Senator BENTSEN. Well, we will take a look at that one and see if we can come up with a way of not disturbing the objective of the profit-sharing trust.

Mr. SCHOTLAND. There is no intention to interfere with the basic exclusion, or perhaps I should say, the reason for the exclusion and the value of such trusts.

May I say, Senator, with respect to what you call touching up everybody, I am enthusiastically for the bill, I call them as I see them, and I only hope they have been constructive points.

Senator BENTSEN. I think they have. I am sure that those other witnesses will not all be in total agrement, and that is fine.

[The prepared statement of Dr. Schotland with attachments follow. Hearing continues on page 91.]

PREPARED STATEMENT OF ROY A. SCHOTLAND, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY

I. THE BENTSEN HEARINGS AND SUBSEQUENT EVENTS—POST HOC ERGO HOC?

That it is such a privilege to appear before you may affect my judgment, but I must commend the Subcommittee for conducting its hearings of last summer and now on S. 2842. It says much about your hearings, and much about

[1] See p.p. 74 ff.

the problems you have aimed at, that by merely discussing and calling attention to them and without any legal compulsion or pressure, a most interesting series of events has occurred since you began. That the events came after you began does not say they all occurred because you began, but note the sequence:

Pursuant to prior announcement, your hearings convened July 24, 1973.

On July 23, pursuant to recommendation of SEC Institutional Investor Study 28 months earlier (March 10, 1971), the first bill to require institutional investors to disclose periodically their portfolio holdings and large transactions, is introduced.

On July 30, the American Bankers Association undertakes a survey of all banks with trust functions, gathering first-time data on asset size, largest equity holdings and some trading patterns.

On September 13, the American Life Insurance Association presents first-time assemblage of data on the largest common stock holdings of the 10 largest life insurance companies.

The SEC prepares alternative disclosure proposals, finally stirred by this body.

Reflecting the same concerns as those underlying the hearings, but perhaps catalyzed and accelerated by the hearings, "several large trust departments in banks have gotten the word from upper-level management to stop fooling around with high P-E stocks and start buying 'value' stocks", the Wall Street Journal on August 30, 1973 quotes an analyst. The Journal goes on to refer specifically to banks' concern over "efforts in Washington" (p. 23).

Reflecting somewhat similar although also somewhat different concerns, in January 1974 the Senate Government Operations subcommittees release a massive study commenced in May 1972, presenting first-time data on major stockholders of major corporations.

Reflecting somewhat similar concerns, the so-called "two-tier" market experiences a great shake-out in the upper-tier institutional favorites, on which we have all seen painful figures and about which one leading magazine has just carried an article entitled "Is Wall Street Shedding Tiers?" (*New York*, Feb. 4, 1974).

II. REAL PROBLEMS, MYTH PROBLEMS, AND THE REAL IMPACTS OF MYTHS

A. Our "Nth" critical shortage: data

Your witnesses and the impressive appendices assembled by your able staff make it unnecessary to repeat here how little information we have about the holdings, or the trading, of employee benefit plan funds, by far the biggest and by even further the fastest growing segment of our securities markets. Since 1933 the cornerstone and operative policy of all securities and securities market legislation and self-regulation has been disclosure, and it is a paradox even more important and unsound than it is surprising and illogical, that we know least about the largest force in our markets. For 40 years we have acted on the commitment that the stock markets will remain efficient and fair only if they are open and informed. Your hearings have helped make clear what serious problems develop when the concern for full disclosure gets lost in the trees of tombstone ads and prospectus boilerplate, and when those responsible for assuring disclosure fail to see that the forest has been moving.

B. Impact on employee beneficiaries of funds

Few plan beneficiaries are protected like the U.S. Steel employees, by the promises of the employer corporation itself. Most people have only the plan funds to rely upon, so they are more likely to be protected if the plan's investments produce a good return reducing the degree to which the employees must make and seek larger new additions to the plan. And they are more likely to be jeopardized if the plan's investments are unduly risky or bear the special risks of undue concentration, or if the investments are in stocks with fad-distorted prices. Also very important, they gain if money managers compete to produce good returns on pension funds.

Protection of pension beneficiaries is, at least in many ways, more important than protection of stockholders. Pension beneficiaries are often completely dependent on their pensions, a problem with which your Committee has recently been grappling so fully. Moreover, pension beneficiaries are not able to protect themselves by choosing not to play in the ballpark, or to play differently. Stockholders have free choice, often are using discretionary, "extra" dollars, often are quite sophisticated, and often if not sophisticated are conscious gamblers (who are entitled to a scrupulously fair game but not to great concern).

C. Impact on portfolio corporations of unrestrained holdings and trading by such funds

This is merely one of the problems which have provoked so much public attention in such terms as institutional dominance of the stock markets, giants wrecking Wall Street, bank trust departments "controlling" operating corporations, the "two-tier" market, and other battle cries. The battle cries are not all accurate descriptions of the actual problems, but battle cries never are, and although they may be colorful over-simplifications of the problems, the fact remains that there are acute problems or there would be no battle cries.

My brief comments about this and the other impacts considered below, about which I have said more elsewhere, should be taken neither in lurid colors nor in black and white: they are all matters of degree, they are only some of the operative forces, and such forces work in many different directions. But these points are at least aspects of important problems which, if reasonably easily altered, warrant action.

There is thought to be a serious problem of institutional investors' "control" of their portfolio corporations. This may well become a substantial problem, and of course, there is some substance behind every myth, but today this is mostly myth. Episodes of such control occur, as seems to have happened in the Cleveland machine tool situation, but in large measure the myth seems to be promoted by those justifiably trying to draw public attention to the more subtle but still so important real problem, institutional influence on portfolio company management. Such influence can be valuable in bringing new expertise and perspectives, but it also can be, and is more likely to be, injurious in bringing the investors' short-term, bottom-line orientation as against managements' longer-term commitment and wider concern for all affected by their corporation. Moreover, the mere existence of large institutional holdings, whether voted or not, reduces management's accountability to the more numerous and diverse family of smaller, often longer-term stockholders.

D. Impact on other stockholders in portfolio corporations

In addition to the change in management's orientation and accountability, other stockholders are actually affected by large institutional members of their stockholder family in three ways.

First, access to information. The myth is of a serious problem of receipt and use of illegal "inside" information. Episodes of this kind will never be entirely eliminated or perhaps even kept insignificant, but the too-little attended to reality is of preferential access to "grey-area" information and to information which clearly may be given to anyone but is too bulky to publish.

The actual result, regardless of the extent to which the information flows as per myth or as per propriety, is a public perception of discriminatory information advantages, undermining confidence in the markets.

Second, ability to use information. The institutional stockholder can assimilate and act upon information faster than individual stockholders. This is an inevitable consequence of professionalization of money management. It is part of an increase in market rationality. It inevitably leads in some measure to driving individuals out of direct investment, which is not entirely a bad result but which can be overdone. The answer lies not in interfering with the gains we may enjoy from institutionalization, but rather in assuring that we are not injured by abuses which are bound to flow if institutionalization is left entirely unrestrained as if it were the one good thing of which we cannot get too much.

Third, institutional presence in the stockholder family is likely to lead to less continuity in stock prices. As Donald Regan said in opening your hearing in July (Hearings, Part 1, p. 5), we know too little "for certain" about the impacts of institutional trading, and I hope you will call for a study of the trading in a number of "air pocket" situations. As Regan said and so many say, volatility is up and institutions sometimes sell hastily and carelessly. This leaves wounds. But the problem is not solely the result of massive funds' speculation and/or herd movements: quick moves are often the result of sophisticated responses to new circumstances. Speculative and herd trading is undesirable, but rational responses to new circumstances are a desirable increase in the soundness of market prices. Impeding large stock moves by large investors would improperly lump together the undesirable and the desirable moves, and thus seriously interfere with the extent to which prices reflect sound investment judgments as well as interfering with the many advantages that institutionalization of money management bears for the beneficiaries of those funds. I will later offer a proposal for reducing speculative trading by institutions without impeding trading based on sound investment judgment.

E. Impact on stock markets generally

In large measure the market is only a composite of markets for particular stocks: whatever affects many particulars will affect the whole. Stockholders' fears, based a bit on myths and a good bit on realities, about inequality of access to information, ability to use information, transaction costs, and the impact of the fact that institutions are not immune from fads and thus sometime distort prices unsoundly, all affects the market by reducing public participation. For decades we have talked of the importance of public confidence in the markets. Myths and realities undermining that confidence command correction. Institutions know they have obligations to their own beneficiaries, they know they also have obligations to the markets such as not to manipulate and not to trade on inside information, but the new gargantuan size of instituional funds commands that their obligations to the markets rise above merely avoiding fraud.

F. Impact on the economy

In addition to impacts on sectors such as pension beneficiaries, stockholders, and portfolio corporations, other corporations and the economy generally are affected if pension fund investments are allowed to dominate the markets, reduce public stock ownership and draw sharp distinctions between institutionally favored stocks and all others.

Reduced participation in equity markets reduces liquidity and lowers the general level of equity prices.

Lower equity prices reduce the ability to secure new equity financing.

Reduced access to equity financing increases demand for debt financing and also decreases growth of corporations less able to finance internally or to command prime rates.

Increased demand for debt financing raises its cost, thus adding to the too-many other forces raising interest rates generally, and also inhibiting growth of smaller corporations less able to secure, or bear the cost of, borrowed funds.

Reduction of growth and an increase of mergers results, leading toward an economy both more sluggish and more concentrated.

The economy becomes more subject to the views and interests of lenders and money managers, and less subject to the views and interests—and greater diversity, in terms of kinds of people, geography, backgrounds, skills, ages, etc.—of operating managements.

G. Must the horses be stolen before we act

The problem is not solely one of what if any serious abuses and injuries have occurred. In large measure, the problem is one of serious abuses and injuries which are at very least thought to be occurring and which therefore have the real and injurious impact of reducing public confidence in the markets. Just as justice must not only be done but also appear to be done, the markets must both be, and appear to be, fair.

In larger measure, the problem is that the trends are clear, as I will show in a moment, and we are plunging ahead without speed limit or brakes.

H. Assumptions needing study

My list of problems or impacts assumes, rather than treating, at least four matters on which this Subcommittee, or Joint Economic or the Banking and Currency Committees or Ways and Means or Congressman Moss's subcommittee, would do us a great service by conducting hearings: *First,* to what extent do stock prices, and public participation in particular, affect corporations' ability to retain earnings? *Second,* to what extent does the much greater amount of debt financing for corporations mean that the level of equity availability is important only to some corporations at some times, or does it affect most corporations much of the time? *Third,* some say that a large proportion of equity financing is less the promotion of new ventures than the promotion of promoters; to what extent does that mean that the drying up of equity financing is not an important problem? *Fourth and last,* precisely what are the disadvantages of public participation in the markets through institutional intermediaries rather than directly, apart from impact on broker-dealers? While I have views on these questions, and while many views and some information have been presented in these and other hearings, I think we're far from firm understanding beyond a few data, or a consensus beyond rhetoric.

III. INFORMATION AVAILABLE—LIMITS, GAPS AND SLANTS

As noted earlier, these hearings have directly and indirectly developed new information, but much remains to be done on the information front and even if the disclosure bill is enacted this session, this work would remain valuable for several years.

A. An inventory of what we have

I have tried to compile the beginning of an inventory of relevant available information, in outline form.

1. Information on self-administered employee benefit plans: severe limits of Labor Dept. data.

2. Information on such plans administered by others—

(a) aggregate holdings managed by insurance companies: state law requires reporting and Best's compiles.

(b) Bank trust assets:

(i) total assets, assets by categories of accounts and by categories of assets held: Federal bank regulators' annual report.

(ii) One hundred largest trust departments' total assets: "American Bankers" annual survey.

(iii) Individual banks' reports on pooled equity funds (assemblages and performance comparisons are available).

(iv) Individual banks—Starting in 1971, a handful of individual banks' reports on trust department holdings, giving a variety of data—

See compilation in Fortune article reproduced in Hearings, Part 1, pp. 282–3

See reports of Morgan, First National City, Manufacturers Hanover, Chase, Bank America, Citizens & Southern

(v) Bentsen survey of 25 largest trust departments; end–1972, mid–1973 data including first-time information on aggregate size of employee benefit assets managed, "complete discretion" portion thereof, etc.

(vi) ABA survey of end–1972, some 1973 data.

(vii) Patman Report: 1967 data on larger holdings, including distribution of voting authority.

(viii) Institutional Investor Study: 1969 data on aggregates and on a sample of holdings, including distribution of voting authority.

(ix) Metcalf-Muskie Report: 1972 data on 30 largest holders of 89 major corporations.

(c) Investment advisers: No reporting (full reporting on investment companies' holding and trading, but not on any other assets under management).

(d) Aggregate assets under management: Money Market Directories.

If others agree with me about the value in pulling together the picture of what we have, I hope they will add to this outline.

B. Limits on available information

Information tells us little unless we have a sense of trends: if we know that the Morgan manages $27 billion, that information is of little utility if we don't know whether the figure is a drop of $X billion from the prior year or, as it was, a rise of 5 billion, or 21%. In short, single-year, balance-sheet type data tells us too little to act upon. Trends show what the problems may be and how consequential they may be. For example, in the ABA survey of trust departments last summer, one cannot know, let alone evaluate, the meaning of information on average number of corporations held, or sizes of equity orders, or concentration of holdings, unless one knows something about the direction and pace of movement. Is concentration dropping slowly or rising sharply? Their data leave us in limbo for purposes of action, although I applaud the survey's being done; I hope it will be repeated regularly, and enlarged.

Of course sometimes we get trend data which is so incomplete as to leave one in the air or suspecting that the numbers are being slanted to support an argument. Thus in your hearings, Bankers Trust Company (who with the Chase were the only non-respondents to Senator Bentsen's October letter survey), to show how "flexible" is their investment approach, compared their 50 largest holdings in 1972 and 1963 and found only 16 on both lists. Since a great change in investment management occurred in the mid–1960's, I think the Bankers Trust Company should give fuller information or forget about credibility.

Gaps in information are particularly serious if one source reports total assets, another reports equity assets, a third breaks it down by kinds of accounts, a fourth has a break-down by degree of voting authority, and a fifth, a break-down by discretion over investments, the last, only a sample of holdings. This hodge-podge is our present situation, and I am delighted we have what little we have, but the variety of the questions asked means that each report or survey stands alone too much, and cumlation and assemblage are rendered unduly difficult. I hope that your hearings and survey, and the recent massive Metcalf-Muskie survey, will be pulled together with other public data to tell us what we know about the whole elephant.

In addition to the variety of questions, every survey faces problems of definition and responsiveness. For example, in Senator Bentsen's October letter survey the banks were asked for holdings of over 5% of outstanding stock in discretionary accounts.

The Morgan didn't answer the question as you asked it; the First National City, managing $10.4 billion of discretionary funds, answered listing seven stocks, and the U.S. Trust, managing $6 billion of discretionary funds, listed 38 stocks. Perhaps those two completely cooperative respondents had the same understanding of "discretionary", but one can't help wondering.

Until we have systematic and periodic disclosure, we run too great a risk of learning only whatever the people with the information think we should learn. The ABA survey of last summer may be 100% valid on all points, but until one is certain of that it should be used with care. Let me give three examples. The Survey Report gives information on the size of equity orders, but: a) trust departments have rightly or wrongly long followed a practice of making separate orders for separate accounts, so of course they will have a very large number of orders. b) We need to know how many orders are entered on the same day for the same stock. c) We need to know more about the size of the orders. d) We need to know whether the tendency is toward larger orders, because of bunching or for other reasons. e) We need a distribution of sizes of trust departments much more informative than three categories below $750 million total assets, but only one above. Without more such information, we cannot give much weight to the Report's argument that trust departments do not invest "in a monolithic manner".

For a second example, the Survey Report shows that the average number of common stocks held by all trust departments was 507. Of course the number is not 25 or 30—only a fool would think that the "favorite fifty" are the only stocks held, and the Report is arguing against a straw man. Everyone knows that trust departments hold many close corporation stocks as well as other essentially "inherited" positions. Here again, we need data not on the department as a whole but on employee benefit funds, and we need trends and breakdown on the larger banks as we are given on the tinies.

For a last example, the Report gives the 25 largest holdings as a percentage of total equity holdings. Again, without some data showing how this compares with prior years, and without as much data on the bigger banks as on the little, we can be sure only that we need not be worried by straw men.

IV. WHAT IS TO BE DONE

A. Disclosure—clear utility and clear limits

All are for disclosure of institutional investors' holdings and tradings—the ABA in 1973, the SEC since 1971 at least, leading bi-partisan members of the Banking and Currency Committee who have introduced a bill, and members of this Subcommittee. Doubtless disclosure entails cost burdens, but it is equally doubtless that the social and economic gains of full disclosure warrant those costs. Just what is to be disclosed, how often and to whom, are issues of important details but not pertinent here today.

Disclosure *alone* will do little or nothing to halt or even discourage speculative or other destructive trading by massive institutional investors—I have heard no suggestion yet as to how it would reduce the institutional faddism, the investment research which is self-fulfilled by the sheer force of the portfolios using that research, and the "air pockets" that we have been seeing so much of as major blocks move in and out, sometimes for valid investment reasons, sometimes because sheer speculation is at play.

B. Legal restrictions on amounts of institutions' trading? No.

Inevitably, some suggest that there should be legal barriers restricting the amount of stock any one or all institutions can sell or buy in any one day. I submit that that "cure" would be worse than the disease. Such trading limits seem feasible in the commodities markets and they are feasible for the small category of corporate "control persons" in the stock market. But institutional investors are distinguishable in so many ways, and there are such strong reasons for allowing them to trade according to their investment judgments, and for avoiding legal obstacles that would interfere with the free, open, fair operation of market pricing mechanisms. I think the unwisdom of such limits was made clear by your first witness last July, Donald Regan, who said he had once supported such a notion but now believed it needed at least much more study. "It is always dangerous to tinker with the mechanisms of the market" (Hearings, Part 1, p. 7).

In a moment I will suggest how we might reduce the extent to which institutional investors trade not on investment judgment, as is the practice of the trust departments represented here today, but instead on sheer speculation, which characterized the "go-go" years and which will come-come back as soon as the market rises. Before getting into that, we should note how greatly the bill before you will aid this situation.

C. Limits on pension managers' holdings

In addition to disclosure, a sure improvement for the liquidity of the markets, the safety of pension portfolios, the sanity of market pricing, and public confidence that the markets are not dominated by greedy gargantuans, is to make sure that no single institution can hold too great a portion of the stock of any one company. I say "make sure", because according to what I had always been told, and on which we now have firm information from the Bentsen letter survey last October of the 25 largest bank trust departments, virtually all of these money managers follow flat limitation rules or give great weight to avoiding unduly large positions. Therefore, the Bentsen bill's proposal to make percentage limitations legally binding is merely an incorporation of the best banks' best practice, an assurance that these practices will not weaken as enormous money flows continue to pour into these trust departments, and a further assurance that all pension managers will follow the practices of the best managers.

One of your Subcommittee's earliest witnesses, Salim Lewis of Bear, Stearns, said "we should have been sitting here talking about this about 2 years ago or 1½ years ago, and not when the damage has been done. . . ." (Hearings, Part 1, p. 53.) It is an unfortunate fact about legislation, indeed one of the irreducible tragedies of legal process, that we usually act on problems only after great damage and loss, and sometimes suffering, have occurred, because it is only after pain that the body politic is moved to act. This is at least as true of legislation in the stock market area as in any other area.

Senator Bentsen and others have brought out how acute are the problems of shortage of capital, shortage of venture capital, distortion of stock market pricing, continued dominance of the market and of too large positions in too many corporations by too few institutions, and shortage of public participation in the markets. The public will come back when the market rises, but while some forces are functioning to correct the other problems, massive trends are under way to make worse much of those other problems.

I refer particularly to the continued enormous growth of pension plan funds, and the continued flow of such enormous portions of those funds to bank trust departments. Taking NYSE-listed stocks alone, private *non*insured pension funds held stock totalling $19.8 billion in 1961. (To all these figures must be added private insured funds, which in 1961 represented a much larger proportion, over one-third of private pension fund assets than is true today, but which are still huge.) By 1971, their NYSE stockholdings totalled $77 billion, for a growth of 57.2 billion over the decade. That kind of growth can be dwarfed quickly by only two figures, the U.S. Budget, and the projected growth for private noninsured funds in the current decade. The official NYSE projection of June 1972 is for another $120 billion in NYSE-listed stocks alone; the SEC's projection is for a total stockholding by such funds in 1980 of $269 billion. (See Disclosure of Corporate Ownership, Senate Gov. Ops. Subcommittees, Dec. 1973, p. 159.) So in the current decade such funds are expected to grow in NYSE-listed stocks alone, more than twice as fast as in the 1960's! And this does not count growth of pension monies managed by insurance companies! (See *ibid.*) While I have no data showing just how much of these funds goes to self-managed plans, how much to investment advisers and how much to bank trust departments, I am confident the data would show flatly that the trust departments have always had and continue to hold the vast bulk of these funds. I hope your other witnesses can provide data on this, either today or pursuant to a request I urge the Subcommittee to make.

Of the enormous flow into bank trust departments, the largest banks are getting under their management both an enormous and a constant portion. From 1968 through 1972, the top five trust departments have held their share of the market for trust asset management, where of course the main growth is in pension monies, at 23 to 25 percent. The top 10 have held at 31 to 36 percent. Banks in New York State alone have held at 46 to 50 percent. I have assembled these figures on the next page.

We all know of the limits on investment companies and on insurance companies with respect to the amount of stock they may hold in any one company. It is not a mere matter of one hour's draftsmanship to draw comparable limitations on bank trust departments and investment advisers, for substantial differences must be, but can be, grappled with. But is it not utterly clear that the time is ripe and getting riper—and it is said that ripeness is all, and to wait beyond it is to allow rot to enter—for making sure that the best practice of the best banks is the assured practice of all, and that the limits on investment companies and insurance companies are appropriately applied to investment advisers of all kinds?

Your bill must go forward.

ASSETS MANAGED BY BANK TRUST DEPARTMENTS [1]

Year	All banks [2]		New York banks [3]				Top 10 departments,[4] all accounts		Top 5 departments,[5] all accounts	
			All accounts		Employees benefit funds					
	All accounts	Employees benefit funds	Number	Percent	Number	Percent	Number	Percent	Number	Percent
1968	282,711	92,843	95,149	34	45,315	48	(6)	(6)	(6)	(6)
1969	280,109	95,430	96,341	34	47,505	50	101,850	36	69,484	25
1970	292,196	103,294	99,004	34	50,428	48	103,905	36	70,531	24
1971	343,320	123,685	112,724	33	58,089	47	117,181	31	78,579	23
1972	403,582	150,549	132,503	33	69,157	46	136,561	34	92,657	23

Year	Morgan Guaranty [7]				First National City Bank [8]				Citizens and Southern [9]			
	All accounts		Employee benefit funds		All accounts		Employee benefit funds		All accounts		Employee benefit funds	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
1968	19,126	6.8	10,683	11.5	(6)	(6)	(6)	(6)	1,188	0.4	583	0.6
1969	19,189	6.9	10,970	11.5	11,589	4.2	5,383	5.6	1,156	.6	772	.8
1970	19,337	6.6	11,153	10.8	11,682	3.9	5,904	5.7	1,573	.5	750	.7
1971	22,657	6.6	13,267	10.8	14,257	4.2	7,452	6.2	1,664	.5	907	.6
1972	27,437	6.8	16,555	11.0	17,157	4.3	9,326	6.2	2,109	.5	979	.6

1 Figures are stated in millions.

2 Trust Assets of Insured Commercial Banks—Board of Governors of the Federal Reserve System, et al.

3 Trust Assets of Insured Commercial Banks—1968 through 1972. Figures are stated as dollar amounts and as a percent of totals appearing under the heading "All banks." Percentages have been computed from figures published in the text. "All accounts," and "Employee benefit" columns are compared separately for each year.

4 American Banker. Trust assets of top 100 banks and trust companies. And see footnote 3.

5 American Banker, trust assets of top 100 banks and trust companies. And see footnote 3.

6 Not available.

7 Reports of the Trust and Investment Division, Morgan Guaranty Trust Co. And see footnote 3.

8 Reports of the Investment Management Group of First National City Bank. And see footnote 3.

9 Report of the Trust Department of the Citizens and Southern National Bank. And see footnote 3

Note: For preparation of this table, I am indebted to Mr. Kelly Addy, 3d-year student, GULC.

D. S. 2842.—With respect to the precise language of the wise and much needed S. 2842, seven points:

(1) I am troubled about the legal differences the bill will introduce between self-managed pension plans, like that of U.S. Steel, and plans managed by outsiders like your witnesses later this morning. Why should U.S. Steel pension funds be able to hold up to 10% of the stock of any one company, whereas Exxon pension funds managed by trust departments, would be limited by law to holding only a tiny fraction of 10% of most appropriate stocks, since their funds must share the percentage limit with other pension funds under the same money manager? Of course the point is not limited to the largest corporations. The percentage limits are utterly necessary, but it is unnecessary and unwise to allow them to create distinctions between self-managed and outside-managed funds. As members of the Finance Committee are surely well aware, many people believe self-managed pension funds present particularly sharp problems, some believe they should not be allowed, and an especially large number would agree that legislation should not encourage self-management, nor even offer a rationalization for any corporation to explain its choice of self-management.

This new discrimination in favor of self-management warrants serious consideration, and I hope your other witnesses will address themselves to it constructively, and not merely use it as a stick for standing pat against this wise bill. I am not sure what the answer is, but I believe it lies along such lines as these: First, perhaps existing self-managed plans are entitled to more favorable treatment in these regards than new ones. Second, if the 5 and 10 percent limits are sound for large aggregations of pension funds, then for a self-managed plan lower figures seem in order, scaled still lower according to the size of the plan's assets.

(2) Profit-sharing plans are excluded from the bill's provisions by Section 408(a). I agree with exclusion with respect to such plans' holdings of stock of the employer corporation, but I question whether all assets of all profit-sharing plans should be excluded.

(3) While I am sure that some amendment is needed to deal with the first problem noted above, for this point I am not sure there even is a problem, and wish merely to raise question: The percentage limits in Section 408(b) (1) apply to all the pension trust assets. Perhaps the base should instead be only the equity investments?

(4) Should the 5 percent limit of Section 408(b) (1) be rigid regardless of the size of the fund in question? I would think some modest scaling, so as to allow a small fund to buy, for example, a reasonable amount of IBM or Superior Oil, would be in order.

(5) Section 408(d) (2), defining "discretionary investment authority", is very important because there are many variations in the actualities as well as the legalities of discretionary investment authority. An unduly legalistic definition will fail to embrace many accounts which ought to be included. Consideration should be given to amending the definition to conform with that in the bill on disclosure, S. 2234. The definition there is wisely realistic. Moreover, conformity is desirable in terms of policy, of ease of compliance and of administration, and for soundness of the statistics and judgments to be made in the years to come on the bases of these new laws.

(6) I am troubled about Section 408(e) (2) and the way in which the new percentage limits are applied to existing securities positions. Is it wise, or necessary, to say that if on December 31, 1974, a fund is 5% invested in one corporation's securities, it is flatly barred from further acquisitions except to the extent of 5% of new money inflows? While many of us are troubled about the degree to which the institutions have concentrated on their favorites, won't it be unnecessarily disruptive of the markets in those stocks to pass a statute saying, in effect, "Starting a few months from now, the major source of demand for the following 50 stocks will be for the most part stopped up." I am not sure of the right answer, but believe it lies between the present language and the preposterous never-never alternative of simply ignoring all positions acquired prior to the act's effective date.

Probably the answer lies along lines of a phase-in period of, say, three years, during which existing positions can be added to annually in amounts not exceeding the average purchase of that stock for that fund over the prior three years, or in amounts not exceeding 1% of the outstanding stock (or ½% of the fund's assets), whichever figure is smaller. The phase-in period would apply only to stocks in which the fund has a substantial position at the time the Act becomes effective, and "substantial position" would have to be spelled out specifically. We sorely need this bill's percentage limits, but I believe we can afford a reasonable phase-in for existing situations whereas we need not and should not cause sudden disruptions.

(7) With respect to the *capital gains treatment*, six brief points. *First*, applause. *Second*, applause in particular for resisting those Wall Street promoters of speculation who want to reduce the holding period to three months. The irresponsibility and selfishness of their position is summed up, I believe, by this general evaluation stated last June by Senator Williams:

> I want to say a final word about the *Securities Industry Association*, and the way that organization has presented this matter officially to us. Quite frankly, their position is, "let us have what we have had for 200 years; only make it better for us." Of course, holding to that same old 200-year system and making it better for them, it makes it worse for everybody else and that includes the small investor. The *SIA* officials came in with their chevrons as duly appointed industry leaders, with this story, but many other members of the *SIA* and the industry who do not come with chevrons tell us an entirely different story. Some of the real leaders of the industry told me publicly and informally that they know the old order has to give way. The *SIA* appear to have one function and that is to stand in the way of the inevitable happening. (Congressional Record, June 18, 1973, p. S11377.)

Third, as is probably known but is worth repeating, the proposal to raise the 50% capital gains exclusion was put forward just over a decade ago by the Kennedy Administration. At that time, the distinguished stock market commentator, Burton Crane, said:

> No financial subject has caused more regrettable misunderstanding than the capital gains tax. Investors who should know better will report with every show of sincerity that the tax "freezes" them into their holdings. Actually, only investors who expect to die in the near future are "frozen in." Death provides a new capital gains basis, the market price at the time. A man about to die would be foolish to pay a 25 per cent long-term capital gains tax this week and have his estate pay perhaps 30 per cent more in inheritance tax. But nobody else is "frozen in." This is probably a case in which propaganda has been believed by the wrong persons. Wall Street intended it for Congress, hoping to get rid of the tax or to have it reduced. Instead, it was believed by Wall Street's customers. There is no doubt that the feeling of being "frozen in," false though it is, has kept many an investor from realizing his gains. (New York Times, Feb. 5, 1956, § 3, p.1.)
>
> In a recent study of high income taxpayers, it was found that many of the realized losses reported appeared to be related to tax considerations (the desire to make use of the loss for tax purposes); about one fifth of investors owning appreciated assets gave evidence of being "locked-in" to some extent by taxation; *and only a very small proportion seemed to be affected by the six-month holding period*. Barlow, Brazer, and Morgan, Economic Behavior of the Affluent (1966). (Bittker and Stone, Federal Income, Estate & Gift Taxation, 498 (1972).)

Fourth, may I suggest, with no intention to criticize, that the problem of lock-in caused by our capital gains tax treatment is dealt with only partially, and too partially, by changing the exclusion percentage or tax rate and ignoring the long-criticized stepped-up basis upon death. Whether or not the step-up should be wholly eliminated, at least the amount of step-up might be reduced in relationship to the length of holding period. If locked-in holdings are to be unlocked, shouldn't we use a key and not merely a bobby-pin? Also, there may well be some who would think that reducing the capital gains tax while preserving intact the stepped-up basis, is wanting to eat the cake and still have it.

Fifth, may I urge reconsideration for special capital gains treatment in the case of reinvestment in publicly traded securities. Your first witness, Donald Regan, urged this, suggesting treatment parallel to that presently given upon sale of a residence and timely purchase of a new one. Encouragement of savings, and particularly encouragement of savings by participation in the securities markets, would gain greatly and soundly from Regan's suggestion. At very least, if the capital gains tax is not postponed upon timely reinvestment, a substantial increase in the percentage exclusion should be considered.

E. Discouraging speculative trading by institutions: an anti-gambling tax for greedy gargantuans

Spurred by economic incentives for short-term performance, many institutional "investors" take speculative positions seeking quick gains and with little concern for longer-term soundness. By the nature of such trading, it often involves what have come to be called "herds" of institutions moving relatively together and causing relatively sudden, wide price movements. The pending proposals for broader disclosure of institutions' holdings and trading are a critical first step toward correction of such trading, but disclosure alone will do too little on this problem. Holding size limits also will do too little to inhibit such trading. Economic incentives, or disincentives, are also needed.

We should consider imposing a tax to encourage purchase for a reasonable holding period. We must stop thinking of securities held by institutional portfolios of over, say, $10 million, as ordinary capital assets to be treated for tax purposes the same as shares held by individual investors. There are unique needs and problems in trying to affect holding periods for securities in such institutional portfolios, but our thinking cannot stop with the simple period set for taxation of capital gains generally.

Large institutional portfolios with an activity rate above a level to be determined after careful study, ought to pay a capital gains tax graduated according to both the length of the holding period for the particular security and the portfolio's overall activity rate. For example, if a mutual fund with an activity rate which is extremely high relative to other portfolios in the same category, buys and sells within one month, there is a good case for taxing away most of its profit. Losses would be set off against longer-term profits. If the turn-around is within three months, the tax might be 60 percent; within 6 months, 50 percent; 9 months, 40 percent; etc. Obviously, this is submitted subject to the need for further refinement, but these are the lines along which work is needed.

Some would call such a tax confiscatory. Others would call it a turnover tax, or an anti-churning tax. I call it an anti-gambling tax.

We must never freeze investors into particular investments. Nor should we treat an institutional portfolio with low or reasonable turnover the same as "swinging" portfolios, for anyone may make mistakes which he wants to correct quickly, anyone can have the misfortune of buying a stock just before a major negative event, and in such cases quick sales should not be inhibited or penalized. But the time has surely come to consider seriously the need for limiting organized gambling with vast amounts of other people's money. Those who wish to get their gambling kicks in our securities markets should do so with their own money or in relatively small pools.

This proposal was first put forward in April, 1970, in Hearings on Investment Policies of Pension Funds, before the Joint Economic Committee's Subcommittee on Fiscal Policy. It was repeated one month later when I "key-noted" the annual meeting of the Investment Counsel Association of America.

To add weight to the proposal, may I note that it drew nationwide press coverage, but that coverage did not go beyond the "here's an interesting idea" treatment and some quotation. However, perhaps because I had only recently returned to academe from serving as Chief Counsel of the SEC's Institutional Investor Study, I received considerable comment from members of the investment community. That comment, doubtless because of the self-screening that occurs when people are conveying their reactions, was uniformly favorable. The chairman of the board of one of our largest insurance companies wrote: "I have an instinctive sympathy with the idea that the government should not subsidize by favorable tax treatment action that it finds socially undesirable."

Obviously, I would be happy to pursue the proposal further if any other member of the Subcommittee is so inclined.

V. PROMOTING SAVINGS

Going beyond the precise jurisdiction of S. 2842, but not the jurisdiction of your Committee, may I take this opportunity to call your attention to recent articles noting how much our tax laws penalize individuals' savings. The puritan virtue of thrift is not greatly in vogue, but America's soaring needs for capital in the coming years have recently drawn increasing attention and concern. I realize that personal saving can make only a fractional contribution to our needs for new capital, but I submit that the least we can do is to stop penalizing small savers. Between inflation and ordinary income taxes on savings account interest or capital gains tax on investment sales, how can small savers protect their future, how can we talk seriously about encouraging personal saving? Robert Metz recently had a column in the *New York Times* about Amherst College's President Charles Cole, who wrote that a $75,000 investment in the stock market in 1955, sold in 1973 at $125,000 for a ⅔ gain, represented no gain at all after inflation and taxes. And as he showed, if one had a 33% gain to $100,000 upon sale, one actually had suffered a loss. *The Wall Street Journal* recently had a column showing the same preposterous paradox with respect to savings accounts.

America saves too little. There are many reasons, of many kinds and not all of them reducible to bad or good, why America since 1960 saves as a proportion of after-tax income, at a rate lower than Britain's, only 2/3 of the rate in France, just over half of the rate in Germany, and would you believe, only about 40% of the rate in Japan? (Dept. Commerce, Dom. & Intl. Bus. Adm., Internat'l Economic Indicators, Table 27, Sept. 1973.)

We have grown greatly by promoting consumption, but we will not continue to grow greatly enough or wisely enough if we do not promote saving and investment more. May I at this point applaud our leading banks for their aggressive new monthly stock investment plans, which will efficiently bring in more saving and will encourage direct public participation? It is unfortunate but true that the securities industry cannot do the same think as efficiently, and their cries of anguish against the banks' action seem to come down apart from fear of losing their monopoly, to the interesting claim that the banks are limiting the plan to too few stocks.

We need not merely more equity capital and more venture capital, we also need to redirect capital flows. Equity market distortions bear significant responsibility for our excessive investment in fried chicken and other "fast food" stands, "discount" furniture outlets, etc. Equity market improvement, combined with tax and other revisions, can help meet the great needs for fundamental plant building, from refineries and utilities to rolling stock, mass transit and the inner cities. If our vision is to meet our challenges, we must go beyond equity and venture capital and improve our tax treatment of saving generally, including such possibly small steps as giving little people's saving account earnings the same advantage presently given to dividends from stock, and possibly large steps such as restructuring our system of financing housing and indeed much of our antiquated financial framework.

One of our finest businessmen, J. Irwin Miller, two years ago wrote an article entitled "Can We Afford Tomorrow?" Since I believe that we would be rather in trouble if the answer to that question were "No," I believe the question before us is whether we will meet our challenges well enough to keep reasonable the costs of getting to tomorrow, and the value of getting there.

[From the Wall Street Journal, Sept. 28, 1973]

THE TWO-TIER MARKET REEXAMINED

(By Samuel R. Callaway)

Commentary on the stock market has been replete with references to "two-tier" pricing and with confident assertions as to the cause of that phenomenon. In what has become the conventional explanation, the wide disparity between the price-earnings ratio of some stocks and those of others—a gap, by the way, that has narrowed somewhat in recent weeks—is attributed mainly to the policies and practices of institutional investors, especially the trut departments of large banks.

The proponents of this thesis, pointing to large institutional holdings of stocks that sell at high multiples of earnings, ascribe motives that range from whim to conspiracy. They almost never concede that the reason for the holdings may be solely investment judgment.

LOOSE CHARGES

Having assigned blame for the two-tier market, they loosely bundle into the charge allegations of responsibility for such associated problems as the recent generalized weakness of stock prices, the reduced level of trading, financial difficulties in the securities industry, and the inauspicious climate for the floating of new issues. A corollary proposition states that the very presence of the institutions in the market deters participation by individuals.

All this simply too facile. It may satisfy some deep-seated human need to lay blame in bad times. But scapegoatery is no substitute for analysis. The reasons for the two-tier market go deeper than the fact that the top-tier stocks are among those which institutions have bought aggressively and held tenaciously.

Let me hasten to say, speaking for the institution with which I am familiar, that a high multiple in itself has never been what attracts us to a stock. If we could find two stocks with identical histories, identical current situations, and identical future prospects, with one selling for 30 times current earnings and the other for 15 times, we wouldn't have to call a meeting to decide in favor of the latter.

If, however, our research and analysis led us to believe the higher-multiple stock had better long-run future prospects, then it would become a question of how much better, and the margin might be great enough to make that stock a better investment in the long run. And long-run investment results are what our clients are primarily interested in.

The ideal investment opportunity for any long-term investment program, of course, is one in which a stock can be bought at a relatively low multiple of current earnings and held while earnings increase and the multiple rises. But even the more common case, where the multiple levels off or falls despite continued good growth in earnings, can be a rewarding investment. The growth in earnings and dividends can more than outweigh the decline in price-earnings ratio.

The emergence in recent years of an uncommonly wide margin of investor preference for a relatively few stocks was a stage in a process of investment evolution that began at least two decades ago. The series of short, steep recessions that occurred in the years after World War II brought the discovery of a new kind of corporate creature, the recession-proof company. This was a company able to maintain growth in earnings and dividends even during economic downturns. Its special virtue may have been a product or service with a growth trend strong enough to carry through a business slump, a big enough order backlog to last through the down part of the business cycle, or perhaps a flow of income sustained by customers' payments of equipment rentals.

In any case, companies that took recessions without breaking stride were singled out for special recognition in the stock market. Their price-earnings multiples began to reflect their special standing. The upgrading, however, apparently went too far too fast, because they were the stocks that suffered most in the market shakeout of 1962.

That market reappraisal of the troubleproof companies was in a way prophetic. There ensued an unusually long period during the '60s in which the economy was free both from recession and from the feverish variety of inflation. Total output and corporate profits kept growing fairly steadily. As a result, distinctions between companies on the basis of their resistance to adversity became less important to investors than they had been in the 1950s. There were still tiers in the stock market, but the distances separating them tended to narrow.

The recession of 1969–71 changed that. It was different in configuration from the earlier postwar recessions. Instead of being short and steep, it was long and shallow. Its adverse impact reached a greater number of companies, including some that previously had been considered recession-proof. But there still were some that managed to come through relatively unscathed, and once again the market—this time more emphatically than before—conferred a premium on them.

The imposition of price, wage, and dividend controls intensified the distinction. Coming just as the economy was starting to look up, controls made it apparent that many companies would not be able to increase their earnings at a rate greater than the continuing inflation. The stocks of such companies naturally suffered, and this served to accentuate the preference for companies more favorably situated.

CURBING DIVIDEND INCREASES

The stock market's attitude toward cyclical companies during this period was particularly affected by the controls on dividend increases. In many cases shares of cyclical companies were held by investors who preferred current yield over long-term growth. With dividends under restraint, those investors found high-yielding bonds increasingly attractive. But the limitations on dividend payout had little or no effect on the market valuation of growth stocks. Investors in those stocks typically look to future, rather than current, dividend income.

By the time controls were relaxed, many investors felt it was too late for the non-growth stocks, which had suffered the down side of the business cycle, to enjoy the full effect of the compensating up side.

This whole combination of factors, I submit, was the main cause of what came to be known as the two-tier market. Investors, whether institutional or individual, didn't will it into existence or have any desire to maintain it. They were merely reacting to the situation they perceived. Blaming the two-tier market on investors is like blaming a rainstorm on the people who put up their umbrellas.

At the height of concern over the two-tier market there were suggestions that legislation or regulation be devised to restore a more even gradation of investor preference among stocks. The answer does not lie in trying to force investors to stop behaving like investors. If we retain our belief in the ability of markets to allocate resources, it should be evident that the correction has to be more fundamental. What is required most essentially is that investors become convinced that the economy is entering a period of sustainable growth with a lower rate of inflation than we have had over the past six or seven years.

That kind of setting will pull tiers much closer together. Although a brighter sky makes all parts of the landscape look better, the best of the companies that have been in the lower tier are likely to show proportionately greater price gains than the upper-tier favorites in a generally improved economic climate.

Right now some investors—and we are among them—are appraising opportunities among companies currently out of favor but likely to find a better environment in the years ahead. Actually, we have always invested over a much broader range of companies than the current mythology about institutions would suggest. Data we published earlier this year show that at the end of 1972 we had holdings with market value of $1 million or more in each of 569 different stocks.

Our largest holdings, not surprisingly, were in the stocks of large companies. But it may be interesting to note that, of our 50 largest holdings at the end of 1972, only 20 were stocks that had been among our 50 largest holdings five years earlier.

It also should not be surprising that our major holdings included a number of stocks that ranked high on lists published by other institutions. This doesn't mean, as is frequently inferred, that we or the other institutions aren't investing in anything else.

INVESTING $1.8 BILLION

Last year, on behalf of pension and other employe benefit funds of which Morgan Guaranty is trustee, our Trust and Investment Division made common stock purchases totaling $1.8 billion, of which $1 billion was new money contributed into the funds or earned on invesments and $800 million was proceeds from the sale of investments. We put the $1.8 billion into a total of 228 different stocks. Of the 15 stocks in which we made our largest purchases, totaling $800 million, only four had been among our 22 largest holdings ($150 million or more) at the start of 1972.

Our purchases on behalf of employe benefit funds have included stocks of a number of relatively small companies. The amount invested in each is necessarily modest, but in the aggregate over the two-year period 1971–72 we put $261 million into stocks of 213 companies with market capitalization of less than $100 million.

Ironically, if a limitation were put on the percentage of a company's stock a bank trustee may hold—and such limits have been suggested as an antidote to the two-tier market—the effect would be to discourage investment in smaller companies and cause a greater proportion of funds to go into stocks of the largest companies, where there usually would be plenty of room inside the limit. Thus the result would be the opposite of that intended.

[From the New York Times, Feb. 19, 1974]

MARKET PLACE: REGIONAL BANKS—POINT TO RESULTS

(By Robert Metz)

It never pays to suggest, as New Yorkers are wont to do, that everything is done better in the Big Apple than elsewhere. That's because the "elsewheres" write in to argue the point.

And so it was a group of out-of-town banks after performance results for major New York City banks were published showing how poorly the banks here had done in managing their commingled equity funds invested for their corporate pension account customers.

An article detailing the New York experience went on to comment that, if the local banks had had trouble, "it is nothing to what must have happened to the out-of-town banks."

Many small banks discovered the nifty-fifty were outperformers late in 1972 and early 1973," the article continued. "All they got for their money was the down move."

A number of regional banks responded. The Philadelphia National Bank pointed out that recent studies of investment performance by both the academic community and several performance evaluation services indicated "no correlation between results and geographical location."

The bank added that, "in fact," some of the best results have come from Philadelphia, Denver and Hartford banks.

The figures for Philadelphia National were provided to compare with those of the New York banks on a three-year basis and they are included in the table below—along with figures for the other Philadelphia banks, obtained from a different source.

As Philadelphia National points out, if the five largest Philadelphia banks were taken with the results of the nine from New York City, the Philadelphia group would hold high positions—1, 2, 4 and 5—for 1973.

In alphabetical order, here are partial results for several banks. The banks acknowledged, by and large, that small size was perhaps an advantage in that they could establish meaningful positions in the stock of small companies the big banks would have to pass by. Again, they thought it an advantage that their relatively small positions in given stocks could be liquidated without undue impact on stock market liquidity.

The Casco Bank and Trust Company, Portland, Me., manages close to $200 million. By buying 50 per cent growth stocks, 25 per cent speculative stocks and 25 per cent bonds, the bank experienced "only a 10.7 per cent overall decline."

The First Bank and Trust Company, Springfield, Mass., with more than $300 million, was down 6.92 per cent in 1973.

The Marine Midland Bank-Rochester said its commingled corporate pension fund recorded an 8.3 per cent decline (income reinvested) for the 12 months ended Dec. 31, 1973.

The New England Merchants National Bank of Boston said that its commingled pension and profit-sharing capital fund was up 25 per cent in 1971, up 22 per cent in 1972 and down 12.2 per cent for 1973, leading to a compound rate of return of 10.2 per cent. Income was reinvested in all these figures.

The Willimantic Trust Company in Connecticut was down about 4.3 per cent with dividends reinvested in 1973.

COMMINGLED EQUITY FUNDS FOR EMPLOYEE BENEFIT ACCOUNTS—TOTAL RATES OF RETURN—WITH INCOME REINVESTED (YEARS ENDED DEC 31)

[In percent]

	1973	1972	1971	3 yr. compound return
Philadelphia:				
Philadelphia National	−8.3	+30.9	+28.3	+15.5
Provident National	−9.9	+15.8	+24.2	+9.0
Girard Bank	−14.1	+19.3	+14.1	+5.4
Fidelity Bank	−20.6	+7.1	+17.9	+.9
First Pennsylvania	−13.2	+13.4	+16.4	+4.6
New York:				
Bank of New York	−11.2	+19.7	+19.5	+8.3
Chemical Bank	−16.3	+11.4	+25.9	+5.6
Chase Manhattan	−17.9	+6.5	+15.1	+.2
First National City	−18.3	+22.4	+22.8	+7.1
Irving Trust	−18.4	+22.5	+18.8	+5.9
Manufacturers Hanover	−20.2	+25.1	+22.8	+7.0
Morgan Guaranty	−20.8	+25.9	+10.1	+5.6
U.S. Trust	−22.9	+21.2	+20.4	+6.5
Bankers Trust	−20.4	+20.8	+30.1	+8.6
Potential Market Averages Standard & Poor's 500	−14.67	+16.99	+14.05	+8.1

[From the New York Times, Sept. 9, 1973]

WHY THE MARKET WILL REMAIN STRATIFIED

(By John R. Beckett)

The stock market, as many have observed, is a multitier affair. At the upper tier are a few stocks, perhaps 50 to 75, selling at 25 to 55 times their most recent 12 months' earnings.

The lower tier contains almost all the other companies, numbering several thousands, selling at 12 times, or less, down to an incredible four times their most recent 12 months' earnings.

Then there are a modest number of fortunate companies between these extremes, which I term the middle tier.

The reason it is a multitier market is that the only large sums of new money coming into it are investments of pension funds which for reasons I will describe, are invested largely in a few select companies.

These companies are the strong upper tier. Foreign investors who usually operate in the upper part of the lower tier, and in the middle tier, moved out of the market to a considerable extent several years ago in anticipation of a dollar devaluation. As yet they have not returned.

The American public also is not now active in the stock market, and the mutual funds are net sellers on balance. Thus, there is no real support for either the middle tier or the lower tier. The lower tier especially has been drifting downward.

A question may be asked: Are the tiers likely to remain so pronounced and stratified? For example, will the upper tier move down and the lower tier move up in relation to each other?

To help answer this question you might wish to study the institutional holdings of New York Stock Exchange-listed companies.

You will see that each year pension funds have been investing billions of dollars of new money in common stocks. Inasmuch as the pension fund managers are usually responsible to a committee, often a bank trust committee, it is no wonder that these men continue to buy the same strong, high-growth leaders in noncyclical industries that are already accepted by their committees as prudent investments. Why be venturesome? Why be bold? Why not follow the line of least resistance and stay with the same group of companies one's peers are buying?

Will this type of investing continue? For example, will Johnson & Johnson continue to sell at 46 times earnings, International Business Machines at 32 times earnings, Eastman Kodak at 35 times earnings and Baxter Laboratories at 53 times earnings? In my judgment, looking out over a reasonable period of time, the answer is yes—or at even higher price-earnings multiplies as the funds invest additional new money each year in the same places.

My first conclusion, then, is that the sharply tiered stock market will be with us for many years, and that certain noncyclical growth companies that are leaders in their fields will sell at even higher price multiples than they do today.

And, of course, while some companies, such as the ones I have mentioned, deserve high multiples, I would question a few speculative high-flyers on the pension buying list and would not predict higher price-earnings ratios for them.

Eventually, however, the sums of new pension money will become so large and the disparity between the tiers so magnified that there must be a spill-over. When that occurs, and to some extent it is beginning, pension-fund investments will be made in the middle-tier companies and then in the lower tier.

By then the pension-fund list will have 400 to 500 active names instead of the 75 to 100 names that now dominate the scene. Thus, looking to the future, I conclude also that there is hope for this kind of pension-fund buying support for mnay of us who run large organizations classified in the middle or lower tier. But, we must be patient.

A third conclusion is that it will be difficult in the future for mutual funds to grow as they once did. In fact, they have been shrinking in size. One reason for this is that, unlike the pension-fund managers, the mutual-fund managers did not immediately perceive that the only strength for awhile would be in those shares being bought by the pension funds.

In other words, the mutual funds were more venturesome, feeling that they had to prove to their shareholders their analytical expertise, which under the conditions I have described was not particularly useful.

Thus, in recent years, mutual funds have not performed as well as they might have, and the public is discouraged about them.

Further, the bureaucrats, in their usual wisdom of doing exactly the wrong thing with the best of intentions, took away the front-end load for contractual sales and, thus, made it nonprofitable for a salesman to seek the small saver and sell him on the idea of periodically investing his small savings in mutual funds.

I conclude we will see no great burst of activity in the fund business to bail out the stock market, and, because of redemptions, the funds could continue to be net sellers.

Finally, as mentioned, the public has left the stock market for the time being. The private investor finds it psychologically difficult to buy a stock at 30 to 55 times earnings.

Logic tells him that such a stock is high-priced. He also wonders how he can compete with the knowledge of the portfolio managers who are current about developments within this select group of companies.

He knows that if any one of these stocks starts down because of a change in earnings outlook, it could move down rapidly as the portfolio managers unload.

On the other hand, the private investor is also frightened by stocks at six to eight times earnings.

So instead of stocks, many private investors are buying tax shelters, land, gold and even art objects as a hedge against inflation. Even the speculators have moved from the stock market into the commodity markets.

I conclude from this that when the private investor realizes we are not going to have a deep recession, and when he sees that inflation is being brought under temporary control, he will come back into the stock market, at least on a gingerly basis.

At that time there will be a fairly strong upsurge in the lower-and middle-tier issues, but then the market will settle back as additional inflationary problems arise.

I expect this rally at any time, beginning with the fourth quarter of this year when the prime interest rate will have peaked. While I expect a strong rally, it will certainly not be the start of another bull market.

When foreign investors are convinced that we will not devalue again—which should be soon, because we wil not—they wil again invest large sums in our stock market, which is cheap compared with their markets. I would expect these foreign investments to be made in large companies in the lower and middle tiers, in these issues selling at eight to 15 times earnings. This, too, should bolster the market base.

All indications are, therefore, that the stock market is near its bottom, or that it is there already. I expect to see an improvement by the fourth quarter, even if the rally is not sustained.

Looking at the matter over a longer time span, and providing inflation is controlled, aggressive investors in the months ahead could enjoy one of the great speculative buying opportunities of all times in large, sound, lower- and middle-tier companies.

Strange as it may sound, even when price-earnings multiples are high, because of the likelihood of continued pension-fund buying as I have described, conservative investors should stay with high-multiple noncyclical growth companies that are not "johnny-come-latelys" to the scene.

These super companies should be in capital-intensive nonregulated industries that are difficult for competitors to enter, should have the dominant market-share in their industries and should have exceptionally strong balance sheets.

And if it sounds as though I am talking about companies like I.B.M. and Eastman Kodak, I am.

[From the Wall Street Journal, Aug. 29, 1973]

THE BLIGHT OF THE TWO-TIER MARKET

(By I. D. Robbins)

As a trustee under wills, I have occasionally been subjected to powerful selling efforts by bank trust departments seeking to serve as investment advisers. Not long ago, a co-trustee and I, at the request of a beneficiary who had met a persuasive bank officer, acceded to a switch from one bank to another. Although some minor changes in the common stock portfolio were recommended, there was, in my opinion, no significant change in the general character of the list. Both banks, whose combined managed assets exceed $35 billion, were essentially recommending the same relatively small list of stocks.

I must admit that the trustees tended to narrow the bank's recommendations still further to the stocks we had come to regard as having more conservative quality. We told ourselves that if we were investing for ourselves we might do it differently, but who were we to argue with the combined judgment of the great banks?

I did, however, feel a certain discomfort as I became increasingly aware that the ratio of price to earnings of many of the recommended stocks was extremely high, that dividend income as a return on investment was low and that we had no rationally based sense of security to combat the danger of major selloffs by one or more of the institutional investors who made the market what it is.

When we questioned the advisers, they made two basic replies: (1) How can you quarrel with success? and (2) We have to be able to move a lot of stock without upsetting things and there are only a limited number of situations where this can be done. I sensed also that despite large research staffs, the bank people felt limited in their ability to be "experts in everything." The salesmen or account executives for the banks were not themselves security experts, but were required to defend the underlying investment program of the bank.

Recently there has been much written about the two-tier market: some stocks favored by the large institutional investors and often showing a high price-to-earnings ratio and a much larger number of issues not favored and showing a low price-to-earnings ratio. Typical of the current literature was the article in the July issue of Fortune by Carol J. Loomis, which presented persuasive evidence that a bear market for most stocks not favored by the institutions has existed for five years.

Officers of companies in the second grouping are often thoroughly depressed. By dint of mighty effort they increase profits, only to see the market value or P–E of their stock plummet. They want to expand and grow but the value of what they have to offer is downgraded. They turn to brokers, investment bankers, economists and market experts and commentators. What do they hear? Only that these things go in cycles, that the investor always returns to the market and will this time too. Or that some big institutional investor will have to get a black eye before any significant change occurs. At any rate, they are told, given the power of the big institutional investors who have to put out the money and the counter-pulls which dissuade the retail investor, nothing is likely to help until the major portfolios begin to change.

NO SIMPLE EXPLANATION

There is probably no single, simple explanation of the phenomenon of the two-tier market, but those companies which don't benefit from it and those portfolio managers who are uneasy about their fiduciary responsibilities should be even more deeply concerned than they seem to be so far.

The matter has been considered from many angles and certain hypotheses can be offered:

1. The two-tier market is an expression and effect of the monopoly of money management. Given the early investor experience with such wonders as IBM, it was inevitable that those with large sums to invest would be similarly attracted. The concentration of funds then begins to have a circular effect, each investment act tending to encourage another and each supporting all others. The reverse occurs with those securities which are not favored. This condition, contagious throughout the money management field, has the quality of a self-fulfilling prophecy.

2. The effect of the two-tier market is to confuse the individual or retail investor and cause him to lose confidence in the market. If earnings are not reflected in the price and the price is not reflected in earnings, where can the investor turn? And why should he put his money in the stock market?

3. If a few institutions controlling vast sums have the power to profoundly affect the market, the purpose and value of the free market is lost, or rather there is not really a free market upon which buyers and sellers can depend, nor one from which a company in offering its shares can expect reasonably equal and rational treatment or response.

4. The most pessimistic hypothesis of all is that the two-tier market reflects a loss of confidence in the American economy and in the general outlook. There is a strong suggestion that we are experiencing a collapse of values: political, moral and economic. The business and investment communities have been shocked at the stunning pace at which other national economies are rising and the consequent need for dollar devaluations, two of them in a short time. If investment

is a form of discounting the future and the future looks insecure, it is reasonable for all investors, wholesale and retail, to seek the companies which on the basis of past performance seem to have the most secure future.

5. Institutional investing is all that is left because the individual investor has tended to lose confidence in Wall Street. The back office messes, thefts of securities, the capital shortage crunches all hurt. After 40 years of "full disclosure," self regulation and discipline and the SEC, the investor still experiences a too-frequent disaster in the very issues which have been touted in the Street and most widely publicized for their success. Consider LTV, Equity Funding, Litton, Levitz.

It has been consistent national policy that the concentration of economic power tending toward monopoly is per se wrong. This is, as the Congress and courts have held, because it is alleged to restrain trade and discourage enterprise and opportunity. A case could be made that when financial power is concentrated, the effect on the American enterprise system is compounded by channeling investments before the conventional defenses against market control and other forms of monopoly can come into play. The institutionalized two-tier market was not recognized at the time of the Temporary National Economic Committee studies several decades ago. Is it time for an in-depth analysis of this new phenomenon by a well qualified public body?

On an immediate, practical level the two-tier market has handicapped many companies with good operating records and fundamental values on their books. Executives of these non-favored companies believe the money managers have lost their perspective and have adopted dubious new standards of value which have influenced all buyers. As a result there are many real bargains available but no takers except for some foreign investors who are entering the market with cheaper dollars.

There may be other reasons for a weak market. Perhaps our values are distorted by the generally higher multiples which existed in the mid-60s. What is a reasonable multiple for a well-run company in today's market? Is there a sure-fire rule of thumb?

In the face of today's competing tax-free municipal bonds returning close to 6% and corporate bonds paying more than 8½%, it would seem to take a P–E ratio as low as 7 to 10 to make common stocks a good investment compared to bonds and other money market issues. Then what about the soundness of Polaroid at 80; McDonald's, 57; Disney, 53; Johnson & Johnson, 50; Hewlett-Packard, 45; Xerox, 43; Coca Cola, 42; American Hospital Supply, 40; or American Home Products, 37?

These are fine companies, but is Avon at a P–E of 50 two and a half times as good as Revlon? And is Avon, a marketer of what are equivalent to intangibles six times as secure and desirable for investment as General Motors, the epitome of tangibles? Is an investment in Polaroid more than twice as good as an investment in the photographic market leader, Eastman Kodak? Or is the value of a dollar earned by Polaroid 20 times as great as the same dollar earned by Ford? Why? Prove it as a future prospect?

THE LESSON OF HISTORY

Unless the two-tier market reflects a permanent lack of confidence in the future of most American enterprise, history tells us there will be a change. And when it happens, a lot of people and pension funds could take a bath. Reverse leverage can be a terrible thing. Contemplate the insecurity of a pension fund with large holdings in some of these super-high multiple stocks. If these investments returned to even a high—but within reason—multiple, the fund, to remain sound, would have to reach back for a lot of new money.

Since, based on history, the two-tier market seems to be an aberration, it is likely that it will pass. How?

By legislation attempting to control the money managers? A slow process.

By improving the dividend payouts of the low P–E ratio companies? Though attitudes have changed with the reduction in maximum income tax rates and higher capital gains rates, there is still insufficient hard evidence that higher dividends will attract investors.

By reason of mounting fears among the money managers that they are mutually trapped by their common strategy and that they and their clients could be the victims of a sudden collapse of values?

This last would seem to be the most likely development. The thoughtful managers must right now be considering how—and how fast—they can avoid it.

How can they get off the hook? How can they make significant changes in their portfolios without causing too much damage? It seems likely that it will be impossible for them to avoid some severe losses. But they still must make the changes.

Some students of the stock market feel that any pressure on the high multiple market leaders will cause the entire market to sell off. Short term, this probably will happen. But the next effect will probably be that, as the high multiple stocks are sold, investment funds will be selectively channeled into worthy stocks that have been neglected. As different stocks become the beneficiaries of the enormous purchasing power of the institutions, they will rise in price. There will still be substantial differences in market evaluation of stocks, but there will not be a two-tier market as we have known it.

The final effect, given a satisfactory general business and political atmosphere unrelated to the practices of the money managers, is that the investing public will be encourged to come back to the market.

[From the New York Times, July 31, 1973]

Market Place: Stock Dumping By Institutions

(By Robert Metz)

If an investor buys stock in a company only to see that stock fall dramatically a day later when an institution dumps a major position, he can hardly be blamed if his confidence in the underlying structure of the stock market sinks.

Yet this kind of thing has been happening to investors on a fairly regular basis for several years now, and the effect has been to temper enthusiasm for a market that no longer can be depended upon to provide orderly, gradual price changes.

There are people in Wall Street who argue that, when a mutual fund dumps tens of thousands of shares and knocks the price substantially lower, it reflects a decision taken collectively on behalf of thousands of shareholders—the once-removed shareholders of the fund.

But Paul Kolton, chairman of the American Stock Exchange, has become increasingly outspoken in his criticism of institutional dumping. He made the case strongly last week before the subcommittee on financial markets of the Senate Finance Committee.

"There is now widespread agreement that there should be periodic disclosure by [all financial] institutions of information relating to their activities and holdings in the markets, similar to disclosures now required by the S.E.C. of mutual funds," he testified.

He endorsed in principle a measure, introduced last week in the Senate, that would provide such disclosure. He had not had a chance at the time, he testified, to study the bill. He said he thought such a measure would have a "salutory effect on the patterns of institutional activity in the market.

"Beyond the question of disclosure, we think it timely to develop clear guidelines concerning the methods and patterns of institutional trading," Mr. Kolton said.

This suggestion is based on our view that the demands that institutions make on the markets are often greater than the markets are reasonably designed to fulfill.

"This suggestion is based on our view that the demands that institutions make on the markets are often greater than the markets are reasonably designed to fulfill.

"For example, where an institutional investor has acquired a large position in a stock over an extended period of time, it may be unreasonable to expect the markets to absorb that position within a few hours—or minutes.

"One effect of such sudden dumping of positions is to change drastically the market price of a security, even though no fundamental corporate events have occurred which would alter the security's inherent value."

He said that, when price fluctuations of this kind occurred only because of a decision by an investment manager to liquidate a position, public confidence could be expected to suffer.

"Over the years, one of the hallmarks of the United States exchanges has been the orderliness and gradualness with which price changes normally occur," Mr. Kolton said.

"This has done a great deal to inspire public confidence and participation. And the stockholders today who sees a large percentage of the paper value of his holdings disappear during one trading session is likely to be wary of those markets and of the market mechanism itself."

Mr. Kolton then suggested something other commentators have been urging—limiting an institution's sales over a given period of time.

"For example," Mr. Kolton said, "perhaps an institution's volume should be limited to a given percentage of average weekly volume on the exchange during the previous few weeks.

"This is a technique the Amex has used over the years in connection with so-called shelf distributions. In this procedure, selling stockholders and companies undertake to sell securities in an orderly manner, generally over a period of time, and the results have been markedly satisfactory."

Mr. Kolton did not say so, but it has seemed to many observers that stock prices have gotten out of line on occasions in which the institutional investors have acted in what might be termed "inadvertent conspiracy." A stock like Levitz Furniture becomes popular and no one wants to sell, thus tipping the applecart, until it is demonstrated emphatically that the price has gotten out of line by any reasonable standard.

This tacit understanding—if indeed it does exist—leads to further and further accumulation until someone panics and sells out.

If an institutional investor's selling instincts were affected by artificial volume limits like those Mr. Kolton is suggesting, then the temptation to ride a stock into the upper atmosphere might well be tempered.

Heard on the Street

(By Charles J. Elia)

The stock market's two-tier system—the boon of bank trust departments and the bane of most of the rest of Wall Street—hasn't exactly collapsed, but technical analysists are starting to think it may be in the process of becoming maybe just 1½ tiers.

It's still early to say for sure, but the market's gyrations during the past three months have emitted clues of changes. Technicians assessing those clues believe that institutional fascination with 40 or 50 quality growth stocks that comprised the top tier is growing relatively less pronounced, if not wanting, and that money is beginning to flow into some of the once-shunned stocks having low price-earnings multiples.

"Some of our broader indexes held above their earlier summer lows last week while the Dow Jones industrial average and the Standard & Poor's composite index dropped to new lows," says Stephen C. Leuthold, of Piper, Jaffray & Hopwood Inc. "The market is broadening out."

Contrary to expectations of some analysts, high-powered growth stocks favored by banks and other institutional investors haven't cracked and collapsed as a group, although a few individual issues have tumbled.

But many have weakened, along with the rest of the market, and have been outstripped in their recovery ability by such prosaic stocks as papers, aluminums and machinery.

"You're beginning to see a big rotation of interest into cyclical secondary stocks," says John D. Greely, analyst at McQuade Curd Sullivan Inc. Mr. Greeley, who has done extensive studies of the divergence between high-multiple growth stocks and the rest of the market sees in this development a greater willingness of institutional managers to put new-money inflows into cyclicals with large capitalizations.

"The leading averages haven't been representative for a while," comments Mr. Greeley. "There's growing recognition that the average stock made its low more than two months ago and that growth stocks aren't completely immune to an economic downturn. Money managers aren't dumping growth stocks but they're apprehensive enough about having to pay up for high multiples that they're directing their inflow of new money into stocks with a strong outlook and lower P-Es."

Another analyst says some of the redirected investment decisions may have policy overtones as well as an investment rationale. "I know of several large trust departments in banks which have gotten the word from upper-level management to stop fooling around with high P-E stocks and start buying 'value' stocks," he says. Large banks, he suggests, are concerned that the market's two-tier structure might lead to efforts in Washington to regulate institutional trading. Banks also have been hearing protests on this score from some of their corporate customers whose low-multiple stocks have been long depressed, he adds.

For whatever reason—and the signs are still tentative—technical analysts believe the market's character has changed this year, particularly in the past several months. Interest in secondary-type stocks, demonstrated most dramatically during a sharp market rally in July, has persisted although leading averages have since dropped to new lows. The Dow Jones industrial average set its year-to-date low of 851.90 on Aug. 22. It closed yesterday at 883.43.

A review of several indicators by Ralph J. Acampora, Jr., technical analyst at Harris, Upham & Co., indicates that in the past month a broad measure of stocks held onto more of the summer-rally gains between June 25 and July 27 than did either the popular averages or Harris, Upham's glamour-growth stocks index.

Between Jan. 1 and last Tuesday's close, most stocks were still worse off than the averages. In that period, the Dow Jones industrial average fell 15.5%, Harris Upham's glamour-growth indext was down 20.7% and the Value Line index of 1,400 stocks was down 27.1%.

But a look at what happened after June 25 indicates the broadest of these—the Value Line index—did better in both the July rally and the subsequent decline to the Aug. 22 lows. On that roller-coaster ride, the Dow Jones average rose 7.8% and then dropped 9.1%, and the glamours went up 7.2% and then fell 6.8%, but the 1,400-stock index climed 11.3% and then declined only 8.6%.

Mr. Acampora believes the market's apparent change of tempo has been preceded by a major period of "distribution" by lrage holders of some of the most broadly held growth stocks. Distribution is the technician's way of describing steady and increasingly persistent selling of stocks near a top in their price trends. "In a distribution phase, sellers ar moving their stocks out during rallies," says Mr. Acampora, "and they become more aggressive as they go along."

Mr. Acampora interprets his charts of price movements as indicating that major distribution has been going on for some time in the more widely held big-investor favorites, particularly Exxon, Du Pont, McDonald's, IBM, Standard Oil (Calif.), Standard Oil (Indiana) and Xerox. He considers recent rebound moves by some of these stocks "strictly technical." Here's how he sees each of them on a technical chart basis:

Exxon: Major selling between 103 and 95 indicates it could drop to the mid-70s. It closed yesterday at 89⅝. Du Pont: Vulnerable to the 135 area. It closed yesterday at 160. McDonald's: If near-term support at 53–55 is broken, a drop to the mid-30s could occur. It closed at 66⅜ yesterday. IBM: Renewed selling after summer rally enhanced prospects of a 250–260 target. It closed yesterday at 304¼.

California Standard: Intermediate to long term, a drop to the 50s is possible. It closed yesterday at 66¼. Indiana Standard: Having broken out below an eight-month range between 81 and 91 recently, downside target is the low- to mid-60s. It closed yesterday at 81½. Xerox: The 140–145 level is critical, and a drop below 140 could signal a potential decline to the 110–120 area. The stock closed yesterday at 155¼.

[From the New York Times, Sept. 5, 1973]

Market Place: P-E Ratios Pose Paradox

(By Robert Metz)

Here is a stock-market paradox.

Company A earned substantially more money than Company B during the five-year period ended in 1972.

Would not one think that the stock of Company A would sell at a significantly higher price-earnings ratio than that of Company B?

Actually, the answer to that question is no. For in chalking up its record, Company A did exceptionally well in the first year of those five years; dropped the ball in the second year and, despite year-to-year gains thereafter, didn't manage to surpass the first year's earnings until the fifth year.

Company B, for its part, tacked gain upon gain, having started from a substantially lower base in 1968. The actual figures on earnings per share follow:

Year	Company A	Company B
1968	$2.00	$1.24
1969	1.77	1.47
1970	1.81	1.72
1971	1.88	1.89
1972	2.14	2.16
Total share earnings (5 years)	9.69	8.48
Dividends (5 years)	6.00	5.38

Now the average investor might want to give Company B higher marks because it has shown an ability for a five-year period to tack one substantial earnings gain on another.

Still, Company A has shown that after a setback it had enough resiliency to recover, keep its dividend rolling and even surpass the five-year record of Company B.

Let's say you are an investment manager for a mutual fund, bank pension fund or some other major organization that invests huge sums of the public's money.

Would you place a substantial premium on Company B, according it, say, twice the price-earnings multiple of Company A? Well, perhaps that's a bit much. After all, the dividend has been better for the owner of Company A.

A look at the market itself shows just how the two companies are valued. As recently as Aug. 28, Company A was selling at a price-earnings ratio of 6 and Company B at 50.

The companies: Amerace and Avon Products.

This example offered by V. T. Norton, chairman of the board of the Amerace Corporation, is dramatic evidence of the absurdity of the current two-tier market—even though Mr. Norton is an interested party.

Mr. Norton is philosophic about the situation—to a degree. But in his capacity as a co-trustee with a large institution, is rankled by the "usual recommendations" from the institution: ". . . [We recommend the following stocks], which have superior growth in both earnings and dividends which entitles them to the high multiples they enjoy."

In response to that specific recommendation, he replied:

"I do not agree with you. A substantial portion of these high multiples is caused by what has been labeled an 'inadvertent conspiracy' created when the institutions get on and ride. Having taken major positions for themselves or their clients, their continued recommendations or purchases of these stocks may well be in fact a conflict of interest.

"Where there is adequate recognition of how pension trust money is siphoned from deserving corporations into trust departments which then invest the money disproportionately in the 'favored fifty' stocks, regulations may follow. Capital-needed corporations that created this money should not be deprived of its investment benefits."

Mr. Norton added that no one would "quarrel" with the premise that good continuous earnings should be attractive to investors. "Some companies," he said, "should enjoy higher price-earnings multiples than others. However, this does not justify the stratospheric multiples in the stocks that are the darlings of the money managers."

[From the New York Times, Sept. 6, 1973]

MARKET PLACE: PUBLIC CAPITAL HARD TO FIND

(By Robert Metz)

Hundreds of promising corporations that need money to survive have learned that banks are not the only source of capital that is priced out of reach.

The public, traditional source of growth capital, has also become too selective to make funds available at reasonable cost. The public is undoubtedly influenced by the current stock market, which values most stocks at bargain levels and still finds no ready takers.

Whatever the reason, the potential cost of money from this source is so high as to make it, in effect, unavailable to scores of corporations important to the nation's future.

As an indication of the scope of the problems, common shares offered the investing public in the first half of 1973 totaled $1.2 billion, compared with $4.8-billion in the first half of 1972; with the bulk in both cases representing secondary financings by major corporations.

More clearly indicating the degree to which the market has dried up for young corporations is the fact that there were only 18 initial public offerings, in which $5-million or more were sought, in the first six months of this year, compared with 149 in the comparable 1972 period.

The time of stress, while worsening, goes back some time.

Item: In 1971, the International Hydronics Corporation of Princeton, N.J., was unable to find financing for a highly sophisticated plant in the Chicago area with potential to treat 75 million gallons of concentrated chemical wastes a year and thus reduce environmental pollution.

Both the company president and the underwriter pounded the streets of Chicago in a futile effort to sell shares in the then-raging bear market. Finally, a socially conscious bank bought a substantial part of the issue and this broke the roadblock. But proceeds of a bit less than $1.3-million failed to cover building costs in a period of rampant inflation.

While more financing would have been readily available in a period of normal capital markets, the corporation had to resort to bank loans that could only be secured through collateral pledged by two well-connected directors.

Without the high-cost loans, the plant would never have been completed at a time when pollution control is high on the list of national priorities.

Today, things would be worse still. Peter A. (Tony) Russ, vice president for corporate financing at Thomson & McKinnon Auchincloss, Inc., estimates that a small corporation such as International Hydrants would have to pay well over the 9¾ per cent prime rate to borrow from the banks and have to leave more money on deposit—the so-called compensating balance.

The brokerage firm official gave this example of these costs in comparison with those on the public capital market for a small growing corporation.

If the corporation wanted to make a $2-million capital improvement, it might borrow $1.7-million of that sum from a bank.

The corporation would probably have to pay a raw rate of 11 per cent. A 20 per cent compensating balance would raise the total cost of the money to 13¾ per cent, a year. That the brokerage official pointed out, would call for a "very substantial rate of return on the installation just to break-even."

Such costs, needless to say, increase the risk to all shareholders since a cutback in orders or production delay could cripple, even kill, the struggling company.

Now the public market. Assume that the company was doing well, and was in a reasonably attractive field while the stock market was in a more bullish phase. Its shares could sell at, say, 15 times earnings. If the capital were raised through the public market under those conditions, the relative cost of the $1.7-million would probably be from 6 to 8 per cent, even allowing for the stock dilution.

But in today's capital market, the company would be more likely to bear a price-earnings ratio of 6—or even less. making the cost of money by way of the public route excessive—if it were available at all.

Mr. Russ spoke of an apparel company that would ordinarily command the industry's traditional price-earnings ratio of 7–10 and that recently withdrew a planned public offering in disgust.

The company related its financing prospects to an established apparel company whose price-earnings ratio dropped to about 2½ times, based on a projection of current fiscal earnings. The second company had earned $1.12 a share two years ago, $2.81 last year and was expected to earn $4.50 to $5 a share in the current fiscal year. It is now selling at 13.

Curiously, there are pockets of interest even in these market doldrums. The worldwide grain shortage which has led President Nixon to put back into production the nearly 60 million acres farmers have been paid not to farm (Soil Bank) has brought renewed interest in related fields. A new issue of a hybrid-corn producer is expected to be a popular one.

It will be a rare item if it is and will simply dramatize the extraordinary and harmful effects of a market that is selective on the one hand and blinded to value on the other.

[From the New York Times, Sept. 12, 1973]

Market Place: Investment Role of Institutions

(By Vartanig G. Vartan)

United States Senators are becoming big drawing cards for luncheon meetings of the New York Society of Security Analysts, a group that usually listens to corporate executives and stock-market observers.

Next Monday, the society will play host at its 15 William Street meeting place to Senator Lloyd Bentsen Jr., the Texas Democrat.

It is expected that the Senator will shed some light on the role of institutional investors, which have become the big guns of the stock market in recent years.

Senator Bentsen is chairman of the Senate Subcommittee on Financial Markets, which held public hearings in Washington this summer while examining the impact of institutional investors on the securities scene.

Senator Bentsen's remarks will be of prime interest to the society, a spokesman said, inasmuch as one-half of its 5,000 members belong to financial institutions, such as banks, insurance companies and mutual funds.

The institutions often deal in large blocks of stock and this form of trading can cause volatile swings in the price of individual issues. It is understandable, therefore, that this practice helps to disillusion many small investors—often to the point where they elect to stay out of the stock market.

Thomas Hart Wilkins, who manages investment research for the Royal-Globe Insurance Companies, is the man who has arranged for Senator Bentsen's appearance. Mr. Wilkins even has drafted some possible questions that members of the audience may put to the Texan after lunch—and the prepared address—is over.

Among those questions are the following:

Does the Senator favor disclosure of stock-portfolio holdings by institutions?

Does he favor lowering the capital gains tax in order to increase the incentive of holders to sell stocks with large capital gains and then allocate the money to new ventures?

Should institutions be prevented from "dumping" large blocks of stocks suddenly on the market and thereby create an immediate impact on prices?

These are meaty questions and the analysis undoubtedly will come up with other queries, since that is part of their stock in trade.

On the matter of the capital gains tax, however, it should be noted that many institutional investors are—unlike the individual investor—exempt from such tax liability.

The biggest Senatorial drawing card at these analyst luncheons was Senator George McGovern Aug 29 of last year during the heat of the Presidential campaign.

In his appearance, Senator McGovern outlined a new program of tax reforms and moderated his approach to welfare reform. He also implored the nation's investors to accept both out of economic self-interest and in a spirit of "social responsibility."

Senator McGovern, of course, caused termors in the stock market during the 1972 campaign, to the point where falling prices were described as "a McGovern market."

"It was shoulder to shoulder with McGovern," remarked Mr. Wilkins yesterday as he described the crowd jamming into the second-floor meetingplace.

The turnout was so dominated by reporters, politicians, political followers and television crews, in fact, that the analysts were a minority group. Box lunches were served in place of the standard set meals.

"Senator McGovern's speech was interrupted at least 19 times by applause," one reporter wrote, "but the clapping rarely spread beyond a small group that appeared to include some of his staff."

END OF TRADITION

A small tradition has fallen by the wayside at Merrill Lynch, Pierce, Fenner & Smith, Inc. In the past, whenever a customer reinvested $500 or more that had been kept in his Merrill Lynch account as a cash balance, the world's biggest brokerage firm credited the account with 1 per cent a year on the reinvested cash.

"We are eliminating this payment on any new cash balances created after the end of August," Merrill Lynch has informed its customers.

The reason? "Our customers are finding more productive ways to put their excess funds to work," responds the firm.

Much of the idle cash is going into Treasury bills and fixed-income securities—or straight into bank accounts.

HEARD ON THE STREET

(By Charles J. Elia)

Managing billions of dollars in corporate pension funds may have become the most glamorous game in town in recent years, judging from the aura of power that surrounds the bigger Wall Street institutions. Behind the mystique, however, many pension fund managers have as much trouble coping with a long market decline as anyone else.

One of the biggest names in the business is Morgan Guaranty Trust Co. At the start of 1973, its trust department was managing $27.4 billion of investments, with about 650 corporate employe-benefit plans accounting for $16.5 billion of the total.

Aside from listing its largest holdings in each of the past two years, Morgan Guaranty hasn't made known its investment results until now, except to trust department clients, maintaining that there isn't any such thing as a representative account and that any figures it disclosed might be misleading.

The disclosure logjam is easing, at least in part. The bank has made available annual statements on its "pooled" funds, separate entities run much like mutual funds. It uses these commingled funds in managing part of most clients' pension money, investing a portion of each account in the pooled funds on a unit-value basis, similar to the net asset value per-share method used by mutual funds.

The bank has eight of these funds. Together, they have assets of $3.2 billion. Five are invested in bonds, rural estate, mortgages and money-market instruments. More closely followed by Wall Street, if only on the rumor route, are three diversified stock funds of varying aggressiveness.

The scorecard is in for the three stock funds for their fiscal year ended last Sept. 30. By way of comparison, in those 12 months the Dow Jones industrial average was off 0.6%, Standard & Poor's 500-stock index was off 1.9% and the New York Stock Exchange composite index was off 3.4%. Here's how Morgan Guaranty's big pooled stock funds did:

The Special Situations fund, which had assets of $918 million on Sept. 30, 1972, and of $971 million at year-end 1972, ended last Sept. 30 with assets of $748 million. An aggressive fund geared to investment in less seasoned, "emerging" companies, it realized gains of $62 million but had unrealized losses of $221 million. On a unit-value basis, investors lost 18% before dividends.

The Intermediate fund, invested in medium-sized companies, boosted its assets from $570 million on Sept. 30, 1972, to $625 million in the next 12 months but, because of a large inflow of new money and more units, it fell 11% on a unit-value basis. The fund took in $120 million of new money from investor-clients but had realized losses of $31 million and unrealized losses of $34 million.

The Common Stock fund, oriented toward quality growth stocks and established companies, did relatively better than the other two, dropping about 2% in unit value. Assets rose to $513 million from $444 million. Realized losses were minimal but unrealized losses ran to $11 million.

Samuel R. Callaway, executive vice president of Morgan Guaranty, says calendar 1973 results aren't in yet but that he expects the pooled funds did worse than the averages for the full year particularly the more volatile special situations and intermediate funds, just as they tend to swing further on the upside in rising market periods. The popular averages were down 17% to 19% in calendar 1973.

The Special Situations fund did somewhat more selling than buying of stocks in fiscal 1973, disposing of $202 million worth while adding back $194 million worth.

Eliminated were 208,200 shares of Loew's Corp., 200,012 shares of Revco D.S., 479,200 shares of Rite-Aid Corp., 1,055,400 shares of Levitz and 674,358 of MGIC Investment. The fund realized a profit of $15 million on its Levitz sale, indicating it got out at about $25 a share; yesterday, the stock close at 3⅞.

Although MGIC was disposed of on the fund's books at a profit of nearly $44 million, Mr. Callaway says it wasn't an open-market sale. "When companies get too big for the fund, we disperse the shares into the pension accounts directly," he explains. "That's what we did with MGIC." Some of the stock, in fact, showed up as a purchase by the Common Stock fund, which boosted its holdings of MGIC to 168,670 shares.

Other stocks sold by the Special Situations fund included Tiffany, Tropicana, Minnetonka Labs, Dreyfus Corp. and Capital Cities Broadcasting. The fund took losses of nearly $6 million in heavy selling of once-favored mobile home and building stocks. Nearly $22 million worth were eliminated, including 465,000 shares of Champion Home Builders.

Among the largest purchases by the Special Situation fund were Marriott (the fund held 872,373 shares on Sept. 30), Ponderosa, Lowe's Cos., Molex, Hartz Mountain, Damon and Colonial Penn Group, and Associated Coca Cola. Newcomers to the portfolio included Almaden, Northrup-King, Pioneer Hi-Bred, Mary Kay Cosmetics, Gilbert Associates, and John H. Harland Co.

Some of the fund's unrealized losses stem from unregistered "investment letter" stock. There were 24 such issues in the portfolio, valued at about half their $53 million cost. Among them: $4.2 million of National Student Marketing carried on the books as being worth $170,000.

One of the biggest losses realized by the Intermediate fund's portfolio sales was $6.9 million on 330,733 shares of Penn Life. The fund also is carrying as worthless 375,000 shares of Equity Funding Corp., which cost $16 million.

[From the New York Times, Jan. 15, 1974]

MARKET PLACE: INFLATION MAKES TAX BITE BIGGER

(By Robert Metz)

If the individual is turning away from the stock market, it is not hard to find reasons why.

In the first place the market has been unrewarding to all but the most astute investors since 1969, when a sustained bear market began that continues today.

For individuals with strong stomachs there was always the short side of the market. But one had to be nimble, indeed, to make money buying stock in one of the few sustained rallies since 1969.

Even long-term investors are stymied if they have profits and wish to realize them. For capital gains taxes are going to have a considerable impact in this era of substantial inflation.

Charles W. Cole, president emeritus of Amherst College, gives this example of what has been happening.

In an effort to make his point fairly, Mr. Cole has assumed a relatively low rate of inflation—certainly a much lower rate than we see today.

Assume then that the rate of inflation has been 3 per cent a year since an individual bought stock for $72,000 on June 30, 1955. Assume further that the investor has done well enough to increase the value of his portfolio by two-thirds at the end of 1973.

His securities would be worth close to $125,000. As Mr. Cole points out, he would have a sum equal in purchasing power to his original investment.

Nevertheles, he would have to pay capital gains taxes presently ranging up to about 25 per cent of his gain of $53,000.

Even worse off is the investor who made the same investment on June 30, 1955, and sold for $100,000 at the end of the month.

In terms of purchasing power he has actually lost $25,000, and yet he will be required to pay capital "gains" taxes on $28,000.

Using a more recent example and assuming an inflation rate of 3 per cent, a $10,000 purchase on June 30, 1965, would have to be sold for $12,500 at the end of last year to bring equal purchasing power. But even if the investor sells his shares at $11,000 for a purchasing power loss of $1,500 he owes capital "gains" taxes on $1,000.

States Mr. Cole:

"In countries such as Chile or Brazil where inflation has been perennial, people are well aware that a tax on capital gains is frequently a tax on actual losses.

"If we continue to have even moderate inflation, this realization will gradually come home to us. And with it may come the thought that since inflation is to a large degree the result of the policies of the Federal Government, taxes should be designed to be reasonably fair to those affected by those policies.

AVERAGES AND PRICES

In speaking of the stock market in terms of averages it is easy to forget that the market is made up of stocks. Thus, while the Dow-Jones industrials were at roughly the same level on Dec. 31, 1970, and Dec. 31, 1973, the average was brought to those levels through an entirely different combination of prices last month. Here are the Dow-Jones industrials and the prices for the stocks in the average—with 1970 prices adjusted as necessary to account for stock splits.

DOW JONES INDUSTRIAL AVERAGE

Dec. 31 closing average	1970: 838.95	1973: 850.86	Dec. 31 closing average	1970: 838.95	1973: 850.86
Allied Chem	$24⅛	49	Int Nickle	45⅜	35¼
Alum Co Am	57¼	72¾	Int Paper	35¼	52
Amer Brands	45⅛	32¼	Johns Mansv	40½	16½
Amer Can	39¾	26½	Owens Illinois	57	30⅞
Amer Tel	48⅞	50⅛	Procter & Gam	58	92
Anaconda	21	26⅛	Sears	76¼	80¼
Bethlehem Stl	22⅞	33	Std Oil Cal	[1] 27¼	35
Chrysler	28	15⅝	Xon	73⅜	94⅛
DuPont	133⅜	159	Swift	30⅛	24⅛
Eastman Kodak	75⅝	116	Union Carb	39⅞	34⅛
General Elect	[1] 46 15/16	63	Texaco	34⅞	27⅜
General Foods	[1] 43¾	24¾	United Airct	33¾	23¾
General Motors	80½	46⅛	U.S. Steel	32⅝	37⅝
Goodyear	21⅝	15¼	Westinghouse	[1] 33⅜	25⅜
Int Harv	27½	25¾	Woolworth	36½	18⅜

[1] Adjusted for splits.

[From the New York Times, Jan. 17, 1974]

Market Place: A Losing Year at Bank Funds

(By Robert Metz)

Those closely guarded figures telling how well the major New York City banks have done with their commingled corporate pension accounts have surfaced, disclosing stunning losses for 1973 almost all along the line.

With one exception, not a single bank managed to beat the leading market averages with their massive commingled common funds and not one bank beat an average of growth funds with their more aggressive special equity accounts.

If a loss can be termed a good result, then the Bank of New York takes the prize for a setback of just 11.2 percent of its common stock fund. This compared with a drop of 13.6 in the Dow-Jones industrial average and a drop of 14.8 percent for the Standard & Poor's index of 500 industrials. Both averages have been adjusted to allow for reinvestment of dividends as have all results for the major banks.

The Bank of New York also did the best work in its special equity fund, down just 25.1 percent for the year. However, an average of growth funds, weighted to give appropriate emphasis to funds of different size, was off just 22.2 percent.

There had been a great deal of speculation that the major New York City banks, with their alleged emphasis on the first tier of a two-tier market—the Avon Products's, the Xeroxes, the I.B.M.s and Eastman Kodaks to name a few—would fair poorly for the year as a result of heavy selling in the group late last year.

Two banks in particular have been known for their preference for these stocks—Morgan Guaranty Trust and U.S. Trust. Both did rather worse than the rest of the banks. Morgan Guaranty's common fund was down 20.78 and its special equity fund, down 39.46. U.S. Trust dropped 22.85 percent in its common fund and 42 percent in its special equity fund.

The commingled funds are by and large massive accounts with billions of dollars in assets while the special equity accounts are much smaller, some with just a few millions in assets.

One commentator, when told of the results, said that gains of the last several years had probably been wiped out for the special equity funds in many cases. The banks have used these relatively small funds to show that they can be aggressive and, until recently, to show that they can be right as well.

He also thought the first-tier stocks had been "bought fairly well"—that is at relatively low prices several years ago. But the current figures suggest that they not only rode them up, they rode them back down to ground zero.

But if the New York banks have had their troubles it is nothing to what must have happened to the small out-of-town banks. Many small banks discovered the "nifty-fifty" were "outperformers" late in 1972 and early 1973. All they got for their money was the down move.

The figures are passed around from bank to bank on a confidential basis. The fact that United States Trust did not disclose its figures this time suggested to some that the bank was in the lower range in performance for 1973.

A spokesman was unable to reach the officers to verify this late yesterday.

	Common fund	Special fund
Bank of New York	−11.2	−25.1
Chemical Bank	−16.3	−23.9
Chase Manhattan	−17.94	−30.45
First National City	−18.32	−32.5
Irving Trust	−18.41	−35.54
Manufacturer's Hanover	−20.18	−43.44
Morgan Guaranty	−20.78	−39.46
U.S. Trust	−22.85	−42.0
Banker's Trust	NA	NA
Dow-Jones Industrials	−13.6	
Standard & Poors	−14.8	
Mutual Funds	−18.7	
Growth Funds	−22.2	

All figures, including those for the market averages and the mutual funds, assume reinvestment of dividends. Reintroduction of dividends for the D.J.I. and S. & P. was done by Computer Directions Advisers. The same organization provided the mutual fund averages, which are weighted in accordance with each fund's asset size. The larger the fund, the more weight it gets.

MERRILL LYNCH IMPACT

The importance of Merrill Lynch, Pierce, Fenner & Smith to stock exchange liquidity was clearly evident yesterday.

When Merrill's computer went down preventing order transmission to the exchange the New York Stock Exchange delayed the opening for 15 minutes.

The brokerage firm said that the computer problem was manual rather than electronic and involved customer orders made after the close of trading on Tuesday and stored on tape for execution at the opening yesterday.

The exchange said the purpose of the delay was to permit notification of all member firms that the overnight Merrill orders would not be present when opening prices were determined.

The explanation emphasized the critical importance of Merrill to the market. Accounting as it did for 12 per cent of securities traded on the Big Board in 1972 and somewhat more than that, it is believed, in 1973.

Brokers said that without Merrill there might have been substantial price gaps. Apparently this was the feeling at the exchange. It was the first time in exchange history that the opening was delayed because of malfunctioning of a member firm's computer. Donald Regan was said to have been furious at the decision, but he could not be reached for comment yesterday.

Dr. Malca, would you proceed with your testimony?

STATEMENT OF DR. EDWARD MALCA, PROFESSOR OF ECONOMICS, RICHMOND COLLEGE OF CITY UNIVERSITY OF NEW YORK

Dr. Malca. Thank you, Mr. Chairman.

I am Edward Malca, professor of economics at Richmond College of the City University of New York.

Mr. Chairman, I wish to thank you for this opportunity to present my views on this issue. I would like to summarize my statement in one sentence. Unfortunately, while this might be appreciated, the subject matter does not lend itself to such brevity.

The bill under consideration tries to come to grips with the dual problems of increased institutionalization of the stock market and the diminution of the role of the individual investor in the equities market. If this trend should continue over a longer time span, it will pose a serious threat to our efficient and highly liquid stock market. This committee is no doubt well aware of the ramifications of such trends, as evidenced by the extensive hearings conducted last year on the impact of the institutional investor in the stock market.

In discussing the institutional investor, one must keep in mind that private noninsured pension funds are, by far, the largest institutional investor in the market today. In 1972, these pension funds owned 11 percent of all stocks traded on the New York Stock Exchange, and there is no doubt that this figure has risen to 12 percent by now. Each year this group purchases more common stocks than all other institutional investors combined. This concentration of financial assets is further accentuated by the fact that 80 percent of these pension funds are administered by bank trust departments. In fact, the 10 major banks probably control close to 50 percent of all private pension assets.

The increasing tendency of the institutional investor to dominate the stock market has been well documented. Among the many indications are: (*a*) In 1973, institutions accounted for an estimated 73 percent of the volume on the New York Stock Exchange. Just a decade earlier, these same institutions accounted for only 35 percent of this daily volume.

(*b*) A recent New York Stock Exchange survey estimated that all institutions, including trust departments, own 45 percent of all stocks traded on the exchange.

(*c*) During the four quarters ending September 30, 1973, financial institutions made net purchases of common stocks totaling in excess of $7 billion. In fact, during the year 1972, they purchased over $10.7 billion in stocks.

(*d*) Block trading increased substantially during the last decade. In the third quarter of 1973, there were 6,980 blocks—trades of 10,000 or more shares—traded, comprising 167.1 million shares. The market value of block trading for the first 9 months of 1973 was $16 billion.

(*e*) At the end of 1972, the top 10 bank trust departments owned the following percentages of these companies: 30 percent of Polaroid; almost 30 percent of Xerox; over 30 percent of Avon; and over 35 percent of Walt Disney.

(*f*) Private noninsured pension assets stood at $154.3 billion at the end of 1972. Of this total, 73.5 percent, or $113.4 billion, was in common stocks. For the first 9 months of 1973, these pensions were net purchasers of $3.3 billion of common stocks.

In order to maintain an efficient stock market, it is necessary that there be many participants with diverse views. With a significant concentration of the market in the hands of relatively few institutions, efficiency is diminished. A possible misallocation of financial resources may result.

This misallocation tends to distort relative market values and, in turn, affects the ability of firms to obtain new equity capital.

This brings us to the controversial issue of the "two-tier market." This situation was not created solely by the institutional investors, but rather has some assistance from the economic conditions of inflation, interest rates, and governmental controls. However, without the significant concentration of equity assets, this two-tier system could not have developed and prospered.

There has been a decrease in the number of brokerage houses and analysts. Furthermore, the concentration of equity assets has increased. Thus, the number of differing opinions heard by the financial institutions has diminished significantly, causing an increased concurrence in equity decisions. This in no way assumes conspiracy; rather, such concurrence is the natural outgrowth of the aforementioned circumstances.

A possible remedy is to limit the stock holdings of pension managers. By limiting their holdings to 5 percent of their aggregate discretionary pension assets in any one equity security, these administrators are forced to invest in and investigate other securities. This provision will encourage some of the bank trust departments to diversify their holdings into issues that have not traditionally been institutional favorites. This should help increase the efficiency of the market by deconcentrating investments.

I recently conducted a study, bank-administered commingled pension funds, in which I found that these funds increased their portfolio concentration during the 1960's.[1] For the 1962–65 period, the average number of issues held by these commingled pension funds was 60, while for the later period, 1966–70, the number of issues decreased by 17 percent to 50 different equity securities. Concurrently, the funds were growing at a 24-percent compounded rate. Thus, although these funds were, on average, doubling in size every 4 years, the number of equity securities they held decreased, thus increasing their concentration.

I have every reason to believe that this trend has continued to the present time. By limiting the holdings of bank trust departments to 5 percent of their total discretionary pension assets, this trend would tend to be reversed. To better understand the magnitude of such concentration, one should realize that it has been estimated that, by 1980, private pension funds will have assets of $269 billion. If the percentage in equities stays constant, they will hold over $190 billion in common stocks.

The 5-percent limitation on stock holdings is well within reason and will not cause any grave hardships in the investment community. Mutual funds and life insurance companies in New York have had similar limitations with few negative effects. Such limits upon pension fund managers would tend to halt the escalating concentration in the favorite 50.

The companion rule requires that pension managers hold no more than 10 percent of any equity security of any one company with respect to the aggregate discretionary pension accounts. This rule seems, indeed, to be the minimum step necessary in keeping the control of our economy from being overly concentrated. In 1972, as noted earlier, the top 10 bank trust departments owned over 30 percent of Xerox, Polaroid, Walt Disney, and Avon. This type of density of control tends to influence management, and thus has potential for influencing the direction of the corporation. Whether or not this potential control

[1] See p. 103.

is utilized is not the significant issue, since the power exists and will be exercised if the situation warrants it.

As mentioned previously, I conducted a study on bank-administered commingled pension funds in which I attempted to ascertain whether or not there was any distinction between the performance of large banks and smaller banks. The results demonstrated that there was no difference in performance between large and small banks, although the former manage the lion's share of pension assets. Thus, a deconcentration of assets would be possible with no deterioration in performance.

The stock holding limitations under discussion will not apply to investments in companies with capital accounts of less than $25 million. It may be advantageous to raise this capital account exemption to $35 million in light of current inflation. Also, the committee should consider the possibility of including only a partial grandfather clause in the provision on limitations of stock holdngs. Perhaps those pension managers who have holdings above the stipulated limits should have 10 years to comply, while obviously adhering to these limitations for all future purchases. This would be in the best long-term interests of both the stock market and the economy.

The emphasis upon pension performance is very strong today, and this will continue for the foreseeable future. The reason? Rather simple, for it has been estimated that a 1-percent increase in pension performance reduces employer contribution by 25 percent, and thus dramatically increases profits. This is no small expense, since in 1972 pension assets increased over $9 billion at book value, and most of this was contributed by the employer.

In a recent survey, it was found that the cost of retirement benefits relative to total payroll costs increased from 4.7 percent in 1967 to 5.5 percent in 1972. Contributions increased 50.3 percent during the 1967–71 period and over 12 percent for each of the past 2 years. With pension costs continually increasing, corporations are emphasizing shorter pension performance evaluation periods. This study also found that, for their performance evaluation period, 42 percent of the firms allow 3 years or less, and 17 percent of these firms allow only 2 years or less.

In searching for a manner with which to increase the efficiency and liquidity of the stock market, the role of the individual investor always comes to mind. It is the individual investor who helps maintain the depth and the breadth of the market. Unfortunately, his appetite for equities has been diminished. According to the New York Stock Exchange, in the beginning of 1972 there were 32.5 million individual investors, and at the start of 1973, there were 800,000 fewer. It is estimated that now, at the start of 1974 there are between 30 and 31 million investors—another substantial decrease. As a consequence, in 1973 the individual investor accounted for approximately only 27 percent of the New York Stock Exchange dollar volume.

The decreased influence of the small investor is well documented. Some of the reasons are no doubt economic in nature——

Senator BENTSEN. Dr. Malca, let me interrupt you there.

When you say he has 27 percent of that market, would it not be a fair statement to say that probably a reasonable part of that 27 percent might be made up of companies buying through their own accounts, because their multiples were so low that they were going into the market and buying some of that?

Dr. MALCA. Yes; that is possible, Senator.

Senator BENTSEN. Well, you know you have a substantial number of companies buying for their own accounts. I think that the amount of so-called individual small investors' participation is even smaller than what you say.

Dr. MALCA. Well, this figure was obtained last week from an estimate by an official at the New York Stock Exchange. It is possible that many corporations are buying their own securities, and that number may be lower than 27 percent.

Senator BENTSEN. Excuse me. I am sorry. I have to go present some testimony on another bill of mine before another committee.

Our problem is we have an energy hearing going this morning, a serious hearing in the Senate Armed Services Committee, and I am delighted to see Senator Bennett has arrived.

Senator Bennett, if you preside while I go testify——

Senator BENNETT. Tell me where we are, and then I will be glad to.

Senator BENTSEN. Dr. Malca has made some very cogent remarks about this and has demonstrated a keen understanding of it. He is right in the middle of his testimony, at the bottom of page 9.

Senator BENNETT. And Mr. Schotland?

Senator BENTSEN. He has testified, but we have not gone into questions.

Senator BENNETT. Are these the two gentlemen at the desk?

Senator BENTSEN. That is correct.

Senator BENNETT. Good.

Senator BENTSEN. I want to pose just one question for the two of them before I leave.

Mr. Lynn Townsend, who is going to be before us later this afternoon, has given us some figures showing the book value and the market value of McDonald's Hamburger and United States Steel. These are very interesting numbers.

He is going to testify that McDonald's Hamburger at the end of 1972 had a book value of about $200 million and a recent market value of about $2.1 billion; that United States Steel has a book value of $3.6 billion and a recent market value of $2.2 billion. So obviously, the value of the stock is not related to the assets of the company. And it is also very obvious that we are in short supply on steel capacity and seemingly have a plentiful supply of hamburger stands.

Now, I want to know what kind of a capital market we have that makes it prohibitive for the steel industry to raise capital, but makes it very easy to raise capital for hamburger stands? And that is my concern, if you gentlemen would address yourselves to that problem.

Senator BENNETT. It is obvious that in the present meat situation, it is possible to extend hamburgers.

Mr. SCHOTLAND. Senator, I tried to open up the discussion at just that point in concluding my statement, where I referred to fried chicken rather than hamburgers, and also to discount furniture. I was told this weekend by a gentleman who is with an institutional investor, about a presentation in Europe I believe in the summer or fall of 1972, that the representative there from the Morgan Bank was singing high the praises of Levitz Furniture.

And the person who told me the story said he simply pulled out his notebook and did a little calculation and saw that the value at that time of Levitz Furniture, according to the stock market, was $7 billion.

Senator BENTSEN. Mr. Callaway, you will have a chance to rebut that.

Mr. SCHOTLAND. I said that with that awareness, Senator. I think the fact is the equity markets have, Senator, caused distortions. I think they have caused distortions because while we have basically sound investors like Morgan, whatever the Levitz situation may have been, we have also had the go-go type investors who, I am afraid, I think will come—come back as soon as the market heats up. We need to do things to limit the impact of this situation, such as the bill before your subcommittee.

Senator BENNETT (presiding). Well, I walked in midstream without having heard what has gone on, and so I will sit here, and if you will tell me where you are about to take up, I will follow you.

Dr. MALCA. I would like to reply to that question, Senator.

It was always the case that the value of a company was related to the growth of earnings. The problem has been that the extreme between the growth companies and the more mature companies such as United States Steels has been accentuated in recent years. The reason for this, I believe, is the increased concentration of financial assets in the hands of relatively few institutions. So the problem we now have is that diverse views in the market have significantly diminished.

Because of this concentration, stocks with extreme growth and earnings potential have very, very high price-earnings ratios. Meanwhile, some very necessary companies such as United States Steel, which have relatively low growth earnings potential, find it very, very difficult to raise new equity capital because of their low PE's. For example, last week, or 2 weeks ago, Public Service Electric and Gas floated a new equity issue, I believe at 19¾. It was approximately $5 below book value. Nonetheless, they needed this money and were willing to dilute stockholders' earnings in order to raise capital in this way.

Until there is some sort of deconcentration of the assets which are still in the hands of relatively few institutions, this situation of extreme PE differentials between companies will continue to exist.

Senator BENNETT. Again, I came in in the middle of things.

Could this discrepancy be explained in any sense because everybody sees a McDonald's hamburger stand on the corner and looks at the crowds buying and thinks, that is something I can get into. I can understand it; it is simple, and United States Steel is a distant operation with high technology and serious problems?

Dr. MALCA. Senator, I do not believe so. First of all, there are many other companies, such as Wetson's and other hamburger stands. If anything, I would think that U.S. Steel, with its high technology, its basic product which is needed by all, and its lack of new competition, would convey the image of a sound company. It appears to me that a McDonald's hamburger company—it is not very difficult for another company to produce a hamburger. Many, many companies sell hamburgers.

Senator BENNETT. I know, but no other company has a big sign with an M that says "4 billion sold to date."

Dr. MALCA. Six, I believe it is today.

Senator BENNETT. I am not a customer.

Mr. SCHOTLAND. You have not looked since yesterday.

Senator BENNETT. I just wonder if there is not some of that psychology in the situation.

Dr. MALCA. Perhaps.

Senator BENNETT. It is very obvious, it is very apparent to everybody, and the growth is measured on their signs. It is obvious to everybody that it is a growth company. I think there is some psychology there.

Mr. SCHOTLAND. Senator, doubtless there is, but I think it is also important to notice that the public has not been exactly dominating the markets lately, for one thing. For another thing, if you look at institutional investor portfolios, you will find they must be eating a great many McDonald's hamburgers and forgetting all about U.S. Steel.

But a second point which I should have mentioned earlier, I think we cannot compare market valuation solely with book value. I think we have also got to take into account what the market does pay more attention to, which is the earnings. For example, I do not know what the book value of the Morgan Bank is, but I do not think it would relate to their stock price the way, for example, a railroad's book value might figure.

[The following additional comments of Dr. Schotland was subsequently received for the record:]

To make the same point another way, I don't know what is the book value of one share of Morgan or City Bank or Chase stock, but I doubt there is so great a difference among them, or that the market paid much attention to any such difference, as to explain why it values Morgan and City earnings at a multiple of about 17, compared to a multiple of about 10 for the Chase. The market, in coming to those sharply different P/E's, is stating an evaluation of the different managements, and expectations about rates of growth of earnings, much more than any judgment about existing assets.

I think the market looks more at earnings than book value. That is probably sound. That is not to say that the whole difference between McDonald's and U.S. Steel is sound.

Senator BENNETT. Well, that is fine.

I would be very happy to have you take up where you left off before I come in.

Dr. MALCA. Thank you, Senator.

The decreased influence of the small investor is well documented. Some of the reasons are no doubt economic in nature: Inflation, interest rates, and economic controls. But there are other factors involved. Among them are: (*a*) Commission rates; (*b*) poor performance of the market in recent years; (*c*) the belief that the market is manipulated; and (*d*) the change in the treatment of capital gains tax in 1969.

It is interesting to note that, according to Salomon Bros., for the 5-year period 1969–73 common stock investment provided the lowest average rate of return of the five selected capital instruments. In this respect, the individual investor was well advised to diminish his activity in the equity market during the last 5 years.

The proposed provision of a graduated capital gains tax will do much to facilitate the return of the small investor. It would become most advantageous for this individual investor to return, especially the longer term investor. Such a provision for a graduated capital gains tax will obviously help to unleash the billions of dollars of long-term capital which has been locked in for so long because of the present tax structure. The U.S. Treasury will certainly reap the benefits, but, more importantly, this provision, coupled with liberalized capital loss treatment, will bring about increased liquidity and efficiency in the capital market.

Two other possibilities would further facilitate the return of the small investor to the stock market. These are full disclosure and reduced inflation. It is unfortunate that a proposal for full annual disclosure of all pension fund operations was not included as part of this bill. At last year's committee hearings, many witnesses expressed a belief similar to mine that such disclosure would go a long way in allaying the public's oft-cited suspicion that stocks are manipulated by the institutions. This is imperative for the sake of public confidence in our financial markets.

The second necessity is a reduction in inflation. The stock market is a good hedge against moderate levels of inflation since prices generally can be adjusted. However, with higher levels of inflation, as experienced in 1973, it becomes more difficult to adjust the prices to fully reflect this inflation. Furthermore, high inflation tends to increase interest rates so that the real level of interest rates does not decrease. Also, because of its higher interest rates, the debt market becomes a more attractive alternative than the equity market. This is true not only for the small investor but also for the institutional investor.

The dual factors of high interest rates and low P/E ratios have made the financing of smaller, more risky ventures almost impossible. In order to increase the flow of funds channeled into venture capital, the bill proposes that 1 percent of the assets of any pension plan be exempt from the prudent man rule. This creates the potential for having over $1 billion invested in venture capital. However, strict safeguards against possible abuse must be included in this bill.

This bill comes to grips with a problem which is of serious consequence not only to our financial markets but also to the general well-being of the economy. With the prevention of further excessive concentration of financial resources and with the introduction of enticements for the return of the individual investor to the stock market, this bill provides some remedies for the ever-increasing maladies of the equities market. Such remedies are the minimum prerequisite for maintaining a highly liquid and efficient capital market.

Thank you, Mr. Chairman.

Senator BENNETT. I very much appreciate your getting through.

And, speaking for the chairman, I want to express his thanks to you for coming and sharing these points of view with us.

Mr. SCHOTLAND. Thank you, Senator.

Dr. MALCA. Thank you, Senator.

Senator BENNETT. Thank you very much.

[Dr. Malca's prepared statement, with an attachment referred to, follows. Hearing continues on page 105.]

STATEMENT BY EDWARD MALCA, ASSISTANT PROFESSOR OF ECONOMICS, RICHMOND COLLEGE OF THE CITY UNIVERSITY OF NEW YORK

This Committee is giving consideration to the Stockholders Investment Act of 1973 (S. 2842) which, among other things, tries to come to grips with the dual problems of increased institutionalization of the stock market and the diminution of the role of the individual investor in the equities market. If this trend should continue over a longer time-span, it will pose a serious threat to our efficient and highly liquid stock market. This Committee is no doubt well aware of the ramifications of such trends, as evidenced by the extensive hearings conducted last year on the impact of the institutional investor in the stock market.

In discussing the institutional investor, one must keep in mind that private noninsured pension funds are, by far, the largest institutional investor in the market today. In 1972 these pension funds owned 11 percent of all stocks traded on the New York Stock Exchange, and there is no doubt that this figure has risen to 12 percent by now. Each year, this group purchases more common stocks than all other institutional investors combined. This concentration of financial assets is further accentuated by the fact that 80 percent of these pension funds are administered by bank trust departments. In fact, the ten major banks probably control close to 50 percent of all private pension assets. These developments will be further clarified and amplified in the remainder of my statement.

The increasing tendency of the institutional investor to dominate the stock market has been well documented. Among the many indications are:

(a) In 1973, institutions accounted for an estimated 73 percent of the volume on the New York Stock Exchange. Just a decade earlier, these same institutions accounted for only 35 percent of this daily volume.

(b) A recent New York Stock Exchange survey estimated that all institutions, including trust departments, own 45 percent of all stocks traded on the Exchange.

(c) During the four quarters ending September 30, 1973, financial institutions made net purchases of common stocks totaling in excess of $7 billion. In fact, during the year 1972, they purchased over $10.7 billion in stocks.

(d) Block trading increased substantially during the last decade. In the third quarter of 1973, there were 6,980 blocks (trades of 10,000 or more shares) traded, comprising 167.1 million shares. The market value of block trading for the first nine months of 1973 was $16 billion.

(e) At the end of 1972, the top ten bank trust departments owned the following percentages of these companies: 30 percent of Polaroid; almost 30 percent of Xerox; over 30 percent of Avon, and over 35 percent of Walt Disney.

(f) Private noninsured pension assets stood at $154.3 billion at the end of 1972. Of this total, 73.5 percent or $113.4 billion, was in common stocks. For the first nine months of 1973, these pensions were net purchasers of $3.3 billion of common stocks.

(g) The leading bank trust department increased its assets over 50 percent—from $16.8 billion in 1967 to $27.2 billion in 1972. Eighty percent of its assets are in equities.

Since private noninsured pension funds are the largest net purchasers of stock each year, and since their assets tend to be administered by bank trust departments, the manner in which the banks administer these assets is very important from an efficient market point of view. In order to maintain an efficient stock market, it is necessary that there be many participants with diverse views. With a significant concentration of the market in the hands of relatively few institutions, efficiency is diminished. A possible misallocation of financial resources may result.

As Professor Friend states:

"The contribution to economic efficiency by (institutional) investors depends to a great extent on their ability to help the equity market transfer capital into the most profitable investments in productive goods (adjusted for risk)."

This misallocation tends to distort relative market values and, in turn, affects the ability of firms to obtain new equity capital. An illustrative example occurred just recently when Public Service Electric and Gas sold additional equity at below book value.

This brings us to the controversial issue of the "two-tier market". This situation was not created solely by the institutional investors, but rather had some assistance from the economic conditions of inflation, interest rates, and governmental controls. However, without the significant concentration of equity assets, this "two-tier" system could not have developed and "prospered". There has been a decrease in the number of brokerage houses and analysts. Furthermore, the concentration of equity assets has increased. Thus, the number of differing opinions heard by the financial institutions has diminished significantly, causing an increased concurrence in equity decisions. This in no way assumes conspiracy—rather, such concurrence is the natural outgrowth of the aforementioned circumstances.

A possible remedy is to limit the stock holdings of pension managers. By limiting their holdings to 5 percent of their aggregate discretionary pension assets in any one equity security, these administrators are forced to invest in and investigate other securities. This provision will encourage some of the bank trust departments to diversify their holdings into issues that have not traditionally been institutional favorites. This should help increase the efficiency of the market by deconcentrating investments.

I recently conducted a study, *Bank-Administered Commingled Pension Funds*, in which I found that these funds increased their portfolio concentration during the nineteen-sixties.[1] For the 1962–1965 period, the average number of issues held by these commingled pension funds was sixty, while for the later period 1966–1970, the number of issues decreased by 17 percent to fifty different equity securities. Concurrently, the funds were growing at a 24 percent compounded rate. Thus, although these funds were on average, doubling in size every four years, the number of equity securities they held decreased, thus increasing their concentration. I have every reason to believe that this trend has continued to the present time. By limiting the holdings of bank trust departments to 5 percent of their total discretionary pension assets, this trend would tend to be reversed. To better understand the magnitude of such concentration, one should realize that it has been estimated that, by 1980, private pension funds will have assets of $269 billion. If the percentage in equities stays constant, they will hold over $190 billion in common stocks.

A recent discussion in the New York Times (January 25, 1974) referred to the stock of Colonial Penn, which dropped 5¼ points to 42 on a 379,600 block. This suggests that market liquidity is suffering:

"The discount from market price, as represented by that large block, underscores the caution extending to the blocktrading houses. Sources in Wall Street noted that block traders had reduced their exposure commitment in recent months as a means of avoiding possible losses.

"By the same token, this tends to reduce market liquidity for institutional investors, many of whom often insist on moving large blocks in a hurry."

Part of this portfolio concentration can be attributed to the influence of several studies which were conducted in the mid-to-late 1960's. It was found that a high degree of diversification could be achieved with fifteen to twenty different securities in a portfolio. Above that number, little added diversification would be achieved. This manner of thinking definitely caught on, since it enabled the analysts to follow fewer securities, but in greater depth. The aforementioned studies are true in theory—however, the ramifications upon the stock market and upon the liquidity of the institutions were not fully explored.

The five percent limitation on stock holdings is well within reason and will not cause any grave hardships in the investment community. Mutual funds and life insurance companies in New York have had similar limitations with few negative effects. Such limits upon pension fund managers would tend to halt the escalating concentration in the "favorite 50".

The companion rule requires that pension managers hold no more than 10 percent of any equity security of any one company with respect to the aggregate discretionary pension accounts. This rule seems, indeed, to be the minimum step necessary in keeping the control of our economy from being overly concentrated. In 1972, as noted earlier, the top ten bank trusts owned over 30 percent of Xerox,

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[1] *Bank-Administered Commingled Pension Funds Performance and Characteristics, 1962–1970.* Lexington Books, D. C. Heath and Company—Lexington, Massachusetts, 1973.

Polaroid, Walt Disney and Avon. This type of density of control tends to influence management, and thus has potential for influencing the direction of the corporation. Whether or not this potential control is utilized is not the significant issue, since the power exists and will be exercised if the situation warrants it. This concentration in and control of major U.S. corporations by a relatively small number of large banks is definitely not in the best interests of a free and viable economy. Excessive concentration must always be guarded against, and the 10 percent ownership limit is an excellent step in that direction.

One of the questions raised in last year's Committee hearings considered the possibility that equal treatment of clients cannot be achieved if any limitation on stock ownership is legislated. This can be answered in two ways. First, bank trust departments will be forced to seek out other securities with prospects which are comparable or better than such favorites as IBM. This entails additional work on the part of the analyst. As a second alternative, if a bank trust department agrees that a particular stock is the best investment but has reached its 5 percent limitation, the client must go to another pension manager to obtain such securities. This will facilitate deconcentration in the pension field, and this is certainly a most desirable effect.

It may be too late to sufficiently prevent the institutionalization of the stock market; however, we should at least attempt to stimulate interest in increasing the number of managers of these funds. Because of the general affluence of society and the tax advantages of pensions, pension fund growth may be inevitable, but it is not mandated to be managed by the largest banks.

As mentioned previously, I conducted a study on bank-administered commingled pension funds in which I attempted to ascertain whether or not there was any distinction betwen the performance of large banks and smaller banks. The results demonstrated that there was no difference in performance betwen large and small banks, although the former manage the lion's share of pension assets. Thus, a deconcentration of assets would be possible with no deterioration in performance. In fact, for the 1962–1970 period, my study concluded that, adjusted for risk, these bank-administered commingled pension funds performed 1.6 percent worse per annum than an average "unmanaged" portfolio with similar risk.

The stock holding limitations under discussion will not apply to investments in companies with capital accounts of less than $25 million. It may be advantageous to raise this capital account exemption to $35 million in light of current inflation. Also, the committee should consider the possibility of including only a partial "grandfather" clause in the provision on limitations of stock holdings. Perhaps those pension managers who have holdings above the stipulated limits should have ten years to comply, while obviously adhering to these limitations for all future purchases. This would be in the best long-term interests of both the stock market and the economy.

The emphasis upon pension performance is very strong today, and this will continue for the foreseeable future. The reason? Rather simple, for it has been estimated that a 1 percent increase in pension performance reduces employer contributions by 25%, and thus dramatically increases profits. This is no small expense, since in 1972 pension assets increased over $9 billion at book value, and most of this was contributed by the employer. In a recent survey conducted by Standard and Poor's/InterCapital, it was found that the cost of retirement benefits relative to total payroll costs increased from 4.7 percent in 1967 to 5.5 percent in 1972. If relative to gross or net income, these percentages would be much higher. Contributions increased 50.3 percent during the 1967–1971 period and over 12 percent for each of the past two years. With pension costs continually increasing, corporations are emphasizing shorter pension performance evaluation periods. This study also found that, for their performance evaluation period, 42 percent of the firms allow 3 years or less and 17 percent of these firms allow only two years or less.

With the increasing likelihood that the new pension plan bill will be enacted stricter funding and vesting provisions will cause pension costs to increase significantly. Pressure on performance will be greater in the next several years due to these new funding and vesting provisions. The corporations must guard against maintaining too short a performance evaluation period, thus turning pensions into speculative funds. In my study, the turnover rate for bank-administered commingled pension funds was second only to mutual funds among institutional investors.

In searching for a manner with which to increase the efficiency and liquidity of the stock market, the role of the individual investor always comes to mind.

It is the individual investor who helps maintain the depth and the breadth of the market. Unfortunately, his appetite for equities has been diminished. According to the New York Stock Exchange, in the beginning of 1972 there were 32.5 million individual investors, and at the start of 1973 there were 800,000 fewer. It is estimated that, now at the start of 1974, there are between 30 and 31 million investors—another substantial decrease. As a consequence, in 1973 the individual investor accounted for approximately only 27 percent of the New York Stock Exchange dollar volume.

The decreased influence of the small investor is well documented. Some of the reasons are no doubt economic in nature: inflation, interest rates, and economic controls. But there are other factors involved. Among them are: (a) commission rates (b) poor performance of the market in recent years (c) the belief that the market is manipulated, and (d) the change in the treatment of capital gains tax in 1969.

It is interesting to note that, according to Salomon Brothers, for a five-year period 1969-1973 common stock investment provided the lowest average rate of return of the five selected capital instruments. Only in two years, namely 1971 and 1972, did returns on common stocks exceed the return on three-month treasury bills. In fact, the investor would have been more substantially rewarded during this five-year period if he had placed his savings in either treasury bills or in a savings account. In this respect, the individual investor was well-advised to diminish his activity in the equity market during the last five years.

The proposed provision of a graduated capital gains tax will do much to facilitate the return of the small investor. It would become most advantageous for this individual investor to return, especially the longer-term investor and not the so-called "trader". Such a provision for a graduated capital gains tax will obviously help to unleash the billions of dollars of long-term capital which has been "locked-in" for so long because of the present tax structure. The U.S. Treasury will certainly reap the benefits, but more importantly, this provision, coupled with liberalized capital loss treatment, will bring about increased liquidity and efficiency in the capital market.

Two other possibilities would further facilitate the return of the small investor to the stock market. These are full disclosure and reduced inflation. It is unfortunate that a proposal for full disclosure of all pension fund operations was not included as part of this bill. At last year's Committee hearings, many witnesses expressed a belief, similar to mine, that such disclosure would go a long way in allaying the public's oft-cited suspicion that stocks are manipulated by the institutions. This is imperative for the sake of public confidence in our financial markets.

The second necessity is a reduction in inflation. The stock market is a good hedge against "moderate" levels of inflation, since prices generally can be adjusted. However, with higher levels of inflation, as experienced in 1973, it becomes more difficult to adjust the prices fully to reflect this inflation. Furthermore, high inflation tends to increase interest rates so that the "real" level of interest rates does not decrease. The creditor will naturally increase his interest rate in order to at least compensate for his reduced purchasing power as caused by inflation. This inflation-interest rate relationship tends to affect industries, e.g. utilities, which have a very substantial annual debt requirement. Also, because of its higher interest rates, the debt market becomes a more attractive alternative than the equity market. This is true not only for the small investor. but also for the institutional investor.

The dual factors of high interest rates and low P/E ratios have made the financing of smaller, more risky ventures almost impossible. In order to increase the flow of funds channeled into venture capital, the bill proposes that one percent of the assets of any pension plan be exempt from the prudent man rule. This creates the potential for having over one billion dollars invested in venture capital. However, strict safeguards against possible abuses must be included in this bill.

CONCLUSION

This bill comes to grips with a problem which is of serious consequence not only to our financial markets, but also to the general well-being of the economy. With the prevention of further excessive concentration of financial resources and with the introduction of enticements for the return of the individual investor to the stock market, this bill provides some remedies for the ever-increasing maladies of the equities market. Such remedies are the minimum prerequisite for maintaining a highly liquid and efficient capital market.

SUMMARY CHAPTER OF STUDY, "BANK-ADMINISTERED COMMINGLED PENSION FUNDS" (LEXINGTON PENSION BOOK, D.C. HEALTH & CO., LEXINGTON, MASS., 1978)

This concluding chapter will incorporate and summarize the results found throughout this analysis of bank adminstered commingled equity funds for employee benefit plans. Such a procedure will be helpful in attaining an overview of this study.

In Chapter I, the writer introduced and discussed the growth of private pension funds as an institutional investor. In so doing, it was shown that noninsured pension funds are growing more rapidly and have significantly more assets than do their insured counterparts. In fact in 1970, over 70 percent of all private pension reserves were held by noninsured plans.[1] Furthermore, in the last decade these noninsured funds emphasized common stock investing to the point where they are now the major institutional purchaser of equities each year.

It is generally known that commercial bank trust departments administer the bulk of noninsured pension reserves. Thus, with noninsured pension funds placing such an emphasis upon equities, there has been increased emphasis upon the equity investment performance of bank trust departments. Unfortunately, little is known about this performance, since the data is quite confidential in this area.

In an attempt to evaluate equity performance of bank trust departments, this study analyzed the performance of their commingled equity funds for employee benefit plans. These commingled funds have grown from approximately 1% in 1960 to 9% of total private pension assets in 1970.[2]

Interviews were conducted with bank vice-presidents in charge of trust operations, and it was found that they expect very similar returns for their commingled equity funds as they expect for the equity portions of their regular pensions. As one trust officer stated, "This is our public exposure."

The empirical examination included thirty-seven commingled equity funds of the possible seventy-two that have been in operation continuously since January 1, 1962. None of these commingled funds began operation prior to 1956.

Almost all funds doubled in asset size during the study period.[3] The average compound growth rate of fund assets was 24%, with a range of 6.3% to 44.9%. During the years of the study, it was found that there was a slight deconcentration of assets among the largest funds. This can be explained by the finding which showed that the smaller funds grew at a more rapid rate than the larger funds. This inverse relationship proved to be statistically significant.

On the inception date for the study period, January 1, 1962, the asset size ranged from below two-hundred and fifty thousand dollars to above fifty million dollars, with the majority of the funds below $10 million. By 1970 there was no fund with assets below $2 million, and most funds were in the category below $25 million in total assets. It was found that there is a direct relationship between the asset size of commingled equity funds and the size of the banks which administer these funds.[4]

INVESTMENT PERFORMANCE

The method used to determine the investment performance is similar to that employed by the Securities and Exchange Commission's *Institutional Investor Study.*[5] Using quarterly data, the average quarterly rate of return is found. The beta coefficient is used to determine the systematic risk assumed by each fund. The writer proceeded to calculate the performance measure (risk-adjusted alpha), by obtaining both the quarterly rates of return and the risk measure (beta coefficient). This performance measure "represents the average incremental rate of return on the portfolio per unit of time which is due solely to the manager's ability to forecast future security prices."[6]

[1] Securities and Exchange Commission, *Private Noninsured Pension Funds, 1971,* Release No. 2581, April, 1972.

[2] During interviews with this writer, several bank Vice Presidents in charge of trust operations estimated that 9% of all pension assets were in the form of commingled funds.

[3] Study period was January 1, 1962 to September 30, 1970.

[4] Bank size is defined as total deposits for the year ending December 31, 1970.

[5] Also used by Jensen, "Mutual Funds"; Bank Administration Institute, *Measuring the Investment Performance of Pension Funds;* Levy, "Performance".

[6] Jensen, "Mutual Funds," p. 394.

$$(5\text{-}1)\quad r_t - r_b = \alpha_i + \beta_i\,[r_m - r_b]$$[7]

where:

R_m = return on the market portfolio (S. & P. 500 stock average),
r_b = 3-month Treasury bill rate,
β_i = Beta coefficient: systematic risk,
r_t = return on fund for period t,
α_i = risk adjusted performance measure (alpha).

If the results are positive after calculating alpha, then the fund performed better than did an unmanaged portfolio with similar risk. The reverse is also true—a negative alpha indicates that the fund performed more poorly than did an unmanaged portfolio with similar risk.

It was found that, on average, the commingled equity funds had a beta coefficient of .98, which is slightly less than the risk for the market in general. The range was from .70 to 1.16.

With the use of equation (5–1) as shown above, it was found that the mean alpha was —.0039 quarterly or approximately —.0156 annually for the study period. This demonstrates that these commingled funds had an approximately 1.6% lower return than would be expected from the risk taken. This conclusion seems to be consistent with several recent studies of institutional investors which found the mean risk adjusted alpha to be negative.[8] It was also found that, for this period, there were seven funds with positive alphas ond thirty with negative alphas. The range of these alphas was from approximately —6.1% to +6.3% per annum.

It was found that, for the period of January 1, 1962, through December 31, 1965, the mean performance measure was —.0055 quarterly with only three funds having positive alphas and thirty-four having negative ones. For the second half of the period, January 1, 1966, through September 30, 1970, the number of positive alphas increased to eleven. However, the mean performance measure still remained negative (—.0032 quarterly). This tends to substantiate the fact that throughout the study period, these funds did not perform as well as an unmanaged portfolio with similar risk.

It was determined that there was no relationship between performance in one year and performance the following year. This indicates that there was no fund which consistently outperformed the market, adjusted for risk.

Upon examination of the entire study period, it was determined that there was no direct statistically significant relationship between fund size and performance. Also, no statistically significant relationship was found beween average annual compound growth rate of fund assets and performance. One would think that better performance would lead to a larger inflow of funds, but this was not supported by the conclusions arrived at in this study.

No direct relationship was found between the size of the banks administering commingled reserves and the performance of these reserves. If there were any relationship, it would be a slight inverse association between performance and bank size. However, this relationship was found not to be consistent over time. This finding raises the question of why the larger banks administer such a disproportionate amount of pension reserves. The answer seems not to be based upon performance.

It was demonstrated that funds with higher volatility tended to have higher measures of performance. However, this was not consistent in all periods. This is a similar result to that found by the SEC.[9]

During the study period, there was no relationship found between performance and portfolio activity rates, nor between performance and diversification measure (R^2). It is noteworthy that over 87% of the average volatility of these funds was explained by movements in the market.

Since New York City banks command a leading position in the administration of private pensions, the writer tested their mean performance to determine whether they outperformed banks outside New York City. No statistically significant difference was found between the performance of New York City banks and the performance of those banks outside of New York City. This finding tends to question whether these New York banks should hold this commanding position over pension reserves.

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[7] *Ibid.*, p. 398.
[8] For example see: Friend, *et al., Mutual Funds;* Jensen, "Mutual Funds"; S.E.C. *Study*; Levy, "Performance".
[9] S.E.C. *Study*, p. 401.

CONCLUSIONS

Before one can fully understand the conclusions of this study, one must realize its limitations. The study dealt only with bank administered commingled equity funds for employee benefit plans. This was necessitated by the fact that other pension data was not available. Furthermore, the study was limited to equity performance and did not take bond performance into consideration.

It was stated in Chapter I that an investigation into the risk-adjusted performance of commingled equity funds would help foster a better allocation of financial resources. The results of this study show that the performance of these commingled funds was inferior to the performance of unmanaged portfolios with similar risk. This tends to demonstrate that the bank trust departments do not have the ability to forecast future security prices. Moreover, their ability to forecast security prices is further questioned since there is no relationship between performance in one year and in the following year.

The conclusion for the study period is that the performance of commingled equity funds has been inferior to what would have been achieved by an unmanaged portfolio of similar risk. Thus, the null hypothesis, which states that these funds performed as well as the market adjusted for risk, must be rejected. This concludes that the allocation of these funds to bank trust departments is at a suboptimum level. Thus, they are partially misallocated, since an unmanaged portfolio of similar risk would have performed better.

One pertinent finding was that higher risk portfolios outperformed lower risk portfolios after adjusting for differences in risk. This was not fully consistent in all periods. Further research should be initiated in this area to determine whether or not this relationship is consistent over a longer time period.

A further purpose of this study was to find whether the administration of these pension reserves by New York City banks is justified by performance. Performance was found not to be the justification—perhaps it is due to other factors such as location and "old-line" ties.

What is still needed in this field is an all-inclusive study of private pension fund performance. Also needed is a thorough analysis of bank trust departments, which are the largest administrators of equity assets. This will not be possible until Congress passes laws that require trust departments to make public the annual reports on their operations. Today, this field is cloaked with secrecy, but because of the enormous wealth and the public nature of these pension funds, this information *must* be made available. This is necessary to determine whether the allocation of these pension reserves is at an optimum level.

Senator BENNETT. Now, at this point we are going to hear two witnesses representing banks whose programs have been discussed very much during the hearings, Mr. Samuel R. Callaway, executive vice president of Morgan Guaranty Trust and Mr. George M. Lingua, senior vice president of the First National City Bank.

Gentlemen, we are happy to welcome you to the table. I guess on the basis of alphabetic distinction, Mr. Callaway is scheduled to present his statement first.

STATEMENTS OF SAMUEL R. CALLAWAY, EXECUTIVE VICE PRESIDENT, MORGAN GUARANTY TRUST CO., AND GEORGE M. LINGUA, SENIOR VICE PRESIDENT, FIRST NATIONAL CITY BANK

Mr. CALLAWAY. Senator Bennett, I am Samuel R. Callaway, executive vice president of the Morgan Guaranty Trust Co. and head of its trust and investment division.

Senator BENNETT. Mr. Callaway, you have been here before, have you not, in an earlier set of hearings?

Mr. CALLAWAY. Yes; I was here in July of last year.

Senator BENNETT. Yes; I think I remember.

Have you been here before, Mr. Lingua?

Mr. LINGUA. No; I have not.

Senator BENNETT. The fact that Mr. Callaway survived to come back should give you some encouragement.

Mr. CALLAWAY. I wish to thank this committee for granting my request to appear before it a second time; on this occasion to comment on S. 2842, the bill titled "Stockholders Investment Act of 1978." The bill's stated purposes are "to provide for the continuing availability of capital for economic growth and the creation of new jobs and to provide for greater competitiveness in our economy". To accomplish this, the bill would "impose limitations on institutional holdings of securities" and offer certain tax incentives "to encourage individuals to invest in securities."

Though I have serious reservations about the institutional investor provisions of this bill, and the reasoning behind them let me say at the outset that I am in profound accord with the bill's stated intention to attract small investors to the equity market and to generate more employment, competition and capital. Certainly, a sound economic structure for this country must include an adequate flow of equity financing to business enterprises—new, old, and middle-aged.

But I part company with this bill when I am told that the way to assure that adequate flow of capital is to set fixed limits on institutional holdings, so that pension trust managers will be encouraged to show a greater interest in well-managed smaller companies.

There is no need to resort to compulsion to interest us in such companies. We have been interested in them and actively seeking them out for investment for a number of years. In 1961, our interest was formalized in a special situation investments—equities fund, which draws upon pension assets only, to invest in a diversified list of smaller companies. Though such investments are inherently more volatile over short time spans, the performance of this fund has exceeded—indeed, nearly doubled—our general portfolio performance over the years.

In my earlier testimony before this committee, I described this commingled fund in detail, so I do not propose to go over it again, except to note that at the end of 1978, this fund held investments of approximately $600 million, reflecting equity holdings in over 170 different companies.

While there is no shortage of interest on our part, we have not been able to find a greater number of smaller companies that can meet our investment criteria. Lowering our investment standards would allow us to accommodate a greater number of companies, but that also would represent an evasion of our binding obligation as a product fiduciary to exercise only our best judgment on behalf of our clients.

Proponents of the present bill should realize, moreover, that enacting its investment limiting provisions would by no means assure compulsory diversification.

The equities market does not respond to mechanistic laws like a laboratory experiment, moving precisely from cause to effect. Simply applying a downward pressure on institutional investors will not produce an equivalent upward pressure from individual investors. Forcing investments out of well-situated companies will not automatically force them into companies that in our judgment may not be as well situated.

Once limited in the right to exercise their best judgment in the equities market, institutional investors may choose not to subject their trust clients to consequences of a second-best judgment. They may turn, instead, to bonds which, as a practical matter, most likely would be those of larger, well-established companies.

I stress the importance of maintaining consistent quality in forming investment judgments, whatever the size of the company invested in, because I am very much afraid that the thrust of this bill proceeds from two highly questionable assumptions—first, that a quantitative judgment can somehow be substituted for a qualitative one, and second, that investors should somehow be made to invest where they do not choose.

The proposal to influence the personal investment judgments of pension fund managers with statutory limits on stock holdings appears to be based on the belief that good investments can be legislated and prudence assured with percentages.

This belief is not supported by any trust experience of which I am aware, and indeed, it runs counter to the broad historical trend of trust legislation in recent years, which increasingly has recognized the advantages to beneficiaries of fewer restrictions on the investment discretion of fiduciaries.

Different States progressed to the same general conclusion along different routes. In New York State, for example, until 1950 all invested funds held in trust by fiduciaries had to be placed in fixed-income securities unless the agreement otherwise noted. The trust laws were amended in that year to permit up to 35 percent of such funds to be invested in common stocks. The better results achieved after this liberalizing step led to a series of further amendments increasing to 65 [1] percent the allowable investments in equities. In 1970, all percentage restrictions were dropped in favor of the "prudent man rule."

The advantages of this trend toward more liberal fiduciary discretion are certainly borne out by our experience at Morgan Guaranty. Many of our accounts are limited by specific investment constraints written into the trust agreements. But those accounts—both pension and nonpension—over which we exercise the widest latitude of discretion have consistently outperformed those that are restricted.

From a longer perspective, it is difficult to identify any case in recent decades in which the imposition of artificial controls to manipulate free market forces has done much more than treat symptoms. This generally results in a new set of symptoms requiring yet another round of controls. The underlying problem usually persists until the special genius of free market forces is brought to bear.

Consider, for example, the widespread concern over the two-tier market being expressed 6 months ago when your exploratory hearings were underway. The conventional wisdom at that time was that an excessive concentration of pension fund assets had created a highly favored category of growth stocks that could never drop in value as long as the institutional investors held onto their stock. Each decision to buy additional stock in these companies was viewed as a self-fulfilling prophecy assuring that the companies would remain immune to adverse market forces while less popular stocks fell by the wayside.

I did not subscribe to such "instant cliches" in my testimony last July, and now that the free market forces have caught up with those

[1] This is the figure given in oral testimony and in written text submitted; subsequently it was discovered the figure should be 50 percent.

favored growth stocks and shattered the myth of immunity, it is a rather grim satisfaction for me to point out that this has happened.

Off years have hit the stock market before and will again. And human nature being what it is, there will always be more complaining about the year when a fund drops from $100 million to $80 million than the year in which it goes up by the same amount. As institutional investors have always stressed, however, the longer term objectives of pension trusts are moderating factors over such wide pendulum swings in stock values.

The disintegration of the two-tier structure is fairly well advanced by now and, insofar as we can determine, bank trust departments have not sold off their holdings in the mad scramble for the back door that was solemnly forecast.

The truism of last summer, that only new restrictive legislation could remedy a sharply tiered market, seems quite remote that market forces have intervened to deal with the issues at a more fundamental level.

This temptation to tinker with free markets and tamper with fiduciary responsibilities is not new, of course. It recurs from time to time. In the early 1960's the public policy aspects of managing private pension plans were given intensive review by President Kennedy's Committee on Corporate Pension Funds and Other Private Retirement and Welfare programs.

The committee observed that minimal liquidity requirements and long term investment objectives allow pension fund managers to be flexible and responsive to changing investment opportunities. Based on this observation, they concluded that "regulations or formulas for asset management would reduce this flexibility without the likelihood of improving the quality of the judgement and discretion exercised by trustees or plan managers." The committee advised against "the substitution of a new set of statutory standards for the recognized standards of fiduciary responsibility."

I submit that that continues to be sound advice.

Nonetheless, legislation is before this committee proposing to reverse the historical trend and revert to a framework of fixed percentage limits on the stockholdings of pension fund managers. Several reasons or given for advocating this step.

Once again, we are told that only this new restrictive legislation can adequately protect the Nation's 30 million or so members of pension plans from excessive concentration of investments in relatively few stocks.

Neither in my own day-to-day activities, nor as an interested observer of the hearings of this committee, or the many other forums where pension trusts are being examined, have I seen any evidence that would lead me to conclude that beneficiaries are endangered by the prevailing investment strategies of institutional pension fund managers.

Of greater social concern, I should think, is the prospect that retirement funds might cease to receive the kind of personal case-by-case investment judgments that they now enjoy, with each stock transaction initiated on its intrinsic merits.

As to the need for stimulating individual investors, I can state our position succinctly. We favor any measures that will make the equities market more attractive to small investors, provided they do not simultaneously make it less attractive to institutional investors and to the millions of pension beneficiaries and other individuals on whose behalf they act.

My deepest reservation, however, about the committee's present bill is the way in which real problems have been lumped together with imaginary ones and then treated with equal seriousness.

Protecting the interest of trust beneficiaries is certainly a very genuine concern and one that we share with this committee. But we see no need for additional legislation to compel what already exists.

We also are told that this legislation is essential in order to prevent a few banks from massing enough corporate stock to gain control over the American economy.

It is difficult for us to share in this anxiety when we consider that banks are forbidden to own corporate stock for their own account. Except for unusual cases, such as stock acquired in an effort to recover on a defaulted loan, banks hold stocks on behalf of clients and of trusts for which they are trustee. Our fiduciary obligations require us to act solely in the interests of our clients and trusts, not for purposes of gaining or exercising control of any company.

Those of us who are involved in bank trust management on a day-to-day basis realize that it is a full-time occupation, leaving no opportunity to indulge in preoccupations such as how to take control of the national economy.

We are quite busy just keeping up with the investment needs of our individual and corporate clients. They have their own ideas of what a bank trust manager ought to be doing to retain their business—and dominating the Nation's economy, company by company, is not among them.

We are in basic agreement with the desire of this committee to find constructive ways of dealing with the real problems that confront potential investors and the companies that are seeking capital in our currently depressed equities market. I would respectfully urge, however, that the committee is on more promising grounds when it moves toward incentives for those individual investors who may have left the market, rather than disincentives for the institutional investors who have stayed in.

Again, I thank the committee for this opportunity to express our viewpoint on these issues of deep concern to you, to us and to the Nation.

Senator Bennett, I have a very short addition to the statement. If I could make it at this time, sir——

Senator BENNETT. Of course, go ahead.

Mr. CALLAWAY. In connection with the assertions that bank trust departments have the potential to control corporations, I would add to my statement that we have been actively exploring ways of divesting ourselves of voting rights with respect to the stock we hold as trustee. This presents problems of legality, practicality, and the assurance that the interests of our beneficiaries will be adequately protected. If these problems can be solved, we would welcome being rid of the burden of voting our trust holdings and the notion that we somehow desire to control corporate management.

Thank you Senator.

Senator BENNETT. Thank you.

I have one question, more or less as a matter of information. On page 2, you refer to your special situation investment equities fund, and quote a figure of $600 million in 170 companies.

Is the $600 million a specific amount set aside, or do you vary that amount as additional attractive opportunities present themselves?

Mr. CALLAWAY. The second way you stated is accurate. We only invest in that fund if we can find attractive smaller companies to invest in.

Senator BENNETT. Do you have an ongoing affirmative program to seek such companies?

Mr. CALLAWAY. Yes, we do, Senator.

Senator BENNETT. Just as a matter of interest, a year ago how many companies did you have?

Or is the number of companies growing?

Is the fund growing?

Mr. CALLAWAY. Over the years the fund has grown very substantially. I think we had more companies, I am sure, a year or two ago, then we have today, and I would suspect that in the future we will have even more than that, sir. I think today we have 170-odd companies. I would guess that the number may have gotten close to 200 at one point, sir.

Senator BENNETT. In other words, they are a little harder to find than they were earlier?

Mr. CALLAWAY. I believe that is the case. In addition, as the company grows in size and maturity, it can be taken out of that fund and directed to all of the other pension trusts in the banks which have already had an interest in that company.

Senator BENNETT. I see.

So it is kind of an adolescent period for these companies?

Mr. CALLAWAY. Yes, sir. That is right, Senator.

Senator BENNETT. Thank you.

And now, Mr. Lingua, I would be very happy to hear your testimony.

STATEMENT OF GEORGE M. LINGUA, SENIOR VICE PRESIDENT, FIRST NATIONAL CITY BANK

Mr. LINGUA. Thank you, Senator Bennett.

My name is George Lingua, First National City Bank. My written statement and related exhibits are contained in this blue-coated letter sized document so designated. Behind the title page is the requested one-page summary of the major points I hope to make, and following the summary the written statement begins.

I will make my oral summary of the full statement and charts and exhibits within the 10 minutes allotted.

My experience has been primarily investment oriented. In addition to over a decade of working with pension funds, I have had some years of experience with the motivations and attitudes of individual investors.

Attainment of the bill's basic objectives, which City Bank fully supports, will require enlarging the total pool of capital, as well as encouraging an appropriate amount of risk taking, particularly on the part of individuals. Increasing the deductibility of capital losses for individuals, is appropriate, desirable, and should be effective in both respects.

The graduated capital gains tax provisions would probably have an initial liberating effect on old or greatly appreciated holdings. However, it would not increase the total pool of capital, as even a reduced tax rate on gains transfers some capital from individuals to Government. Therefore, our Economies Department has suggested—it is in addendum A of the full statement—an alternative which would involve a tax-free rollover when proceeds are fully reinvested in other capital securities. This treatment, as has been mentioned earlier, is already provided for what is the principal equity investment for most individuals and often the only one, often the most successful one: their own homes.

The limitations on holdings, while reasonable and even consistent with our own voluntary self-imposed guidelines, are neither necessary nor likely to be effective in assisting the attainment of the bill's objectives. An adequate facts base has not been established to support these limitations. Lacking this, we believe a potentially dangerous precedent would be set for regulating the aggregate holdings of individual fiduciaries who must act for the exclusive benefit of many separate trust accounts.

We cannot and we must not subordinate our fiduciary responsibilities for these individual accounts. The limitations are not necessary to protect the interest of beneficiaries, nor certainly to reduce potential for economic control by large investing institutions.

We believe there is no evidence that we have even attempted to control companies in which we invest. We have not, nor do we intend to even try. If the objective is to force the large bank trustees to disperse investments more broadly, it is very doubtful that limits on institutions separately would cause a broader dispersement of investments for institutional holdings in the aggregate. The aggregate dispersion is already quite broad when one looks below the tops of the lists of major institutional portfolios.

For example, we analyzed the full holdings in the commingled general equity funds of 21 large bank trustees, and found that over 400 companies were represented in these lists, of which none was held by all 21 banks, only 5 by as many as 12 banks, and 230 were held by only 1 bank.

Then, when you include the supplemental or special equity vehicles that we have established over the years, the breadth of interests and holdings becomes much more diverse and demonstrable. We tabulated the holdings at just 10 such large bank trustees and found 791 different issues; many are listed on the various exchanges and 361 actually in the over-the-counter or unlisted market.

Now, we are confident that the facts of our holdings, transactions and voting authority will support our position. Therefore, we advocate and fully support disclosure requirements which would establish the necessary fact base.

Incidentally, Citibank, I think, you may know, pioneered disclosure several years ago. In our fourth Annual Report, when it comes out in a few weeks, we will give you even more detail on our transactions as well as our holdings and voting authority. And pending the enactment of legislative specific requirements, we intend this year to issue quarterly reports for the world to see the facts of our holdings and our transactions.

I would like to turn to exhibit one as an example of this type of disclosure.* Here we have listed our 100 largest holdings, ranked by market value according to column (2), that we hold in a fiduciary capacity. These are trust accounts, investment management, and investment advisory accounts. It shows the percentage of each company's outstanding shares which we hold in total for all customers in the first column, including custody accounts for which we have no investment responsibility, just safekeeping for the customers, as well as on the far right the lesser amount for which we exercise voting authority.

Whenever possible, voting authority is passed along to the beneficial owner or co-trustee.

Exhibits 2 and 3——

Senator BENNETT. Before you leave that——

Mr. LINGUA. Yes, sir.

Senator BENNETT. So I can understand it, and it is interesting, I just wrote down a note for myself. I wanted to ask you about proportional voting authority you held. Look at Mobil Oil, No. 2 of your list. You hold 1.1 percent of their assets, according to that list.

Now, is the .44 percent in the same decimal relationship?

In other words, roughly 40 percent of your holdings, on 40 percent of your holdings you hold voting authority?

Mr. LINGUA. Yes, sir. The holdings are quite small for all customers, but a smaller amount still, about three-quarters of 1 percent of the company's total shares are held in fiduciary capacity, and a little more than half of that is what we exercise voting authority for. We are able to pass along, in other words, voting authority to the beneficial owners.

Senator BENNETT. So it is not—oh, the two figures are in the same percentage relationship?

Mr. LINGUA. Yes, sir. They are. The percentage of the company shares. The one above that is interesting, too—the Bendix Corp. You see, we have practically none we vote the shares for. Almost all of the stock is held for the employees' profit-sharing fund and we pass along the voting authority to the beneficial owners.

Senator BENNETT. For the people in the room, that figure is one-one hundredth.

Mr. LINGUA. One-one hundredth of 1 percent of that voting authority. Yes, sir.

Senator BENNETT. Thank you. I am glad to get that particular thing straightened out.

Mr. LINGUA. There are many interesting examples in this list of holdings like that.

Under tab exhibits 2 and 3 we show our commingled equity vehicles.** The one with the chart in the older fund, the supplemental fund, with the plotting of the unit values of each yearend, and showing the investment results for each year, and cumulatively from the beginning of 1964. This is close to a half-billion dollar fund now and it was quite a bit above that before the market slide in 1973, by the way.

Senator BENNETT. Are these 21 stocks in the——

*See p. 118.
**See pp. 120 and 121.

Mr. LINGUA. That is a smaller fund, sir. The one before that is 93 companies with $477 million of market value.

Senator BENNETT. Well, are those the top tier stocks, or are those——

Mr. LINGUA. No, sir. This is a vehicle now well suited to investment in medium-sized and larger companies, including some of the so-called lower tier for which there may be very good potential for earnings gains or recovery, but for which there is a lesser degree of predictability or confidence that the potential will be realized in each case.

Senator BENNETT. And what are the stocks?

Mr. LINGUA. In the next one, the special equity fund was formed just a little under 2 years ago for going at the really smaller companies. It is only $36 million in size now with 21 companies. But it has an enormous potential if we are able to find sufficient candidates to meet to a reasonable degree the investment criteria we have outlined on this page. We believe these are very reasonable criteria, and necessary for a prudent fiduciary to look at companies and see if they combine to a reasonable degree these criteria.

Senator BENNETT. Another question pops into my mind that I would like to address to both of you.

How widely spread are the stocks in these special equity funds geographically?

Are they concentrated in the New York area, or are they spread across the country?

Mr. CALLAWAY. In our case, Senator, they are spread very widely across the whole United States.

Mr. LINGUA. That is true for us as well. We are not bound by geography. We look for good companies wherever they can be found. This is a big country of ours.

Senator BENNETT. Thank you.

Mr. LINGUA. The enormous advantages, I would like to submit, of these commingled vehicles are two. It enables you to achieve broad diversification of risk, and even more importantly it enables you to equalize the investment experience of all of the participating trusts over a given time period, so that when you decide you should move out of one stock into another there is no question of whose shares are sold first. Everyone gets the same execution.

The point I hope to make is that we do have these vehicles, we have the commitment and an extensive research effort to try to seek out, wherever, the expanding companies of all sizes, particularly smaller ones.

Now I would like to address, in my minute or two remaining, what I believe to be the real problems and the regrettably low price earnings ratios of the large lower tier companies, which include many of our basic industries. The real burden on this sector and on the stock market in general is the twin-headed albatross of rising inflation and price controls—price controls which obviously do not work to control inflation, but which knowledgeable investors believe inevitably will work to stifle or suppress profits, of basic industries especially, and of some basic industries more than others.

Therefore—and I did not realize the steel industry would be discussed to such an extent today, but I have put that as my second chart. First under chart 1* let us look at the Dow Jones industrial average,

*See p. 122.

over the period since 1960. The Dow Jones, as you probably know, with few exceptions is made up of large, long-established, relatively mature companies, many in our basic industries.

Now, the dotted line of inflation in the Consumer Price Index accelerated after 1967. It looks innocuous on this chart, but on a later one you will see it as we felt it. In 1968, the vertical line marked the peak in the Dow Jones average at the time that inflation accelerated.

Then, the abatement in inflation which you will see on a later chart in 1971 and 1972 coincided with a strong recovery in stock prices.

Senator BENNETT. Since I consumed some of your time, you may go ahead.

Mr. LINGUA. Thank you, Senator, it will only be another minute.

Senator BENNETT. No hurry.

Mr. LINGUA. Now, the steel industry illustrates quite clearly the impact on an industry which was among the first to feel heavy political restraint on its product prices, back in 1962. It never recovered from the 1962 bear market, the most severe phase of which was triggered by the steel price increase rollback in April of that year.

Now finally, in 1973 steel industry profits exceeded the mid-1960's level. But investors remain skeptical, with price controls still in place and the 1974 economy slowing down.

My final chart covers a 20-year span, and shows how these variables related to each other late in 1972.** This is the way the world looked to us then. Inflation rates, shown in red when rising, and as annual rates of increase rather than the monthly increase plottings on the two previous charts, are represented here on a scale more appropriate to their real impact on the stock market.

Now, looking back to 1962 you can see the drastic market break in that year, from which steel and some other basic industries have not fully recovered. Also shown on the charts, the wide black bars under the P/E pointer in the center lower part, are the ratios for the Dow average, the price/earnings ratios, which is a reflection or a barometer of the confidence level of investors in general. It was above the 20 level pre-1962, and is now around 10 times 1973's earnings, and about 11 times estimated 1974 ultimated earnings.

In placing our primary investment emphasis on large, growing, technologically advanced or consumer-oriented companies in the so-called top tier we have been trying to exercise our best judgment in carrying out our fiduciary responsibilities for the beneficiaries of these long-term capital funds. Now if the market prices of these top tier stocks get too high at times, the market will correct this, as it did in 1962 and 1966 and 1970 and again more recently.

Periodic recurrence of this phenomenon is unavoidable if we are to have free markets, and its timing is essentially unpredictable, for practical purposes. Market price valuations which are not in time supported and validated by earnings will inevitably be corrected in the marketplace, which is where it should occur.

I thank you, sir.

Senator BENNETT. Thank you very much.

Senator BENTSEN. Thank you very much.

**See p. 124.

[Mr. Lingua's prepared statement, with attachments, follow:]

PREPARED STATEMENT OF GEORGE M. LINGUA, SENIOR VICE PRESIDENT, FIRST NATIONAL CITY BANK

SUMMARY

S. 2842

Citibank in full support of basic objectives:

Improving, broadening our capital markets.

Providing needed capital for expanding companies.

Treatment of capital gains and losses:

Increase in loss deductibility highly desirable.

Graduated gains tax has counter-productive potential after initial impact.

Enlargement of capital pool, especially risk capital, is basic objective; alternative suggested.

Limitations on holdings

Percent limits of S. 2842 reasonable, but—

Facts base does not exist to support either *need* for, or confidence in *effectiveness* of, percent limits to achieve bill's objectives.

Lacking facts base, limits would set dangerous precedent for regulating trustees with multiplicity of fiduciary accounts/responsibilities.

Citibank wholly supports adequate *disclosure* requirements to build necessary facts base.

General

Availability of capital for expanding companies: Large bank trustees already have well suited vehicles, and stated commitment, to invest in sound, growing companies of all sizes.

The real problems of the stock market and of "lower tier" companies:

Rising inflation rates in combination with price controls.

Deterioration in investors' confidence.

Inflation also reduces individuals' ability and willingness to invest.

STATEMENT

I am in charge of the Institutional Investment Division of Citibank's Investment Management Group, and a member of the Group's Investment Policy Committee.

The fiduciary accounts served by my Division are primarily employee benefit funds, for the most part pension funds for which we typically act as trustee with full investment discretion.

Prior to my 12 years in this Division, I was for several years in charge of a group of personal investment advisory accounts, and thereby gained some insights as to the motivations and attitudes of a wide variety of individual investors.

Citibank is entirely in accord with and in support of the basic objectives, as stated for S. 2842, of improving and broadening the functioning of our capital markets, particularly with respect to providing continuing availability of capital needed by expanding companies of all sizes.

I would like to address first the provisions of S. 2842 designed to provide more incentives and encouragement to individuals to increase their direct participation in the capital markets by changing the treatment of capital gains and losses.

To increase the capital loss deduction against ordinary income from $1,000 (unchanged since 1942) to $4,000, along with the three-year carryback, appears highly desirable, more equitable, and should significantly enhance the willingness to invest, as well as the available income resources, of individuals who can afford a reasonable amount of risk taking.

As to the graduated capital gains tax provisions, our Economics Department has submitted a written comment (Addendum A) which, while endorsing the objectives, points out some potentially counter-productive aspects. In summary:

The "lock in" of long term gains might be reinforced, after the initial liberating effect.

Enlargement of the capital pool, by encouraging individuals to invest more, spend less is partly offset by any tax on capital.

Therefore, enlargement of pool *and* elimination of "lock in" tendency would be much more effectively achieved by deferral of tax if individual fully reinvests proceeds of sales (as permitted for personal residence house).

With respect to the limitations on holdings, we readily concede that the specific percentage limitations in the bill are reasonable, and even consistent with the self-imposed guidelines or checkpoints which some large fiduciary institutions, including Citibank, have used as disciplines in monitoring their aggregate holdings of each company.

However, we do not believe that such limitations are necessary to achieve the basic objectives, nor that real evidence exists to support the belief that the limitations would be effective even in assisting the achievement of these objectives.

Lacking this evidence, we strongly feel that the Congress would be acting unwisely, and setting a potentially dangerous precedent, in imposing percentage limitations on the aggregate holdings of fiduciaries which are investing for hundreds, or even thousands, of separate beneficial accounts.

Although in this instance the application would be only to discretionary pension fund assets, one undesirable and unwarranted effect would be to inhibit the corporate sponsors of pension plans in the exercise of their freedom and objective judgment to select the fiduciary/manager of their choice, not only with respect to new appointments but also as to the allocation of contributions, as most large pension plans typically have two or more funding fiduciaries.

We submit that a fact base does not exist to support the need for these limitations to achieve the several basic objectives stated for S. 2842:

To protect the interests of beneficiaries

To the contrary, the history of percentage limitations on investments of pension funds, as well as for personal trust funds, is that they have almost invariably contributed to inferior investment results. This certainly has been the experience for most state and municipal employees pension funds.

To reduce potential for economic control by large institutional investors

Again, a fact base does not exist to support belief that large institutions have even attempted to exercise control over the companies in which they invest.

Citibank has not attempted to do so, and has no intention of attempting it.

To force the large bank trustees to disperse investments more broadly, to promote achievement of better functioning capital markets

It is very doubtful that the limitation, per se, would promote a broader dispersion of investments by these institutions in the aggregate.

In fact, their aggregate investment interests and holdings are much broader than has been implied by the most widely publicized critical essays in business publications. These essays have focused on the tops of the lists of the large banks. Even this top-sighted analysis does not support the more exaggerated accusations of "concentration" we have heard.

Examples

The influential *Fortune* magazine tabulation of the 20 largest holdings of each of 17 large bank trust departments actually comprised a total of: 101 companies of which only 3 were held by all 17 banks and 58 were held by only 1 bank.

Our tabulation of the entire number of holdings in the commingled general common stock funds (for pension trusts) of 21 of the largest bank trustees comprised a total of 400 companies, of which none was held by all 21 banks, only 5 were held by as many as 12 banks, only 11 were held by as many as 10 banks, only 43 were held by as many as 5 banks, and 230 were held by only 1 bank.

Moreover, if the "Supplemental" and "Special Equity" commingled funds of bank trustees for pension funds are included, the diversity of interest and of holdings is even more demonstrable. We tabulated the holdings of 10 such bank trustee pooled funds, aggregating $3.5 billion in market value and found: 791 different issues, 200 were on the New York Stock Exchange, 142 on the American Stock Exchange, and 361 were unlisted on an exchange.

Not one of these 791 stocks were in all 10 funds, only 1 was held by as many as 5 funds and 587 of the 791 were held by only 1 fund.

More information on our supplemental equity pooled vehicles will follow, in the context of the basic recommendation which Citibank is making to this distinguished Subcommittee at this time:

We urge the limitations on holdings provisions of S. 2842 be deleted, and action along these lines be deferred until a sufficient fact base is established to determine whether or not such limitations are necessary, and whether they would be significantly effective.

Citibank fully supports disclosure requirements for bank trustees which would establish an adequate fact basic, with confidence that the true and full facts will support our position that our holdings and our market transactions—

Have not been adverse to the interests of the beneficiaries of the pension funds for which we are trustee, and for whose exclusive benefit it is our fiduciary responsibility to act.

Do not represent any evidence of potential to control, or intent to control, the companies in which we invest.

Exhibit I is indicative of one form of disclosure which would contribute to such a fact base. It tabulates the 100 largest common stock positions which our Investment Management Group holds in a fiduciary capacity, and shows this to be typically a lesser portion—often substantially lesser—than we hold for all our customers inclusive of custody-only holdings. Lesser still, in almost all cases, is the portion for which we exercise sole voting authority.

Exhibit II, relating to our Supplemental Common Stock Fund, fits into the context of "effective disclosure" in another sense, as does our Special Equity Fund summarized in Exhibit III.

The first Supplemental Fund was started over 10 years ago as a vehicle primarily to invest in smaller companies. It is now close to ½ billion dollars in market value, and was well above that level before the 1973 market slide. It is now a vehicle well suited to investment in a broad band of medium size and larger companies, including some of the so-called lower tier, for which there may be very good potential for earnings growth or recovery, but also a lesser degree of predictability or confidence that the potential will be realized in each individual case.

The Special Equity Fund is not quite two years old, has a potential far beyond its present size. This fund is specifically oriented to smaller, expanding companies. These commingled or pooled vehicles have the great advantages of (1) broad diversification of risks and (2) equalizing the investment experience of all participating pension trusts over given time periods.

Our investment selection criteria, as adapted for candidated for this fund, are summarized in Exhibit III. We believe they are reasonable, and we are eager to find and invest in smaller companies which fit these criteria in sufficient combination and degree.

With respect to the much discussed problems and regrettably low price/earnings ratios of the "lower tier," which includes many of our essential basic industries, we respectfully wish to express our strong conviction as to the fundamental investment/economic problem which confronts this critically important sector:

The real burden on our basic industries, and the earnings multiples of the stocks which represent ownership in them, is the twin-headed albatross of rising inflation and price controls—price controls which obviously do not work to control inflation but which, knowledgeable investors believe, inevitably will work to stifle or surpress profits, of basic industries especially, and of some basic industries more than others.

This fact of our lives may be graphically seen in Charts 1, 2 and 3 which follow, which relate market prices, profits and inflation.

The Dow Jones Industrial Average, with only a few exceptions, is made up of large, long established, relatively mature companies, many in the basic industries: chemicals, steels, oils, autos, papers, metals and mining, etc. These industries also bear a heavy burden of cost increases for pollution control to comply with the Environmental Protection Act.

The dotted line of inflation in Chart 1 rose gradually and innocuously until the latter half of the 1960's, then the rate of increase in the Consumer Price Index began to accelerate. Late in 1968 the Dow average peaked, prior to the devastating 1969 to mid-1970 bear market.

The strong recovery from mid-1970 through 1972 was accompanied by a healthy abatement in inflation rates. When this trend was reversed in 1973, by a powerful resurgence of inflation, the stock market quickly reverted to the downside, notwithstanding prospects for record corporate profits which, in fact, were achieved.

Chart 2: The steel industry illustrates, probably better than any other, that some of our essenitial, basic industries have been affected even more adversely than others by restraints and controls on prices of steel products, while production costs were pushed up by inflation and pollution control requirements.

The steel industry in fact was the first to feel a really heavy hand of political restraints upon prices of the industry's products. It never recovered from the 1962 bear market, the most severe phase of which was triggered by the Administration's steel price rollback. Prices were restrained also for the rest of the decade by competition from rising imports of foreign steel producers, some of which have been operated more as instruments of national policy, with profitability a secondary if not minor consideration. Finally, in 1973, industry profits exceeded by mid-1960's level, and by a large amount. But investors remain skeptical, with price controls still in place and the 1974 economy slowing down.

Chart 3: (1953–72) Inflation rates, shown in red when rising, and portrayed as annual changes rather than the monthly index plottings in the two previous charts, are represented here on a scale more appropriate to their real impact upon the stock market.

The 1962 market break, from which steel and some other basic industries have not recovered, is clearly shown.

Also shown on this chart is the range of price/earnings ratios for the Dow Average, which is a reflection or barometer of investor confidence levels. It was above the 20 level pre-1962; now it is around 10 times 1973's earnings and about 11 times estimated 1974 earnings.

We respectfully submit that it has not been the large institutional investors, not the large bank trustee managers of pension funds, who have caused this erosion of confidence in the future prospects for some of our basic industries.

In placing our primary investment emphasis on large, growing, technologically advanced or consumer oriented companies in the so-called "top-tier", we have been trying to exercise our best judgment in carrying out our fiduciary responsibilities for the beneficiaries of these long term capital funds.

If the market prices of these top tier stocks get too high at times, the market will correct this, as it did in 1962, 1966, 1970 and again in 1973–74. Periodic recurrence of this phenomenon is unavoidable, if we are to have free markets, and its timing is essentially unpredictable, for practical purposes.

Market price valuations which are not in time supported and validated by earnings, will inevitably be corrected in the marketplace, which is where it should be done.

EXHIBIT I

FIRST NATIONAL CITY BANK

Rank by market value of fiduciary holdings (2) (as of Dec. 31, 1973)	Percent of company's share outstanding which Citibank— (1) Holds for all customers	(2) Holds in a fiduciary capacity	(3) Exercised sole voting authority
1. International Business Machines Corp	3.75	2.31	1.45
2. Xerox Corp	7.42	6.07	4.22
3. Eastman Kodak Co	3.10	2.14	1.37
4. Merck & Co., Inc	10.30	5.10	3.29
5. Coca-Cola Co	4.00	3.73	2.90
6. General Electric Co	3.11	2.44	1.64
7. Johnson & Johnson	4.20	3.62	2.60
8. Atlantic Richfield	5.44	4.31	3.29
9. Minnesota Mining & Manufacturing Co	2.96	2.43	1.75
10. Exxon Corp	1.72	.98	.52
11. Avon Products, Inc	6.39	5.36	3.84
12. Sears, Roebuck & Co	2.13	1.53	.94
13. Texas Instruments, Inc	8.71	7.04	5.41
14. J. C. Penney Co., Inc	5.22	4.04	2.64
15. S. S. Kresge Co	4.53	4.29	2.95
16. Caterpillar Tractor Co	5.39	4.25	3.58
17. Eli Lilly & Co	4.68	3.01	2.01
18. First National City Corp	7.71	2.40	0
19. General Motors Corp	1.36	.89	.47
20. Hewlett-Packard Co	5.19	4.79	4.06
21. Corning Glass Works	8.15	7.73	.22
22. J. P. Morgan & Co., Inc	5.31	3.96	2.40
23. Texaco, Inc	1.89	1.19	.36
24. Philip Morris, Inc	4.24	2.64	.67
25. American Hospital Supply Corp	6.32	5.98	3.60
26. Motorola, Inc	6.45	5.63	4.50

EXHIBIT I

FIRST NATIONAL CITY BANK

Rank by market value of fiduciary holdings (2) (as of Dec. 31, 1973)	Percent of company's share outstanding which Citibank— (1) Holds for all customers	(2) Holds in a fiduciary capacity	(3) Exercised sole voting authority
27. Emerson Electric Co	4.21	3.38	3.17
28. American Home Products Corp	1.78	1.17	.46
29. Schering-Plough Corp	2.49	1.96	1.09
30. General Telephone & Electronics Corp	2.89	2.23	1.67
31. Honeywell, Inc	6.34	4.70	3.38
32. Sony Corp	4.64	3.14	2.39
33. E. I. duPont deNemours & Co	2.40	.74	.17
34. American Telephone & Telegraph Co	.60	.20	.08
35. American Express Co	2.10	1.70	.94
36. Walt Disney Productions	3.75	3.48	2.56
37. Westinghouse Electric Corp	3.08	2.10	.26
38. McDonald's Corp	2.39	1.96	1.25
39. Whirlpool Corp	7.85	4.82	3.41
40. Baxter Laboratories, Inc	3.78	3.08	2.16
41. AMP Inc	3.21	2.81	1.83
42. Bendix Corp	13.98	13.08	.01
43. Mobil Oil Corp	1.10	.75	.44
44. Travelers Corp	4.07	2.69	2.44
45. Standard Oil Co. (Indiana)	1.39	.55	.19
46. Virginia Electric & Power Co	6.61	5.20	3.35
47. Colgate-Palmolive Co	2.49	2.17	.01
48. Upjohn Co	4.35	1.73	1.06
49. Ford Motor Co	1.85	.90	.69
50. Perkin-Elmer Corp	9.31	6.44	4.71
51. Southern Co	3.34	2.55	1.85
52. Continental Telephone Corp	7.25	4.98	3.93
53. Union Oil Co. of California	3.04	2.13	1.69
54. Federated Department Stores, Inc	3.49	2.39	1.89
55. Proctor & Gamble Co	.77	.39	.22
56. Digital Equipment Corp	2.87	2.47	1.27
57. TRW, Inc	6.38	6.22	6.06
58. Chesebrough-Pond's, Inc	3.64	3.09	2.12
59. First Chicago Corp	3.84	2.01	.89
60. Florida Power & Light Co	8.04	3.25	2.07
61. Texas Utilities	4.06	2.15	1.61
62. Middle South Utilities, Inc	4.22	3.57	2.70
63. Moore Corp., Ltd	2.71	1.76	1.52
64. First International Bancshares, Inc	8.77	3.60	2.54
65. Doubleday & Co., Inc	37.21	30.33	1.82
66. Chubb Corp	10.36	4.16	.64
67. Pennzoil Co	5.27	4.02	3.67
68. United Telecommunications, Inc	4.72	4.25	3.34
69. Armstrong Cork Co	4.39	4.27	4.22
70. Marcor, Inc	4.48	4.20	3.97
71. Textron, Inc	3.97	3.81	3.73
72. Carolina Power & Light Co	7.27	4.62	3.41
73. First Bank System, Inc	3.71	4.63	2.34
74. Matsushita Electric Industrial Co., Ltd	1.46	1.37	1.15
75. FMC Corp	6.17	4.16	2.99
76. Southern California Edison Co	4.79	2.72	1.92
77. Commonwealth Edison Co	2.26	1.47	.94
78. Beatrice Foods Co	1.38	1.27	.98
79. Schlumberger Ltd	.93	.42	.07
80. Consumers Power Co	4.17	3.17	.63
81. Standard Oil Co., of California	1.20	.31	.19
82. Duke Power Co	3.14	2.77	1.79
83. Marriott Corp	3.26	3.10	2.42
84. Rank Organisation Ltd	1.64	1.54	1.15
85. Colonial Penn Group, Inc	2.54	1.93	1.14
86. Hobart Manufacturing Co	7.08	7.07	0
87. Associated Dry Goods Corp	5.16	4.91	4.60
88. Economics Laboratory, Inc	3.85	3.42	3.12
89. Louisiana Land & Exploration Co	1.25	.88	.38
90. General Mills, Inc	2.92	1.22	.10
91. Masco Corp	3.12	3.08	2.33
92. National Cash Register Co	3.17	2.11	.72
93. Oklahoma Gas & Electric Co	4.30	3.65	3.32
94. General Reinsurance Corp	1.47	1.30	1.10
95. Lubrizol Corp	2.53	1.90	1.36
96. Northern Indiana Public Service Co	4.70	3.90	3.39
97. Standard Oil Co. (Ohio)	1.99	.68	.19
98. International Flavors & Fragrances	1.51	.99	.46
99. Southern Pacific Co	1.79	1.32	1.01
100. Dow Chemical Co	3.46	.26	.07

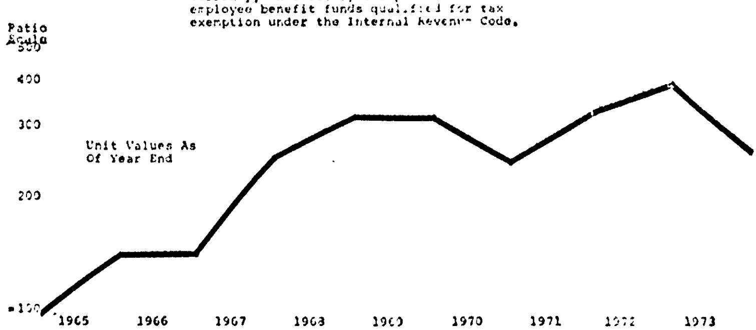
Exhibit II | Exhibit II

FIRST NATIONAL CITY BANK

Commingled Supplementary Common Stock Fund*

Total Market Value 12/31/73 = $477.8 MM
Total Number Of Companies Held = 93 Companies

*Under Regulation 9 of the Comptroller of the Currency, exclusively for pen[illegible]n and other employee benefit funds qualified for tax exemption under the Internal Revenue Code.



	1965	1966	1967	1968	1969	1970	1971	1972	1973
Rates of Return**									
For Year =	43.0%	0.5%	78.5%	28.[illegible]%	(-2.3%)	(-23.[illegible]%)	33.8%	10.6%	(-32.5%)
Cumulative from 1964, Annual Rate =	-	19.9%	36.9%	34.6%	26.3%	16.3%	18.6%	[illegible]	11.[illegible]%

**Income and market appreciation (or depreciation). Cumulative figures are annualized rates, compounded annually.

First National City Bank

Exhibit III

COMMINGLED SPECIAL EQUITY FUND *

Total Market Value 12/31/73	=	$36 million
Total Number of Companies Held	=	21 companies

*Established 4/1/72 under Regulation 9 of the Comptroller of the Currency, exclusively for pension and other employee benefit funds qualified for tax exemption under the Internal Revenue Code.

Objectives: Up to 5% of equity positions of participating employee benefit trusts. Oriented to smaller rapidly expanding companies which meet, to a reasonable degree, the following investment criteria:

Investment Criteria:

(a) Competent, experienced management (especially financial management)

(b) Products/services with proprietary or distinctive characteristics, and outstanding demand growth potential

(c) Demonstrated innovativeness, productivity of research

(d) Effective marketing, distribution system

(e) Manageable production costs and capital costs

(f) Quality of "Wall Street" sponsorship (investment banking, underwriting, market making; continuing interest in and knowledge of company).

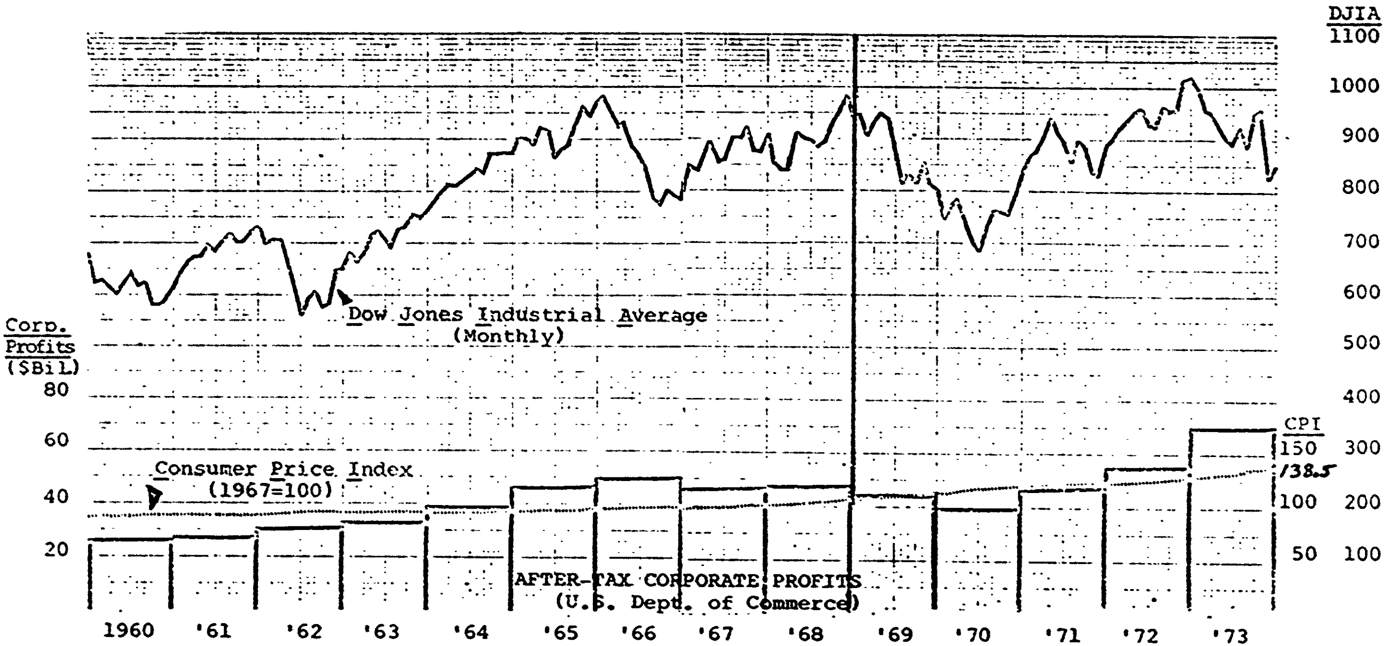
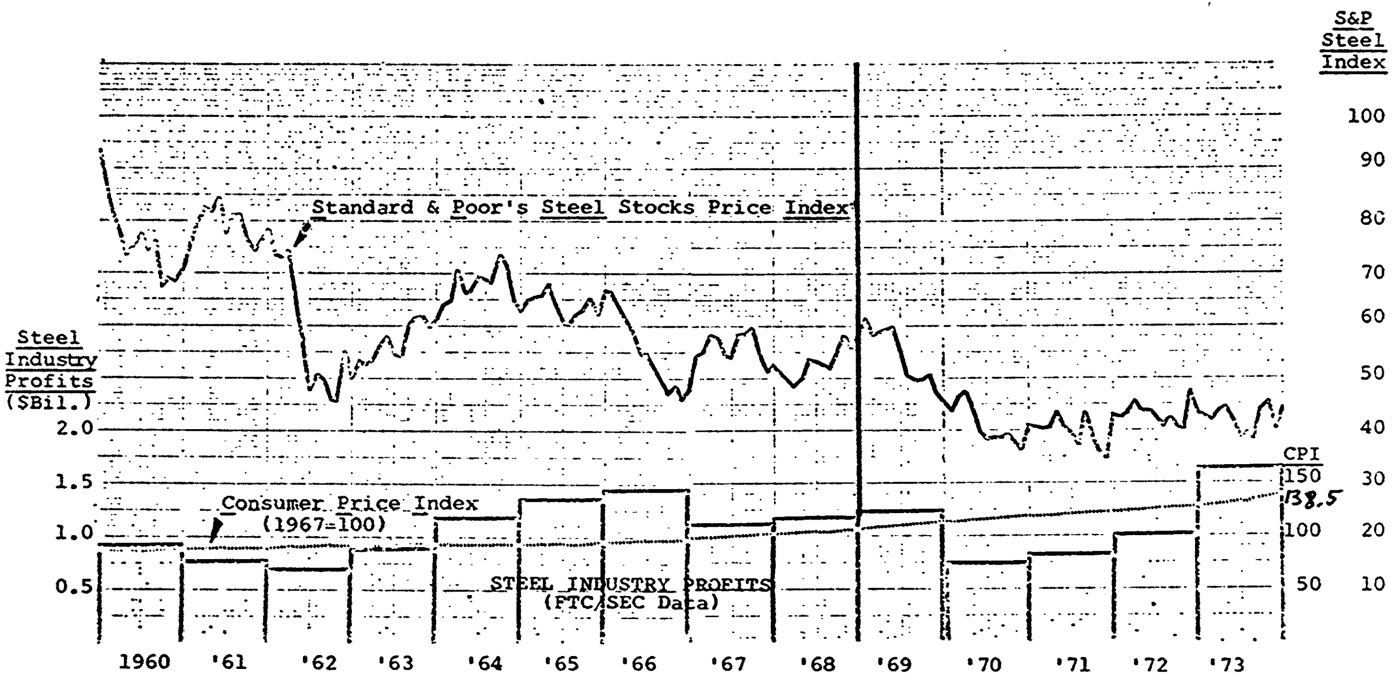


CHART 1.—Corporate Profits And The Dow-Jones Industrial Average Related To Inflation



*Index consists of Armco, Bethlehem, Inland, Interlake, Lykes Youngstown, National, Republic, U.S. and Wheeling Pittsburgh Steel Companies.

CHART 2.—The Steel Industry: Steel Industry Profits And Prices Of Steel Stocks Related To Inflation

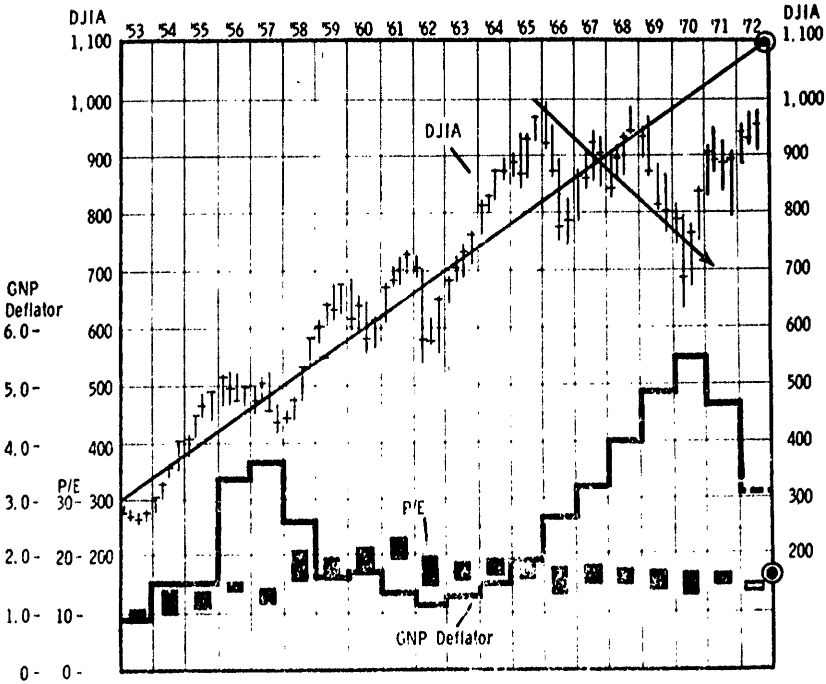


CHART 3

ADDENDUM A

COMMENTS ON THE GRADUATED CAPITAL GAINS PROVISIONS OF SENATOR LLOYD BENTSEN'S PROPOSED "STOCKHOLDERS INVESTMENT ACT OF 1973" (S. 2842) BY THE ECONOMICS DEPARTMENT OF THE FIRST NATIONAL CITY BANK OF NEW YORK, JANUARY 16, 1974

Citibank heartily endorses the basic objectives of the bill, S. 2842, and of its graduated capital gains tax provision. It is important to encourage greater investment by individuals in the equity securities of American corporations, and of new and smaller companies in particular. We feel, however, that the introduction of a graduated capital gains tax rate would be less effective in promoting the bill's objectives than other proposals that Congress might consider.

Every society must determine how much of its current output of goods and services it will consume currently and how much it will plow into investments which will increase the amount of future production. Investment is the key to a growing economy and a steadily rising standard of living for the nation's citizens, a fact that is clearly understood by the Soviet Union and the many developing countries. But in our society, investment cannot be taken for granted, for it is not dictated by the government but rather is supplied by the voluntary acts of individuals and families who forego current consumption to release a share of current output which is then used to augment the supply of productive capital.

In a free society, government can try to encourage more investment in two ways. One is to increase the potential reward for saving and investing. The other is to decrease the risks associated with investing.

The potential return can be increased by reducing the tax bite on investment income. The degree of risk associated with equity investments can be reduced by improving the function of markets for corporate equities so that price fluctuations are more moderate and investors have greater assurance that they can find a ready market for any shares they may purchase.

The graduated capital gains provision of S. 2842 contains incentives of both sorts since it provides for a lower capital gains rate in many cases and seeks to reduce the degree to which current tax laws lock investors in to existing stock portfolios. The emphasis appears to be on reduction of the "lock-in" effect, however, and this is the aspect of the bill that was stressed by Senator Bentsen in his statement accompanying the introduction of the bill.

The lock-in effect has received a good deal of attention from tax experts in recent years, in part because both those who want to increase taxes on gains (i.e. through a tax on unrealized gains held at the time of death) and those who want to reduce them can reasonably assert that their proposals will reduce lock-in. But it is easy to exaggerate what a reduction in lock-in would mean to the economy.

Some commentators have spoken as if the sale of appreciated securities would provide great resources for new investment and have even implied the amount of unrealized gains on corporate securities represents a pool of capital which could be used to provide additional investment. But to an important degree, those who might sell appreciated securities would merely be unlocking themselves by locking in others. The owner of a share of corporate stock has a financial asset which can only be converted into cash by locating someone who has cash he is willing to exchange for the asset. The exchange doesn't increase the volume of real resources available for investment in capital goods, it only shifts their ownership.

Reducing the lock-in effect of the current capital gains tax, therefore, can only increase the amount of investment in a fundamental sense if it increases the amount of current income that is saved and invested. While unlocking of itself would tend to encourage increased saving by improving the performance of security markets, there is also no question that an outright reduction in the tax on the returns to investment would have a much more powerful effect.

It must also be pointed out that the extent to which lock-in would be reduced by the introduction of a graduated rate scale is subject to question. The initial impact of the provision might well lead to sales by holders of long standing, but this effect would be in the nature of a once-and-for-all change. Thereafter, investors might be tempted to wait for lower future tax rates. At any given time during the 15-year period of graduation, an investor might well decide to delay a prospective sale until the tax year was up and the tax rate was lower. Such reactions would be particularly likely if the proposal in the bill were modified to provide for two or three steps instead of 15. The number of objections raised on the grounds of technical difficulty (i.e. how to compute holding periods in the case of stock dividends and stock splits) suggest that the bill might well be amended in this fashion on its way through Congress.

We respectfully submit, therefore, that more effective methods are available to encourage more investment through the tax laws. Among them are a cut in the percentage of gains which must be included in taxable income and a provision to permit tax free exchanges when one security is sold merely to provide the means to purchase another. The latter, known as the tax-free rollover, now applies to gains from the sale of a personal residence. Tax on such gains is deferred if the taxpayer purchases or builds a new residence within a specified interval centered around the time of the sale of the first residence. Application of this principle to transactions in stock would act as a powerful incentive to investment by both raising the return on prospective investments (but only if the investor viewed his commitment as permanent) and greatly reducing lock-in effects.

Senator BENTSEN. Mr. Callaway, in your appearance before the subcommittee last time, you stated that you were investors and not traders, that the profiles of your investments changed over a period of time, but not at a rapid pace.

Could you tell us, since your last appearance in July, what the Morgan has done with IBM, Xerox, Eastman Kodak, Avon?

What has been the change in the asset value of these stocks?

Mr. CALLAWAY. Senator Bentsen, I think I can tell you generalities without absolute specifics. I believe that in some of these stocks—and I know it is true in IBM—we have added to our holdings in the last part of 1973, and on others I believe you will find that we have sold some of them. The reasons behind the purchase or the sale is still an individual judgment of the intrinsic investment long-term merits of the stock.

I think it is fair also to say, as I mentioned when I was here in July, that also money continued to go into what are called the lower tier stocks. We are not investing solely, nor have we ever invested solely in the top tier.

Senator BENTSEN. Well Mr. Callaway, that kind of an answer is perhaps as good as you can give off the top of your head, so to speak. But I would really like something much more definitive than that for the record. If you would give us some figures which are definitive and submit them for the record, we would appreciate it.

Mr. CALLAWAY. I would be delighted to do that, sir.

That is for the year 1973?

Senator BENTSEN. That is correct.

[The information referred to above was subsequently submitted by Mr. Callaway:]

MORGAN GUARANTY TRUST CO. OF NEW YORK,
New York, N.Y., February 14, 1974.

Hon. LLOYD BENTSEN,
Chairman, Subcommittee on Financial Markets, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BENTSEN: As you may recall, during my testimony before your Subcommittee on Financial Markets on Tuesday, February 5th, you asked me what transactions had taken place in certain of our large holdings, such as I.B.M., Xerox, Eastman Kodak and Avon.

I now have a copy of the transcript of my testimony and from it I note that the time span covered in our part of my testimony covers the period starting when I appeared before your Subcommittee in July of 1973 and in another part of my testimony covers the entire year 1973. I, therefore, have enclosed two schedules covering both of these periods which show the purchases and sales in shares and in dollar value of the fifty largest common stock holdings in our retirement trust accounts.

I hope that if you have any questions, you will not hesitate to let me know.

Sincerely yours,

SAMUEL R. CALLAWAY.

MORGAN GUARANTY TRUST CO. OF NEW YORK, TRUST AND INVESTMENT DIVISION—PURCHASES AND SALES AMONG TOP 50 EQUITY HOLDINGS IN RETIREMENT TRUSTS

	Purchases: Jan. 1–Dec. 31, 1973		Sales: Jan. 1–Dec. 31, 1973	
	Shares	Cost	Shares	Proceeds
I.B.M	232,135	$74,462,720	4,800	$1,428,333
Xerox	170,800	25,478,990	1,500	217,599
Eastman Kodak	213,950	29,217,388	7,700	1,026,943
Avon Products	158,500	19,407,620	60,000	7,536,550
Polaroid Corp	139,800	14,174,836	4,200	509,674
Sears Roebuck	273,200	28,449,299	2,200	215,265
Schlumberger	164,600	15,525,540	7,200	817,165
Philip Morris	418,500	51,103,930	2,000	229,900
Coca-Cola	422,700	60,318,130	1,000	144,200
American Express	97,100	5,210,525	8,000	491,225
Procter & Gamble	208,800	21,055,591	4,500	452,450
American Home Products	618,600	52,807,711	2,600	112,683
S. S. Kresge	798,500	29,790,576	2,000	79,561
McDonald's Corp	881,450	57,850,896	2,000	143,900
Walt Disney Productions	48,100	4,930,859	9,200	718,451
J. C. Penney	387,400	32,545,017	7,900	611,168
General Motors	236,400	15,696,160	5,700	379,600
Exxon Corp	14,700	1,359,549	500	49,663
M.G.I.C. Investment	387,370	33,494,000	8,885	729,950
Merck & Co	115,700	9,568,773	600	49,840
Schering-Plough	50,200	6,215,775	5,200	408,781
Mobil Oil	41,800	2,517,459	6,000	395,515
First National City			400	32,730
PepsiCo Inc	206,500	16,594,916	4,000	327,925
Squibb Corp	311,500	30,528,240	3,000	291,035

	Purchases: Jan. 1–Dec. 31, 1973		Sales: Jan. 1–Dec. 31, 1973	
	Shares	Cost	Shares	Proceeds
AMP	77,400	4,613,832	15,800	693,923
Anheuser-Busch	1,103,800	55,687,137	53,900	2,122,618
Johnson & Johnson	59,000	6,950,517	11,100	1,243,670
Texaco Inc	90,900	3,145,355	3,300	105,109
Westinghouse Electric			245,720	8,295,391
Ford Motor	149,100	8,687,480	2,200	137,490
Sony Corp	20,000	1,004,424	5,709	205,807
Eli Lilly	347,700	27,161,942	4,400	347,860
International Paper	12,700	587,851	21,000	815,424
Pfizer Inc	272,200	12,210,567	10,900	437,243
Chesebrough Ponds	156,325	12,275,701	99,325	7,524,919
Upjohn Co	51,800	4,844,537		
Louisiana Land	3,000	142,500	59,600	2,044,914
Jos. Schlitz	265,500	15,370,084	1,000	61,575
Minnesota Mining	5,900	497,940	10,000	833,907
Heublein Inc	11,500	583,680	36,700	1,692,836
Burlington Industries			199,300	6,022,881
Standard Oil of California	289,500	23,216,441	1,500	97,425
Clorox Co			30,290	493,441
Gillette Co			46,100	2,582,665
International Telephone & Telegraph	58,300	1,975,925	303,950	11,134,777
Halliburton Co	150,400	26,381,020	2,100	312,965
Richardson-Merrell	443,300	26,797,222	3,000	208,016
Simplicity Pattern	100,000	5,618,231	89,000	4,922,141
Federated Department Stores	130,900	5,205,988	45,800	1,845,524

	Purchases: July 1–Dec. 31, 1973		Sales: July 1–Dec. 31, 1973	
	Shares	Cost	Shares	Proceeds
I.B.M	162,185	$43,548,593	4,400	$1,257,717
Xerox	90,100	13,099,916	1,000	145,950
Eastman Kodak	44,800	5,752,745	7,100	945,322
Avon Products	50,800	5,155,986	11,000	1,217,550
Polaroid	102,000	9,594,363	3,600	433,128
Sears Roebuck	89,400	8,721,052	2,000	191,650
Schlumberger	12,700	1,432,251	5,900	700,555
Philip Morris	124,400	13,853,664	2,000	229,900
Coca Cola	42,700	5,670,360	1,000	144,200
American Express	15,400	888,950	8,000	491,225
Procter & Gamble	72,500	6,941,843	3,500	349,975
American Home Products	224,300	9,222,067	1,400	62,493
S. S. Kresge	151,600	4,915,531	2,000	79,400
McDonald's	92,600	5,187,773	2,000	143,900
Walt Disney Productions	2,000	151,000	9,200	718,451
J. C. Penney	117,300	9,106,031	7,500	572,438
General Motors	189,200	12,230,988	4,400	286,880
Exxon	9,700	903,611		
MGIC Investment				
Merck & Co	112,100	9,246,673	600	49,840
Schering-Plough	9,300	753,125	2,600	212,611
Mobil Oil	34,600	2,044,367	2,500	148,440
First National City				
Pepsico	142,400	11,241,757	4,000	327,925
Squibb Corp	186,900	17,336,316	2,400	229,955
AMP Inc			15,800	693,923
Anheuser-Busch	161,500	6,622,162	53,000	2,079,350
Johnson & Johnson	31,400	3,642,747	10,500	1,173,800
Texaco	39,300	1,258,510	2,500	74,849
Westinghouse			155,420	5,135,526
Ford Motor	135,600	7,795,529	2,000	121,650
Sony Corp	10,000	431,506	5,709	201,490
Eli Lilly	183,700	13,771,196	4,400	347,860
International Paper	12,700	587,851	10,400	410,348
Pfizer	182,800	8,573,221	500	22,562
Chesebrough Ponds	107,925	8,156,548	99,325	7,524,919
Upjohn	41,500	3,348,695		
Louisiana Land	3,000	142,500	3,000	142,350
Jos. Schlitz	72,700	4,292,881	1,000	61,575
Minnesota Mining	2,000	175,200		
Heublein	11,500	583,680	5,300	302,270
Burlington Industries			75,700	2,084,620
Standard Oil of California	10,400	763,702	1,500	97,425
Clorox			28,290	451,616
Gillette				
International Telephone & Telegraph	57,300	1,932,800	152,000	4,770,024
Halliburton	148,700	26,153,740	300	54,080
Richardson Merrell	344,400	19,318,684	2,000	133,400
Simplicity Pattern			89,000	4,922,141
Federated Department Stores	130,900	5,205,988	5,800	233,368

Senator BENTSEN. I apologize to both of you for not being here to hear your testimony. But I had a problem in having to testify on another bill before another committee.

Did you have any further questions, Senator Bennett?

Senator BENNETT. No; I asked them as they went along.

Senator BENTSEN. Now, several banks have stated that they voluntarily comply with the holding limitations I have in my bill.

Could you give the subcommittee some examples of where you might want to deviate from those limitations?

Mr. LINGUA. Yes, sir. I would be glad to give you one. One is the case of a great company called Texas Instruments, where I believe we now own—close to 5 percent of our discretionary pension assets are invested in that company.

Senator BENTSEN. Well, that would be in compliance.

Mr. LINGUA. But we are so close that if new accounts were to come into us, the market value would be over the 5 percent by the market. It is true we would not have to sell, but we would not be able to take in new accounts without having to tell them: One of our most favorite stocks that we would like to buy for you, in the exercise of our fiduciary judgment, we are not permitted to buy.

Now, there may be a few others like that, so our ability would be constrained as to investing in some of the stocks that we feel represent the best long-term investments in advanced technological areas in this country.

Now, that presents a potential conflict of interest, which I am confident we would resolve in favor of the beneficiary. But in order to make room, possibly to take on new accounts, we might be tempted to sell some of that stock, even though our better judgment would suggest that we should hold. That is a temptation which we would resist.

Senator BENTSEN. Well, Mr. Lingua, more than 70 percent of the trading volume on the New York Stock Exchange is attributable to institutions?

Would you not be concerned if, instead of it being 70 percent, that it went on up to 80, 90, 95 percent?

Mr. LINGUA. We are concerned now, sir, in all aspects of our relationship to the marketplace. We try to be responsible and in all ways act in such a way that will not impair the functioning of the marketplace.

Senator BENTSEN. Well, let me ask you this. Do you think it would be bad for the market if this trend was increased so that institutions had 95 percent of the volume of trading on the New York Stock Exchange?

Mr. LINGUA. I think it would be bad for the basic reason that your bill would suggest, that would mean that the individual investor had lost confidence in participating directly in this.

We are completely in support of encouraging the individual to become more active and own more directly, as a direct investor in this country of ours.

Senator BENTSEN. Since there are 1,400 other stocks to pick from on the New York Stock Exchange and, as good as Texas Instruments may be—and I happen to think it is a very fine company—aren't there sufficient other stocks to pick from?

Mr. LINGUA. Yes. I believe there are many other good alternatives. I was addressing only the question of whether, if we believe that several companies represented the very best among all of the alternatives, that it would be wrong for us to be precluded from buying the ones that in our best judgment were the best.

Senator BENTSEN. Even if it was the best, is there not also a counterbalancing force of not having too much of one's assets in one company, as good as that company may look today?

The Japanese developed a calculator. It was extremely competitive with Texas Instruments. And then Texas Instruments came back with their product and recaptured the market.

But you can have a substantial overnight change in technology, that can give a company, as good as it may be, an extremely serious problem, and this is something that may not have been foreseen by the most prudent investors.

And therefore, should not a portfolio manager put some kind of limitation on how much of the assets of a pension plan he is going to put in one stock?

Mr. LINGUA. Sir, that is why we have the self-imposed guidelines, that we have put in checkpoints, for years—to stop before we accumulate more shares, percentage shares, of the company unless we intensively again review the investment criteria.

I will say it is a matter for our Investment Policy Committee, if we believe it merits an exception of going beyond this checkpoint level.

We look to many of the criteria we have outlined for this, even for smaller companies.

Senator BENTSEN. Mr. Lynn Townsend has pointed out that McDonald's has a book value of about $200 million and a stock market value of $2.1 billion. The United States Steel Co. has a book value of $3.6 billion and a recent market value of $2.2 billion.

We know we have a shortage of steel and apparently no shortage of hamburger stands. You have the steel industry publishing statements that they are not going to be able to expand to as much of the market as otherwise would be available for their products, because they cannot raise the capital fast enough. Therefore, the Europeans and the Japanese are going to pick up part of that market. And we are very much concerned about supplying our own economy here with steel and also having some assistance for our balance of trade; and that we are not just developing into the grainery of the world; that we have some manufacturing capability.

What can you do?

What do you recommend?

Mr. LINGUA. That is why I used the steel industry as an example here of what we believe, at the City Bank, as the basic problem of our basic industry. And steel illustrates it perhaps better than any other.

It has been under price restraints for over a decade, the first of which were politically administered in 1962. Since that time it has been under the further restraints of intense foreign competition when it had excess capacity; imports rising in this country from foreign producers, many of whom were operated more as instruments of national policy with a profit motif secondary, if not minor, in consideration.

And now that the steel industry is finally in a shortage position, it is unable to earn enough on the tremendous amounts of capital that are required to invest in new steel, basic steelmaking capacity.

And investors who want to risk their capital perceive this. They would rather buy the bonds of the steel industry at 8 to 8½ percent than own their equity.

I think that is wrong. I think that is too bod. But we must get to the basic causes of this.

Mr. CALLAWAY. May I add to that comment?

Senator BENTSEN. Yes. Mr. Callaway.

Mr. CALLAWAY. I agree with what Mr. Lingua said, and I think it is also true what Dr. Malca pointed out—that the investor, although he is interested in book value, is much more interested in earnings, and the trend of earnings, and the prospect of future earnings. And to go back tto book value, it seems to me you can liken it to owning a piece of property in a section of a town that deteriorates, and the book value of that property may be very high, what you originally invested in. But there may be no attempt to purchase that property anywhere near that value.

And I maintain, as Mr. Lingua said, that the earnings outlook for these companies are very much more important than the book value to the investor.

Thank you.

Senator BENTSEN. Oh, I would agree, Mr. Callaway, generally on that; but then you go very much to the other extreme, too. And we have the record of one company that had a great trend line on its earnings out on the west coast, a beautiful trend line.

But as of today it is in a process of bankruptcy. A very large company in which a lot of people were involved and a lot of people were hurt. And if you look just at earnings, on that point it was spectacular, if you did not bother to look at book value.

So it is a balance of these things and all to be considered, is it not?

Mr. CALLAWAY. It certainly is, Senator. I agree.

Senator BENTSEN. Thank you very much, gentlemen.

I will look forward to reading your testimony in detail.

Thank you for your appearance and contributions.

Our next witness this morning is Mr. Howard E. Hallengren who is a vice president, First National Bank of Chicago.

Would you take the stand, please?

Would you proceed, sir?

STATEMENT OF HOWARD E. HALLENGREN, VICE PRESIDENT, TRUST DEPARTMENT, FIRST NATIONAL BANK OF CHICAGO, ACCOMPANIED BY BENJAMIN HOMOLA, VICE PRESIDENT, LEGAL DIVISION, TRUST DEPARTMENT

Mr. HALLENGREN. Thank you, sir.

Mr. Chairman, members of the committee, my name is Howard Hallengren. I am a vice president of the Trust Department of the First National Bank of Chicago, responsible for the trust department's investment staff.

I am accompanied by Benjamin Homola, vice president in the legal division of the trust department.

We appreciate the opportunity to appear before the committee to present the position of our bank on the Stockholders Investment Act of 1973.

Since we are a manager of employee benefit plans, we are vitally interested in any legislation which would affect our investment. After reviewing the proposed legislation, we would like to offer our comments on several aspects of the bill.

Our full statement which we request be made a part of the record and, of which I believe you already have copies, covers the practical investment consequences of the proposed legislation; the implications of the bill as to the trustee's fiduciary obligations and; some additional comments as to the technical language used in the drafting of the bill.

I intend to confine my summary remarks primarily to the investment consequences of the bill. However, we will be happy to answer questions as to any portion of our full statement.

When the Stockholders Investment Act of 1973 was introduced in the Senate last September, Senator Bentsen indicated that one of his primary concerns was to reverse the trend which prior hearings of this committee had investigated, toward increasing concentration on the part of large institutional investors in a relatively small number of common stocks.

Accordingly, the bill established various criteria which it was indicated would serve to limit the apparent concentration. We believe that it is appropriate to question whether or not the proposed limitations would in fact bring about the stated objective of causing large institutions to introduce greater diversity into their equity portfolios.

We will do this by examining their possible effect on our own activities.

The first limitation is that no more than 5 percent of all pension trust assets managed by a given pension manager can be invested in the securities of any corporation. We believe that this proposal would have little or no practical effect as far as the Trust Department of the First National Bank of Chicago is concerned.

A literal interpretation of the bill would indicate that we could place up to 5 percent of the value of all pension trust assets over which we have discretionary investment authority in the securities of any corporation.

We have, of course, many pension trusts over which we have discretionary investment authority, which are invested in accordance with their particular objectives and the particular provisions of the respective trust instruments.

For example, we have discretionary investment authority, as defined in the bill, over some trusts which are invested entirely in bonds and others which are invested entirely in real estate.

Apparently, these kinds of trusts and others with special investment provisions could be included in the total or our managed assets against which the 5 percent limitation would apply. If this is the cause, the bill would seem to place virtually no meaningful limitation on the concentration of investments in an individual pension account.

Even assuming that the intention of the bill is clarified so that the 5 percent limitation applies to the holdings of the securities of any corporation in an individual pension trust, we would have serious objections to this provision, since we oppose the concept of limiting by legislation our ability to respond to investment opportunities as they arise.

Senator BENTSEN. Let me ask you, do you put a voluntary limitation on yourself?

Mr. HALLENGREN. Yes. I come to that.

Senator BENTSEN. Well, if you managed yours prudently, you then move to the conclusion that all other bank trust departments manage theirs equally as prudently and have such limitations?

Mr. HALLENGREN. I would assume that all bank trust departments operating under prudent man-rules would have to look at the degree of concentration of the assets which they manage.

Senator BENTSEN. That is not an answer. Give me a specific point. You say the 5-percent limitation does not bother you because you have that as a voluntary compliance.

I am now asking you do you also assume that all other bank trust departments have a 5-percent limitation?

Mr. HALLENGREN. I cannot make that assumption.

Senator BENTSEN. Well, I tell you they do not. What we want is to stop the aberrations.

Mr. HALLENGREN. I think what I was suggesting here, Senator, is that the 5-percent limitation, if we apply it to all of our pension assets, really does not have any great effect. We could probably have a larger concentration under this interpretation, the way the bill is written.

Senator BENTSEN. Well, I can tell you that for some bank trust departments it does have an effect and a very material one.

Go ahead.

Mr. HALLENGREN. OK. I can only speak for ourselves.

Additionally, we believe that this provision might add a further destabilizing element to an already unsettled securities market if all pension trusts, which your committee has identified as among the most important factors in the market today, were prohibited by an artificial limitation from purchasing stocks of fundamentally sound companies during a period of market weakness.

Senator BENTSEN. Well, do you think if you had 1,400 stocks to pick from, that a 5-percent limitation stops you from picking fundamentally sound stock?

Do you think you are limited to 20 stocks?

Mr. HALLENGREN. I do not feel that in any way.

The second limitation proposed in the bill is that any pension manager cannot buy more than 10 percent of any class of security of any corporation. We agree with the broad objective indicated by this proposal; and we do, in fact, generally limit our own purchasing or ownership to less than 10 percent of the outstanding stock of any corporation.

Our Trust Investment Committee adopted a rule 3 years ago restricting our ownership position for discretionary holdings to 8 percent of the outstanding stock. It must be emphasized, however, that we retain the flexibility of increasing our position to a figure greater than 8 or 10 percent if particularly good buying opportunities should occur—a flexibility which we might lose if this proposed provision were enacted into law.

The problem with any arbitrary limitation such as the proposed 10 percent ceiling is that it cannot take into consideration all of the many variables which might exist in an investment situation.

We believe that it is necessary to consider such matters as trading volume of a given security, as well as the percentage, if any, which might be closely held in order to determine an effective limitation on the holdings of that security.

We believe that we are obligated under the existing Illinois prudent man rule to consider these factors. Accordingly, in companies such as Hewlett Packard, Tektronix, and Carnation, where over 50 percent of our outstanding shares are closely owned by family or management interests, we do not believe that it would be appropriate for us to take position of 10 percent of the outstanding stock, which would result in our owning 20 to 25 percent of the floating supply of stock.

Therefore, we believe that the prudent man rule is a fare more effective and meaningful limitation on our accumulation of large concentrations than is the bill's proposed 10 percent figure.

Senator BENTSEN. Well, let me ask you this. There is nothing in my bill that proposes more restrictive limitations on the part of management than the 10 percent. Is that not true?

Mr. HALLENGREN. Yes. I understand that.

The third provision of the bill provides that a trustee may invest up to but not to exceed 1 percent of qualified pension trusts and securities of any corporation with a capital account of less than $25 million.

When Senator Bentsen introduced this bill in the Senate last December, he stated that this provision "would facilitate the flow of institutional money to small- and medium-sized companies."

In our view, however, the provision of this bill as it was written might be counterproductive and might in fact impede the flow of money into small companies. The first impediment is the proposed 1 percent limitation.

At the present time, under our interpretation of the existing prudent man rule, we have invested a portion of our pension assets both in a comingled special situations fund and in a venture capital company formed expressly for our employee benefit trusts. In some trusts these investments exceed 1 percent of the market value of all assets of the trust.

Accordingly, if our holdings in this type of security are not to exceed that level, our interpretation of the proposed bill would require us to reduce our commitment to this type of investing in the future.

Senator BENTSEN. If that is the case, Mr. Hallengren, then there is a very good possibility that you misinterpreted the provisions of the new pension reform bill that passed the Senate last September. The purpose of my bill is to try and free up some funds, because of our deep concern that the prudent man rule as applied in the pension reform bill might be overly restrictive.

But we are trying to accomplish the same objective; and our lawyers had better get together on interpretation of the prudent man rule.

Mr. HALLENGREN. I think we are very sympathetic with the objective that you stated when you introduced the bill. We do not believe the bill actually provides it.

Moreover, we believe there is a conflict between these objectives that you stated when you introduced the bill and the bill itself.

Senator Bentsen indicated this 1-percent provision would be a leeway clause which would relieve a fiduciary from liability with respect to the riskiness of an investment. Section 4 of the bill, however, seems to place restrictions on this type of investment, since it requires the trustee to take into account various factors which might be interpreted as giving the trustee less leeway than he now has under existing interpretations of the prudent man rule.

While disagreeing with the specific provisions of this bill, we believe that many of you know that we have shared the concerns which led to your initial hearings on this matter. We might comment that 4 years ago we expressed our concern over some of the practices which were then prevalent in the investment community.

You may recall that at that time in 1970 we had just emerged from the era of the so-called "hot stocks." These issues, some of which unfortunately were bought in employee benefit trusts, were generally new issues or were issues of relatively young and emerging companies.

If specific legislative action had been taken in 1970 to correct the abuses which had occurred in the late 1960's, it seems to me that there undoubtedly would have been prohibitions placed upon the purchase of new issues or more speculative types of investments for qualified pension plans.

It is ironic that here is 1974 we are trying to find means of encouraging investments in smaller capitalization companies and venture capital type investments. We believe this indicates the great dangers which are inherent in trying to find specific and narrowly based legislative remedies for problems which may very well prove to be quite temporary.

Accordingly, we urge the committee to place primary reliance on the expansion and strengthening of the prudent man rule to correct whatever problems may exist in the investment of employee benefit trusts.

Senator BENTSEN. Mr. Hallengren, you are making some very relevant observations. I have interrupted you several times. Why do you not take another 5 minutes now?

Mr. HALLENGREN. I just have another minute here.

Finally, I feel that we feel strongly that the requirements that pension managers aggregate trust holdings to comply with federally imposed investment restrictions would violate the basic trust concept and the established trust law requirement that each trust is to be administered individually.

The trust concept is part of our U.S. legal system and had its origin many hundreds of years ago in the English system of equity jurisprudence. Over the years the various laws governing fiduciaries, together with the body of court decisions, have effectively set forth investment restrictions on trustees' pension plans.

With the imminent passage of a Federal prudent man rule, we see no need at this time for further Federal intervention. I believe that it would be difficult to find abuses in trust investment activities, for which there will be no remedies at law once a Federal prudent man rule is enacted.

Thank you very much.

Senator BENTSEN. Well, Mr. Hallengren, I appreciate your testimony. I find it interesting. I congratulate you on some of your self-imposed limitations.

I well understand the very normal reaction that you do not want legislative restrictions that tell you to do the same thing you are already doing. I do not think that the insurance companies have found it particularly onerous. Insurance companies have worked under comparable types of limitations for many, many years. Mutual funds, to a lesser degree, have had some such limitations, although I know that they have means of avoiding them where they get a number of funds operating under the same management company. The limitation only applies to 75 percent of their assets.

But what we have tried to structure here is something that would not have the investor not acting like an investor, but would give him a wide variety of investment choices. And I think we have done that in this particular bill.

It is not a perfect bill. I am sure that it can be improved upon. Some of the things you pointed out I think will be of contribution in that regard.

The bill is not proposed as a panacea for the stock market. We are not going to resolve all of the problems of the stock market. But some of us think it is a contribution. I think it will help. I think it is a very serious and meaningful protection to the pensioner from abuses that sometimes result by some institutions that do not impose and abide by the limitations you say that your fund managers impose on themselves.

Since I asked questions through your testimony, I do not have any further ones at this time.

[The prepared testimony of Mr. Hallengren follows:]

PREPARED STATEMENT BY HOWARD E. HALLENGREN, VICE PRESIDENT, TRUST DEPARTMENT, THE FIRST NATIONAL BANK OF CHICAGO

Mr. Chairman and members of the Subcommittee on Financial Markets. My name is Howard E. Hallengren. I am a Vice President in the Trust Department of The First National Bank of Chicago, in charge of the Trust Department's Investment Staff. I am accompanied by Benjamin C. Homola, Vice President in the Legal Division of the Trust Department. We appreciate the opportunity to appear before the Subcommittee on Financial Markets to present the position of The First National Bank of Chicago on the Stockholders Investment Act of 1975.

The First National Bank of Chicago acts as Trustee, or agent for individual trustees, of over 630 employee benefit plans, holding assets in excess of $4 billion. During the past year, we made regular monthly pension payments to over 45,000 retired employees on behalf of the pension plans which we manage, and these payments totalled close to $78 million. Therefore, we are vitally interested in any legislation which would affect the investment of employee benefit trusts in general, and pension trusts in particular.

After reviewing the proposed legislation, S. 2842, we would like to offer our comments on several aspects of the bill. Our comments will cover the practical investment consequences of the proposed legislation; the implications of the bill as to a trustee's fiduciary obligations; and some additional comments as to the technical legal language used in the drafting of the bill.

I. INVESTMENT CONSEQUENCES OF S. 2842

When the Stockholders Investment Act of 1973 was introduced in the Senate last December, Senator Bentsen indicated that one of his primary concerns was to reverse the trend, which prior hearings of this committee had investigated, toward increasing concentration, on the part of large institutional investors, in a relatively small number of common stocks. Accordingly, the bill established three specific criteria which, it was indicated, would serve to limit the apparent concentration. These criteria would be: (1) that no more than 5% of all pension trust assets managed by a given pension manager could be invested in the securities of any corporation; (2) that any pension manager could not buy more than 10% of any class of security of any corporation; and (3) that up to, but not to exceed, 1% of a qualified pension trust could be invested in the securities of any corporation with a capital account of less than $25 million. We believe that it is appropriate to question whether or not the proposed limitations would, in fact, bring about the stated objective of causing large institutions to introduce greater diversity into their equity portfolios.

The first limitation would have little or no practical effect, as far as the Trust Department of The First National Bank of Chicago is concerned. A literal interpretation of the bill would indicate that we could place up to 5% of the value of all pension trust assets, over which we have discretionary investment authority, in the securities of any corporation. We have, of course, many pension trusts over which we have discretionary investment authority which are invested in accordance with their particular objectives and the particular provisions of the respective trust instruments. For example, we have "discretionary investment authority," as defined in this bill, over some trusts which are invested entirely in bonds, and others which are invested entirely in real estate. Apparently, these kinds of trusts, and others with special investment provisions, could be included in the total of our managed pension trust assets against which the 5% limitation would apply. If this is the case, the bill would seem to place virtually no meaningful limitation on the concentration of investments in an additional pension account.

Even assuming that the intention of the bill is clarified so that the 5% limitation applies to the holdings of the securities of any corporation in an individual pension trust, we would have serious objections to this provision. In the first place, the practical effect at this time would not be great. In the guidance which the senior investment officers of our Department give to our pension fund account managers, we specify the percentage which is to be invested, at any given time, in a particular security. At this time, all of our holdings in discretionary pension accounts would be under 5%, with one exemption. In that one case, the holding is designated as 7%.

More importantly, however, we oppose the concept of limiting, by legislation, our ability to respond to investment opportunities as they arise. From time to time, the stocks of some major, high quality corporations decline in price to levels which, in our judgment, appear to make them extraordinarily good values. We do not believe that it is in the best interests of the pension trusts which we manage, or of the beneficiaries of those trusts, for us to be legislatively prohibited from increasing our position as those buying opportunities occur. Additionally, we believe that this provision would add a further destabilizing element to an already unsettled securities market, if all pension trusts, which your committee has identified as among the most important factors in the market today, were prohibited by an artificial limitation from purchasing stocks of fundamentally sound companies during a period of market weakness.

The second limitation proposed in the bill is that any pension manager could not buy more than 10% of any class of security of any cooperation. We agree with the general objective indicated by this proposal, and we do, in fact, limit our own purchasing, or ownership, to less than 10% of the outstanding stock of any corporation. Our Trust Investment Committee adopted a rule three years ago restricting our ownership position for discretionary holdings to 8% of the outstanding stock. Our portfolio managers may make purchases which would bring our holdings over that level only with the express approval of the Committee. In making these determinations, we must take into consideration all of the factors which affect the liquidity and marketability of a given stock. It must be emphasized, however, that we retain the flexibility of increasing our position to a figure greater than 10% if particularly good buying opportunities should occur, a flexibility which we would lose if this proposed provision wer eenacted into law.

The problem with any arbitrary limitation, such as the proposed 10% ceiling, is that it cannot take into consideration all of the many variables which might exist in an investment situation. We believe that it is necessary to consider such matters as trading volume of a given security, as well as the percentage, if any, which might be closely held, in order to determine an effective limitation on the holdings of that security. We believe that we are obligated, under the existing prudent man rule, to consider these factors. Accordingly, in companies such as Hewlett Packard. Tektronix and Carnation, where over 50% of the outstanding shares are closely held by family or management interests, we do not believe that it would be appropriate for us, operating under the prudent man rule, to take positions of 10% of the outstanding stock, which would result in our owning 20 to 25% of the floating supply of the stock. Therefore, we believe that the prudent man rule is a far more effective, practical and meaningful limitation on our accumulation of large concentrations than is the bill's proposed 10% figure.

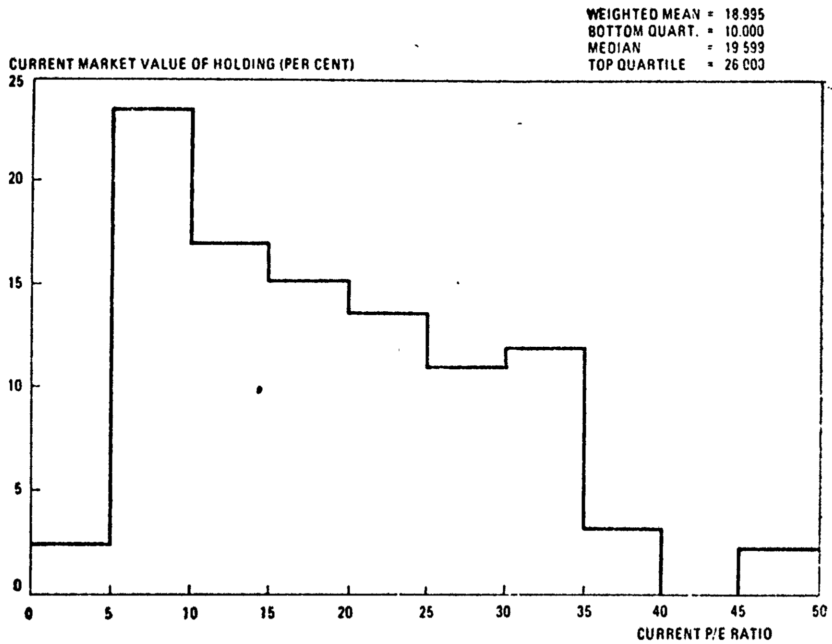
The third provision of the bill provides that a trustee could invest up to, but not to exceed, 1% of a qualified pension trust in securities of any corporation with a capital account of less than $25 million. When Senator Bentsen introduced this bill in the Senate last December, he stated that this provision "would facilitiate the flow of institutional money to small and medium-size companies." In our view, however, this provision would be counter-productive and would, in fact, impede the flow of money into smaller companies. The first impediment is the proposed 1% limitation. At the present time, under our interpretation of the existing prudent man rule, we have invested a portion of our pension assets both in a commingled special situation fund and in a venture capital company formed expressly for our employee benefit trusts. Approximately 25% of the assets in our special situations fund, and all of the assets in our venture capital operation, are represented by investments in companies with capital accounts of less than $25 million. It has been our policy to place 5% of the assets of a typical pension account in our special situations fund, and approximately 1% of selected pension accounts in our venture capital operation. Accordingly, if our investments in this type of security are not to exceed 1% of the market value of all assets of the trust, we would have to reduce our investment in this type of security. We do not believe that the waiver in subsection (b) would afford us relief in this regard.

Moreover, we believe that there is a conflict between the objectives stated when Senator Bentsen commented upon this section at the time he introduced the bill and the bill itself. Senator Bentsen indicated that this 1% provision would be a "leeway clause" which would relieve a fiduciary from liability with respect to the riskiness of an investment. Section 4 of the bill, however, seems to place restrictions upon this type of investment since it requires the trustee to take into account "the need for diversification within the trust with respect to the type of security, the type of industry, the degree of risk, and the potential for return." This provision might be interpreted as giving the trusteee less "leeway" than he now has under existing interpretations of the prudent man rule.

We would also comment that the proposed criteria for selecting these securities (a capital stock account of less than $25 million) seems to us to be quite nebulous. In examining corporation balance sheets, we find all too little consistency in the application of accounting rules and procedures. We believe that serious questions would arise as to the practical application of this provision, when viewed from the standpoint of the security analyst. In addition, we wonder if some corporations might hesitate to make necessary adjustments to their balance sheets in order to remain on one side or the other of this rather arbitrary benchmark.

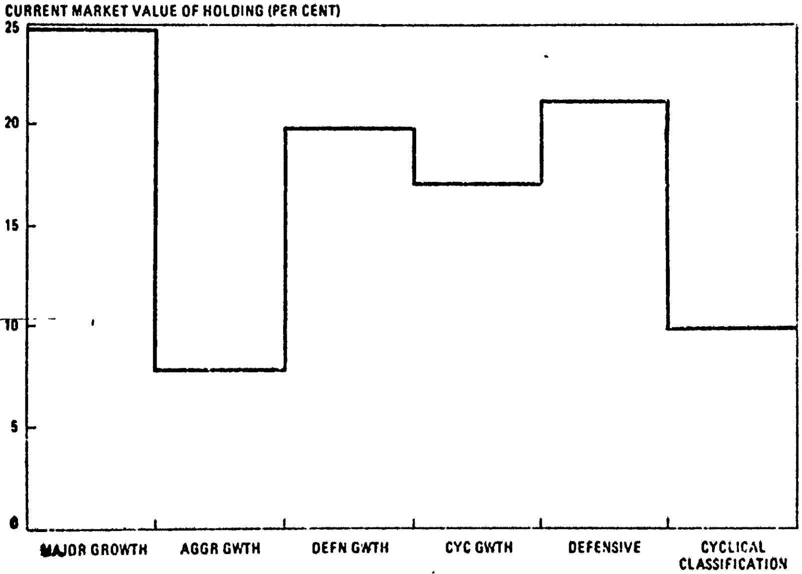
While disagreeing with the specific provisions of this bill, we believe that many of the committee members know that we have shared the concerns which led to your initial hearings on this matter. We might comment that four years ago we expressed our concern over some of the practices which were then prevalent in the investment community. You may recall that at that time, in 1970, we had just emerged from the era of the so-called "hot stocks." These issues, some of which, unfortunately, were bought in employee benefit trusts, were generally new issues, or were issues of relatively young and emerging companies. If specific legislative action had been taken in 1970 to correct the abuses which had occurred in the late '60's, there would undoubtedly have been prohibitions placed upon the purchase of new issues or more speculative types of investments for qualified pension plans. It is ironic that here in 1974 one of the objectives of the bill is to encourage investment in smaller companies and venture capital situations. We believe that this indicates the great dangers which are inherent in trying to find specific and narrowly based legislative remedies for problems which may very well prove to be quite temporary.

CHART 1



We believe that a far more productive approach to the investment problems which the hearings of this committee have been investigating would be to expand and strengthen the prudent man rule. I might comment that we believe, in the Trust Department of The First National Bank of Chicago, that the prudent man rule requires us to look at a great many factors when considering the diversification of one of our accounts. We believe, for example, that we must look at the diversification of price earnings multiples within an account, since we believe that there should not be an excessive concentration in one level of p/e multiple. We have an on-line computer program which gives this information for each of our accounts on an almost instantaneous basis, and the portfolio manager is provided upon request with an analysis of each of his accounts, similar to chart #1 on page 8–A.

CHART 2



In addition, we also try to diversify our accounts not only by industry, but also by type of security, so that excessive concentrations do not occur in any one class of stock. Portfolio managers are given precise guidance by the senior investment officers as to diversification by stock classification. A typical computer report for this type of analysis would be similar to chart #2 on page 8-A.

These are ways in which we have gone about trying to exercise our obligations as a prudent trustee, and we believe that these procedures also meet many of the objectives set by this Committee.

In conclusion, we do not believe that the specific provisions contained in S. 2842 would have the practical effects intended, and may, to some extent, even be counter-productive. Accordingly, we urge the committee to place primary reliance on the use of the prudent man rule to correct whatever problems may exist in the investment of employee benefit trusts.

II. LEGAL AND EQUITABLE CONSIDERATIONS

Today a bank may be authorized to act as a fiduciary under state law or by permit issued by the Comptroller of the Currency. If a bank is to exercise trust powers, it must not only create a separate trust department, and hold fiduciary assets separate from the general assets of the bank, but each trust account must be administered individually, and separate records must be maintained for each account.

The principles, rules and standards governing the conduct of trustees are exacting. Certain of the duties of the trustee arise from the nature of the relationship; others are imposed by the terms of the trust instrument. Perhaps the most important duty is the duty of loyalty to the beneficiary, which requires that the trust be administered solely in the interest of the beneficiary. In selecting investments the trustee may be guided by the best interests of the beneficiaries, present and future, rather than any possible advantage to the trustee.

The requirement that pension managers aggregate trust holdings to comply with federally imposed investment restrictions would violate that basic trust concept and the established trust law requirement as stated above that each trust is to be administered individually.

The trust concept as part of our United States legal system had its origin many hundreds of years ago in the English system of equity jurisprudence. There is ample law governing fiduciaries. In view of the great body of law which evolved over a hundred years in the United States relating to trusts, we see no need for federal legislation which would specifically set forth restrictions on the investments which may be made in trust accounts.

The interests of beneficiaries of pension trusts are adequately protected without the imposition of specific federal investment restrictions. In fact, the proposed restrictions themselves will undoubtedly product an adverse affect on trust beneficiaries in some situations.

Presently there are remedies available to trust beneficiaries and safeguards to protect their interests, and the proposed pension legislation, which seems so imminent, will further protect the interests of beneficiaries of pension trusts.

If a trustee fails to perform its responsibilities or commits a breach of trust detrimental to the interests of a beneficiary, suit may be brought by the beneficiary. The beneficiary may maintain a suit: (1) to compel the Trustee to perform his duties as trustee; (2) to enjoin the trustee from committing a breach of trust; (3) to compel the trustee to redress a breach of trust; (4) to remove the trustee and have a successor trustee appointed. If, for example, the trustee purchases assets from itself, a beneficiary may have the sale set aside. The general rule is that if there is a profit to the trustee resulting from the act of self-dealing the trust is entitled to retain the profit, but if there is any loss resulting from the act of self-dealing the trustee, in his individual capacity, must make good the loss. Thus, if the trustee commits a breach of trust, he is chargeable with (1) any loss or depreciation in value of the trust estate resulting from the breach of trust; or (2) any profit made by him through the breach of trust; or (3) any profit which would have accrued to the trust estate if there had been no breach of trust. A beneficiary's right of action against a trustee is usually a continuing right, not ordinarly being subject to statutes of limitation.

Despite the development of a highly sophisticated set of equitable and legal rules protecting the rights given beneficiaries and making those rights enforceable by court action, trusts administered by corporate fiduciaries have become highly regulated by administrative agencies.

The authority to grant fiduciary powers to national banks and to regulate national banks exercising such powers is vested in the Comptroller of Currency. Regulation 9 promulgated by the Comptroller establishes a set of rules and regulations for national banks exercising fiduciary powers and limits the authority of national banks to such fiduciary powers as are authorized for state banks or trust companies operating under the laws of the state in which the national bank is located. Regulation 9 places the responsibility for all matters pertaining to the exercise of fiduciary powers on the Board of Directors of the Bank, requires that all accounts for which the bank has investment responsibility be reviewed upon initial acceptance and that a further review of each such account be made at least once during every calendar year thereafter to determine the appropriateness of holding the assets in trust; requires that adequate books and records be kept for each separate fiduciary account and that all such fiduciary records be kept separate from the assets of the bank; expressly directs that a committee of directors, excluding any bank officers, audit the trust department at least once each calendar year or have that audit carried out by auditors responsible only to the Board of Directors.

Representatives in Trust of the Comptroller's office periodically examine the trust departments of national banks to determine whether or not fiduciary responsibilities are being carried out in accordance with Regulation 9. Similarly, state banks which are granted fiduciary powers are subject to periodic examination by representatives of State banking authorities, and representatives of the Federal Reserve Board annually examine state chartered banks which are members of the Federal Reserve System. The report required by the Federal Reserve Board gives information as to pledges of securities with state authorities, trust department accountings and controls, internal and independent audits, officers, committees, and their functions, policies and procedures for the acceptance of fiduciary accounts, and trust investments. The report gives information as to the holdings of stock of the bank in fiduciary accounts and the rendering of accounts to trust beneficiaries. Most states require a deposit of securities for the protection of trusts, and Regulation 9 provides that if a state refuses to accept a deposit of a national bank, the Federal Reserve Bank is authorized to hold the deposit. In the case of cash deposited in the bank, there are requirements for further pledging of bank assets so that, in the case of a bank failure, the trust assets will be protected.

In conducting periodic examinations of trust departments of national banks, the Office of the Comptroller of Currency reviews the investment policy of each department to make certain that it observes its duty to diversify investments.

Questions asked in connection with the examination include such items as: "Do accounts where the bank has investment responsibility contain unauthorized investment concentrations in the obligations or equities of a single entity?" "Does the bank have a policy regarding investment percentages in common stock?" The examiners look for heavy concentrations of particular issues, in individual accounts, and also when reviewing totals held by a trust department.

A variety of federal laws already provide for indirect government regulation of trust departments. With respect to employee benefit trusts, Section 401 of the Internal Revenue Code sets forth the requirements which must be met in order to qualify the trust as a tax exempt organization under Section 501 of the Code. One of those requirements is that the trust must be for the exclusive benefit of the employees or their beneficiaries. Section 503(c) of the Code sets forth certain transactions between the trust and the employer which are prohibited. The trust will lose its tax-exempt status if not used for the exclusive benefit of the employees or if it enters into any one of the "prohibited transactions."

All major pension reform bills now pending before Congress contain a federal prudent man rule. The concept of a federal prudent man rule has been approved by the American Bankers Association and the Corporate Fiduciaries Association of Illinois, both of which our Bank is a member. We have no doubt that pension legislation will be enacted in the relatively near future and that it will contain a federal prudent man rule.

If such will be the case, we see no need for another federal law also governing investments by pension managers. The major pending pension bills preempt state law in order, among other things, to eliminate confusion in the trust law field so that only one standard would be applicable and not fifty-one. It seems to us that it is a mistake to create two different federal prudent man rules, the one contained in the pending pension bills, and a second standard if S. 2842 were enacted. We suggest, therefore, that there is no need for the Senate to take additional action at this point, since we believe that the federal prudent man rule contained in pending pension legislation will adequately protect the interests of plan participants.

Since the Senate unanimously passed H.R. 4200, and since it contained provisions relating to fiduciary standards and disclosure to plan participants, it would seem that the Senate is of the opinion that those standards and disclosure provisions will adequately protect the interests of those participants.

It should also be kept in mind that what may be deemed imprudent at one point in time may subsequently be deemed prudent. It was not until the last several decades that investment in common stock was a universally acceptable trust investment. If Congress had enacted a bill limiting or prohibiting purchases of common stock back in the thirties, would we have had such a tremendous growth in our Gross National Product? Would our securities markets have provided the capital that enabled companies like IBM, Xerox and Polaroid to grow and provide thousands of jobs and make a major contribution to our economic expansion? It would seem the answer to both would be "no". Times change and investment conditions change, and we must exercise caution so as not to enact legislation which could be counterproductive.

Over the years, courts in equity, the IRS enforcement of the Code, and remedies available to beneficiaries have effectively set forth investment restrictions on trustees of pension funds. With the imminent passage of a federal prudent man rule, we see no need for further federal intervention. We believe that it would be difficult to find abuses in trust investment activities for which there will be no remedies once a federal prudent man rule is enacted. We do not believe that restrictions should be placed on the prudent man rule as set forth in H.R. 4200 and unanimously passed by the Senate.

III. TECHNICAL COMMENTS

We have several comments as to the technical provisions of S. 2842 as drafted. These comments follow:

(1) As drafted, Section 408 should be clarified in that Section 401(a) of the Internal Revenue Code refers to plans in addition to pension plans. By their very nature stock bonus plans should be excluded from the bill. Also, since money-purchase pension plans are in many respects similar to profit sharing plans, shouldn't they also be excluded? As 408(a) reads, it implies that a profit sharing plan is a form of pension plan and, of course, that is not the case. Should the words, "profit sharing" in the proposed 408(a) be changed to "money-purchase pension"? Then to emphasize the fact that only standard pension plans

are to be affected perhaps a statement could be added to the effect that this section is not applicable to stock bonus or profit sharing plans.

(2) Since most pension programs consist of two documents—a plan and a trust agreement, the words "or the trust agreement implementing such plan" should be added after the words "unless that plan" in Section 408(a).

(3) When an asset is sold, the market value of the trust assets are not reduced—the security sold is merely replaced by the proceeds of the sale price. Including sales in that section is confusing and also inconsistent with proposed Section 4950 which provides for a tax on the "amount of each investment." Therefore, the words "or sell" and "or sale" should be deleted from 408(b).

(4) Sub-section (c) of proposed 408 is confusing when read in conjunction with sub-section (b). Sub-section (b) is prospective in nature in that no investment can be made if as a result of such investment, the percentages are exceeded. It would permit the retention of securities which exceed the limitations—it just would not permit any further purchases. In addition the bill may be inconsistent in that it does not appear to require divestiture and yet, sub-section (c) sets forth instances when divestiture is not required. Also, when introducing S. 2842, Senator Bentsen stated that the limitations would not apply retroactively and managers of pension accounts would not be forced to dispose of current stock holdings to meet the limitations. For these reasons, we do not believe sub-section (c) is necessary and it should be deleted. The proposed pension legislation will set forth minimum funding standards, and since new money is being funneled into pension plans annually, in a relatively short period of time the limitations set forth in 408(b)(1) will be met without divestiture of present holdings. Divestiture could be very detrimental to the plan participants by requiring "fire sales".

(5) The bill should make clear that the limitations set forth in 408(b) are not violated if a pension manager succeeds another pension manager who holds securities which, when added to the assets managed by the successor, would exceed the limitations. In such a case, the successor would be prevented from purchasing additional shares, but should not be deemed to be violating the bill merely by succeeding another pension manager. Also a deposit of securities or a stock dividend should not be deemed an investment at the time of such deposit or receipt of the dividend. Of course, the deposit or dividend would be included in the value of the assets before further purchases would be made.

Perhaps these problems could be solved by changing the words "invest" and "investment" to "purchase" in the bill.

(6) The excise tax imposed by proposed Section 4950 is too severe especially where there is no loss to the beneficiaries. Pending pension legislation sets forth enforcement procedures if a trustee enters into a prohibited transaction or violates the fiduciary standards, and we suggest that those enforcement procedures be applicable to S. 2842 without the imposition of an excise tax.

(7) Section 4 of the bill raises certain questions. Of course, our comments with respect to money-purchase pension plans and stock bonus plans set forth above relating to 408 (a) are also applicable to Section 4.

It appears that Section 4 is establishing another new prudent man rule in lines 14 through 17 on page seven of the bill. This will confuse fiduciaries—a federal prudent man rule in pension legislation, restrictions on that rule in S. 2842 and another prudent man rule in S. 2842. There is no need for the rule set forth in lines 14 through 17, and therefore, we suggest lines 14 through 17 on page seven be deleted. In fact, we suggest language be added which would clearly exempt investments of 1% of the assets of smaller corporations in a pension trust from any prudent man rule. Senator Bentsen stated that they would be so exempt, but the bill provides for a different test which must be met. Of course, a problem then arises as to the conflict between this bill and the pending pension legislation if enacted subsequent to S. 2842.

(8) If lines 14 through 17 of Section 4 are not deleted, we are confused as to the effect of Section 4 as it relates to securities of any corporation with a capital account of less than 25 million dollars. The limitations set forth in Section 408(b) do not apply to those small corporations and therefore 100% of the stock could be purchased by a pension manager if deemed prudent. Instead of permitting greater investment in smaller corporations Section 4 would limit each investment in that it permits 100% to be purchased for one trust but only if the value does not exceed 1% of the value of that trust. If it does but the trustee deems the investment prudent, will the trust be disqualified?

Since these small corporations are excluded from the limitations in 408(b) and if Section 4 contains a form of a prudent man rule, it would seem that Section 4 will not accomplish what is intended. As stated above, Section 4 would be meaningful if it specifically provided that it need not meet the prudent man rule, but that is not the way we interpret it.

Senator BENTSEN. Our next witness is Mr. Michael Dingman, president of Wheelabrator-Frye, Inc., speaking on behalf of the Committee of Public Owned Companies.

Mr. Dingman, if you will take the stand please, and if you would proceed.

STATEMENT OF MICHAEL DINGMAN, PRESIDENT, WHEELABRATOR-FRYE, INC., ON BEHALF OF THE COMMITTEE OF PUBLICLY OWNED COMPANIES

Mr. DINGMAN. Mr. Chairman, it is a pleasure to be here today to represent the 619 companies that make up the Committee of Publicly Owned Companies. We have currently approximately 1.4 million employees represented, and 2.3 million shareholders in this group. There are 102 New York Stock Exchange companies, 335 American Stock Exchange companies, and 182 over-the-counter companies. Exhibit C to this testimony will give the names of those companies.

I would appreciate it if you would take this entire segment and put it on the record.

Senator BENTSEN. We will be pleased to put it in the record, as we have with the statements of the other witnesses this morning.

Mr. DINGMAN. My name is Michael Dingman. I am a member of the executive committee of the Committee of Publicly Owned Companies, and I am president and chief executive officer of Wheelabrator-Frye, Inc. I have attached a biographical sketch to this statement.

The stock of Wheelabrator-Frye is listed on the New York Stock Exchange. We are active in 22 countries of the world. We have over 6,000 employees in the United States and over 80,000 public stockholders own our company.

Our domestic sales for the past year approximate $257 million. Our after-tax profits are in excess of $10 million. Despite the fact that our sales have grown 33 percent compounded over the past 3 years and our earnings per share from continuing operations have grown 71 percent compounded over the same period, our stock, like many others—and this is not complaining, but nonetheless it is true—is selling at 14 which is just about its book value.

This is even more remarkable because we are associated in what is considered a growth industry. That is, we are principally involved in the design, engineering, and manufacture and sales of systems and equipment that meet the environmental and clean-energy markets. We are also engaged in the graphic arts business.

I appreciate this opportunity to appear.

The Committee of Publicly Owned Companies appeared before this subcommittee on July 26, 1973, through the testimony of Mr. C. V. Wood, the chairman of the committee. At that time we filed a good deal of material with the subcommittee.

In the time intervening since the committee's previous appearance before this subcommittee, the problems to which our testimony was addressed have become more, and not less, acute, and the need for helpful legislation, if we are going to meet the challenges confronting corporate America, have become more urgent.

I am filing with this statement as exhibit B a short memorandum summarizing and updating some of the facts which were included in our original statement. In brief, these facts demonstrate the following: The individual investor has not returned to the securities markets. For all except a few institutional favorites, there is a wide disparity between company earnings on the one hand and market value on the other.

Very few companies have found it possible to raise needed funds by new public offerings of their securities.

The debt-equity ratio of American corporations has become even more adverse and dangerous. Companies have deferred expansion and modernization plans requiring new capital, and those that have gone ahead with such plans have had to do so by bank borrowings at extremely high interest rates.

Senator BENTSEN. Let me ask you this: I have been told that it takes about $25,000 in new capital to create a job. Today we see unemployment increasing in this country. This adds very much to our problem, does it not, when companies who have growth patterns such as yours, earnings growth such as yours, apparently in a growth field where they have other markets they would like to move into, and we are trying to take care of the problems of people being laid off in some of these industries. There is no way in the present market—what multiple are you selling for?

Mr. DINGMAN. About 11, in that area; $1.26 a share we earned in 1973.

Senator BENTSEN. Well, say you sold at 8. You would have to find pretax earnings—that would be, what, 25 percent?

Mr. DINGMAN. We paid full taxes, so pretax earnings would——

Senator BENTSEN. About 25 percent?

Mr. DINGMAN. A little bit more than that; about 48-percent tax rate, corporation.

Senator BENTSEN. No, no, no. I said you would have to find an investment that would pay you about 25-percent return before taxes to be able to go to the market and sell your stock at eight times earnings. Is that not about right?

Mr. DINGMAN. Absolutely. We would not sell stock at this level.

Senator BENTSEN. All right.

Mr. DINGMAN. The difficulties today, Senator, in the equity market, I am sure, are precipitated only by the problems we mentioned in this discusion. I think, frankly, Mr. Townsend's comments hit it right on the head. We are facing a situation where hamburgers are not going to be bought if we do not have steel.

Deliveries and problems of raw materials today are acute. We have many, many companies that are not represented in the so-called upper-tier, upper-structure stocks and there has to be a place for these companies.

Senator BENTSEN. Well, we have had a unique asset in our country. We have the most effective free market for the trading of equities any place in the world. Have we not had this in the past?

Mr. DINGMAN. Completely.

Senator BENTSEN. Our capital markets provide equity capital to help our Nation and industry grow and to create the jobs that are necessary as our population increases, and that is why our capital markets are critical to the future growth of this country of this country. And it appears to me it is in danger.

Mr. DINGMAN. I think there is one more very insidious factor that I do not know that we have focused on, and that is the inflationary factor and the cash needs of most corporations. This is not the case with our company, fortunately, but the growing need of companies and the inflationary aspects have forced a great cash drain by increasing inventories and receivables, and the inability of those companies to either raise additional debt because of restrictive limitations or to raise additional cash through equity offerings has completely stymied them.

And I do not know where the solution rests, but it certainly is partly in some of the suggestions that your subcommittee is proposing.

Senator BENTSEN. Well, if you would proceed, sir.

Mr. DINGMAN. The market value of the stocks of many companies continue their steep and arbitrary declines despite increased earnings. For example, according to a Fortune magazine survey of 382 leading companies, at the end of 1973 more than three-fifths of them were selling at multiples below 10. At the end of 1972, less than one-fifth of these same companies were selling at these depressed multiples.

The large bank and trust companies still appear to be concentrating their investments in the institutional favorites or so-called upper-tier stocks.

Coming to S. 2842 and S. 2787, Mr. Chairman, I want to express the appreciation of the committee and its membership for the constructive measures proposed by these bills. Both of these bills contain desirable changes in the capital gains tax, but S. 2842, introduced by the chairman, also contains important provisions dealing with certain aspects of pension fund investments.

We have discussed these provisions with a representative sample of our members and have found overwhelming support for its provisions.

Mr. Chairman, it would be idle for me really to take the subcommittee's time to analyze these bills in detail. With some supplementary suggestions that I shall refer to, we entirely endorse the more comprehensive measure, 2842. The chairman's own statement, which appears in the Congressional Record for December 20, 1973, is an admirable and comprehensive statement of the reasons which should impel the Congress to quickly enact this bill.

In our opinion, the enactment of S. 2842 will serve the following urgently needed purposes. It will protect the 30 million workers who are beneficiaries of the pension plans, and indirectly help their jobs.

It will avoid the overfeeding of a few favored companies of great size and the starvation of the second and third tier companies, which is a significant problem. But I do not know that this in itself will solve it; but I think it will help.

It will induce pension fund managers to direct excess equity capital to a greater number of companies. Again, Senator, we cannot have 10 percent on top and 90 percent down below and have an America today. And in many places the man that makes screws is just as important as the man who makes the steel. We cannot have one without the other. In this way it will aid the survival and help to strengthen the 90 percent of American companies which are not institutional favorites, in many cases just because they are smaller than the companies institutions like to invest in.

I want to emphasize, Mr. Chairman, that it is these companies, the broad spectrum of American business, that will determine the health and vigor of our Nation.

Second, the exemption of 1 percent of the assets in any pension fund from the so-called prudent man rule, so as to make those funds available for investment in new or expanding companies, will also be a material and direct aid to the smaller companies upon which the vitality and competitiveness of America depends.

Third, and of the greatest importance, are the provisions of the bill with respect to the capital gains tax. We believe, Mr. Chairman, that no single measure can be more effective in providing the necessary stimulus and incentive to revive our securities markets than constructive changes in the capital gains tax.

We are not prepared to compare the desirability of the different scales of capital gains tax in S. 2842 and S. 2787, except to state our preference that the initial breakpoints for the reduced capital gains tax, rather than ordinary income tax, should not require that the securities be held longer than 6 months. In fact, many of our members would prefer a reduction in this holding period to 3 months.

But, in general, as the chairman's statement in the Congressional Record makes clear, a graduated capital gains tax such as he proposes would reduce the present lock-in position of securities that have been held for many years and would provide greater liquidity in our capital markets. At the same time, it would relieve a real hardship which our present capital gains tax imposes upon individual investors.

Our present single rate capital gains tax penalizes the investor, as compared with the short-term trader. In an inflationary economy—which we have had many years—an individual who has brought securities and held them for many years becomes less and less able to dispose of them and shift into a different kind of investment which is better adapted to his needs because of the impact of the flat-rate capital gains tax.

Mr. Chairman, there are two additional measures which we believe are of great importance to the purpose which the pension fund provisions of your bill will serve with respect to the national interest in the securities markets. First is to require disclosure of bank and trust company holdings and trading. We realize that you are fully aware of the necessity of such disclosure and presumably have not included disclosure provisions in your bill because of deference to another committee of the Senate.

Second, as we have urged in our first appearance before this subcommittee, we believe that it is essential that legislation be enacted to prevent the unreasonable and destructive dumping of securities on the market by institutional holders, a practice which has undermined investor confidence in the securities markets and the soundness of American companies, and which, in our opinion, cannot be justified by the legitimate needs of institutions in their management of pension funds or otherwise.

Senator BENTSEN. Let me say there that we understand the problem. We do not know the solution to it, though. We do not know how you can impose such a trading limitation and have an orderly market. The one thing we were trying to avoid, if possible, is putting a limitation on the investor that prevents him from selling something that he thinks has to be sold.

And if an institution had to make a public statement that it was going to sell it and if you tried to impose an inside trader rule, and you had to trickle this thing out as an inside trader does, 1 percent in 6 months or something like that—even if you gave them substantially more than that—I would hate to be the fellow who had the responsibility of trying to sell that stock over that period of time.

Mr. DINGMAN. I think it is a very difficult decision, and, frankly, I am caught a little bit between my committee role and personal preference, whether you get the disease over all at once, or whether you let it dribble out over a period of time.

A fund manager makes up his mind to dispose of a particular investment. But I do know that the ability to know what is going on today is very limited.

The third market is very active. Securities float in large blocks back and forth where they are very difficult to measure. And even from the corporate standpoint it is very difficult to know where the ownership of the securities rests today, in communicating with our shareholders.

Now, these are other problems that from the management side we have to address ourselves to.

We certainly applaud your actions in regard to capital losses, which in principle correspond to the capital gains amendments. These changes would also provide substantial stimulus and incentive to the securities markets.

Mr. Chairman and members of the subcommittee, at our previous appearance before this subcommittee, we proposed an additional amendment of the capital gains provision which we should again like to urge for your consideration. We believe that our proposal would be a highly useful addition to the pending bills.

The present conditions in the securities markets are so depressed and so threatening to the interests of our Nation that we believe that a direct, immediate stimulus is necessary. It is for this reason that we have proposed that capital gains realized on corporate equities, up to $1,000 per year, should be excluded from taxation. We think that adoption of this provision would provide for an immediate and powerful incentive to individuals to return to the securities markets.

This idea, originally proposed by the Committee of Publicly Owned Companies, has recently also been proposed by the New York Stock Exchange. The Exchange has suggested that the $1,000 exclusion should be limited to people whose total capital gains do not exceed 25 percent of earned income. The committee has no objection to this qualification.

I should like to offer for the record as exhibit D a study prepared for the committee by Dr. Norman B. Ture, analyzing our proposal for a $1,000 annual exemption of capital gains realized on corporate equities. Attached to this study is a listing of Dr. Ture's qualifications.

In conclusion, on behalf of myself and of the committee and our over

619 corporate members, I would like to thank the subcommittee for its consideration of this vital measure. We hope that you will see fit to approve the suggestions that we have made for improvement of the bill, and we strongly recommend that the Congress proceed with the utmost speed to enact this urgently needed measure.

Senator BENTSEN. Mr. Dingman, you made a statement that I certainly think is a very important one when you talk about the interdependence of all of these different corporations, all on each other and the economy. I can think of one particularly good example with respect to the energy crisis. Today the oil industry is having exceedingly difficult time getting sufficient drilling pipe to drill the wells that are necessary to try to develop energy self-sufficiency in this country. The steel industry is not able to, or does not have the capacity, to produce enough of this tubular steel drilling pipe to meet the demand. And then that is followed by the stock of steel companies selling at a very low multiple so that it is very difficult for them to go to the market to try to raise that kind of money. So the infrastructure is such that when one part of the economy gets in trouble in raising their capital, the entire economy is in trouble.

Mr. DINGMAN. It is a very difficult time, Senator, and I am sure your subcommittee better than most realizes the problems of this interdependence. They must be cleared up quickly, for it takes time both to build facilities as well as to raise capital.

And I must say, in all fairness, I cannot criticize the institutions for all of the problems by a long shot. But I think there are changes that can be made to open up the market to all the companies that have to raise equity capital.

Senator BENTSEN. Would it also be a fair statement to say that some companies sell at low P/E because of problems of the management itself?

Mr. DINGMAN. Clearly, it has to reflect the ability of management, for which I have to apologize to my own stockholders.

Hopefully in the future [laughter].

Senator BENTSON. Well, I would say in your defense, from the numbers you have cited me and the growth of your earnings, it sounds like management has been doing a good job, Mr. Dingman.

Mr. DINGMAN. Thank you.

Senator BENTSEN. What choice does a small company have, let us say a medium-sized company, that has an expanding market. Let us say it has competent management, and its earnings have been progressing reasonably well. But let us say it is selling at eight times earnings, and let us say they are not old enough to have a long history that makes them attractive from most portfolio managers' view points on bonds, or a long enough history.

Where do they go? What do they do to expand and create the jobs and meet that market and the demand for their product?

Do a lot of them not just sell out to the big companies?

Mr. DINGMAN. I think today, Senator, many little companies with emerging ideas and technologies must go to the larger companies for the capital. And in many cases they have gone to foreign companies to raise this capital. And I think, in that regard, there are many foreign investors that think more of America than Americans. I think that has been made clear in cases where they have had dollars to invest in our country. But, for the most part, I do not know where you raise capital today. It is just nonexistent.

I have looked at some statistics on the number of firms that are left as broker-dealers. They are decreasing almost weekly.

Now, admittedly, some of that is a reflection on the management abilities.

Senator BENTSEN. Well, they cannot be all bad, can they?

Mr. DINGMAN. They cannot all be that bad, but an important purpose of our committee is to try to get the companies which are affected by the attrition of broker-dealer firms together to do something about it and bring it to the attention of the Congress.

But, again, you yourself reflected we need oil well pipe to drill more oil wells to get more energy to run the steel mills and the other factories, including McDonald's hamburgers. And it is out of whack.

And then we look at the demands of our people for improved automobiles, which we have to have, and the jobs which are tied into the automobile industry indirectly and directly—it is phenomenal. And yet Wall Street sets new lows every day.

Senator BENTSEN. Do you believe the holding limitations that I proposed would get portfolio managers to spread the equity capital more into additional companies?

Mr. DINGMAN. I do. I think that just having these hearings has probably helped.

Senator BENTSEN. Do you think some of them might even be looking at other companies now?

Mr. DINGMAN. I think that probably you will find that the institutions have managed to look at more companies—and there are a lot of good ones.

Senator BENTSEN. Thank you very much, Mr. Dingman. I appreciate your testimony, and we will include your entire testimony in the record.

[The following material was submitted by Mr. Dingman:]

PREPARED STATEMENT OF MICHAEL D. DINGMAN, MEMBER OF THE EXECUTIVE COMMITTEE OF THE COMMITTEE OF PUBLICLY OWNED COMPANIES AND PRESIDENT OF WHEELABRATOR-FRYE, INC.

SUBJECT: S. 2842; S. 2787

Mr. Chairman and Members of the Subcommittee, my name is Michael D. Dingman. I am a member of the Executive Committee of The Committee of Publicly Owned Companies. I am President and Chief Executive Officer of Wheelabrator-Frye, Inc. I have attached a biographical sketch to this statement as Exhibit A.

The stock of Wheelabrator-Frye, Inc., is listed on the New York Stock Exchange. We are active in 22 countries. We have over 6,000 employees in this country alone, and over 80,000 public stockholders.

Our domestic sales for the past year approximate $257,000,000. Our after tax profits are in excess of $10,000,000. Despite the fact that our sales have grown 33% compounded over the past three years and earnings per share from continuing operations have grown 71% compounded over the same period, our stock is selling at 13, which is just about its book value.

This is even more remarkable because we are primarily in what is generally considered a growth industry: That is, we are principally involved in the design, manufacture and sale of systems and equipment to meet the needs of the environmental and clean energy markets. We are also engaged in the graphic arts business.

I greatly appreciate the opportunity to appear before you.

The Committee of Publicly Owned Companies appeared before this Subcommitte on July 26, 1973, through the testimony of Mr. C. V. Wood, Jr., Chairman of

The Committee of Publicly Owned Companies. At that time, we filed a good deal of material with the Subcommittee.

In the time intervening since the Committee's previous appearance before this Subcommittee, the problems to which our testimony was addressed have become *more*, and not *less*, acute; and the need for helpful legislation, if we are going to meet the challenges confronting corporate America, has become even more urgent.

I am filing with this statement as Exhibit B a short memorandum summarizing and updating some of the facts which were in our original statement. In brief, these facts demonstrate the following:

1. The individual investor has not returned to the securities markets. For all except a few institutional favorites, there is a wide disparity between company earnings on the one hand, and market values.

2. Very few companies have found it possible to raise needed funds by new public offerings of their securities.

3. The debt-equity ratio of American corporations has become even more adverse and dangerous. Companies have deferred expansion and modernization plans requiring new capital, and those that have gone ahead with such plans have had to do so by bank borrowings at the very high rates that are prevailing.

4. The market value of stocks of many companies continue their step and arbitrary declines despite increased earnings. For example, according to a *Fortune Magazine* survey of 382 leading companies, at the end of 1973, more than three-fifths of them were selling at multiples below ten. At the end of *1972*, less than one-fifth of these same companies were selling at these depressed multiples.

5. The large banks and trust companies still appear to be concentrating their investments in the institutional favorites or upper tier stocks.—It is particularly relevant to the legislation that this Subcommittee is considering to realize that only one leading New York City bank, despite its concentration in the upper tier stocks, turned in a record better than the market average in 1973. On the contrary, for example, the two principal banks known for their preference for institutional favorites, did even worse than the rest of the banks. The figures that we are submitting show, for example, that while in 1973 the Dow Jones Industrials were down 13.6%, the U.S. Trust Company "Common Fund" was down 22.85% and Morgan Guaranty was down 20.78%.

Coming to S. 2842 and S. 2787, Mr. Chairman, I want to express the appreciation of the Committee and its members for the constructive measures proposed by these Bills. Both of these Bills contain desirable changes in the capital gains tax, but S. 2842, introduced by the Chairman, also contains important provisions dealing with certain aspects of pension fund investments.

We have discussed the provisions of S. 2842 with a representative sample of our members, and we have found overwhelming support for its provisions. We believe that the fact that our Committee and its members applaud the principles of both Bills before this Subcommittee is of considerable significance because our membership represents a broad segment of American business—over 600 publicly owned companies of varying sizes. One hundred and two are listed on the New York Stock Exchange; 335 are listed on the American Stock Exchange; and the securities of 182 are traded over-the-counter. I am submitting for the record as Exhibit C a list of our members as of December 1973.

Mr. Chairman, it would be idle for me to take the Subcommittee's time to analyze these Bills in detail. With some supplementary suggestions that I shall refer to, we entirely endorse the more comprehensive measure, S. 2842. The Chairman's own statement, which appears in the Congressional Record for December 20, 1973, is an admirable and comprehensive statement of the reasons which should impel the Congress quickly to enact this Bill. In our opinion, enactment of S. 2842 will serve the following urgently needed purposes:

First, the limitation on concentration of investment by pension funds will:

a. Protect the 30,000,000 workers who are the beneficiaries of the pension plans;

b. It will help to prevent a few large banks from achieving excessive control over our economy by investing pension fund money which they control so as to acquire a dominant position in our leading corporations;

c. It will avoid the overfeeding of a few favorite companies of great size, and the starvation of the second and third tier companies; and

d. It will induce pension fund managers to direct excess equity capital to a greater number of companies. In this way, it will aid the survival, and will help to strengthen, the 90% of American companies which are not institutional favorites—in many cases, just because they are smaller than the companies institutions like to invest in. I want to emphasize, Mr. Chairman, that it is these companies—the broad spectrum of American business—that will determine the health and vigor of our Nation.

Second, the exemption of one percent of the assets in any pension fund from the so-called "prudent man rule," so as to make those funds available for investment in new or expanding companies, will also be a material and direct aid to the smaller companies upon which the vitality and competitiveness of America depends.

Third, and of the greatest importance, are the provisions of the Bill with respect to the capital gains tax. We believe, Mr. Chairman, that no single measure can be more effective in providing the necessary stimulus and incentive to revive our securities markets than constructive changes in the capital gains tax. We are not prepared to compare the desirability of the different scales of capital gains tax in S. 2842 and S. 2787, except to state our preference that the initial break points for the reduced capital gains, rather than ordinary income tax, should not require that the securities be held longer than six months. In fact, most of our members would prefer a reduction of this holding period to three months. But, in general, as the Chairman's statement in the Congressional Record makes clear, a graduated capital gains tax such as he proposes would reduce the present "lock-in" of securities that have been held for many years and would provide greater liquidity in our capital markets. At the same time, it would relieve a real hardship which our present capital gains tax imposes upon individual investors.

Our present single rate capital gains tax penalizes the investor, as compared with the short-term trader. In an inflationary economy—which we have had for many years—an individual who has bought securities and held them for many years becomes less and less able to dispose of them and shift into a different kind of investment which is better adapted to his needs because of the impact of the flat-rate capital gains tax on the difference between his cost and selling price.

Mr. Chairman, there are two additional measures which we believe are of great importance to the purpose which the pension-fund provisions of your Bill will serve with respect to the National interest in the securities markets. First, is to require disclosure of bank and trust company holdings and trading. We realize that you are fully aware of the necessity of such disclosure, and presumably have not included disclosure provisions in your Bill because of deference to another committee of the Senate. Second, as we urged in our first appearance before this Subcommittee, we believe that it is essential that legislation be enacted to prevent the unreasonable and destructive dumping of securities on the market by institutional holders—a practice which has undermined investor confidence in the securities markets and the soundness of American companies, and which, in our opinion, cannot be justified by the legitimate needs of institutions in their management of pension funds or otherwise. We hope that the Subcommittee will give this problem further consideration.

We also applaud the changes which S. 2842 would make with respect to the treatment of capital losses, which in principle correspond to the capital gains amendments. These changes would also provide substantial stimulus and incentive to the securities markets.

Mr. Chairman and members of the Subcommittee, at our previous appearance before this Subcommittee, we proposed an additional amendment of the capital gains provisions which we should again like to urge for your consideration. We believe that our proposal would be a highly useful addition to the pending Bills. The present conditions in the securities markets are so depressed and so threatening to the interests of our Nation, that we believe that a direct, immediate stimulus is necessary. It is for this reason that we have proposed that capital gains realized on corporate equities, up to $1,000 per year, should be excluded from taxation. We think that adoption of this provision would provide an immediate and powerful incentive to individuals to return to the securities markets. This idea, originally proposed by The Committee of Publicly Owned Companies, has recently also been proposed by the New York Stock Exchange. The exchange has suggested that the $1,000 exclusion should be limited to people whose total capital gains do not exceed 25% of earned income. The Committee has no objection to this qualification.

I should like to offer for the record as Exhibit D a study prepared for The Committee of Publicly Owned Companies by Dr. Norman B. Ture, analyzing our proposal for a $1,000 annual exemption of capital gains realized on corporate equities. Attached to this study is a listing of Dr. Ture's qualifications.

At the bottom of page 4 of Dr. Ture's study, dated December 6, 1973, he summarizes his conclusions. In brief, he believes that the proposal will strengthen the securities markets so as to make it increasingly feasible for corporations to obtain equity financing to meet their urgent needs, and will reduce the dependence of corporations on debt financing. He concludes that it is probable and perhaps highly likely that the net result of this annual exemption will be to increase rather than reduce revenues, by promoting an increased volume of transactions.

In conclusion, on behalf of myself and of The Committee of Publicly Owned Companies and its over 600 corporate members, I should like to thank the Subcommittee for its consideration of this vital measure. We hope that you will see fit to approve the suggestions that we have made for improvement of the Bill, and we strongly recommend that the Congress proceed with the utmost speed to enact this urgently needed measure.

EXHIBIT A

Name: Michael D. Dingman.

Place and date of birth: September 29, 1931, New Haven, Conn.

Names of parents: James E. Dingman and Amelia Williamson Dingman.

Education: The Hun School of Princeton and University of Maryland.

Married: Jean Hazlewood Dingman.

Children (names and dates of birth): Michael D. Dingman, Jr., Feb. 13, 1954; Linda Channing Dingman, June 2, 1955; James Clifford Dingman, Aug. 26, 1957.

Business activities—Executive positions occupied: Wheelabrator-Frye, Inc., president and chief executive officer—Feb. 1970 to date; Drexel Durnham & Co., general partner, limited partner, Nov. 1964 to May 31, 1971; Sigma Instruments, Inc., sales, engineering and general management—April 1, 1958 to Nov. 27, 1964; various sales engineering positions from 1953 to 1958.

Directorships: Wheelabrator-Frye, Inc., the Rust Engineering Co. (chairman), and other subsidiaries and affiliates; Temple-Eastex, Inc.: United States Freight Co.

Member: Executive committee, the Committee of Publicly Owned Companies.

Professional society: Institute of Electrical and Electronics Engineers, Inc.

Clubs: Mount Kisco Country Club, New York; Lyford Cay Club, Nassau, Bahamas; The Recess, The Links, N.Y.C.

Michael D. Dingman, age 42, has been president, director and chief executive officer of Wheelabrator-Frye, Inc., since February 1970. After attending college, Mr. Dingman started his business career in 1953, as a factory trainee. He followed this activity with various responsibilities in supervision, sales, engineering, and general management in industry until 1964, when at 33, he joined Burnham & Co. as an associate in corporate finance, later becoming a general then limited partner of that banking firm. In 1969 Mr. Dingman, at 37, moved back into industry as a director and stockholder of several companies. He is a member of IEEE and a director of various companies.

Since 1970 Wheelabrator-Frye has been positioning itself to meet the needs of the growing environmental and clean energy markets. Through early planning the company realized that this environmental market ultimately would be fulfilled by companies with strong proprietary process engineering, service and technology orientations.

Wheelabrator-Frye was formed from a 1971 merger of a holding company, an investment company and two operating companies. This merger, and the subsequent sale of unrelated assets, provided building capital while the two operating companies—Wheelabrator and Frye—provided the operating base upon which to build.

The company has grown steadily, achieving substantial growth in sales and earnings while establishing a strong proprietary technology, systems engineering competence, manufacturing-capability and operating management team.

Wheelabrator-Frye is active in 22 countries worldwide and has over 6,000 employees in the U.S. alone, including 2,700 engineering technicians and support personnel.

The company's environmental and clean energy activities range from systems for coal gasification and sophisticated gas cleaning to waste water treatment and sand reclamation.

In the field of converting refuse to energy, the company is currently supplying all finance, engineering and technology for a new Boston area facility—the country's largest—that will convert over 1200 tons of refuse per day into the BTU equivalent of 76,000 gallons of clean fuel for the General Electric Lynn plant. This refuse-energy facility, now under construction, is based upon proprietary know-how and engineering gained in over 50 similar operations by Von Roll Ltd., Zurich.

Further supplementing WFI's R&D are exclusive licensing arrangements for environmental technology from Lurgi Apparate-Technik of Frankfurt, West Germany.

Wheelabrator-Frye has achieved record sales of $180,564,000 and record earnings of $6,505,000 for the nine months ended September 30, 1973.

The company's Graphics Group—Sinclair Valentine & Frye, the smaller of the two company groups—is engaged in graphic arts. It is not related to the company's prime environmental areas, but represents a substantial asset in value for its stockholders.

The company's continuing efforts will be devoted to building its environmental technology and capabilities.

EXHIBIT B

MEMORANDUM

Following is a brief factual update of the serious conditions in the securities markets adversely affecting our companies set forth in our testimony before this Subcommittee on July 26, 1973:

1. The individual investor has not returned to the securities markets.

a. By the end of 1972, financial assets of individuals in the United States had increased by 21% to $2.3 trillion, compared with $1.9 trillion at the end of 1968. However, net new savings invested in common and preferred stocks during this period decreased by a *minus* figure of $16 billion. (*New York Stock Exchange.*)

b. Annual personal savings totalled $17.0 billion in 1960 and increased to $54.8 billion by 1972. (*Economic Report of the President*, January 1973.) Yet in no no year since 1961 did individuals increase their net holdings of corporate stocks. (*New York Stock Exchange.*)

2. Very few companies are able to raise funds for expansion or other needs by new public offering of their securities.

a. Only 99 new issues were marketed during all of 1973, compared with 568 in 1972. (*New Issue Outlook.*)

b. During the last ten months of 1973, there were less than 20 new offerings of common stock in which $2.5 million or more was sought. This compares with 23 such offerings in the first two months of 1973. (*Institutional Investor*, January 1974.)

c. In 1973, only $6.9 billion was raised in 401 common stock offerings. This compares with $13 billion raised in 1,383 common stock offerings in 1972. (*Newsweek*, February 4, 1974.)

3. Debt service is increasingly a severe burden on our companies, threatening the financial soundness of many of them.

a. The prime rate on loans charged by major commercial banks is currently 9½%, compared to 6% one year ago.

b. Corporate debt outstanding now totals $900 billion—more than double its level in the mid-1960's. Cash held by corporations now amounts to only about 20% of their current liabilities—about half the level in the early 1960's. (*Wall Street Journal*, December 11, 1973.)

c. As of the end of 1972, the median total debt to tangible net worth rates for 71 manufacturing categories surveyed by Dun's Review was 86.1%, up 5.2% from the end of 1971. (*Dun's Review*, November 1973.)

4. The market values of the securities of many companies remain depressed, despite increased corporate earnings.

A survey of 382 leading companies by Fortune Magazine revealed that the number of companies with multiples below ten had grown from less than one-fifth at the end of 1972 to over three-fifths of the total by the end of 1973. (*Fortune*, February 1974.)

5. Investments of large banks and trust companies remain heavily concentrated in the securities of a few companies, to the detriment not only of the thousands of companies starved out of the equity markets, but also of the millions of participants in pension plans managed by bank trust companies.

a. The New York Times recently reported that, with only one exception, not a single leading New York City bank—with their commingled corporate pension accounts—managed to beat the leading market averages in 1973. Times' columnist, Robert Metz, noted that two banks "known for their preference for [upper tier] stocks . . . did rather worse than the rest of the banks."

The reported results:

Bank:	*Common fund (percent)*
Bank of New York	Down 11.2.
Chemical Bank	Down 16.3.
Chase Manhattan	Down 17.94.
First National City	Down 18.32.
Irving Trust	Down 18.41.
Manufacturer's Hanover	Down 20.18.
Morgan Guaranty	Down 20.78.
U.S. Trust	Down 22.85.
Bankers Trust	Down 28.4.
Dow-Jones Industrials	Down 13.6.
Standard & Poor's 500	

b. The median multiple of the 21 stocks listed as institutional favorites by the Weisenberger Service was 28 as of January 31, 1974. This compares to a median multiple of less than ten for the 382 leading companies surveyed by Fortune Magazine.

EXHIBIT C

New York Stock Exchange
American Stock Exchange
Over-The-Counter

A Voluntary Committee of Chief Executives

To Represent Corporate America's interests in Fair Market Prices and Fair Trading Practices in the Securities Markets

THE COMMITTEE OF PUBLICLY OWNED COMPANIES

Membership List
December 1973

Executive Committee

C. V. WOOD, JR., Chairman
President, McCulloch Oil Corp.

JOSEPH E. COLE,
Chairman, Cole National Corporation

MICHAEL D. DINGMAN,
President, Wheelabrator-Frye, Inc.

JOHN A. GILLETT, JR.,
President, Circle K Corporation

FRANC M. RICCIARDI,
Chairman, Richton International, Inc.

REVIS L. STEPHENSON,
Chairman, Clarkson Industries, Inc.

WILLIAM R. TINCHER,
Chairman, Purex Corporation

FRED M. ZEDER,
Chairman, Hydrometals, Inc.

A-1 Kotzin Co.
A.A.R. Corp.
A.A.V. Companies
Action Industries, Inc.
Acme United Corporation
Addmaster Corporation
A.D.M. Industries
Affiliated Capital Corporation
Airpax Electronics, Inc.
A.J. Industries, Inc.
Albany International Corp.
Alcolac Inc.
Alco Standard Corp.
Allied Artists Picture Corporation
Allied Control, Inc.
Allied Products Corporation
Allied Thermal Corp.
Alpha Industries, Inc.
Altamil Corp.
Altius Corp.
Aluminum Specialty Co.
AMBAC Industries, Inc.
Amcord, Inc.
American Appraisal Associates
American Business Products, Inc.
American Capitol Insurance Co.
American Financial Corp.
American Greetings Corp.
American International Group Inc.
American International Pictures, Inc.
American Petrofina Company, Inc.
The American Plan Corp.
American Precision Industries, Inc.
American Recreation Centers, Inc.
American Training Services, Inc.
Anthony Industries, Inc.
Anza Pacific Corp.
A.O. Industries, Inc.
APCO Oil Corp.

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ARA Services, Inc.
'ristar Management, Inc.
.arizona-Colorado Land & Cattle Co.
Arpeja-California
Arwood Corp.
Asamera Oil Corporation, Ltd.
Askin Service Corp.
Aspro, Inc.
Atlanta Corporation
Atwood Oceanics, Inc.
Austral Oil Co., Inc.
Bache & Co., Inc.
Badger Meter, Inc.
Baker Bros., Inc.
Bandag Inc.
Barclay Industries, Inc.
Begley Drug Company
Bell Industries
Belscot Retailers, Inc.
Beneficial Standard Mortgage Investors
Benham-Blair & Affiliates, Inc.
enrus Corporation
Bergen Brunswig Corp.
Bernzomatic Corp.
Beverly Hills Bancorp.
Binning's, Inc.
Bolt, Beranek and Newman, Inc.
The Boston Company
Bowmar Instrument Corp.
Bowne & Co., Inc.
Braun Engineering Co.
John Breuner Co.
C. Brewer & Co., Ltd.
B. Brody Seating Co.
Brooks & Perkins, Inc.
Brunswick Corp.
The Budd Company
Buell Industries, Inc.
Burns International Security Services, Inc.

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R. L. Burns, Corp.
Burnup & Sims Inc.
Burris Industries, Inc.
Cabot, Cabot & Forbes Land Trust
California Computer Products, Inc.
California-Pacific Utilities Co.
Canadian Homestead Oils Limited
Canadian Hydrocarbons, Ltd.
Canoga Industries
Capitol Industries, Inc.
Carrier Corp.
Central National Bank
Century Industries Co., Inc.
Century Papers Inc.
Cenville Communities, Inc.
Certron
Chadwick-Miller, Inc.
Chemical Express Co.
Chemtrust Industries, Corp.
Cherry-Burrell Corp.
Chicken Unlimited Enterprises, Inc.
Child World, Inc.
Chilton Corp.
The Circle K Corp.
Citizens Financial Corp.
Citizens Mortgage Investment Trust
C & K Petroleum, Inc.
Clark Cable Corp.
The Clarke Corp.
Clarkson Industries, Inc.
Cleve Trust Realty Investors
Clopay Corp.
Coachmen Industries, Inc.
Coca-Cola Bottling Co. of N.Y., Inc.
Coca-Cola Bottling Midwest Inc.
Cohen-Hatfield Industries, Inc.
Cohu Electronics, Inc.
Coit International, Inc.
Cole National Corp.

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Coleman Company
Collins Foods International
Colwell Company
Colwell Mortgage Trust
Comarco, Inc.
Communications Industries, Inc.
Community Psychiatric Centers
Compac Corp.
Compo Industries, Inc.
Computer Election Systems, Inc.
Conchemco Inc.
Consyne Corp.
Cook Electric Company
Cook Paint and Varnish Co.
Cooper-Jarrett, Inc.
Core Laboratories, Inc.
Corometrics Medical Systems, Inc.
Corroon & Black Corp.
Cramer Electronics, Inc.
A.T. Cross Company
Crouse-Hinds Co.
Crowley, Milner & Co.
Cubic Corp.
Curtis Noll Corp.
CW Transport, Inc.
The Cyclotron Corp.
Dain, Kalman & Quail, Inc.
Dart Industries, Inc.
Data Card Corp.
Data Products Corp.
Davis Water & Waste
Daylin, Inc.
Delta California Industries
Deltown Foods, Inc.
Dennison Manufacturing Co.
Den-Tal-Ez, Inc.
Dentsply International Inc.
DeRose Industries, Inc.
Diamond M Drilling Co.

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Diebold Venture Capital Corp.
Digi-Log Systems, Inc.
Diplomat Electronics Corp.
Discount Fabrics, Inc.
The Diversey Corp.
Diversified Earth Sciences, Inc.
Donaldson Company, Inc.
Dorchester Gas Corp.
Drew National Corp.
Duckwali Stores, Inc.
Ducommun Incorporated
Duplex Products Inc.
Dynamics Research Corp.
Earth Resources Co.
The Eastern Company
Egan Machinery Co.
Elco Corporation
Electronic Data Systems Corp.
El Paso Natural Gas Company
Emersons, Ltd.
Emery Industries, Inc.
Empress International, Ltd.
Epko Shoes, Inc.
Equity National Industries
ESB Incorporated
Esquire, Inc.
E-Systems, Inc.
Euthenics Systems Corp.
Evans & Mitchell Industries, Inc.
Everest & Jennings International
Fabien Corp.
Fabri-Centers of America, Inc.
Fairfield-Noble Corp.
Familian Corp.
Family Finance Corp.
Family Record Plan, Inc.
Farr Company
Fashion Fabrics, Inc.
Federal Resources Corp.

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Federal Sign and Signal Corp.
Filtrol Corp.
First City Bancorporation of Texas, Inc.
First Conn. S.B.I.C.
First of Denver Mortgage Investors
Firstmark Corp.
First Mid America, Inc.
First Railroad & Banking Co. of Georgia
First Realty Investment Corp.
Fischer & Porter Company
Fisher Scientific Company
Flowers Industries, Inc.
John Fluke Mfg., Co., Inc.
FMC Corp.
Foremost-McKesson, Inc.
Fotomat Corporation
The Foxboro Company
FPA Corporation
Fuqua Industries, Inc.
Florida Mining & Materials Corp.
Gabriel Industries
Galaxy Carpet Mills, Inc.
The Garcia Corporation
Garlock, Inc.
Garvin Bantel Corp.
G.C.A. Corp.
General Bancshares Corp.
General Educational Services Corp.
General Employment Enterprises, Inc.
General Cinema Corp.
General Instrument Corp.
General Interiors Corp.
General Plywood Corp.
General Research Corp.
Genisco Technology, Inc.
Giddings & Lewis, Inc.
Giffen Industries, Inc.
The Gilbert Companies, Inc.
Glasrock Products, Inc.

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Glen-Gery Corp.
Globe Industries, Inc.
Globe Security Systems, Inc.
Globe-Union Inc.
Glosser Brothers, Inc.
Gloucester Engineering Co., Inc.
Glover, Inc.
Golden West Mobile Homes
Gorman-Rupp Company
Grand Auto, Inc.
Granite Management Services, Inc.
Graphic Controls Corp.
Graphidyne Corp.
Gray Drug Stores, Inc.
The Gray Manufacturing Co.
Great Basins Petroleum Co.
Greenman Bros. Inc.
Greenshields & Co., Inc.
Gruen Industries, Inc.
Guardsman Chemical Coatings, Inc.
Guilford Mills, Inc.
Gulf Mortgage and Realty Investments
Gulf Republic Financial Corp.
Gulf Resources & Chemical Corp.
Gulf & Western Industries
Hallcraft Homes, Inc.
Hammermill Paper Company
Handy Dan, Inc.
Hanna Mining Co.
Harlyn Products, Inc.
Harvest Industries, Inc.
Hayes-Albion Corporation
Walter E. Heller International Corp.
Hermetic Seal Corporation
Hesston Corporation
Hi-G, Inc.
Higbee Co.
Holly Corporation
Hollymatic Corporation

D.H. Holmes Co., Ltd.
'lorn & Hardart Co.
.lospitality Motor Inns, Inc.
House of Vision, Inc.
Houston Oil & Minerals Corp.
Howell Corporation
Harvey Hubbell, Inc.
Hungry Tiger Inc.
Huyck Corporation
Hycel, Inc.
Hydrometals, Inc.
Imoco-Gateway Corp.
Ingress Manufacturing Co., Inc.
Inland Credit Corporation
Integrated Resources Inc.
Intercraft Industries Corp.
Intermark, Inc.
International Funeral Services, Inc.
International Seaway Trading Corp.
Interphoto Corp.
Interplastic Corp.
ɔnics, Inc.
Iowa Beef Processors, Inc.
Iowa Power and Light Co.
Ipco Hospital Supply Corp.
Iroquois Industries, Inc.
Irvin Industries, Inc.
Jaclyn, Inc.
Jacobs Engineering Co.
Jamesbury Corp.
Jeannette Corp.
Jetero Corp.
Johnson Products Co., Inc.
Jostens Inc.
Jupiter Industries, Inc.
Kaneb Services, Inc.
Kaufman and Broad, Inc.
Kay Corporation
Ketchum & Co., Inc.

The Key Company
Kin-ark Corporation
Kirby Industries
Kleer-Vu Industries
Knogo Corporation
K-Tel International Inc.
Kuhlman Corporation
Kuhn's Big K Stores Corp.
LaBarge, Inc.
LaMaur Inc.
Lane Wood, Inc.
Lewis Business Forms
Liberty Fabrics of New York, Inc.
Liberty Leasing Co., Inc.
Lloyd's Electronics, Inc.
Loehmann's Inc.
Lomas & Nettleton Financial Corp.
Longs Drug Stores
Loomis Corporation
LTV Corporation
Luby Corporation
Ludlow Corporation
Lyon Metal Products, Inc.
MacMillan, Inc.
McCulloch Oil Corp.
McDonald Micradata Services, Inc.
McDonough Co.
McKeon Construction
McQuay-Perfex Inc.
Macrodata Corp.
Magma Energy, Inc.
Mangel Stores Corp.
The Manitowoc Company, Inc.
Marcus Corporation
Markan, Inc.
Mary Kay Cosmetics, Inc.
C.H. Masland & Sons
Meadowbrook Inc.
Medalist Industries, Inc.

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Medenco, Inc.
Mego International, Inc.
Meisel Photochrome Corp.
Mem Company
Metropolitan Maintenance Co.
Michigan General Corp.
Michigan Mobile Homes Corp.
Mickelberry Corporation
The Midland Co.
Milco Electronic Corp.
Herman Miller, Inc.
H. Miller & Sons, Inc.
Minnesota Natural Gas Co.
Mirro Aluminum Co.
Mitchell Energy & Development Corp.
Mitchum, Jones & Templeton, Inc.
Moamco Corp.
Modern Maid Food Products, Inc.
Mogul Corp.
Mohasco Industries, Inc.
Moog, Inc.
Samuel Moore & Co.
Morrison-Knudsen Co., Inc.
Motorola Inc.
MPO Videotronics, Inc.
MSI Data Corporation
Narda Microwave Corp.
National Aviation Underwriters, Inc.
National City Bank
National Distributing Co., Inc.
National Medical Enterprises, Inc.
National Recreation Industries, Inc.
National Silver Industries, Inc.
L.B. Nelson Corp.
Neptune Meter Company
Newell Companies, Inc.
New England Nuclear Corp.
New England Patriots Football Club
New England Tel & Tel

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Newpark Resources, Inc.
Niagara Frontier Services, Inc.
Noel Industries, Inc.
North Canadian Oils Limited
North Central Airlines, Inc.
Northeast Petroleum Industries, Inc.
Novo Corporation
Offshore Logistics, Inc.
Oglebay Norton Company
The Oilgear Company
Olympia Brewing Company
Onan Corporation
Opelika Mfg. Corp.
Optical Plastics, Inc.
Ormand Industries, Inc.
Outdoor Sports Industries, Inc.
Overhead Door Corporation
Overmyer Corporation
Oxford Industries, Inc.
Pacesetter Building Systems
Pacific Holding Corp.
Pacific Oil and Gas Development Corp.
Paine, Webber, Jackson & Curtis, Inc.
Pall Corporation
Palomar Mortgage Investors
Papercraft Corp.
Paramount Packaging Corporation
Parker-Hannifin Corp.
Patagonia Corp.
Peerless Tube Company
Pemcor, Inc.
Pennsylvania & Southern Gas Co.
Penobscott Shoe Company
Pentron Industries, Inc.
Pepcom Industries, Inc.
Perini Corporation
Petro-Search, Inc.
Philippine Long Distance Tel. Co.
Piedmont Industries, Inc.

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Pioneer Systems, Inc.
Pioneer Western Corp.
Pizza Corp. of America, Inc.
Plant Industries, Inc.
Ply-Gem Industries, Inc.
Post Corporation
Potlatch Corporation
Potter Instrument Company, Inc.
The Presley Companies
Products Research & Chemical Corp.
Providence Gas Co.
Provincial House, Inc.
Prudential Funds, Inc.
Punta Gorda Isles, Inc.
Purex Corporation, Ltd.
Questor Corporation
Ranco Incorporated
Ransburg Corporation
Raymond Precision Industries Inc.
Raypak, Inc.
R.B. Industries, Inc.
Reading & Bates Offshore Drilling Co.
Reading Industries, Inc.
Real Estate Investment Trust of America
Realty Refund Trust
The Reece Corporation
Reid Provident Laboratories, Inc.
Regal-Beloit Corporation
Republic Housing Corporation
Reserve Oil and Gas Company
Resistoflex Corporation
Revco D.S. Inc.
R.H. Medical Services, Inc.
Richford Industries, Inc.
Richton International Corp.
Risdon Manufacturing Co.
Riviana Foods, Inc.
Robertson Distribution Systems, Inc.
Rohr Industries, Inc.

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Ronco Teleproducts, Inc.
Roper Corporation
Rosemount Inc.
Rospatch Corporation
Rowan Companies, Inc.
Milton Roy Co.
Royal Industries, Inc.
Royal Palm Beach Colony, Inc.
Ruddick Corporation
Russeks, Inc.
Russell Corporation
Safeguard Industries, Inc.
Safetran Systems Corp.
Sage International Inc.
St. Johnsbury Trucking Co., Inc.
Salem Carpet Mills, Inc.
San Fernando Electric Manufacturing Co.
Sav-a-Stop Incorporated
SCA Services, Inc.
Schiller Industries, Inc.
Scientific-Atlanta, Inc.
Scientific Computers, Inc.
Scientific, Inc.
Scrivner-Boogart, Inc.
Season-All Industries, Inc.
Securities-Intermountain, Inc.
Sedco, Inc.
Seiscom Delta Inc.
Selas Corporation of America
Self Service Restaurants, Inc.
Seligman & Latz, Inc.
Semtech Corporation
Service Corporation International
Servomation Corporation
Seton Company
SGL Industries, Inc.
Shelter Resources Corporation
Shenandoah Oil Corporation
Shirley of Atlanta, Inc.

Sierracin Corporation
Signet Corporation
Sikes Corporation
Slaughter Brothers, Inc.
Sloan Technology Corporation
Solitron Devices, Inc.
Sonderling Broadcasting Corp.
Soundesign Corp.
South Carolina Insurance Company
South Jersey Industries, Inc.
Southern Industries Corp.
Southern Union Production Company
Southland Royalty Company
Southwestern Electric Service Co.
Speizman Industries, Inc.
Spencer Companies, Inc.
Splentex, Inc.
S.S.P. Industrie.
Stanadyne Inc.
Standard Alliance Industries, Inc.
Standard-Coosa-Thatcher Company
Standard Dredging Corporation
Standard-Pacific Corporation
The Standard Products Company
Standard-Thomson Corp.
Standun Inc.
Stardust Inc.
Sta-Rite Industries, Inc.
Star Supermarkets, Inc.
State Exploration Co.
State Savings & Loan Assn.
Statham Instruments
Steelmet, Inc.
Steenberg Mobile Homes, Inc.
Sterling Electronics Corp.
SuCrest Corporation
Sun Electric Corporation
Super Food Services, Inc.
Superscope, Inc.

Super Valu Stores, Inc.
Synalloy Corp.
Tab Products Co.
Taco Bell
Tapecon, Inc.
Tasty Baking Co.
Tax Corporation of America
Technical Operations Inc.
Teleflex Incorporation
Tensor Corp.
Terramar Corporation
Tesoro Petroleum Corp.
Texas Gas Transmission Corp.
Thiem Corporation
Thriftimart, Inc.
Thriftway Leasing Co.
Tiburon Vintners, Inc.
Tonka Corporation
Topps Chewing Gum, Inc.
Torin Corporation
Tridair Industries
Tumer Fisheries, Inc.
Union Electric Steel Corporation
United Aircraft Products, Inc.
United Inns, Inc.
United Piece Dye Works
U.R.S. Systems Corp.
United States Ceramic Tile Company
U.S. Filter Corporation
U.S. Rubber Reclaiming Co., Inc.
Universal-Rundle Corporation
Vacu-dry Co.
Valmac Industries, Inc.
Varadyne Industries, Inc.
Varo, Inc.
Vega Precision Laboratories, Inc.
Vesely Co.
Viatech, Inc.
Voplex Corporation

VTN Los Angeles
Vulcan, Inc.
Wabash Magnetics, Inc.
Sam P. Wallace Company, Inc.
Wallace Business Forms, Inc.
Wards Co., Inc.
Watsco, Inc.
Wavecom Industries
Wells-Gardner Electronics Corp.
The Western Co. of North America
Western Decalta Petroleum Limited
Wheelabrator-Frye, Inc.
Whitaker Cable Corp.
The Williams Companies
Williamhouse-Regency, Inc.
Wilson & Co., Inc.
Wilson Pharmaceutical & Chemical Corp.
Jack Winter, Inc.
Wolverine Industries, Inc.
Wolverine World Wide Inc.
Wood Industries, Inc.
Woodmoor Corp.
Worcester Controls Corp.
Work Wear Corp.
Worthington Industries, Inc.
Barry Wright Corporation
WTC Airfreight
Wyle Laboratories
The Youngstown Steel Door Company
Zero Manufacturing Co.

EXHIBIT D

PREPARED STATEMENT BY DR. NORMAN B. TURE ON BEHALF OF THE COMMITTEE OF PUBLICLY OWNED COMPANIES

A $1,000 ANNUAL EXEMPTION OF CAPITAL GAINS REALIZED ON CORPORATE EQUITIES

I. Annual Exemption $1,000 of Capital Gains on Corporate Equities: Revenue and Cost of Capital Effects

In our report "Tax Policy and the Corporate Securities Market, An Agenda for Constructive Tax Revision," we estimated the revenue loss from an annual exemption of $1,000 of capital gains at about $600 million (based on 1971 levels of income and capital gains). It must be emphasized that this is a "first level" or "initial impact" estimate, i.e., it assumes no change in taxpayer behavior in response to the tax change, hence no change in the amount of saving invested incorporate equities, no change in the volume of transactions in these assets, no change in the average percentage gain, etc. Such first level or initial impact estimates are those that are generally provided for purposes of evaluating tax revision proposals, desipte the obvious fact that such estimate are of limited significance.

It is surely apparent that the no-charge assumptions upon which these first-level estimates are based are implausible and that the estimates are, accordingly, unrealistic. Enactment of the proposed $1,000 annual exclusion would certainly attract the attention of a great number of individuals. It would surely afford a strong inducement for the investment of a larger part of personal saving in corporate equities. It would undoubteedly reduce or eliminate the present tax barrier to realization of accrued gains. As a consequence of these effects, it would assuredly result in a larger volume of transactions in stocks by individuals and a larger volume of annual capital gain realizations, even if the rate of appreciation in the value of corporate equities were unaffected. But the rate of capital gain accrual would undoubtedly be increased, at least for some time: the exemption would increase the demand for equities because it would enhance the net-of-tax return on savings invested in corporate equities and the market would capitalize that increase in higher prices for these assets.

The actual revenue effect of adopting the $1,000 annual exemption, therefore, would depend basically on the extent of individuals' responses thereto. Even a relatively slight increase in transaction volume and in the amount of gains realized would offset the estimated initial impact revenue loss. In 1970, for example, a $3.2 billion, or 16.3 percent, increase in total realized gains—would have generated sufficient additional revenues to offset the revenue loss from the $1,000 annual exemption. Assume that half of the $18.8 billion of gains in 1970 were realized on the sale of publicly traded stock. Since such sales totaled $130.9 billion in 1970,[1] the estimated average gain was 7.7 percent (i.e., $9.4 billion, the estimated gain on stocks, divided by $121.5 billion, the value of sales of such stocks, $130.9 billion, minus the gain of $9.4 billion therein). Had the average gain been 9.0 percent instead of 7.7 percent, the additional tax revenues would have offset the estimated initial impact loss from the $1,000 exemption. Gains of 9.0 percent or more of sales are certainly reasonable in order of magnitude; gains as a percent of sales exceeded 9 percent in each of the five straight years preceding 1970.

This calculation assumes no increase in the volume of transactions. If the actual 1970 ratio of gains to sales is assumed, an increase in transaction volume from $130.9 billion to $150.2 billion would have produced additional revenues adequate to offset the initial impact revenue loss from the $1,000, annual exemption. Since sales volume in five of the past six-years had exceeded $152.2 billion, the increase in volume required to offset any revenue loss falls well within a reasonable range.

Enactment of the annual exclusion would very likely result in a dramatic increase in the volume of transactions in the short run, compared to the levels which would otherwise be attained. The portfolio effect of the annual exemption as noted, is to increase the share of an individual's total savings which he wants to keep in corporate equities. Even if total individual saving were unaffected, the annual exemption would induce individuals to increase the amount of corporate equities in their portfolios. As the total amount of savings increased over time, even if no more rapidly than in the past, the annual desired addition of

[1] New York Stock Exchange, *1973 Fact Book*, p. 75.

corporate equities would be greater, though the *rate* of increase might be the same. And if the anual exemption were to result in an increase in the saving rate, a quite plausible assumption, additions to corporate equity holdings would be at a higher rate than otherwise.

The corollary to this increase in desired holdings of corporate equities is a reduction in the cost of capital, initially to corporate business but ultimately to the entire business sector. This would result in part from the increase in demand for corporate equities relative to debt instruments, hence over time from a decrease in corporate debt-equity ratios and a reduction in the risk associated with overall capitalization. More important, by reducing the tax drain from the stream of returns to corporate equity, the proposed annual exemption would reduce the target amount of pretax corporate income per share required to avert dilution of existing equity interests at any point in time. And, of course, any number of shares newly issued would provide greater total proceeds to the issuer than otherwise, other things being equal. This reduction in the cost of capital for the corporate sector would be extended throughout the private business sector by the operations of the capital markets.

In sum, the proposed annual exemption would provide a substantially more congenial tax climate for external equity financing. It would, by the same token, contribute significantly to achieving capital market conditions in which corporate business would be less dependent on debt financing. The consequent relative decline in deductible interest payments would contribute to offsetting the initial impact revenue loss of the annual exemption. It is quite conceivable, if not, indeed, highly likely, that the combined corporate and individual taxpayer response to the annual exemption would increase rather than reduce revenues. In fact, based on 1970 levels, a 20 percent gain in volume and an increase from 7.7 percent to 9.5 percent in the average gain per sale in response to the annual exemption would have *increased* tax receipts by $1 billion. Increases in volume and in gains of this order of magnitude have been exceeded several times in recent years.

II. Projections of Capital "Requirements" and Equity Financing

Projections of capital "requirements" must be conditioned by a number of important assumptions about the operations of the economy. For purposes of the initial estimates presented below, the principal assumptions are that (1) the growth in the civilian labor force to 1980 will follow the same trend as its growth in the period 1948–1972; (2) the capital-labor ratio in the private business sector will increase at least as rapidly as in the period 1947–1967; (3) the rate of technical progress in the private business sector will follow the trend of the period 1947–1967; and (4) the 1947–1967 trend relationship between the real wage rate and the price of capital services will continue through 1980.[2] Additionally, estimates of internally generated financial resources (i.e., retained earnings and capital consumption allowances) of the private business sector, particularly of the nonfarm corporate business sector, are based on relationships derived from the period 1947–1968.[3]

On the basis of these assumptions:

Capital "requirements" (excluding residential investment) in 1980 will aggregate about $232 billion in 1972 prices.

Corporate fixed investment, excluding residential, will be about $165 billion (in 1972 dollars).

Including inventory investment, corporate capital "requirements" are likely to be in the range of $175 billion to $180 billion.

Corporate cash flow, i.e., retained earnings plus capital consumption allowances, will range between $135 billion and $162 billion, or an estimated mean value of $148 billion.

To a first approximation, therefore, corporations' internal financial resources would fall at least $13 billion and conceivably as much as $45 billion short of corporate capital "requirements."

The preceding estimates do not adequately account for capital intensification due to environmental control policies, health and safety laws, and increased reliance on domestic sources of energy. By 1980, these factors could, quite

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[2] Cf. Norman B. Ture, *Tax Policy, Capital Formation, and Productivity*, A Study Prepared for the Committee on Taxation, National Association of Manufacturers, 1973, especially, pp. 35 ff.

[3] For this purpose, the time series of retained earnings and capital consumption allowances in the national income accounts were regressed on the time series of private sector capital stock as estimated in *Fixed Nonresidential Business Capital in the United States, 1925–1970*, Department of Commerce, Washington, D.C., Nov. 1971.

plausibly, increase corporate capital "requirements" by 10 to 15 percent. Any such increase implies some combination of a substantial reallocation of a given amount of national saving and a significant increase in the rate of saving, if the assumptions upon which the initial projections are based are to be validated.

Moreover, the shortfall between projected corporate capital "requirements" and cash flow does not fully measure the corporate demand for external funds since excesses of internal funds over uses for corporation with such excesses are not in general directly invested in new issues of corporations with excesses of uses over internal funds. External financing requirements in 1980, therefore, are likely to be significantly greater than the shortfalls estimated above.

Extrapolating the postwar trends of debt and equity in total corporate capitalization and of external financing suggests that not less than one-fifth of external funds would be sought by new equity issues in 1980. Desired new equity issues, therefore, would be not less than $7 billion and might well be $12 billion or more.

BIOGRAPHICAL SKETCH OF NORMAN B. TURE

CURRENT POSITION

President, Norman B. True, Inc., Economic Consultants.

PREVIOUS POSITIONS

Planning Research Corp., 1968–1971. Principal.

George Washington University, 1969–1970. Adjunct Professor of Economics.

University of Pennsylvania, Wharton School of Finance, 1968–1969. Visiting Lecturer.

National Bureau of Economic Research, Inc., 1961–1968. Director of Tax Studies.

Joint Economic Committee, U.S. Congress, 1955–1961. Member of staff (leave of absence April-May 1959 to assist Representative Wilbur D. Mills, chairman of the Committee on Ways and Means; House of Representatives).

U.S. Department of the Treasury, 1951–1955. Analysis Staff, Tax Division, Office of the Secretary.

Ohio State Department of Highways, 1950–1951. Member Senior Staff, Ohio Fiscal Study.

Illinois College, 1947–1950. Assistant Professor of Economics.

EDUCATION

University of Chicago, M.A. and Ph. D., Economics.

EXPERIENCE

Present.—Consulting and research services for corporate clients and trade associations over a wide range of economic problems, particularly in the area of public economic policy, with special emphasis on tax policy and problems.

Prior.—At Planning Research Corporation, designed and directed research for business and government clients, covering a wide range of economic problems.

At the National Bureau of Economic Research, Inc., designed and directed extensive programs of research concerning the effects of taxation on economic growth.

As staff member, Joint Economic Committee, U.S. Congress, developed programs for special studies and hearings by the Committee in fields of tax and expenditure policies. Directed studies of Federal Tax Policy for Economic Growth and Stability (1955), Federal Expenditure Policy for Economic Growth and Stability (1957), Fiscal Policy Implications of Current Economic Outlook (1957, 1958), and contributed to staff report on Employment, Growth, and Price Levels (1959).

During 1959, was on leave from Joint Economic Committee to assist Representative Wilbur D. Mills, Chairman of the Committee on Ways and Means, U.S. House of Representatives, in developing Committee hearings on Federal Tax Revision for Broadening the Tax Base.

As member, Analysis Staff, Tax Division, Office of the Secretary of the Treasury, worked extensively in fields of corporation income tax, excess profits taxation, depreciation problems, individual income tax, and tax treatment of capital gains and losses. Responsibilities with Department of the Treasury involved development of many of the major substantive changes in the Revenue Act of 1954.

Was a member of President Nixon's Task Force on Business Taxation, 1969–1970, Chairman of President-elect Nixon's Task Force on Taxation, 1968, and member of President-elect Kennedy's Task Force on Taxation, 1960.

Consultant for U.S. Department of the Treasury. Was member of Advisory Group to the Commissioner of Internal Revenue, 1964; member of Treasury Internal Revenue Service Committee on Statistics of Income, 1962–1965, and chairman of the committee, 1964–1965.

Has lectured extensively on a wide range of public economic issues before such organizations as the U.S. Chamber of Commerce, the National Association of Manufacturers, the American Mining Congress, the National Tax Association, the Cleveland Business Economists Club, the American Enterprise Institute, the Management Conference, the Graduate School of Banking (Madison, Wisconsin), the Graduate School of Business of the University of Chicago, the Tax Foundation, the Institute of Investment Banking, the American Bankers Association, and the Columbia University Conference of Economists on Money and Banking.

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7. Ture, N. B., Statement to the House Committee on Ways and Means on tax reform, March 28, 1969.
8. Ture, N. B., "Issues in Fiscal and Monetary Policy in 1968," Statement to the Joint Economic Committee in Hearings on the President's Economic Report, February 21, 1968.
9. Ture, N. B., Statement to the Committee on Ways and Means on the August 3, 1967, Tax Proposals of the President, September 12, 1967.
10. Ture, N. B., Statement to the Joint Economic Committee's Subcommittee on Fiscal Policy, *Tax Changes for Shortrun Stabilization*, 89th Congress, 2d Session, 1966.

Senator BENTSEN. Ladies and gentlemen, we will recess now until 2 p.m., when Mr. Lynn Townsend will be the lead witness.

[Whereupon, at 11:55 a.m., the subcommittee was recessed to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

Senator BENTSEN. The hearings will come to order. We will have one witness this afternoon. We have Mr. Lynn Townsend who will be testifying before us as the chairman of the board of the Chrysler Corp. Mr. Townsend, we are very pleased to have you. If you would come forward. We have known of your great interest in capital formation and the needs of industry, competition for capital in the world today and what we are facing in the future. I really think that in the years ahead capital formation is going to be as difficult and as demanding a problem and objective as energy is today.

Well, with that, if you would proceed, Mr. Townsend.

STATEMENT OF LYNN TOWNSEND, CHAIRMAN OF THE BOARD, CHRYSLER CORP., ACCOMPANIED BY WILLIAM G. McGAGH, ASSISTANT TREASURER, CHRYSLER CORP.

Mr. TOWNSEND. Thank you very much, Mr. Chairman. My name is Lynn Townsend and I am chairman of the board of Chrysler Corp. I have with me today Mr. William McGagh who is assistant treasurer of Chrysler Corp., and I do appreciate the opportunity to testify before this subcommittee on a subject which I believe is very important and which I feel very strongly about.

I would like to address the subject of equity capital as it relates to basic U.S. industry, and leave to others more qualified than I the task of speaking about Wall Street, the brokerage industry, the specifics of proposed limitations on the stockholdings of pension fund managers and other important related matters.

We all know that the need for funds for corporate America in the next decade will be enormous. Companies must expand and modernize in order to increase both production and productivity and to create the jobs needed for our growing workforce. Ecological requirements make it essential to modify plants and equipment, often at high cost. Worldwide competition makes it necessary to replace outmoded, inefficient plants and equipment with the latest technology if the United States is going to remain among the first-class powers in the world. In addition, vast amounts of capital will be needed to reach our goal of self-sufficiency in energy.

Much of this need for funds will be filled, of course, from the cash flow of corporations, their retained earnings and the judicious use of debt. The balance, however, must come from new issues of equity and right here is the nub of the problem—the difficulty today of floating large issues of new equity. A new issue may be impossible to sell or may only be sold at prices that are not acceptable either to management or to the current shareholders of the company. In most cases the cause goes to basic deficiencies in the functioning of the capital markets. It is these deficiencies to which I would like to address myself today.

The capital markets in the United States are an essential elements in our competitive free enterprise system. These markets have been the most productive in the world. They depend on the willingness of people to save out of their incomes and put these savings out at risk in the hope of a reasonable return. These markets normally accumualte capital from millions of people and allocate it to those sectors of the economy that have productive use for it. In the process there has been created a source of strength for the country that is immeasurable—thanks to millions of individuals who share in the ownership of American business.

Many of these small "capitalists" today are understandably confused, and I assume after they have left the market at least amused, by a valuation system in the stock market that results in the aggregate market value of the stock of McDonald's Corp., that fine hamburger company, equaling the aggregate market value of the stock of U.S. Steel Corp. They may be somewhat puzzled also by noting that the stock of one cosmetic company, Avon Products, is valued over $1 billion higher than the entire stock of the Aluminum Co. of America. They also note that the price earnings ratio at the end of 1973 for chemicals was about 13, for steels about 7, for aluminum about 15, and for automobiles about 5, while the price earnings ratio of McDonald's was 46 and the Avon Products was 27.

Another interesting comparison can be made between the book value and market values of different companies. McDonald's had a book value at the end of 1972 of about $200 million and a recent market value of about $2.1 billion. Coca Cola had a book value of about $800 million and a recent market value of about $7.1 billion. All we Americans are going to have to do nothing but eat hamburgers and drink Coca Cola if we are ever to make these ratios work out. On the other hand, U.S. Steel had a book value of about $3.6 billion and a recent market value of about $2.2 billion.

The failure in the ability of the capital markets to provide equity capital is the result of many complex factors. The capital gains tax certainly has an influence, and I am pleased to see that this subcommittee has some suggestions in that area. The high level and short- and long-term interest rates provides an attractive alternate investment outlet for funds and tends to make equities relatively less attractive.

Headlines covering the failures on Wall Street, the Equity Funding scandal and other events shake the confidence of the investor, particularly the individual investor, whose interest in the stock market has certainly declined. The New York Stock Exchange has reported that the number of shareholders in the United States has dropped by 800,000 between 1972 and 1973. Odd-lot transactions represented 21 percent of New York Stock Exchange volume in 1960 but only 4.6 percent in 1972.

Who then is doing the trading? As we all know, it is the institutions, whose percentage of the public dollar volume on the New York Stock Exchange has increased from 35 percent in 1963 to 70 percent by mid 1973. According to the SEC, institutional investors owned 26.7 percent of the outstanding stock in the United States in 1960 and by the end of 1972 this had risen to 34 percent. The SEC estimate of the market value of the stockholdings of institutions increased during the year 1972 by $71 billion to a staggering $398 billion.

A large part of these institutional holdings, of course, can be traced to the pension funds of American industry, and these funds are fed each year by massive company contributions. Recent figures indicate, for example, that the annual corporate contributions to pension funds total about $10 billion. Many of my fellow industrialists feel that it is ironic that the very pension fund managers to whom we make these large contributions turn around and use the money to buy additional shares in the "high-flyer" companies. This brings us to another critical aspect of this whole problem, the concentration of investments by the pension fund managers in relatively few, high-price-earnings ratio stocks, contributing to the so-called two-tier market.

This concentration of large amounts of capital, managed by institutions, and invested in a select few "glamour" stocks not only creates high valuations for these "glamour" stocks, but also causes downward pressure on the valuations of "nonglamour" stocks—the basic industries of this country. And with the individual investor shunning the market, the depressed values of most shares poses a critical dilemma for the managements of many of our basic industries. How do we keep our companies growing and financially sound when our stock is valued so low that it is difficult or impossible to sell more shares?

It is absolutely impossible for me to overemphasize the seriousness of the current inability of most companies in this country to raise equity capital. This Nation, in the lifetime of some of us here today, could descend from the relatively self-sufficient industrial power, that has been our great strength, to one large service industry for the rest of the world, largely dependent on other countries for its basic products. What will it profit us to have the world's finest hamburgers, or the most sophisticated cosmetics, if we cannot build a factory, or if we cannot manufacture a refrigerator, or construct a submarine or an aircraft, without the cooperation of other nations? Make no mistake: this shift is already underway.

Fundamental to the low valuations that the stock market places on the equity of the basic industries of the country is the downward trend in profit margins of corporations over the last 20 years. In the early 1950's, nonfinancial corporations earned about 23 percent before taxes on total capital. By the early 1960's, this had declined to about 18 percent and recent numbers put the figure about 13 percent. Government statistics are available that adjust these return figures to what they would have been if depreciation charges had been increased for the higher cost of replacing equipment in these inflationary times. The 23 percent becomes 20 percent, the 18 percent becomes 12 percent and the 13 percent becomes 9 percent.

This need for additional capital for corporations is made particularly acute by the continuing inflation that has gripped the country over recent decades. This inflation has led to a level of cash flow that is entirely inadequate for the modernization and replacement of facilities in our basic industries. Depreciation based on cost results in profits higher than if the depreciation were based on replacement value and then these higher profits are taxed away by the Internal Revenue Service. In the basic industries of the country—steel, aluminum, paper products, chemicals, automobiles, and so forth—the very ones that I would like to emphasize today—this inflationary impact is even more acute because many of the facilities have very long useful lives, giving inflation much more time to do its work.

In the steel industry, for example, the book value of property, plant and equipment is about $14 billion. To replace it at today's prices would cost an estimated $78 billion. It is interesting to note that the total market value of all the shares of the 9 largest steel companies in the United States is less than $6 billion. In other words you can buy for $6 billion $78 billion of capacity. This gap between book value of plant and equipment and replacement cost exists in all industries and must be made up by a combination of retained earnings, additional debt and new equity. Reduced margins in many of the basic industries have tended to limit the contribution that can be made from retained earnings and, of course, the decisions of the Cost of Living Council have been a factor in this. The limitations of price increases by the Cost of Living Council in arbitrary and inequitable ways generated great pessimism and uncertainty among investors, and caused a general decline in market values. Many companies have been forced to add levels of debt to their capital structures that are beyond the levels the management feels are appropriate. High interest rates, coupled with these high levels of debt, lead to a burden of interest expense that weakens the ability of an enterprise to weather the storms that inevitably come during periods of economic downturn.

Now I am not a pessimist: by nature I am an optimist. Neither am I inclined to cry havoc, nor to make much of problems that are familiar to all businessmen. But the problems we are discussing here are new problems; if not in their form, then certainly in their scope, their intensity and their implication I firmly believe that there will be serious adverse consequences if our capital markets are not able to supply to corporate America the equity capital that it needs at prices that are acceptable. Not only will the management and owners of these corporations be damaged, but their employees, their suppliers and the public at large will be damaged as well. Improvements we need to make in our environment will be stretched out and the President's goal of self-sufficiency in energy will be harder to achieve. More and more companies that are unable to grow will sell out to larger companies. The United States will tend to become less and less competitive in world markets because American industry will find it more and more difficult to make the capital investments necessary to improve its productivity. There will be less real growth in our gross national product and fewer jobs for our people. In this connection, we should all keep in mind that many companies in the basic American industries that I have been talking about are the companies that provide the largest number of jobs in this country, directly and indirectly.

The deteriorating situation will tend to feed on itself since low margins and low rates of returns tend to reduce stock prices and these low valuations make it impossible to obtain the equity needed to increase productivity and, thereby, improve margins and rates of return.

Finally, the threat of foreign takeovers of U.S. companies will become more acute. Although I am in favor of foreign participation in the U.S. stock market, the combination of large holdings of dollars by foreigners and depressed stock values of some of our basic industries is cause for legitimate concern. This situation, of course, has been made more serious by the effects of the recent, sharp increases in the price of petroleum. It is somewhat disturbing, for example, to realize that just the increase in the oil revenue of one oil-producing country for 1 month is enough to buy 100 percent of the stock of some of our largest U.S. companies at their current stock valuations.

It is essential that immediate steps be taken to facilitate the flow of equity funds to American business. The individual must have adequate incentive to return to the stock market. The institutional investor in the United States must look beyond the short term and give some consideration to the longrun implications of the kind of investment policy he has been following and what it means to the country in terms of our growth and our self-sufficiency.

In a broader sense, I think it is important for both Houses of our Congress to be aware of these threats to our basic industries, and to give full consideration in all of their deliberations to the need for America to remain strong in her basic manufacturing capability.

We commend the courage and foresight of Senator Bentsen and his fellow Senators in bringing this matter before the public, so that all Americans will come to understand the seriousness of the situation. This particular bill will certainly not cure all the ills of the capital market, but in its general form, it is a sound and constructive step that should be taken immediately.

Thank you very much, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Townsend. I think that is a very constructive statement. It has been very helpful.

I really believe that you and I are sitting in a position today that some were speaking of 4 years ago when we were beginning to really highlight the dangers of what could happen with energy in this country.

A lot of people wanted to turn them off because it was an unpleasant thing to hear. But I think that is what we are talking about with capital formation so that we can create the jobs and let industry expand and keep our trade balances as they should be. And when you talk about our basic industries not being able to raise the funds and our becoming a more and more service-oriented society—I do not believe we can keep a balance of payments and keep our dollar sound just taking in other people's washing. We have to have manufacturing capability. We cannot continue to be the granery of the world, either. We cannot keep our defense industry as strong as it has to be or the steel industry.

They are all interlaced, and they all depend on each other to a degree. Well, we are going to have to depend on distinguished business leaders like yourself, labor leaders, and institutional investors who will do what you say—look beyond just the short term results—and what it finally means to all of the pensioners in this country, whether or not this economy continues to build and grow and create the jobs that are necessary for the future strength of our country.

If more and more of these companies are forced to sell out to large companies, does that not, in effect, lessen some of the competition?

Mr. TOWNSEND. I would think most certainly so. As you know, Mr. Senator, we have questions underway in this country today as to how big companies should be and how much of industries they should control, and as long as the accumulation of small industry by large industry, in order to provide capital continues, we are continuing further in that direction.

Senator BENTSEN. Mr. Townsend, how do we get across to the American public our concerns?

So many of them look on the stock market as just something for speculation, to get in or out of, make a dollar or lose a dollar.

How to explain to the public the importance of our stock markets to the economy?

What should we be doing beyond what we are doing at hearings like this and legislation like this?

Is there any better way we can tell the story?

Mr. TOWNSEND. This is a very interesting question, and of course, as you know, American industry has been trying in its own faltering way to tell the story for a good many years. I think that we must continue that. I personally have been on a course of speaking out now for several years myself, and I think we should encourage others to do so.

We have, among businessmen, considered the fact that our statements when we try to justify profits, when we try to get into these financial terms, go right over the head of many, many people in the United States. And it has seemed to us that we can get further in selling American industry if we can speak out on specific issues as they occur that have an immediate impact on the people. These are issues that they will look at and this is what certain numbers of us have been trying very hard to do, Mr. Chairman.

Senator BENTSEN. One of the problems we run into is the popular view that evrything should be equated to salary, that we should not have any incentives to save, in effect. We are having a problem in this country and we are not saving to the extent of some other countries for capital formation.

I am concerned about the situation of frozen assets, a situation where a person might buy stock in a growth company at a younger age, and as they get older, perhaps go into retirement, they want an income-producing stock. And yet, the stock has had an appreciation in value. They have to commit an overt act to sell it, and at today's capital gains tax they could pay as high as 35 percent. And all of a sudden they find their financial statement reduced by 35 percent of whatever that asset is. So they make a tax decision, rather than an economic decision, and I do not think that is good for mobility of capital to be utilized for the best use in the most efficient way. And that is why I feel strongly that something in the way of a graduated capital gains tax would free up and get more mobility to capital, and perhaps provide capital for additional companies.

Mr. TOWNSEND. I think that is absolutely correct. I think that we have two other considerations in this area, 20 years ago, when these people that are retiring now were younger, 20 years younger, the companies which were our basic American industries, that made up basically the Dow Jones averages, were blue chip stocks. These people tended to believe that their stocks would follow the growth of the country. These people who may have bought steel 20 years ago, may have bought A.T. & T., may have bought auto, may have bought other blue chips now are holding stocks that are down substantially in price. And what they thought they were investing in for retirement is washed out from under them.

I think that we should do everything we can to encourage the small investor to come back in the market. But it is my opinion that they have been so seriously burnt over the last number of years, that this is going to be very difficult. I think everything, that should be done, ought be done to encourage them to come back. But I think the problem is of the size that we are going to have to take additional measures, over just all of our best efforts, to bring the small investor back.

Senator BENTSEN. Well, you have cited another problem that is rather paradoxical. Some companies which have relatively low multiples, have great numbers of employees, large pension funds, and those employees' funds are being invested in the so-called high multiple stocks, rather than being invested back into the equity market in companies with lower multiples.

So you have a situation where they may be trying to give short-term high performance on that pension fund, but they may end up costing the employees' job.

Mr. TOWNSEND. That is correct.

Senator BENTSEN. Now, this capital gains proposal I made is certainly not new. The chairman of the Ways and Means Committee has spoken of his interest in that kind of an approach. A decade ago in the Kennedy administration a proposal was made to raise the 50 percent capital gains exclusion to try to get more mobility in capital. It is my personal judgment—and it is just a judgment, and subjective—it has to be—that the Treasury would probably get more money just by that much more trading in stocks, stocks that would not be traded, that are frozen now as a result of that kind of a limitation. But neither the Treasury nor I am certain of that answer.

I am concerned about the threat of foreign takeovers. We in turn have made great investments in foreign companies, and we want to see a freedom of trade and foreigners having an interest in our companies up to a point.

Mr. TOWNSEND. That is right.

Senator BENTSEN. And I agree with you that with the lower multiples on our stock and what we are seeing, we are seeing more and more attempts, in some instances successful attempts to take over domestic corporations.

Mr. Townsend, I would hope with your leadership in industry, perhaps we can get some of the labor leaders interested and concerned in this too, and I am sure they have a concern in it. Maybe you could help put together, if you have not already, some of these leaders in industry, find ways that we can help in making it easier for capital formation in the future, and make a contribution there.

Mr. TOWNSEND. I would make every effort that I can. I know most of these major business executives personally, and I will make every effort that I can in this regard.

Senator BENTSEN. Thank you very much, Mr. Townsend. We are appreciative of your coming down.

Mr. TOWNSEND. Thank you, Mr. Chairman.

Senator BENTSEN. Ladies and gentlemen, we will stand in recess until the hearings resume tomorrow morning at 9:30.

[Whereupon, at 2:35 p.m., the subcommittee recessed to reconvene at 9:30 a.m. on Wednesday, February 6, 1974.]

STOCKHOLDERS INVESTMENT ACT OF 1974

WEDNESDAY, FEBRUARY 6, 1974

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

The subcommittee met, pursuant to notice, at 9:40 a.m. in room 2221, Dirksen Senate Office Building, Senator Lloyd Bentsen (chairman) presiding.

Present: Senator Bentsen.

Senator BENTSEN. The hearings will come to order.

This morning I am releasing the results of my bank trust survey. Last October I sent a detailed questionnaire to the nation's 25 largest bank trust departments, 21 of these banks have responded and we will be contacting the other 4.

The results of this survey demonstrate that some banks concentrate their investments in a few securities to an unreasonable extent and that some banks hold excessively large portions of the outstanding stock of single companies.

I have proposed that no pension manager invest more than 5 percent of its aggregate discretionary pension assets in one stock and that no pension manager hold more than 10 percent of the outstanding stock of a single large company with respect to the manager's aggregate discretionary pension assets.

It is rather interesting to note that one of the witnesses testified yesterday that if such limitations were placed on them, it would force them out of stocks and into other investments. To me that is a really amazing statement when you have some 1,400 stocks on the New York Stock Exchange, and if you have a 5 percent limitation of assets, that means he could own 20 stocks, and so the connotation is that actually you would only have 20 companies that he could invest in, that would be sound and prudent for him to invest in. I find it very difficult to follow that kind of logic.

My proposal has been referred to as a prudent institutional investor rule. Many pension managers have adopted this rule by their own wisdom. Now, what this proposal that we put before this committee does is to prevent the aberrations in that most pension managers voluntarily comply with this kind of a prudent institutional rule.

Now, I can understand that institutions do not want any limitations. It is like saying you do not want any speed limits on highways. Most people would drive at a rational, sane rate. But there are always those that will violate what is good judgment, and that is why you need rules, and that is why you need some regulations.

So what this prudent institutional rule would do is make sure that the best practices of the best banks is the assured practice of all.

At our hearings yesterday the subcommittee learned that current stock market values have resulted in the peculiar situation in which the aggregate market value of the stock of the McDonald's hamburger company equals the aggregate market value of the stock of the United States Steel Corp. also the stock of the Avon cosmetics firm is valued over $1 billion higher than the entire stock of the Aluminum Co. of America.

We have received testimony about the vital function our stock markets play in promoting economic growth which is so important to every American, and yet when we look at a situation like this on McDonald's hamburger and United States Steel, we know we are short on steel and long on hamburgers. We know we have some work to do in the marketplace to provide equity where it can be most creative and helpful in our balance of trade and creation of jobs, because our capital markets must provide American companies with sufficient equity for business expansion and modernization so that we can create the jobs for a growing work force, so that we can remain competitive in a world market, so that we can pay the costs of meeting environmental standards, and so that we can achieve the goal of reasonable self-sufficiency in our energy.

It is important that we in Congress work closely, I think, with the business leaders, with the union leaders, the institutional investors and the members of the brokerage community because in the long run our objectives are the same, to insure that a sufficient supply of equity capital is available for American business.

This morning the Financial Markets Subcommittee is going to receive some further testimony on these important issues. I think we are fortunate in having a distinguished political economist as Mr. Janeway, the president of Janeway Publishing and Research Corp. with us this morning.

You can proceed, Mr. Janeway.

STATEMENT OF ELIOT JANEWAY, POLITICAL ECONOMIST AND PRESIDENT, JANEWAY PUBLISHING AND RESEARCH CORP.

Mr. JANEWAY. Mr. Chairman, I am privileged to endorse bill S. 2842, the Stockholders Investment Act introduced by the Chairman of this subcommittee, Senator Bentsen. Before putting forth any views of my own, I am anxious to express my appreciation and respect, Mr. Chairman, for your practical and comprehensive formulation of the problem created for our security markets and the economic society they serve by the mass exodus of private investors from the stock market.

Mr. Chairman, I hope that you and your colleagues will not think me unmindful of the antitrust laws in welcoming with some keen sense of professional relief your absence from the market for written analytical products in which I compete. I have no hestitation in nominating your floor statement of December 20, 1973, for the Pulitzer prize for reporting on financial affairs. I agree in principle, as well as in legislative specifics, with its four-point thrust, but have two amendments to suggest.

Two additional proposals which would require far-reaching legislative changes also seem called for to cope with the crisis into which we have drifted.

First, may I say that I share your sense of surprise and, indeed, shock, at the position taken yesterday by leading spokesmen for the fiduciary fraternity which I can only characterize as sheer bourbonism. The mutual funds, after all, have had a pretty good run for their money and have given the country a pretty good run for its money under precisely the two limiting rules of the road the regulations in your bill would suggest, and I think the trust institutions of the country would do well to adjust themselves to it.

Any practical effort to redress the balance between over-institutionalization of the stock market and underparticipation in it by individuals is bound to begin with what caused it in the first place. There's no mystery about it: Big Uncle Sam the tax collector did it. When he did, the policy emphasis was all on the side of promoting the institutional ownership of stocks. Consequently, the tax incentives were structured to give the institutions the right to take profits trading securities, and to compound income from owning them in a tax haven. Predictably, the Niagara of money which moneyed Americans always command began its historic run through tax-free institutional filters into stocks, and the great institutional bull market was on. Offering the private investor with the money but not the will to buy stocks and equalizing tax incentive is the way to engineer the needed switch back into stocks in time to save the situation.

I will begin by explaining my two suggested amendments to the bill in its present form, and then formulate the conditions I believe private investors will insist on seeing met before returning to the stock market with the cure only they can bring it.

Mr. Chairman, in your Dec. 20, 1973 statement, under the heading diversification requirements for pension managers, you offer the reassurance that the limitations specified would not be made mandatory retroactively. Managers of pension accounts, you say, would not be forced to dispose of current stockholdings to meet these limitations. Local governments in their handling of zoning ordinances have institutionalized the acceptance of the grandfather principle to sanction nonconforming uses.

Your stipulation amounts to a nonconforming use and is just as commonsensical in avoiding responsibility for avoiding disturbances from old excesses in the process of avoiding new excesses. My sense of the situation suggests that the proposed limitations may not go far enough in one direction, and may go too far in another.

In the direction of further tightening, I suggest that nonconforming uses sanctioned on day one be subjected to partial divestment on, say, a 5-year schedule with some reasonable, if moderate, progress for scaling down required in each year. My main reason for making this suggestion reflects my fear that still more drastic shrinkage in stock exchange trading volume is ahead. If I am right, you can be sure that still more dislocative breaks in the market prices of institutional grade stocks under liquidation are coming with it. Consequently, nonconforming uses which may seem moderate relative to today's shrunken volume of trading would strike individual investors on the sidelines as excessive in the atmosphere created by the next shrink. Failure to require continuous annual progress toward getting into compliance with the proposed guidelines may, as volume shrinks, invite new excesses which this bill is aimed at avoiding.

In the direction of easing the provision, I suggest that the legislative language adopted take account of the brisk and accelerating rate of turnover in pension fund management-client relationships. In view of the disappointing performance of most pension fund managements, such turnover is both inescapable and healthy. The increases posted in management fees by certain institutions are accelerating the turnover. So are the costly retrospective penalties being levied on pension fund sponsors by independent actuaries to offset the failure of portfolio managements to meet funding goals. So, too, is the general recognition by pension fund sponsors of the prudence of outgrowing historic affiliations and throwing their management needs open to competitive bidding.

The resultant rise in turnover of sponsor-management relationships could create transitional complications in restraint of this healthy competitive trend. A fund whose portfolio is within the proposed regulatory guidelines may find itself disqualified from hiring an institutional manager whose compliance may be on the borderline with respect to one or more securities. I suggest the appropriateness of latitude, again for some reasonable period, in this case, perhaps 1 or 2 years—where the guidelines may be exceeded by the assumption of a new client-management relationship.

I come now to my second suggested amendment.

We have all been reading a great deal recently about the privilege accorded homeowners of deferring capital gain tax obligations on profits taken from selling a house, provided that it is the taxpayer's principal residence and so long as another home is bought within 6 months for as much or more money. As Chairman Mills has said with characteristic clarity and wisdom on so many occassions, the entire basis on which our system rests assumes the right and the ability not only to have and to hold assets but to trade them.

It is the fear of losing this ability which is frightening individuals out of the stock market and inhibiting their re-entry.

The Bentsen bill suggests raising the present $1,000 limit on capital losses deductible against ordinary income to $4,000. This prompts my suggestion not to raise the limit, but to cancel it as a meaningless token. My counter-proposal invites tax-paying securities holders with losses to take their lumps in all of them and to lump the entire deduction against ordinary income in the year taken—subject to one qualification: that the proceeds realized from such liquidation be reinvested within 6 months in dividend- or interest-bearing securities other than tax-exempts: I recommend extending the deductible reinvestment privilege to bonds paying taxable income on the principle that nothing can be good for the stock market which does not begin by being good for the bond market, and that anything that begins by being good for the bond market will soon be good for the stock market.

To sharpen the incentive, deny the deduction altogether to loss-takers content to call it quits. Let us recognize that the present privilege of offsetting all present losses against any future gains is pie in the sky.

The Tax Code has always been quite clear in recognizing the right of taxpayers to get their losses back. But, as a practical matter, limiting the use of this right to the opportunity to take gains will defer for longer than we dare hope or can afford the opportunity to take gains. Given the principle of loss recouping on a tax-free basis, and given the fact of the losses snowballing but untaken, the sooner taxpayers now accruing untaken losses take and offset them, the sooner they will be ready again to declare to the Treasury the partner it needs to be in their next crop of earnings.

The Treasury would not be long in gaining revenue, exactly as it has from the reinvestment privilege granted the homeowner making a profitable tax-free trade.

The two-way trading traffic certain to be stimulated by this simple measure would return brokers to the ranks of taxpayers. It would have the same expansive effect on market volume and on the structure of market prices that the development of a large short interest cannot fail to have. To guarantee recapture of deductions by the Treasury, a stipulation could be added requiring loss-takers claiming the deduction to switch back into dividend-bearing stocks and bonds paying interest taxable as ordinary income when received.

My sense of the situation is that this is what they would do anyway. Taxpaying stockholders stuck with red-ink market positions are richer in capital losses unusable for tax purposes than in any other wasting asset. Typical small investor psychology reasons that losses are not suffered till taken. The waiting process dries up the liquidity of the market, and inflates the losses waiting to be taken. Anyone taking losses fully deductible against ordinary income would opt for buying replacement positions rather than lose deductions, especially now that so many high-yielding values are coming into the reach of investors who are becoming increasingly income-minded. This development, Mr. Chairman, fortifies the point you made in your opening remarks, that clearly there are many more than just what is left of the top tier 40 stocks of interest to investors. The individual investors you are trying to bring back to the market in statesmanlike fashion want income-yielding stocks, of which there are now many.

In a more general vein, may I now set forth in summary form my thinking as to what makes the market run and what makes Mr. and Mrs. Sammy Investor run with it.

First, two popular misconceptions: The first, that stock prices rise when business activity speeds up, and vice versa. The second, that stock prices fluctuate in predictable and consistent relationship to earnings. If both popular misconceptions were pragmatic, or even if either was, the 1973 boom in business activity and the bulge in earnings would have sent the Dow Jones industrial average well above 1,500, with the entire breadth of the market following. The depressing response of the stock market to the business boom and the earnings bulge support my longstanding contention that stock prices fluctuate not with business conditions but with money conditions, and that stock prices capitalize not earnings but dividends.

I feel prompted to add that I held these admittedly dissenting views before inflation had got far enough out of hand to make a mockery of earnings reported after depreciation taken. To borrow a phrase from the law, the market in its anonymous wisdom has learned to pierce the veil woven by depreciation. It was inadequate to replace productive assets, much less to modernize them, before the cost of their competitive reproduction became incalculable. More than ever, the market is insisting on being satisfied about the money-good capability of covering and paying out hard cash dividends.

To recognize that stock prices fluctuate with money conditions and capitalize cash dividends is to respect the fundamental guidelines offered by the interest-dividend spread. Prudent investors would always prefer to own stocks rather than bonds—provided the price is right. It is for the average run of stocks whenever their dividends come within 2 percent of equaling the return paid by bonds.

A 2-percent better offer for the use of money in any form never fails to move it to that other use as, say, from savings accounts to bonds. Given an 8-percent bond market, stocks not endowed with special attributes of growth can be deemed safe or stable anytime they yield 6 percent or more in well-covered cash dividends. Stocks claiming membership in the so-called top-tier group can pass muster in an 8-percent bond market, I suppose, selling on a dividend yield basis approaching 3 percent. In the range of 900 on the Dow Jones average, the 30 Dow Jones stocks yield an aggregate cash dividend in the neighborhood of 3 percent.

The top-tier stocks are now clearly in market disarray under the still preliminary pressure of liquidation from institutions that only yesterday were believed to be traveling a one-way street toward accumulation. They have been yielding under 1 percent. For them to be driven down to a 3-percent yield basis would represent a collapse of closer to two-thirds than one-half for their market prices, or more drastic than the mere 50-percent drop in the Dow that would be represented by the symbolic figure of 500. Such a drop would still leave them priced on a relatively rich premium basis vis-a-vis the average run of stocks and the Dow average.

With the Dow at 500, but with the dividends of the 30 stocks in it paying more or less what they are now, their composite yield would approximate 6 percent. If the growth stocks which have been yielding less than 1 percent with the Dow yielding 3 percent were priced down to yield 3 percent with the Dow yielding 6 percent, the spread representing the relative attractiveness of growth stocks and average grade investment stocks would remain unchanged. But the structure of stock prices would buckle and the few remaining shreds of confidence would be destroyed.

From this perspective on the fundamentals, it is easy to see how the backlash from the higher interest rates is burdening us with lower stock prices. Interest rates are, of course, the fundamental measure of inflation: the faster it spirals upward, the higher interest rates are driven up in its wake. Waiting for stock prices to drop enough to bring dividend yields within two percentage points of bond yields, wherever bond yields may top out, would defeat the constructive purpose of this subcommittee and leave us confronted with a market decline significantly worse than that already suffered.

The contraction in volume is now signaling a follow-on contraction in the structure of stock prices. The two broader proposals I am here to suggest are aimed at moderating the resistance of private persons to participating in the public securities auction market in time to avoid a debacle. The first of these two proposals is not new. I advanced it before the Joint Economic Committee, with Senator Proxmire in the chair in 1970, when the erosion of public participation was then still in a relatively early and therefore more readily reversible stage. It would permit corporations to pay some portion of their dividends, as they do oil interest on their debt, before taxes instead of after. In advancing this proposal for a dividend tax credit in 1970, I was clearly aware that its time had not yet come. Mr. Chairman, I believe it has now.

Consider its specific applicability to the safest and, as I believe, the cheapest investment values available anywhere, the so-called income group of utility common stocks: I fear that they are now on their way to becoming cheaper still. They certainly pass muster by the 2-percent rule: Instead of paying 6 percent in an 8-percent band market, many of them are yielding up to 10 percent and, nevertheless, are attracting no public following from private investors. By law, their stockholders are entitled to a fair rate of return. In fact, the needs of utilities for capital are endless.

In acknowledging that this proposal was a forecast rather than an answer in the still relatively tranquil world of 1970, I said that Congress might not be ready to consider a dividend tax credit as the aid it would be in attracting individual stockholders to utility dividends then yielding 6 percent; but that Congress might decide to do so with utility dividends at 10 percent. Some of them are already there, with a proper host following.

I hope that Congress now will decide to give favorable consideration to a dividend tax credit designed to make stock investment for income for attractive to private persons.

Giving the same cash return to individual investors insisting on it, but at lower cost to the companies needing to pay it and in order to raise new money, would be a mercy to the consumer. In precisely these parts of the country where utility stocks are now yielding 9 to 10 percent, utility customers are being confronted with overnight rate increases on the order of magnitude of 50 percent, this while their costs are still being subsidized by undermarket coal contracts.

Lowering the cost of servicing dividends is admittedly not the answer to this inflationary disaster in its entirety. Only the executive branch can take the lead in reaching the roots of the trouble. But this device offers Congress at least one method for lowering the cost of capital to corporations needing to pay up for it; for limiting the damage being suffered by consumers; and for helping to solve the problem being faced by this subcommittee. Though the dividend-paying corporation would be entitled to treat as a deduction whatever portion of the dividend Congress might qualify as deductible along with interest, dividends received by stockholders would be fully taxable. Utilities and consumers alike would find dividend deductibility particularly helpful where preferred stock issues are needed to shore up equity ratios. The effect of paying 8 percent for preferred stock money is a permanent net money cost of 6 percent to a top-rated money-good company.

Senator BENTSEN. For the record, that would be 16 percent?

Mr. JANEWAY. What did I say?

Senator BENTSEN. You said 6.

Mr. JANEWAY. Yes, 8 times 2, 16, and I think I saw a utility preferred at 8½, which would mean 17 percent money, and this is a pass-on to the consumer.

I come now to the most troublesome and defensive of the proposals I am here to put before you. The question, as your call for these hearings puts it, seeks ways and means of attracting individuals and families into stock market ownership.

Overinstitutionalization is being referred to as if it were merely a condition. Indeed it is, but it is a creeping condition, and the creep is accelerating. The common characteristic of all cancerous conditions, from the real thing medically to its inflationary counterpart in the economy, is that it spreads. Over-institutionalization is spreading now, and at a rate calling for urgent regulatory scrutiny and restraint. Specifically, the way in which its spread is running recalls the abuses which provoked Congress to pass the Glass-Steagal Act after the last depression which, lest we forget, was sped in its tragic course by the jumbling of commercial and investment banking functions.

The Glass-Steagall Act provided for the severe separation of investment and banking functions. I suggest the urgency of a hard-and-fast look by the subcommittee at the need to strengthen the Glass-Steagall Act as it now stands and very possibly to extend it along lines paralleling the Canadian system, which separates commercial banking and trust company functions. I hope that going this far may not prove necessary. The way to avoid the need is to adopt stringent preventive regulation.

Mr. Chairman, in your December 20, 1973, statement, you developed a striking and fundamental contrast between the role of the German commercial banking system and our own: you made this point in connection with your recommendation for limiting the investment impact of pension fund holdings on the incidence of ownership. In Germany, and not just in Germany, the commercial banks are all-purpose institutions. From the standpoint of the problem recognized by your call, the fact that the banks own the businesses is less important in Europe than the result, which is that they and they alone make securities markets. It is little wonder, therefore, that securities markets in the bank-dominated countries are too small to matter, and are readily manipulable, as our markets are not.

Overseas businesses, even the biggest, feel free to travel without an equity base because the banks own them; and, of course, the respective governments control the banks. As for individuals who might otherwise be investors over there, they are either second-class participants through the banks in their token local markets or they are financial refugees. It seems axiomatic to me that the necessary and indispensable precondition for tilting the marketplace seesaw back on the side of greater participation on the part of private persons is to tilt it simultaneously away from still greater domination by the commercial banks and their trust affiliates. Let me cite several different classes of what I regard as creeping abuses threatening still more disruptive consequences.

Multinational corporations, whether American with foreign subsidiaries or foreign with American subsidiaries, are accustomed to being served overseas by all-purpose banks which literally own their clients, which control all the alternative uses of other peoples' money and which dominate their local miniatures of manipulated markets. In looking for financial services here, these multinational operations are understandably seeking the same kind of accommodation from the American commercial banks that they are accustomed to receiving overseas, and they are getting it. When, to take just one recently publicized case, a major British corporation acquired control of a prominent publicly owned retail chain, one of the leading American commercial banks reported earning a finders fee in the upper six figures, I believe that the financial lexicon would categorize this as an investment banking function.

To take another example: A practice is now pending known in the vernacular of the trade as "bunching." The way it works, commercial banks solicit their individual depositors for the opportunity to service their investment needs. They also invite brokers dependent upon patronage from their trust affiliates to furnish them with lists of firm clients for mail solicitation. Of course, the SEC has been insisting quite rightly on the "know your customer" requirement in its regulation of the investment industry. Here, it would be honored in the breach. The SEC also subjects investment brokers, bankers, and advisors under its scrutiny to stringent regulations aimed at avoiding conflicts of interest. The Federal Reserve Board which is the primary center of regulatory supervision over the commercial banking system, has no facilities or exeprience for keeping up with the present overspill of commercial banking functions into the investment banking fields; nor has the Comptroller of the Currency.

In the case of "bunching," the investment management procedure about to be activated into popular merchandising at retail calls for the individual depositor to permit the bank branch to charge the account by an agreed upon amount segregated for a monthly investment program, to collect a supervisory fee; to get the benefit of the free deposit on which it might otherwise have paid interest for most of the month; and then to "bunch" one wholesale order on 1 day a month at a negotiated wholesale and commission rate. Brokers desperate for orders on any rate basis feel under the gun to go along with this latest, I feel, insensitive and indeed irresponsible form of high-powered retail financial merchandising. This practice, adopted in the name of attracting broader individual participation in the market, is certain to compound its illiquidity troubles.

New conflict-of-intrest rules of the road are overdue for the interrelations between the commercial banks, their trust affiliates, the investment banking business and the brokerage business. I hope that this regulatory gap can be closed without the situation getting out of hand to the point where the Glass-Steagall Act will need to be extended to divorce the commercial banks from their trust affiliates as a follow-on to their original divorce from their former investment banking affiliates.

I express this concern and this hope, Mr. Chairman, in a spirit of great confidence concerning the unique role in history the commercial banks have earned for themselves under the watchful and helpful eye of Congress. Reference to Professor Friedman's classic Monetary History of the United States teaches us that every past period of capsizing markets and collapsing confidence has provoked a mass run of private money out of the private banking system. In counting our blessings, let us realize that this latest chapter of distress in our structure of political finance is the first to have spurred a run in the exact opposite direction, into the banks.

I am by no means alone in regarding the depression which has befallen the securities industry as the leading indicator of still more trouble yet to come. In scrutinizing the consequences of over-institutionalization of the stock market, and in improvising incentives calculated to revive direct investment by private persons in it, let us keep the commercial banks safely and visibly on the liquid side of the street and let us be ware of any encroachment outside their proper sphere of activity calculated to aggravate the illiquidity in Wall Street.

Let us keep them insured against the recriminations arising in the wake of the losses being suffered as at least the partial result of over-institutionalization. Congress is the historic guardian of the soundness and the repute of our commercial banking system. The strength of the banks relative to the weakness of the stock market is challenging Congress again to rise to its historic responsibility.

Mr. Chairman, in concluding, let me without intruding on the time of other witnesses, associate myself wholeheartedly with the recomendations being put forward by my lifelong friend, Mr. Thomas Corcoran, in respect to liberalizing capital gains provisions for older and senior long-term holders of assets.

Thank you very much.

Senator BENTSEN. Thank you very much, Mr. Janeway. As always, it is a very interesting contribution that you make and a very helpful one.

One of the points that you make is one that has concerned me about how my bill might work. On the new client for an institutional manager, where that institutional manager is on the borderline of compliance, he has got a new pension fund coming in that he wants to have, but that is not all bad, because that can spread the business more and it can be a deterrent on an institutional manager getting too close to these limitations too, can it not?

Mr. JANEWAY. It certainly would. All I am suggesting is just a bit of elbow room, because we are seeing unprecedented ferment of accelerated comings and goings with it. We are seeing smaller pension funds which nevertheless are big enough to be reached by your bill, discovering that they need competitive managements. Many managements have long-standing positions in securities which they bought many years ago at nominal costs, and feel in their discretion that it might make sense for them to ride out.

So I am just suggesting a bit of discretion, while at the same time suggesting that anyone having a nonconforming use continue to feel the prod to keep moving.

Senator BENTSEN. Your recommendation of allowing all capital losses to be charged against income, so long as the proceeds are reinvested back into securities, is an interesting proposal.

This, in effect, would mean the people who had losses would liquidate them earlier, and as you say, too often a small investor thinks he doesn't have a loss until he actually sells his stock.

Mr. JANEWAY. Yes. I get this in my mail all the time, Senator. People say, well, if I sold I would have a loss, and of course, the oldest rule in the business for professionals is that when you have a stock, any time you are not willing to buy more of it that day, you have really sold it in your mind.

Senator BENTSEN. What effect would that have in the market itself if these people took their losses earlier, and not wait hopefully for the day that stock got back up to even?

Mr. JANEWAY. That is when they always sell. The market does a V, as it were. They get their money back, the money rests, and then the market goes. You would certainly even or iron out the illiquidity gaps in the market. You would even or iron out the spasms of volatility which measure and reflect the illiquidity.

Looking forward, I would think that you would add 2 to 3 million shares a day and if we are heading down to 10 or 8 million shares a day, as the next stop, adding back 2 million shares a day of steady volume would back up into a significant recovery—in fact, almost back to where we are in danger of falling from now. Mere recession no longer describes the plight of the securities industry; it has fallen into a proper depression, measured by bankruptcies, loss of capital, failure to attract even senior capital, unemployment, firms that cannot get out of business because they cannot get out of their leases. Every feature of the normal depression profile is present and showing. As fast as illiquidity, resulting from loss of volume, knocks the support out from under another former member of the top tier family group, the firms whose capital is concentrated in that security are knocked onto the sick list with it.

Senator BENTSEN. Mr. Janeway, I think that we have too much of the public looks on the stock market as a place to make or lose a fast buck. It is much more than that. It has been a great system in this country for providing equity capital for a growing economy, and as I look upon the demands in the way of capital accumulation that are going to be necessary for future years, and I hear that the necessity for U.S. Steel to be able to expand the steel industry, and they cannot raise the capital and they have given part of the markets to the Japanese and part of the markets to the Europeans, and I had a man tell me as late as yesterday tha they were trying to build some of the steel contracts on the Alaskan pipeline insofar as the supporting structures and are having an extremely difficult time getting American steel companies to say that they would be capable of fullfilling that kind of a contract. And then I see we are going to need on the energy side to try to work toward some at least partial self-sufficiency.

How are we going to raise all of that capital if we do not have an equity market that works?

Mr. JANEWAY. And the irony is that we have the only equity market in the world. Add to your comment in your opening statement this morning on Mr. Townsend's statement of yesterday this consideration: That in the top tier of 40 to 50 institutionally favored stocks not only is there not one company representing a basic production industry required by the infrastructure which we are now under pressure to modernize and to recreate, but every company in that group with the possible exception of Disney, has been doing, on the record, better outside the United States than inside the United States.

By contrast, the companies on your mind, like the steel industry, the companies under pressure to recreate an energy base for this economy, the companies I mentioned, the utilities are all entirely American companies, and they are the companies which the market has understandably been rating as losers. It will do so until average Americans decide to put their money behind the judgment that the place to finish first again is America.

So we are talking about reversing our studied downgrading of our proprietary national asset, which this great public market is. People will come back to it. Just give them what the situation calls for.

Senator BENTSEN. Mr. Janeway, as I understand it, we passed the 50-percent mark so far as our society being a service-oriented society, and I get concerned about the manufacturing productive capacity of this country trying to maintain a balance of trade, trying to advance our society and create the jobs, and I just do not believe we can make it taking in other people's washing. I think we have to keep up the productive capacity of industries, like aircraft manufacturing, automobile manufacturing, steel, energy, and so on.

Mr. JANEWAY. The proposals I have put forward—and I entirely agree with you—are calculated to attract capital into these industries.

The process of erosion in the market, measured by the departure of the private investing public, has reduced the securities of the industries you are mentioning to a yield basis which is what these private persons are getting from deposits and from bonds. If you permit the stock market to compete for their money they will reinvest their losses, and they will take their liquid accumulations and switch into precisely the corporations that need this money.

Senator BENTSEN. Mr. Janeway, I would like to hear a lot more of this but we have some other witnesses, and we had better proceed.

Thank you very much for your contribution.

Mr. JANEWAY. Thank you.

Senator BENTSEN. Our next witness is Mr. James J. Needham, chairman of the board of the New York Stock Exchange.

Mr. Needham, I want to welcome to our audience an individual who is your counterpart in London. He is Mr. George Loveday, chairman of the London Stock Exchange. Mr. Loveday, we are pleased to have you and welcome you to these hearings.

If you will proceed, Mr. Needham.

STATEMENT OF JAMES J. NEEDHAM, CHAIRMAN OF THE BOARD, NEW YORK STOCK EXCHANGE; ACCOMPANIED BY DONALD L. CALVIN, VICE PRESIDENT, NEW YORK STOCK EXCHANGE; AND DR. WILLIAM C. FREUND, VICE PRESIDENT AND CHIEF ECONOMIST, NEW YORK STOCK EXCHANGE

Mr. NEEDHAM. Thank you, Mr. Chairman.

My name is James J. Needham. I am chairman of the board of directors and chief executive officer of the New York Stock Exchange. With me today, on my right, is Donald. L. Calvin, vice president, and Dr. William C. Freund on my left, vice president and chief economist of the exchange.

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

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

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

By the way, Mr. Chairman, I want to congratulate your selection as chairman of the Subcommittee on Financial Markets. I know you are eminently qualified for that position, and those of us in the private sector look forward with great expectations to your efforts.

Senator BENTSEN. Thank you very much.

Mr. NEEDHAM. We recognize that you were one of the first to recognize the necessity for congressional action to broaden the individual investor participation in our securities markets. This can only be done if investors have confidence in our system, and Mr. Chairman, if I can depart momentarily from my prepared statement, I want to say that we certainly concur with Senator Mansfield's statement in his annual report on the state of the Union, in which he said, it seems to me that it would be helpful in this connection to bring together on a regular basis representatives of the executive branch and the legislative branch with those of industry, labor and other areas of our national life. The fusion of ideas and interest from these sources should help to give us the economic yardsticks.

We view our appearance here today as perhaps the initiation of that dialogue between the exchange community and the Senate of the United States, and wish to thank Senator Mansfield for pointing out the necessity for the continuing dialogue between the public and the private sector.

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

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

Of special concern in properly allocating the necessarily limited supply of capital to all those diverse needs, is the distorting effects of Government borrowing on the capital markets. The Federal, State and local share of all debt and equity securities issued has edged past the 60-percent mark, with the Federal Government and its agencies by far the Nation's biggest borrowers. Moreover, they enjoy special privileges which are not available to private corporations and individuals. If for no other reason than to keep our capital markets from being overwhelmed by Federal demands, return to a more responsible balanced Government fiscal policy is essential.

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

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

We have, however, prepared a research paper analyzing the pros and cons of the restrictions proposed in S. 2842. This research paper is attached to our full statement as Appendix I.[1] On balance, it appears that the pros of the proposal outweigh the cons. However, for the reasons I have indicated, we are not in a position at this time to offer a final evaluation or comments. Accordingly, while we cannot support the proposed restrictions, neither would we object to their enactment.

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

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

This study, which has been offered to the subcommittee, was based on personal interviews with individual investors. Their actual 1972 portfolios and investment decisions were reviewed and probed.

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

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

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

However, it seems to us that two additional provisions in the bill's tax package will diminish the effectiveness of the exclusion rate plan as a stimulus to new investment and investment turnover. I am referring to the proposed repeal of the present 25-percent alternative capital gains tax rate, and the proposed extension of the minimum capital gains holding period from 6 to 12 months.

If the alternative tax is repealed, the first $50,000 of net long-term capital gains, now taxed at 25 percent, could be taxed initially at rates as high as 35 percent under the proposed graduated exclusion rate plan. An individual investor in the 70 percent income tax bracket would in fact, have to hold onto his assets for 7 years in order to obtain the tax treatment he now receives on the first $50,000 of gains after 6 months. An investor in the 60-percent tax bracket would have to hold assets 4 years to match the rate he now receives after 6 months.

[1] See p. 204.

The Quayle study found that a strong impetus to unlocking capital gains would be a cutback in the present maximum rates. For example, if the maximum capital gains tax rate were halved for taxpayers who are now subject to rates of up to 25 percent, and the maximum for individuals subject to higher rates were reduced to 25 percent, total capital gains realizations in 1972 would have been $16.6 billion higher and tax revenues would have been up almost $1.7 billion. That would have resulted in total capital gains of $49.2 billion and tax revenues of $5.6 billion. But data underlying the published results indicate the effect of cutting the maximum rate from 35 percent to 25 percent would, by itself, produce tax revenues of $1.8 billion, or almost one-third of the total.

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

S. 2842 clearly seeks to enhance capital mobility, an important prerequisite for maximizing growth in a dynamic economy. However, we believe that eliminating the alternative capital gains tax rate and lengthening the capital gains holding period beyond the present 6 months would prove to be inconsistent with that objective, that these two measures would, in fact, have just the opposite effect.

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

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

Stated somewhat differently, we fail to see the justification for penalizing an investor who failed to liquidate a poor investment quickly.

We recommend, therefore, that all long-term capital losses be treated alike, regardless of the length of time investments are held. The most effective course would be to permit full deduction of all capital losses, no matter how quickly or slowly they have been incurred. We would suggest, therefore, that S. 2842 be modified at least to retain the present method of calculating the loss deduction, that is 50 percent of the total long-term loss. And, we believe it would be more in keeping with the intent of the bill to increase the proportion of losses eligible for tax deduction to 100 percent by, say, 1980.

In our testimony before this subcommittee last July, we proposed a comprehensive series of tax recommendations aimed at stimulating individual investment activity. I have referred to several of our proposals in my comments this morning. Other measures which we believe would help achieve the objectives we share with this subcommittee would, briefly, No. 1, allow a $1,000 capital gains tax exclusion from adjusted gross income when gains do not exceed 25 percent of earnings; No. 2, raise from $1,000 to $5,000 the maximum tax deduction against ordinary income for a capital loss; No. 3, increase from $100 to $200 the dividend exclusion from Federal income taxes; No. 4, permit commissions paid on stock transactions to be treated as investment expenses and, thus, as deductions against ordinary income; and No. 5, permit a $1,500 tax deduction for individuals who buy stocks as part of a personal pension plan, provided they are not covered by adequate employer-sponsored plans.

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

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

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

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

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

Senator BENTSEN. You would set that up like a bank would set up something for loan losses?

Mr. NEEDHAM. That is correct, Senator.

Senator BENTSEN. Please go ahead.

Mr. NEEDHAM. I would say, Senator, that the risk inherent in making markets and stocks are far greater that the risk of making loans today.

This proposal is discussed in our research report, Stabilization Reserves—A Route to Easing Cyclical Problems in the Securities Industry, which we have submitted with our full statement as appendix II.

Before I close, I would like to review a couple of statements that were made by other witnesses on the chance that the committee might not interrogate me. I will be as brief as possible.

Senator BENTSEN. That will be okay.

Mr. NEEDHAM. Yesterday, Mr. Townsend, in a very eloquent and well-prepared statement, set forth the needs of the industrial sector of our economy, and he pointed with great accuracy to one of the deficiencies in current financial reporting, and that is the adherence to historical costs in computing depreciation. And I submit to you, Senator, that this is a matter that this subcommittee or the full committee should examine to see whether tax deduction for depreciation should be based on fair value accounting, the cost of replacing the asset rather than on historical cost.

The implications involved in that change are not quantified in Mr. Townsend's statement, nor am I in a position to do that in terms of loss of Federal revenues, but I do believe that a case can be made, at least conceptually, and Mr. Townsend has done it adequately.

With respect to the comments of Mr. Janeway, who immediately preceded me, Senator, I believe very strongly, particularly as a result of my 3 years service at the Securities and Exchange Commission, that the Congress is the place where national policy should be determined, especially with respect to economic affairs. The Congress is the elected representative of the people. The independent agencies, as qualified and capable as they are, do not have any constituency whatsoever, and they tend, because of their very structure, to view matters more in terms of legalisms than economic reality as related to national economic policy.

And I make that statement with great sadness, but it is based on my own experience. This is the place where national economic policy should be decided. This is the place where the structure of our securities market should be determined, and this is the place where the needs of our economy and the needs of our people should be determined—and in my mind, those two needs are interrelated very directly—and not by a group of people who do not have any constituencies.

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

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

Senator BENTSEN. Thank you very much, Mr. Needham.

Your statement is helpful. Some of the things that you have recommended are things we have considered, and they are certainly not without merit. In view of what we thought we could accomplish, we did not do some of those things.

You stated you do not support the limitations on holdings and neither do you oppose the holding limitations that are in my bill, as I understand your statement. I personally do not think these are very onerous restrictions. I would like to ask you whether you believe that there are more than 20 stocks on the New York Stock Exchange and the American Stock Exchange that would qualify for prudent institutional investing on the basis of earnings, on book value, on future growth, on liquidity, and on the float of the stock.

Do you think that there are more than 20?

Mr. NEEDHAM. Senator, there are hundreds.

Senator BENTSEN. And yet we were told yesterday by one of the very major institutions that if this kind of limitation were enacted they would invest in things other than the stock market just because of this kind of limitation.

Mr. NEEDHAM. Senator, let me respond to that solely as the chief executive officer of the exchange rather than the chairman of the board, and the board has not addressed this question in the detail you are posing it.

The very first public speech I gave as a member of the Securities and Exchange Commission, I called for an examination of the growth of financial concentration in the United States, and I gave it before a securities industry audience, because the long-range impact would be felt by the securities industry and the securities market. That speech was given in January of 1970.

It has taken almost 4 years for the awareness to develop to the point—I am a little bit like Mr. Janewry: I am a voice in the wilderness most of the time. But that idea has come, and so the idea that you are suggesting has come. Our inability to quantify it makes us hesitate, but I as an individual feel that the broader subject of financial concentration is one that demands and cries out for the attention of this body.

Financial institutions have expanded into various activities, seemingly unrelated in some instances to the major role they were designed to perform in our economy. The Bank Holding Company Act, which was enacted into law just a few years ago, I think calls out for reexamination. I think the question you are asking falls into that broad category.

Senator BENTSEN. Mr. Needham, these limitations that are in my bill were not casually arrived at. It took a great deal of study and debate and discussion before we arrived at these. We wanted limitations that would not be difficult to comply with but would stop those situations where someone might be imprudent as an institutional investor and wanted to go for broke with a stock.

Mr. NEEDHAM. Senator, let me just say that I am perfectly aware of the quality of work that has been done and of the caliber of your staff. I am not questioning the percents you have there.

You will forgive me, but we have limited resources at the New York Stock Exchange, and a major effort at the exchange in the last year is to stop the Congress from bringing a calamity upon the capital markets of this country.

Senator BENTSEN. Let me say that the subcommittee has released a survey of previously undisclosed information on the holdings of 21 major bank trust departments. I think that the results of this survey illustrate the importance of having a limitation such as this.

Mr. NEEDHAM. Senator, in all fairness to you, we will review your survey.

Senator BENTSEN. On your proposal for the deduction of capital losses, there is a concern there, frankly, of revenue loss. I am just trying to get a feel of what that would be, and that was a major problem.

Now, the other problem is, so far as going 25 percent up to $50,000, again, it was a mechanical problem in trying to work this out on a tax return, and that was one of the reasons for that. Perhaps there is a way we can improve that, because I recognize the merit of your statement in that regard on the small capital loss being at 25 percent rather than 35 percent.

Mr. NEEDHAM. I do not believe, Senator, that the views that I have just expressed on the intent and many of the specifics of the bill are that far apart that we could not support in the main the tax proposals in this legislation.

Senator BENTSEN. You recommended that commissions on stock transactions be treated as investment expenses and, thus, as a deduction against ordinary income. I wondered how that would motivate an investor?

Mr. NEEDHAM. It is a merchandising feature, Senator, quite frankly. With all the attention that commission rates have been given in the last few years, a lot of investors have been led to believe that they are excessive when, in fact, they are not. We just felt that this might be some way of easing their psychological problem.

Senator BENTSEN. Mr. Needham, I think neither you nor Mr. Janeway are voices in the wilderness on this particular issue. I think the question of where we are going to get the capital for the growth of this Nation and the creation of jobs is just as important an issue for a labor leader as a business leader and, frankly, for the consumers of this country.

We are in great competition around the world, with the other countries of the world, trying to accumulate capital. I believe we are in the same position today the problem of capital accumulation that we were 3 or 4 years ago when some of us were talking about an energy problem in this country and what we ought to be doing about it. And I get awfully tired of this country just reacting to crises and being controlled by the events rather than controlling the events. That is why I think it is terribly important the word "planning," even though it has fallen in some disrepute, be done ahead of time and that the appropriate legislation be passed in time.

Mr. NEEDHAM. Senator, I agree with you. At great personal risk in the last year, I have taken a position publicly on behalf of the Board of Directors or the New York Stock Exchange, and I feel very satisfied with having done that in retrospect, because of one factor. If, our views do not prevail in the Congress, then the Congress cannot come to our industry in 3 years and say, why do we have a capital-raising crisis?

We are speaking with the loudest voice we can. We are trying to document our positions. We are trying to take the ifs out of some of the people's theories. But we will not be, I am sure, in a position that the oil companies are in today where they had tried to bring these matters to the attention of appropriate officials of the Government, and now they are being accused, perhaps, of having been derelict in their responsibilities to the American people.

The securities industry is continuously aware of its responsibilities to the American people, and it is for that reason that we are raising our vocies above the crowd, so that 3 years from now the Congress cannot say to us, why did you not speak up and shout. We have spoken up, and we will continue to speak out.

Senator BENTSEN. Mr. Needham, I believe that a sliding capital gains tax will let the investor make an economic decision rather than just a tax decision and it would enable the investor to make the most efficient use of his capital.

I personally think that enactment of a graduated capital gains tax will increase revenues to the Treasury, because there will be that many more transactions. Do you have anything that would buttress that or deny that?

Mr. NEEDHAM. May I ask our chief economist, Dr. Freund, to respond to that? He has in front of him, I believe, the necessary data to do that.

I believe in our testimony we referred to $1.7 billion, but perhaps he can answer that more clearly than I.

Dr. FREUND. Mr. Chairman, we undertook a very extensive survey of shareholder attitudes and questioned investors as to how they would have acted in 1972 under a different set of tax rules, and this was done in March and April of 1973, when tax records were available to them, and their tax filing was still fresh in mind.

We submitted that study for the record. In our statement are some of the tax revenue impacts and the addition of capital gains which would be realized.

Now, at the time we undertook the survey, we did not have available to us the specific sliding scale which is incorporated in your bill, so that it was not possible to survey investors as to how they would have reacted to that specific proposal. Nonetheless, we know that a reduction in the maximum tax to 12½ percent for those who are now at the 25 percent level, and 25 percent for those who are now at 35 percent, which is as close as we came to measuring the fiscal impact of a sliding scale in the survey, shows that in the first year the added capital gains realizations would have increased $16½ billion, reaching a total for all investors of more than $49 billion, so it increases capital gains realizations.

The effect of those increased capital gains realizations—which is another way to say that gains would be unlocked—would have been to increase tax revenues to the Treasury by $1.7 billion.

Now, these figures are not a precise answer to the reaction of investors to the sliding scale you proposed, but I think they show very clearly the direction.

Mr. NEEDHAM. Senator, if I may—as you know, Dr. Freund is an economist, and my background is accounting. I think the thrust of your bill is designed to preserve the revenues of the Internal Revenue Service and the Treasury. And then, if the steps are not taken that this bill urges in the tax area, and that if American industry is not given the financial capability to expand its productive facilities, then the result of that would be a loss of revenues to the Treasury, because our economic growth will not be sustained.

I think one of the mistakes that is made by technicians is to argue on a specific point of whether or not it should be 25 or 35 percent and ignore the overall thrust of the legislation, which I feel I would not want to have happen to your proposal. The thrust of your legislation is excellent. It will take this country forward. It will generate at least the revenues that we are receiving now. Of course, there are other committees of the Senate and the House that know how to deal with the process of matching income and expenses of the U.S. Government, so I thing that is an important observation.

Senator BENTSEN. You say there are other committees that know how to deal with matching income and outgo?

Mr. NEEDHAM. With some degree of expertise.

Senator BENTSEN. Sometimes I do not think Congress even matches outgo and outgo. [General laughter]

Senator BENTSEN. I am hopeful that under the budget reform legislation, of which I am cosponsor, we will finally modernize that system, and we very much need to do it in the Congress.

Mr. Needham, I am very appreciative of your testimony and the contribution you have made for us.

Mr. NEEDHAM. Thank you, Senator. And if we can help you or your staff in any way, please feel free to call.

Senator BENTSEN. Thank you.

[Mr. Needham's proposed statement, with attachments, follows. Hearing continues on page 234.]

STATEMENT OF THE NEW YORK STOCK EXCHANGE, INC.

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

We appreciate the opportunity to express the views of the New York Stock Exchange on Senate Bill 2842, dealing with proposed restrictions on portfolio holdings by pension fund managers and investment tax incentives for individuals. We congratulate this Subcommittee for focusing on the closely related problems resulting from institutional dominance of the U.S. equities markets on the one hand and the disaffection of small investors on the other. We believe that action—by both Congress and the securities industry—is desirable if investor confidence in the fair and orderly operation of the securities markets is to be restored and maintained.

I should like to comment briefly on the portions of the Bill dealing with the pension fund limitations, but at greater length on the proposals for tax revision.

RESTRICTIONS ON INSTITUTIONAL HOLDINGS

Proposed restrictions on holdings by pension fund managers come at a time of growing concern over the financial power and investment practices of large institutional investors. That concern has been heightened by a decade-long decline in the relative importance of the individual investor. As a result, some have suggested that an effective means of restoring the individual's prominence in the equities market would be to reduce, or to limit in some way, institutional participation.

The New York Stock Exchange has not previously taken a formal position on restricting the investments of either all or a selected group of institutions. Instead, we have advocated that, rather than limiting the activity of institutional investors, congressional action and concern should be towards the direct stimulation of greater individual participation in the Nation's capital markets. Efforts in that direction would also serve to minimize institutional impacts.

Our position here today remains the same. We can neither support nor oppose legislation seeking to place limits on the investment of discretionary pension assets in single issues. Without an adequate and comprehensive data base, the task of quantitatively weighing the impact of proposed restrictions is virtually impossible.

In our testimony before this Subcommittee last summer, we urged the acceleration of efforts to enact legislation requiring the disclosure of institutional holdings and activity on a periodic basis.[1] Accordingly, the Board of Directors of the New York Stock Exchange resolved to support the objective of S. 2234 (Institutional Investors Full Disclosure Act) to require disclosure of information relating to large accumulations of securities. In so doing, the Board recommended revisions to S. 2234 which would:

1. prescribe specific criteria for determining what large transactions must be reported, to avoid imposing unnecessary burdens on organizations required to file reports;

2. preclude unnecessarily duplicative reporting where, for example, reports are filed with an exchange and made available to the SEC for their inspection and examination;

3. give the SEC adequate funds to administer the reporting requirements; and,

4. direct the SEC to report back to Congress—one year after the effective date of the legislation—on how the newly disclosed information is being used, along with an evaluation of its usefulness.

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[1] *Statement of the New York Stock Exchange, Inc. before the Financial Markets Subcommittee of the Senate Finance Committee, July 26, 1973, p. 13.*

Only through the disclosure of institutional holdings and transactions could a quantitative evaluation of proposals to restrict pension fund holdings be undertaken. Nevertheless, we have reviewed S. 2842 with respect to its restrictions on pension fund managers on a qualitative basis. I will briefly summarize the strengths and weaknesses of the proposed restrictions as our staff sees them and would like to offer a more detailed review for the hearing record, Mr. Chairman. It is entitled "Strengths and Weaknesses of Bentsen Bill Regarding Investment Restrictions on Pension Funds" (Appendix I).

The proposed Stockholders Investment Act has seven basic strengths with regard to its restrictions on institutional holdings.

1. The focus of the Bill is primarily towards bank trust departments where, according to limited published data, concentration in the largest NYSE issues exists to an unusual degree.

2. Precedent already exists to restrict investments by other types of institutional investors, particularly life insurance companies and mutual funds.

3. Greater diversity in investments should provide additional safety and liquidity for pension assets.

4. The psychological effect may prove beneficial—particularly for the individual investor, if he believes that institutions will be subject to greater control.

5. Market stability will be preserved by placing restrictions on new investments only, thereby avoiding an avalanche of sell orders in situations where the limits are exceeded at the time the legislation takes effect.

6. The possibility is increased that a greater number of companies will have access to capital necessary for expansion at reasonable cost.

7. The opportunity to broaden the ownership of a closely held company is enhanced by limiting to 10% the amount of its outstanding stock that can be held by a single institution.

Despite these strengths, examining the other side of the coin reveals more than an equal number of weaknesses in the proposed legislation.

1. The diversion of a significant amount of investable funds from highly capitalized issues to small and medium-sized companies seems unlikely. It has been suggested that restrictive legislation may actually encourage the investment of a greater amount of funds into other large companies, where room inside the limit will exist for new purchases.

2. The diversion of funds from equities to alternative types of investments, such as bonds and real estate, may be encouraged. The end result: an erosion of volume and market liquidity.

3. Additional cost burdens will be placed on pension managers to seek out alternative investments. Those costs ultimately fall on the fund's beneficiaries.

4. Concentration in the decision-making process will not be reduced by restricting the amount of assets which can be invested in a single issue.

5. Discriminatory practices between large and small accounts may be encouraged by imposing restrictions. In situations where limits in specific issues have already been exceeded, the pension manager will be precluded from making additional purchase in those securities when he accepts new and small accounts.

6. Investment limitations interfere with the free allocation of resources. Penalties are actually being imposed on the efficient, highly capitalized company at the expense of the small and, perhaps, less productive one.

7. Institutional control of small or medium-sized companies may be encouraged. Rather than each fund manager having to search out his own alternative investments, the same group of new companies is likely to become the target of all institutional portfolio managers.

8. Restrictions may prove a time and cost burden, because of the complex reporting and control system that will have to be established.

9. Only *discretionary* pension accounts are affected by the proposed limitations. Presumably, the perfunctory approval of equity purchases by a client would exempt his assets from the 5% and 10% limits.

Obviously, the list of strengths and weaknesses is long and counter-balancing. For example, proposed restrictions on the one hand seek to provide for the continuing availability of capital to all companies. On the other hand, restrictions may simply divert capital from one group of highly capitalized issues to another similar group, or quite possibly, out of equities altogether. The critical element involves a quantifying of those factors—a task that is presently impossible without detailed data on the composition of pension fund holdings. Whether investors who seemingly have the power to control or influence stock prices or trading activity need or need not be regulated is still open to debate. But at the least, fairness and public policy dictate that they should disclose to other investors what securities they hold and how they trade.

INVESTMENT TAX INCENTIVES

In any circumstance, the best counter to the problem of institutional investment concentration is a high level of individual investment activity. Regardless of how well structured—and, perhaps, even necessary—they may be, arbitrary restrictions on investment interfere with the normal forces of supply and demand. Artificially restraining them inevitably impairs the capital allocation process and lessens overall economic efficiency.

The capital gains tax provisions of S. 2842 recognize the imperative need for sharpening investment incentives and stimulating investment turnover. Although the NYSE commends the trust of the proposed tax package, some modifications in its provisions are necessary if its goals are to be fully realized. While in other times the tax provisions of S. 2842 would have represented a good start, the burgeoning need for capital requires that the major impediments to individual investment be removed *now*.

The outlook for meeting the existing and massive new demands for capital is not good under the best of circumstances. Demographic characteristics alone point to a drop in the saving rate. The rising tide of twenty and thirty-year olds—who, typically, are not large savers—is an immutable fact facing the U.S. economy. Positive investment incentives would help offset the impact of populations trends on capital generation and investment.

The NYSE is concerned—as is this Subcommittee—that in the fact of growing capital demands, the individual investor seems to be losing interest in equity investment. In part, at least, that undoubtedly reflects the higher investment tax burden imposed by the Revenue Act of 1969. Ironically, at a time of increasing pressure on our capital raising mechanism, the incentive to invest was cut back. Add to that the impact of inflation and other uncertainties on asset values, and the consequence on individual investor activity in the market is understandable.

As the Exchange has pointed out over the years, U.S. invesment tax incentives have been inadequate to meeting our capital needs. But with capital demands more modest than those now facing the economy, the impact of tax structure shortcomings on meeting capital requirements was less severe than in the current economic situation. A vivid example of the challenge facing the securities markets is the increasing shortfall between corporations' internally generated funds and their investment needs. Through the first half of the 1960's, retained earnings and depreciation were sufficient to cover close to 90% of non-residential fixed investment.[3] The ratio slipped below 80% in 1970 and is expected to continue to trend downward.

To meet the looming investment challenges from both the private and public sectors, sufficient reward must be held out to make investment risks worthwhile. Government is only doing half the job when it mandates spending by business for such social ends as pollution and safety control but does not help create the proper environment for financing them. Fortunately, S. 2842 recognizes the importance of increasing the stimulus to investment.

Comments on S. 2842 Capital Gains Tax Proposals

Though the NYSE applauds the intent of the Bill's capital gains tax proposals, we believe some of its provisions must be modified if it is to be effective in stimulating adequate amounts of investment.

The Bill's basic graduated capital gains plan—raising the capital gains exclusion rate to 80% over 15 years—gives adequate recognition to the longstanding problem of individuals being "locked" into assets over a long period of time. With modifications suggested below, it should go a long way toward enhancing capital mobility, a prerequisite for maximizing growth in a dynamic economy. Unlike other plans, which would raise the exclusion rate in infrequent but sharp steps—every five years, for example—lifting the exclusion rate two points each year should help minimize the tendency to remain locked-in as the holding period necessary to achieve a new, higher exclusion rate approaches.

Despite the merits of the basic exclusion rate plan, two aspects of the package are likely to diminish its effectiveness as a stimulus to new investment and investment turnover. First, repeal of the 25% alternative capital gains tax rate

[3] *Economic Indicators*, Council of Economic Advisers, December 1973, pp. 7 and 8.

would actually *increase* the effective tax on a substantial portion of capital gains. Second, an extension of the minimum capital gains holding period to 12 months would decrease asset turnover and gains realizations. These two changes would result in a net *loss* of revenue to the Federal Treasury and to those states and localities that use the Federal income tax as the basis for their own income taxes.

Repeal of Alternative Tax.—If the alternative tax is repealed, the first $50,000 of net long-term capital gains, now subject to the 25% limitations, could be taxed at rates as high as 35% under the proposed graduated exclusion rate plan. An individual investor in the top 70 percent bracket would have to wait seven years to receive the same tax treatment he now receives on the first $50,000 of gains after six months of holding. An investor in the 60% tax bracket would have to hold assets four years to match the rate he now receives after six months (see Table).

EFFECTIVE TOP CAPITAL GAINS TAX RATES ON FIRST $50,000 UNDER S. 2842

[In percent]

Holding period	Present maximum	Marginal tax rate bracket: 55	58	60	62	64	66	68	69	70
6 to 12 mo (after 1979)	25	55.0	58.0	60.0	62.0	64.0	66.0	68.0	69.0	70.0
1 to 2 yr	25	26.4	27.8	28.8	29.8	30.7	31.7	32.6	33.1	33.6
2 to 3 yr	25	25.3	26.7	27.6	28.5	29.4	30.4	31.3	31.7	32.2
3 to 4 yr	25		25.5	26.4	27.3	28.2	29.0	29.9	30.4	30.8
4 to 5 yr	25			25.2	26.0	26.9	27.7	28.6	29.0	29.4
5 to 6 yr	25					25.6	26.4	27.2	27.6	28.0
6 to 7 yr	25						25.1	25.8	26.2	26.6
7 to 8 yr	25									25.2

Thus, the intended impact of S. 2842 could be diluted by actually increasing the tendency to lock-in—at least in the early years of holding. This conclusion is supported by the results of a recent study of the impact of the capital gains tax on investor behavior.

The study, commissioned by the Exchange, was conducted by Oliver Quayle and Company, the well-known public opinion research firm. Personal interviews were conducted with investors in which their actual 1972 portfolios and investment decisions were reviewed.

The detailed questionnaire covered actual 1972 holdings and transactions and attempted to ascertain how investors' behavior would have been affected in 1972 under different tax provisions than were actually in force. Attention was concentrated on: changes in the maximum rate, changes in the holding period, and a sliding scale of rates and holding periods. Interviews were conducted in March and April 1973, when tax decisions were fresh in the respondents' minds and their tax records for 1972 were readily available.

Among the findings of the Quayle study was that the single largest contribution to capital gains realizations and Federal tax revenues would be a cutback in present maximum tax rates. For example, if the maximum capital gains tax rate were halved for taxpayers who are now subject to rates of up to 25%, and the maximum for individuals subject to higher rates were reduced to 25%, total capital gains realizations in 1972 would have been $10.0 billion higher and tax revenues would have been up almost $1.7 billion. That would have resulted in total capital gains of $40.2 billion and tax revenues of $5.0 billion. But data underlying the published results indicate the effect of cutting the maximum rate from 35% to 25% would, by itself, produce tax revenues of $1.8 billion, or almost one-third of the total. (A copy of the Quayle report is being submitted to the Subcommittee for the record as a separate exhibit.)

Holding Period Extension.—Lengthening the minimum holding period would not be in keeping with the goals of S. 2842, because it would adversely affect both investment turnover and tax revenue. According to the Quayle study, if the holding period had been one year rather than six months in 1972, capital gains realizations would have been lower by an estimated $2.0 billion and tax collections would have been down by more than $450 million.

In apparent recognition of the implications of a change in the holding period, S. 2842 provides for a gradual lengthening of the holding period over a six-year span. While that could mitigate some of the shorter-run adjustment problems, the fact is that the investment flexibility of individuals would be permanently eroded. In the real investment world, no investor makes a stock purchase with a preconceived notion of how long he will hold. His sales decision ultimately is influenced by a myriad of factors—his tax situation being just one. However, the difference between capital gains and regular income tax treatment could often be large enough to swing the decision against selling. To the extent that would occur under a one-year holding period—the Quayle study indicates that total capital realizations would drop 9%—it would run counter to the Bill's aim of achieving a better balance of stock trading between individuals and institutions.

Aside from the immediate effects on stocksales and tax revenues, doubling the holding period could have more far-reaching effects on individuals' willingness to invest. The stock market is simply too unpredictable to depend on perfect timing in order to garner the benefit of a reduced tax rate. For example, if in July 1972 an individual bought a stock that was typical of the NYSE industrials, he would have had an 8.3% gain six months later. If the trade had been postponed for long-term capital gains tax treatment after 12 months of holding, the individual would have seen the price of his stock continually erode. At the end of 12 months, his paper gain would have been transformed into a *net loss* of 5.5%.

The purpose of the holding period is well-defined—to keep those who make a living by stock trading from receiving the same tax treatment as investors. The Quayle study adds to the weight of earlier evidence that the six-month holding period is a suitable cut-off point. The study indicates that, if the holding period were reduced to three months, capital gains realizations would have increased modestly ($500 million).

To the extent that the lengthened holding period would lock in stockholders, it would work to the detriment of the liquidity of the nation's stock markets and be a odds with the intent of the graduated capital gains tax concept. The stock markets badly need more liquidity. Yet, the individual's relative participation in the market is steadily being eroded. Between 1952 and 1971, individual investors' share of NYSE public volume dwindled from nearly 70% to 40%. (In terms of value, individuals accounted for only 30% of 1971 public volume.) That was not primarily due to lower overall stock investment by individuals, but to relatively low turnover.

Individual stock turnover has remained fairly constant over the years while institutional turnover, often unrestrained by tax considerations, has soared. Over the past decade, institutional turnover rose from about twice to four times individual turnover. Restoring incentives to individual participation in trading is vital to the smooth functioning of the stock market. Any stretchout of the holding period could only further drain the wellspring of liquidity, the individual investor. To sum up, the individual must be given investment flexibility as well as an incentive to invest. By lengthening the holding period, S. 2842 limits the flexibility which the securities markets require.

Treatment of Net Capital Losses.—For over thirty years, the deduction for net capital losses has remained unchanged despite the ravages of inflation. S. 2842 represents a considerable advance toward the more realistic treatment of losses. The proposed 4,000 loss deduction, coupled with the three-year carrybacks, should substantially reduce the number of individuals with loss carryovers (the average post-1969 long-term capital loss carryover was $6,300 in 1971).[8] More adequate treatment of losses should also encourage individuals to liquidate poor investments. Together, these two factors should encourage both capital mobility and net new investment.

Though the loss proposal is a notable improvement over the current situation, the NYSE believes it is flawed in one key respect. It would tie the loss to the same sliding scale exclusion rates applying to gains.

Thus, if an investment were held for 15 years, the investor would be entitled to a capital loss deduction of only 20% of his actual loss. Despite appearances, to apply the same treatment to losses as to capital gains is simply not fair. To the individual, a loss is not less meaningful because it was incurred after a long period of holding. His individual financial position and well-being are at least as equally damaged if he incurred a loss after 15 weeks or 15 years. In fact, the longer period is in reality more damaging when the length of time that investment funds have been tied up is considered. An individual taking a

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[8] *Statistics of Income 1971, Individual Income Tax Returns*, Department of the Treasury, p. 20.

quick loss may, perhaps, soon recoup it by transferring his remaining capital to an alternative investment. By contrast, the individual who has held the losing investment for many years has foregone possible appreciation by not shifting.

Furthermore, with only as little as 20% of a loss deductible, the unfortunate investor may decide to continue to hold in hopes of regaining his investment through an ultimate price rebound. That could reinforce the lock-in of older investments on which losses have been incurred—to the detriment of capital mobility.

When he initially commits his capital, the investor ordinarily has no preconceived notion of precisely how long he will hold his investment. And most certainly, no investor invests to incur a loss. The NYSE simply sees no reason to submit the unfortunate investor to an additional tax penalty because he exercised wrong judgment in not liquidating a poor investment earlier. The Exchange recommends that all long-term losses be treated alike—*regardless of the time investments were held.*

Ideally all losses should be deducted in full, since the investor makes no real distinction between a short-term and a long-term loss. A loss is a loss, no matter how quickly or slowly it was incurred. In fact, given prescience, the investor would elect to take his loss as quickly as possible, tax considerations aside. As a stop-gap, S. 2842 should be modified at least to retain the present method for calculating the long-term loss deduction—50% of the total loss. More in keeping with the intent of S. 2842 would be a provision to raise the inclusion rate on eligible losses in steps to 100% by 1980.

Additional NYSE Recommendations

To help stimulate individual investment, the NYSE has drafted a comprehensive list of tax recommendations—some of which are covered in the preceding discussion. The entire program is as follows:

Allow a $1,000 capital gains tax exclusion when gains do not exceed 25% of earned income.

Reduce the highest long-term capital gains tax rate from 35% to 25%. The Quayle study found that this proposal would have the greatest impact on investor activity.

Provide for a sliding-scale system of long-term capital gains inclusion rate that would decline as the holding period lengthens.

Continue at six months the holding period required for capital gains to qualify for treatment as long-term gains.

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

Increase from $100 to $200 the dividend exclusion from Federal income taxes.

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

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

I shall only touch on aspects of this program not covered in my earlier discussion of the S. 2842 proposals.

$1,000 Capital Gains Tax Exclusion.—A $1,000 exclusion of capital gains from adjusted gross income could prove to be a major stimulus to individual investment without unduly affecting tax revenues. To help restrict eligibility for the exclusion to moderate income people, it could be linked to earned income. Thus, in its most restricted form, it might apply only to those individuals whose total gain did not exceed 25% of earned income. Possibly, the exclusion might be pro-rated, so that taxpayers whose gains exceed 25% of earned income might be eligible for a fraction of the $1,000 exclusion, depending on the ratio of gains to earned income. In any event, an arrangement of this type should increase the appeal of stock investment among people of moderate means, at only a minimal cost in Treasury revenue. Our estimate is for a loss in the range of $500 to $600 million. Over the longer-run, the net loss would probably be reduced, because many persons who would otherwise be inactive investors—or who would not have invested at all—would not limit their realized capital gains to precisely $1,000 per year.

Increase in Dividend Exclusion to $200.—An increase in the dividend exclusion from $100 to $200 would serve as a further step toward reducing the inequity of double taxation of corporate earnings. Moreover, in keeping with the intent of

S. 2842, it would encourage individuals to place more of their financial assets in stock investment. Coupled with the capital gains exclusion, it could help overcome the apparent reluctance of individuals to participate in equity investment, which has helped magnify the role of institutions in stock trading.

If for no other reason, the dividend exclusion should be raised to offset the inroads of inflation since 1965, when the $100 exclusion was adopted.

Deductibility of Stock Commissions as Investment Expenses.—Now, commissions paid on the purchases and sales of securities are not deductible. Rather, they are treated either as a part of the cost of securities purchased, or as a deduction from the proceeds received in calculating gains or losses on the sale of securities. The Exchange believes that security commissions should be treated as other non-trade and non-business expenses of investment are treated—as deductible items. Similar expenses now allowed as deductions are subscriptions to investment advisory services, investment counseling fees, and safe deposit box rental charges. Moreover, the treatment of commissions as a deductible investment expense is consistent with an overall program of encouraging greater capital investment by individuals.

$1,500 Deduction for Individuals' Personal Pension Plans.—Permitting a $1,500 tax deduction for individuals who buy stocks as part of a personal pension plan—provided they are not covered by adequate employer-sponsored plans—would parallel the treatment afforded self-employed persons under the Keogh Act.

The effect of this proposal would be to encourage a greater number of individuals to make equity investments. One study of the proposal concludes that older middle-income employees are "likely to be highly responsive to the proposed deduction for retirement saving and would receive significant benefits in terms of increased retirement incomes from it."[4]

BROKERAGE INDUSTRY STABILIZATION RESERVES

No matter how sound this Subcommittee's and the Exchange's proposals for stimulating investment and improving securities market liquidity may be, their effectiveness is limited by the ability of the securities industry adequately and efficiently to serve the investing public. As is well known, the industry is subject to periodic heavy financial buffetings because of the strongly cyclical nature of the securities business. Consequently, brokerage firms have been unable to attract adequate capital.

Particularly in recent years, capital insufficiency has sometimes affected the adequacy of service to the public. Typically, service problems stem from brokerage firms' inability to maintain reserve capacity. The ebbs and flows in capacity necessarily affect the quality of service. To alleviate this problem and to make investment in security brokerage firms more attractive, the securities industry requires sufficient capital reserves to help carry it over cyclical troughs without damaging industry capability.

Toward that end, the Exchange has developed a detailed plan for a stabilization reserve to help alleviate the effects of the securities industry's cyclical problems. The plan is discussed in detail in our Research Report, *Stabilization Reserves—A Route To Easing Cyclical Problems In the Securities Industry*, submitted as Appendix II. I do, however, want to touch on the report's highlights.

Beyond any doubt, brokerage firms perform important financial intermediary functions and, therefore, should be given the same tax treatment afforded other financial intermediaries. A detailed analysis of effective tax rates, however, shows that brokerage firms pay as much as twice the rate of banks and savings and loan associations. This is inconsistent with the historical precedents and intent of Congress, as detailed in our Research Report, in permitting other financial intermediaries to set aside pretax income as reserves against various business contingencies.

The more favorable tax treatment of financial institutions tends to distort the allocation of resources among financial intermediaries, resulting in a less efficient use of capital that is harmful not only to the securities industry but to the economy as a whole. Thus, the attractiveness of investing in brokerage firms, already low owing to the cyclical nature of the securities business, is further reduced by the present tax statutes. At the same time, the favored financial intermediaries obtaining capital at lower cost, are able to invest in relatively less promising projects. The efforts of this disparity in tax treatment are being intensified by the

[4] Ronald B. Gold, "Tax Deductions For Individual Retirement Saving," *National Tax Journal*, December 1972, p. 593.

growing competition among brokerage firms, banks and other financial institutions.

Distinct from considerations of tax equity is the urgent need to moderate the cyclical behavior of the securities industry. Combined, the 1969 and 1970 losses of deficit brokerage firms amounted to over $300 million, excluding losses of firms liquidated before the filing of year-end financial results. In the first nine months of 1973, the aggregate loss for *all* NYSE member firms was $210 million, which suggests an even greater total loss for deficit firms alone. Another indicator of the severity of recent downturns is the disappearance of more than 120 NYSE member firms in 1969-70 and 73 firms in 1973 alone.

A consequence of such extreme cyclical fluctuations is the real danger that the quality and depth of the vital intermediary services which brokerage firms provide are likely to erode. Clearly, the public interest requires a strengthening of the U.S. capital markets at a time of unprecedented capital needs. Therefore, constructive tax policy changes are called for to help stabilize the industry, by providing realistic incentives to set aside funds in good years, to be drawn upon in poor years. Such reserve funds would buttress the financial position of brokerage firms and instill confidence in individual investors.

Our Research Report on a reserve plan shows that the build-up of stabilization reserves by NYSE member firms would require several years, with the length of this period depending on business conditions in the industry. The Treasury's revenue loss during this build-up period is estimated at $216 million, with revenue losses thereafter being minimal. These modest public costs must be measured against the public benefits of stronger U.S. capital markets. Proposed legislative language incorporating a stabilization reserve plan into the Internal Revenue Code is presented in Appendix III.

CONCLUSION

Demands on the corporate securities markets, and the capital markets in general, will continue to intensify in the foreseeable future. The need to finance industrial modernization and expansion, to meet housing requirements, to reconcile the conflicting demands for a cleaner environment and an adequate energy supply, and to finance a host of other private and public undertakings, will strain this country's capital raising ability.

While capital demand will be accelerating, demographic characteristics point to a drop in the saving rate. Steps must be taken *now* to offset the unfavorable impact of population trends on capital generation and investment. That could be accomplished by stimulating individuals' incentive to invest, encouraging capital mobility, and improving the liquidity of the securities markets.

To maximize the effectiveness of tax and other incentives to invest, the nation's investment machinery must be operating at optimum levels. In the past, the securities industry's cyclical problems have hindered its smooth functioning and played havoc with long-range planning efforts.

The Exchange has presented a comprehensive program to deal with the interlocking securities market problems of individual investment incentives and maintaining a high level of efficiency among securities brokerage firms. Together with the proposals of this Subcommittee, they set the stage for meeting the heavy capital demands facing the United States.

APPENDIX I

NEW YORK STOCK EXCHANGE RESEARCH REPORT ON STRENGTHS AND WEAKNESSES OF BENTSEN BILL REGARDING INVESTMENT RESTRICTIONS ON PENSION FUNDS

INTRODUCTION

On December 20, 1973, Senator Lloyd M. Bentsen introduced S. 2842, the Stockholders Investment Act of 1973. Among its provisions, that Bill would limit the investment activities of pension funds. This report examines the strengths and weaknesses of the proposed legislation *with respect to its restrictions on institutional investors only.*

Under the provisions of S. 2842[1] tax-exempt pension funds would be required to be placed in the hands of a pension manager, either outside management like a bank trust department or "in-house" management, that complied with limi-

[1] Reference to S. 2842 throughout this report only refer to its provisions restricting holdings of institutional investors. The Bentsen proposal would also revise the capital gains tax to provide tax incentives for individuals to invest in equities.

tations on the amount of shares of any one company that could be acquired. These limitations apply only to pension funds and to the securities of those companies with capital over $25 million. They prohibit pension fund managers from:

1. Investing more than 5% of the pension fund assets they control on a discretionary basis in any one security (common stock, security convertible into common stock or any other class of stock entitling its owners to vote); and from
2. Purchasing more than 10% of the outstanding security of one company.

In other words, a pension fund manager having control of $2 billion worth of discretionary assets in pension accounts could place up to $100 million (5%) in any single issue—only if that investment represented no more than a 10% interest in the specific company. The manager of that pension fund however, could invest his $100 million maximum in only 180 common issues listed on the NYSE at year-end 1973, since such an investment would represent more than a 10% interest in the remaining 1400 NYSE common stocks.

Penalties for noncompliance are very severe. If the manager of a tax-exempt pension fund exceeds the limitations, a penalty tax equal to 5% of the excess holdings would be imposed by the Internal Revenue Service. Then, failing to dispose of the excess within 180 days, the penalty tax would be 100% of the excess. The Bentsen proposal also contains a "grandfather clause," so that its limitations would not apply retroactively.

With respect to its restrictions on institutional holdings, S. 2842 has seven basic strengths. These are:

1. The focus or direction of the Bill, to reduce concentration in bank trust department holdings of the largest NYSE-listed common stocks.
2. The precedent that already exists for restricting institutional investments.
3. The intent to provide greater safety for pension assets by encouraging diversification.
4. The psychological impact on both individual and institutional investors.
5. The preservation of market stability, while at the same time restricting institutional holdings in single issues.
6. The possibility that a greater number of companies would have access to capital necessary for expansion.
7. The opportunity to broaden ownership of a closely-held company.

On the other hand, the legislation proposed by Senator Bentsen has a number of drawbacks which raise some doubt about its ability to meet the stated objectives. Those are (a) providing for the continuing availability of capital for economic growth and the creation of new jobs, and (b) providing for greater competitiveness in the economy. The weaknesses of the legislation are:

1. The diversion of investable funds from highly capitalized issues to small and medium-sized companies is unlikely. Investment of a greater amount of funds into the large companies, where room inside the limit will often exist, may actually be encouraged.
2. The diversion of funds from equities to other types of investments, such as bonds and real estate, may be encouraged.
3. Burdens are placed on small and large pension fund managers, which will ultimately fall on the beneficiaries.
4. The decision-making process will remain concentrated.
5. Limitations may encourage discriminatory practices between large and small accounts.
6. Limitations interfere with the efficient allocation of resources.
7. Institutional control of small or medium-sized companies may be encouraged.
8. A complex reporting and control system will have to be established.
9. Only discretionary accounts are affected by the holdings' limitations.

STRENGTHS OF S. 2842 REGARDING LIMITATIONS ON INSTITUTIONAL HOLDINGS

1. *Reduced Concentration*

S. 2842 directs itself to the assets of pension funds, a large proportion of which are administered by the powerful bank trust departments. In so doing, the legislation focuses on that group of institutional investors believed to concentrate their holdings in the largest NYSE-listed issues.

The power of the bank trust departments has been well documented. Figures released by the Federal Deposit Insurance Corporation show that all insured commercial banks controlled nearly $404 billion worth of trust assets at year-end 1972, almost two-fifths of which were represented by employee benefit plans. [2]

The phenomenon of the so-called "two-tier" market—in the words of one leading business magazine, "a few high flyers and a lot of duds" [3]—has been attributed to the concentration practices of *all* financial institutions. Whether this commentary is true of all institutions is debatable, but figures released by several leading bank trust departments suggest that those institutions do concentrate their holdings.

Merely to establish that institutions hold significant portions of their portfolios in the same small number of stocks does not necessarily mean that they are overly concentrated in those issues. One should expect stocks of the largest companies to appear both with the greatest frequency and with the greatest concentration in many portfolios—institutional and individual alike. What is not known is the extent to which undue concentration prevails among all bank trust departments or other pension fund managers.

2. *Precedent*

Various types of investing institutions have operated for years under a variety of statutory restrictions on their investment policies with respect to single-issue holdings.

State or Federal restrictions on either the percentage of an outstanding issue that can be held by any one entity or the amount of assets that can be invested in any one security exist for life insurance companies, state and local retirement and pension systems, investment companies and non-profit foundations. In addition, some institutions probably apply self-imposed limits on behalf of accounts under management.

Statutes in almost every state impose limitations on the investments of insurance company assets. Although the rules and percentages vary from state to state, New York State, for example, restricts insurance companies from holding more than 5 percent of the outstanding stock of a company or from investing more than 1 percent of the insurance company's assets in one stock (separate accounts are permitted to hold up to 5 percent of the assets in those accounts in a single issue). Limitations on insured retirement and pension systems are even more restrictive—a maximum of 1 percent of assets in any single issue and 2 percent of the outstanding stock of any of one company. [4]

Under Federal law, diversified mutual funds are restricted from holding more than 10 percent of the outstanding shares of any company or from investing more than 5 percent of the assets of the mutual fund in one security. This limitation, hwever, applies only to 75 percent of the assets in a mutual fund. [5] The 1969 Tax Reform Act also subjected non-profit foundations to restrictions, placing a 20 percent–35 percent limitation on the ownership of any one company. [6]

Thus, despite a number of restrictions placed on the assets of other major types of institutional investors, no such limits currently apply to the discretionary assets of pension funds. Precedent exists, at least for consideration, of controls on the investment of those assets.

3. *Safety of Pension Assets*

The concentration of investment funds in a small number of stocks raises doubts about the safety of pension assets. Ordinarily, investment ceretainty is taken for granted when high-quality stocks are purchased. In excessive quantities, however, even those securities become quite risky and illiquid. A major decline in the price of only a few "high-quality" issues can substantially reduce the value of pension assets. Accordingly, limiting institutional holdings in individual issues reduces the exposure of pension holdings to the fate of one or several corporations. From the viewpoint of the companies, the proposal is also beneficial in that a company's equity is less vulnerable to the investment strategy of a single institution.

4. *Psychological Benefits*

One of the major benefits of legislation restricting institutional holdings may be the psychological impact on the individual investor. That is, a restoration

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[2] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, *Trust Assets of Insured Commercial Banks—1972*, p. 5.

[3] "Bank Stocks Take a Licking," *Business Week*, September 15, 1973, p. 156.

[4] *McKinney's Consolidated Laws of New York*, Book 27, West Publishing Co., St. Paul, Section 81–13(b).

[5] *Congressional Record—Senate*, S23523, December 20, 1973.

[6] *Tax Reform Act of 1969*, House Report No. 91–413 (Part 1), pp. 27–28.

of confidence in the equities market, knowing that the "big guy" will be subjct to some control. Perhaps, too, the pension fund manager will seek to establish a more diversified investment policy, knowing that he is promoting the public interest. To the extent that legislation creates a national sense of awareness of the need to diversify holdings, the public may be more inclined to support its objectives.

5. Stock Market Stability

The inclusion of a grandfather clause should help preserve the stability of the stock market. If not for such a provision, pension fund managers would be forced to dispose of their excess holdings created prior to this legislation, placing tremendous selling or downward pressure on the market.

Moreover, smaller holdings in individual issues would tend to benefit the auction market's pricing mechanisms, all things equal. Generally, the liquidation of 10 percent of the shares of any one company, or 5 percent of the discretionary pension assets of any single institution, would tend to be less disruptive than sell orders involving higher percentages. Also, the potential liquidation value of pension holdings is likely to better reflect the prices used for valuation.

6. Greater Capital to Smaller Companies

Assuming noninsured pension assets continue to grow at their 1968-1972 rate of nearly 18 percent or almost $15 billion per year, and common stocks provide a superior return to fixed-income securities,[7] then a greater number of pension funds are likely to reach the upper limits of what they can buy in their favorite issues. If the relative percentage invested in equities is to be maintained by pension fund managers, investments will have to be made in issues which have not reached their upper limits or that have not been previously purchased. Either way, the benefits will accrue to the companies that otherwise would not be considered for investment. This enhances the possibility of a greater number of companies obtaining the capital necessary for expansion at reasonable cost.

7. Broadened Ownership of Closely-Held Corporations

The portion of any class of security held by management for control purposes is, in reality, not part of the floating supply. That is, the stock is not available to the auction market in response to price movements in that security. Without a holdings limitation, a company could seek to have the bulk of its publicity available stock purchased by a few institutional investors. Limitations of 5 percent and 10 percent should prevent such types of ownerships from developing.

WEAKNESSES OF S. 2842 REGARDING LIMITATIONS ON INSTITUTIONAL HOLDINGS

1. Unlikely Diversion of Investable Funds to Small and Medium-Sized Companies

The ability of the Bentsen proposal to encourage the movement of investable funds from the institutional favorites to the small or medium-sized company is dubious. An investment manager seeking to hold stocks of the large companies will easily be able to do so. For example, if a fund manager already has 5 percent of his discretionary pension assets invested in Corp. A, he will have reached his limits for that issue and will not be able to place additional funds in that company. Nothing, however, prevents him from placing those additional funds in Corp. B, in which he may have only 3 percent of his assets invested. In other words, restrictions on holdings may simply encourage a redistribution of funds from one group of select issues to the other highly capitalized issues. The probability of such a redistribution has already been suggested by a prominent official of Morgan Guaranty, stating that "if a limitation were put on the percentage of a company's stock a bank trustee may hold . . . the effect would be to discourge investment in smaller companies and cause a greater proportion of funds to go into stocks of the largest companies, where there usually would be plenty of room inside the limit."[8]

The Bentsen legislation offers no real incentive to incur the costs of research for (a) the initial investment in a small company and (b) the necessary follow-up to that investment. An investment manager who had 25 percent of his pension assets in five large issues—distributed any way he decided—could still have the same five issues, but simply redistributed due to the new restrictions.

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[7] For a description of the arguments for stocks outperforming bonds between now and 1975 and thereafter, see: Clarence V. Lee, Jr., "Stocks vs. Bonds for Long-Term Investment," *Trusts & Estates*, January 1974, pp. 18–21.

[8] Samuel R. Callaway, "The Two-Tier Market Reexamined," *Wall Street Journal*, September 28, 1973, p. 10. Mr. Callaway is Executive Vice President of Morgan Guaranty Trust Co. and head of its Trust & Investment Division.

HYPOTHETICAL DISTRIBUTION OF INVESTMENT FUNDS BEFORE AND AFTER S. 2842

[In percent]

Issue	Before	After
IBM	8	5
A.T. & T	2	5
Eastman Kodak	4	5
General Motors	3	5
Exxon	8	5
Percent of assets invested in 5 large NYSE issues	25	25

2. *Diversion of Investment Funds from Equity Securities*

An implicit assumption of S. 2842 is that pension fund managers will focus on investing funds in the small and medium-sized company, if prevented from purchasing shares in a company where the 5% or 10% limits have been reached. Restricted from investing in the equity issue of his choice, the pension fund manager may seek other forms of investment, such as bonds and real estate. The end result might be a loss of stock colume, a reduction in commission income and an impairment in overall stock market liquidity. Small and medium-sized companies would remain "capital hungry."

3. *Cost Burden on Pension Fund Managers*

Restrictions on holdings place additional burdens on the managers of small and large discretionary pension trusts which ultimately fall on the investing public.

The small pension fund manager may have neither the staff nor the budget to do the research necessary to diversify his investments. The research costs required to search out optional equity investments, especially in companies with smaller capitalizations, might be prohibitive. The cost for conducting research and analysis needed to make the investment, and the cost to follow the investment properly, once it is initiated, might discourage some institutions—big and small—from seeking out and participating in young companies with future growth potential.

For the large pension fund manager, commission costs are likely to be higher. Commission charges per 100 shares tend to be lower as the average size of an order increases. Therefore, to the extent that restrictions on holdings reduce the size of an order, commission costs will be higher. An increase of ½% per year in costs for a $1 billion pension fund will reduce the value of that portfolio by $5 million.

Ultimately, the higher costs to the pension fund manager will be borne by the fund's beneficiaries.

4. *No Effect on Concentrated Decision-Making*

In discussing the disturbing trends in the securities markets, Senator Bentsen has noted that "the eight-man investment committee of the largest bank trust department—these eight men alone—manage $21 billion worth of securities."[9] S. 2842 does not alter the *concentration* of decision-making in bank trust departments, so long as investments do not exceed the 5% and 10% limits. After enactment of S. 2842, those same eight men can still manage $21 billion worth of securities.

5. *Encouragement of Discriminatory Procedures*

Faced with restrictions on holdings, some pension fund managers may be unable to treat all accounts equally. Once stock acquisitions establish an upper limit in certain securities, no further purchases of those securities could be made. This would preclude investments in such stocks for new customers when single-issue limits have already been exceeded. Moreover, introducing limitations on portfolio holdings may encourage pension fund managers to favor their large accounts over the smaller, less profitable accounts.

6. *Interference with Efficient Allocation of Resources*

Artificial restrictions interfere with the normal supply and demand forces in the marketplace, by preventing an investor from placing funds in the security of his choice. The motivating force behind the purchase or sale of a specific security

[9] Lloyd M. Bentsen, "New Securities Legislation Will Be Proposed," *Investment Dealers' Digest,* December 26, 1978, p. 67.

should be the achievement of maximum investment return, not the amount that is already in an investor's portfolio.

An efficient capital allocation process facilitates the flow of funds to economically productive companies and withholds funds from industries that are less productive. Holdings' restrictions, however, place a penalty on the efficient, highly-capitalized companies—many of which have been the subject of institutional attention. By reducing demand for such issues, the liquidity of holdings of millions of individuals who concentrate in the very same securities as institutions will be impaired.

7. *Institutional Control of Small or Medium-Sized Companies*

So long as pension fund managers feel obliged to match at least average performance, the same group of small or medium-sized companies will probably become the target of all investment managers. Rather than each fund manager having to search out his own new investments, a new "tier," consisting of alternative securities will begin to develop. And since as much as 10% of the outstanding stock of each of these companies may be held by one manager, institutional dominance of that new group appears almost certain. Thus, individuals' participation in the new, growing, small or medium-sized company will be further discouraged.

8. *Need for Complex Reporting and Control System*

A complex reporting and control system will have to be set up to guarantee enforcement of S. 2842. Such a reporting system will have to establish, for example, the holdings of all discretionary assets by pension fund managers. It will have to monitor whether increases over the 5% limitation are due to market value changes, the acquisition of new discretionary accounts or simply noncompliance with the law. In the absence of such a system—adequately funded—any reporting process would be both ineffective and an unnecessary burden on the institutions involved.

9. *Effect on Oly Discretionary Accounts*

S. 2842 applies only to pension assets over which the pension fund managers have *discretionary* investment authority. Advocates of restricting institutional holdings will object to this inherent loophole. The perfunctory approval of equity purchases by a client would apparently exempt his assets from the 5% and 10% limits. Since accounts established on a partial-discretionary basis are not subject to the proposed restrictions, enactment of S. 2842 could create a trend in that direction.

CONCLUSION

Proposed restrictions on holdings come at a time of growing concern over the financial power and investment practices of large institutional investors. That concern has been heightened by a long-run decline in the role of the individual investor.

Clearly, any type of restriction prevents the free allocation of resources which channels capital to the most efficient industries and withholds it from those that are the least productive. In addition, considerable doubt exists as to the ability of restrictions on holdings to help attain some of Senator Bentsen's objectives, e.g., the diversion of capital to new and growing companies.

Unfortunately, no comprehensive data on the composition of pension fund portfolios are available. Without such data, it is virtually impossible to ascertain the immediate or future impact of S. 2842 on the holdings and activities of those funds. A critical first step would seem to be the enactment of legislation requiring greater institutional disclosure.

APPENDIX II

NEW YORK STOCK EXCHANGE RESEARCH REPORT: STABILIZATION RESERVES—A ROUTE TO EASING CYCLICAL PROBLEMS IN THE SECURITIES INDUSTRY

INTRODUCTION AND SUMMARY

A basic precept of good tax policy is that taxpayers who are similarly situated should be accorded similar treatment. This paper examines the argument that securities brokerage firms perform important financial intermediary functions and should, therefore, be accorded similar tax treatment granted to other financial intermediaries.

This argument is bolstered by a number of important related factors, such as the high degree to which stock trading has become institutionalized and the widely recognized need to strengthen the U.S. capital markets.

Distinct from considerations of tax equity and growing competition among various financial institutions is the urgent need to moderate the extreme cycles to which the securities industry has been subject. The efficiency of the U.S. capital markets depends substantially on the intermediary services offered by brokerage firms. It is, therefore, clearly in the public interest to strengthen firms' ability to offer those services in a healthy competitive climate.

A comparison of effective tax rates shows that brokerage firms presently are taxed as much as twice the rate on banks and savings and loan associations—and this is clearly inconsistent with the historical precedents and the intent of Congress in permitting other financial intermediaries to set aside pretax income as reserves against various business contingencies.

While brokers' underwriting activities, margin loans, and trading activities related to market-making are clearly important intermediary functions which can be easily impaired by cyclical downturns, there is no provision under current tax policy to permit brokerage firms to establish reserves against this seriously destabilizing process.

All of these factors combine to point to the need for revising tax policy to extend the concept of reserves to the securities industry. Substantial public benefits can be derived from strengthening the U.S. capital markets at a time when the needs for long-term financing are unprecedented.

To realize these important objectives, stabilization reserves should represent 5% of a base composed of margin loans and underwriting positions, and market-making trading positions. This level of reserves, which for 1972 would have totaled $502 million, flows directly from the need to strengthen the securities industry's capital and the size and character of its recent losses.

BACKGROUND ON TAX TREATMENT OF FINANCIAL INTERMEDIARIES

The favorable tax treatment extended to financial intermediaries stems from the widely held belief that the process of intermediation is an important element in fostering real growth and investment in our national economy.[1] This process centers on the ability to mobilize funds by offering various types of claims to the public; the reduction in the riskiness of such claims via the diversification of large asset portfolios; and the efficient processing of claims and assets, based on economies of scale.

The most visible form of preferential tax treatment is loss reserves—or funds which are set aside from pre-tax income and accumulated in reserve accounts. The levels which these accounts may reach in relation to certain loans or deposits are generally limited by statutory ratios. Ostensibly, the purpose of these reserves is to serve as protection against losses from loans or other types of investments. Actual losses, however, are insignificant in relation to loss reserves which, in fact, serve a far more important purpose. Banks, for example, view them as an extension of their capital base and as insurance against the impact of "local" and cyclical downturns.[2] Savings and loan associations (SLAs), on the other hand, apparently look upon loss reserves as simply an incentive for engaging in a specialized and risk-oriented type of business.[3] These arguments were clearly summarized some time ago by Professor Harry G. Guthman, who asserted that such non-taxed retained earnings should serve as "shock absorbers" for losses. He further stressed that reserves should be related to the riskiness of portfolios, which, in turn, should be the basis for taxing all financial intermediaries.[4]

Historical Background

The history of the taxation of financial institutions suggest a clear Congressional intent to extend favorable treatment to them.[5] Examples involving the origins of the preferential treatment of banks and SLAs illustrate the development of its rationale.

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[1] For further discussion and background, see R. W. Goldsmith's study prepared for the SEC's *Institutional Investor Study Report*, Supplementary Volume 1.

[2] See *The Adequacy of Bad Debt Reserves for Banks, A Preliminary Study*, Carter H. Golembe Associates, Inc., Washington, D.C., 1972, pp. 13–18.

[3] John Valentini, "Taxation of Savings and Loans", *Federal Home Loan Bank Board Journal*, December 1972, p. 17.

[4] "Prospects for Financial Institutions . . . as seen by the Commission on Money and Credit" *Harvard Business Review*, March–April 1962, p. 164.

[5] *Tax Reform Studies and Proposals*, U.S. Treasury Department, February 5, 1969, Part 3, pp. 466–467.

Commercial Banks.—The precedent for allowing banks generous loss reserves that are unrelated to acutal losses is rooted in a long-standing government policy to permit them to build up capital funds. Beginning in 1954, concern grew in the banking community over the falling ratio of capital funds to assets (exclusive of cash and U.S. government securities) which, presumably, made loan portfolios riskier. But given the prevailing high tax rates and the likely detrimental effects of adding to the capital base by increasing retained earnings (and reducing dividends in an industry then considered a kind of regulated utility), the idea of permitting larger loss reserves as a means of increasing capital funds began to gain acceptance. A 1947 Internal Revenue Service ruling thus allowed banks to maintain loss reserves at a level three times the average annual ratio of losses to loans during any previous consecutive 20-year period. Since the banks were thus able to include the heavy-loss period of the 1930's in their calculations, this ruling amounted to a sizeable tax subsidy.[6]

Savings and Loan Associations.—The early history of the tax treatment of SLAs also reflects the idea of using tax policy to encourage financial intermediaries to accumulate a strong capital base. Until 1951, SLAs paid no federal taxes at all, while between 1952 and 1958 they were taxed at an average rate estimated at 0.4%.[7]

Subsequent revisions of the Federal tax code were aimed at equalizing the tax treatment of financial institutions along less generous lines, without, however, altering the underlying principle of special consideration for intermediary activities. This philosophy continued to be reflected in the 1969 Tax Reform Act where the impact on financial institutions was largely restricted to further equalizing their tax burdens in light of the competition among institutions for savings funds and in lending activities.[8]

Tax Burdens of Financial Institutions and Brokerage Firms

Against this background, it is instructive to compare the effective tax rates since the mid-1960's on three important financial intermediaries and the securities industry (Tables 1 and 2). The basis for these inter-industry comparisons is a widely accepted U.S. Treasury definition of an income base designated as "economic income". That definition adjusts reported income to derive the sum of explicit receipts less explicit expenses (including payments to depositors of mutual institutions). Specifically, the income base is taken as the sum of the following items: taxable income reported to the IRS; tax-exempt interest received; loss reserve deductions in excess of recorded losses; and loss carry-overs used in the current year. Implicit tax payments and subsidies and tax deferrals are ignored.[9] The effective tax rate is calculated simply by dividing recorded income tax payments by economic income.

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[6] *Private Financial Institutions*, published by the Commission on Money and Credit, Prentice-Hall, Inc., Englewood Cliffs, N.J., 1963, pp. 390–395.

[7] *Private Financial Institutions*, pp. 401–406.

[8] *Tax Reform Studies and Proposals*, pp. 458–459. It should be noted that the 1969 Act provides for the gradual elimination of the preference feature from loss reserves for commercial banks by 1987. However, the Carter H. Golembe study (footnote 2) suggests that the banking industry is working to modify that provision. In addition, Kane (p. 11 of his paper cited in footnote 9) indicates that, due to the diversified nature of their business, banks have available other tax preferences so that a phasing out of the loss reserve preference would have little impact on their effective tax burden.

[9] Edward J. Kane, *Federal Income Tax Burdens of Commercial Banks and Savings and Loan Associations: A Study in Legislative Relations*, 1972, p. 6. (Kane is Everett D. Reese Professor of Banking and Monetary Economics, The Ohio State University.)

TABLE 1.—FINANCIAL INSTITUTIONS' INCOME TAX AS A PERCENT OF ECONOMIC INCOME, 1965-71

Year	Source	Commercial banks [1]	Mutual savings banks [2]	Savings and loan associations [1]
1965	SOI [3]	23.0	3.3	15.2
1966	SOI [3]	23.0	6.1	16.9
1967	FDIC [4] and FHLBB [5]	22.0	3.4	13.2
1968	Kane	21.5	5.6	15.8
1969	do	19.0	4.7	17.0
1970	do	23.0	([6])	21.0
1971	do	19.0	([6])	21.0

[1] Data for 1965 to 1967 are from Treasury study cited in ([2]). The 1968-71 tax ratios were calculated by Edward J. Kane
[2] "Tax Reform Studies and Proposals," pt. 3, U.S. Treasury Department, Feb. 5, 1959, p. 460.
[3] Statistics of Income—Internal Revenue Service.
[4] Federal Deposit Insurance Corp.
[5] Federal Home Loan Bank Board.
[6] Not available.

Data on effective tax rates (Table 1) suggest that the 1969 Tax Reform Act established approximate tax equality between banks and savings and loan associations at about a rate of 20% in relation to economic income, in accordance with the apparent intent of Congress. (Mutual savings banks apparently continue to receive relatively more favorable treatment, although recent data to demonstrate that is lacking.)

The disparity between the tax burdens of brokerage firms and other financial intermediaries is eye-opening. In recent years, brokerage firms have been taxed, on average, at a rate more than twice that of banks and savings and loan associations.

TABLE 2.—BROKERAGE INDUSTRY INCOME TAX AS A PERCENT OF ECONOMIC INCOME, 1965-71

	12-firm sample [1]	Industry aggregate [2]
Year:		
1965	NA	40.9
1966	NA	43.2
1967	48.1	42.3
1968	50.5	47.8
1969	46.7	46.1
1970	45.5	NA
1971	45.6	NA

[1] The sample firms are Bache, Dean Witter, Paine Webber, Merril Lynch, Reynolds, Donaldson Lufkin, First Boston, First of Michigan, Jas. H. Oliphant, A. G. Edwards, Hayden Stone, and Dain Kalman & Quail. Dean Witter data were not available for 1967 and 1968.
[2] This "Statistics of Income" classification includes all broker/dealers other than pure commodity firms. Between 1965 and 1969, the total number of firms in this group varied from 2,251 to 3,348. Tax rates were computed using the tax liability before investment credit and foreign tax credits in the numerator; and gross taxable receipts and ordinary income less ordinary business expenses in the denominator.
NA—Not available.

The 12-firm NYSE sample is a representative cross-section of institutional, retail and regional members firms. These firms were chosen because consistent financial data on their operating results were readily available from prospectuses and SEC 10K forms. The base need in computing their aggregate tax ratios is consistent with the U.S. Treasury's definition of economic income.

As a test for the presence of bias in the sample results, Federal tax percentages were calculated for all corporate broker/dealers, and it was concluded that the sample figures are a fair measure of the size of the average tax burden of brokerage firms.

The conclusion that broker/dealers are taxed inequitably, compared with banks, SLAs and other financial institutions, must be tested on the basis of whether brokerage firms perform intermediary functions similar to those of financial institutions.

BROKER/DEALERS AS FINANCIAL INTERMEDIARIES

In analyzing the intermediary role of broker/dealers, it is necessary at the outset to determine whether their underwriting and principal trading activities conform with the essential characteristics of financial intermediation.

Most important, a financial intermediary brings together suppliers and users of capital via brokerage mechanisms and contractual arrangements that satisfy the needs of both. The centralization of financial marketing permits the pooling of funds to provide liquidity to lenders and cost efficiencies to borrowers. In These characteristics are readily apparent in underwriting, trading, margin loans, and probably, in certain other activities of brokerage firms. Because of their relative importance, the analysis is restricted to underwriting and trading, where the firm is trading as principal in an issue as market-maker or positioning stock as part of a transaction.

As underwriters, broker/dealers raise capital for borrowers and equity issuers while simultaneously providing liquidity to lenders in the form of marketable instruments. On the one hand, the underwriter provides users of capital with funds—efficiently and at a reasonable cost. On the other hand, the underwriter's reputation, after-market trading activity and wide distribution of financial claims significantly reduce investors market risks.

In 1972 alone, underwriters raised some $42 billion in capital funds—about one-third of total U.S. business investment for the year. And, underwriting activities will loom still larger as the U.S. capital markets are called upon to raise many billions of dollars in new investment funds needed to develop new energy sources and pollution-control equipment, to expand tight manufacturing capacity, and for other new technologies. Obviously, the securities industry will be called upon to expand its historically pivotal intermediary role between investors and new, innovative corporations and industries.

The trading activity of broker/dealers acting as principals in securities plays a vital role in helping to maintain orderly securities markets. In their intermediary functions as market-makers and block-positioners, broker/dealers take positions at risk, thereby supplying liquidity to lenders and investors. Their willingness to hold positions for subsequent distribution serves to smooth the price movements of securities and enables investors to realize actual savings and offers potential savings to capital users.

The economic significance of trading and market making is self-evident if the preservation of strong U.S. capital markets is considered to be in the public interest. The steady institutionalization of the securities markets, highlighted by the fact that institutions now account for approximately 70% of the dollar value of public volume traded on the New York Stock Exchange, underscores the importance of the broker/dealers' intermediary trading function. Huge concentrated institutional portfolio holdings have resulted in the dependence of portfolio managers on market-makers and block-positioners for asset liquidity. Another significant development is the increase in foreign holdings of U.S. securities and rising foreign participation in U.S. markets.[10] To encourage such foreign participation by strengthening U.S. capital markets would seem desirable, especially in view of the large dollar balances currently held abroad.

Certain existing regulations recognize the economic importance of the broker/dealer's intermediary functions. For example, block positioners, specialists and other market-makers are specifically exempted from the Federal Reserve Board's Regulation U, which regulates the extension of bank credit for the purchase of securities. Similarly, New York Stock Exchange rules which prohibit potentially manipulative trading exempt trading activities that contribute to the orderly maintenance of the market.

IMPLICATIONS OF SECURITIES INDUSTRY CYCLICALITY

As noted earlier, the preferential tax treatment of financial intermediaries stems from Congressional concern for their stability. To date, however, that concern has tended to overlook the problems of stability, risk and capital-raising ability inherent in the cyclical nature of the securities business.

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[10] *Recommendations Regarding Foreign Access to the U.S. Securities Markets*, NYSE, July 1973, pp. 20–21.

Lack of Industry Stability

The effects of cyclical business swings on the stability of the securities industry have been well-documented. Despite continuous efforts to maintain adequate capacity levels, the industry has been characterized by continual contraction and expansion of facilities to meet frequent, and often abrupt, changes in business conditions. For example, the branch office networks operated by NYSE member firms, a vital part of the securities distribution process in connection with underwriting, expanded by 21% between the end of 1965 and the end of 1968—and then contracted by 15% during the next two years. In 1971, the branch office network again began to expand.[11]

A more dramatic example of instability was the disappearance of more than 120 NYSE member firms during the 1969–1970 downturn.[12] (Of course, some new firms also joined the NYSE during this period.) An undocumented, but presumably much larger, number of non-NYSE firms also either went out of business or merged with other organizations during that period.

The question of financial stability can be placed in sharper focus by comparing the profitability of broker/dealers with the performance of other important financial intermediaries over the most recent 5-year period for which IRS data are available (Table 3).

TABLE 3.—PROPORTIONS OF FIRMS IN SECURITIES INDUSTRY AND OTHER FINANCIAL INSTITUTIONS REPORTING PRETAX NET INCOME, 1965–69

[In percent]

	Broker/dealers	Commercial banks and trust companies	Savings and loans	Mutual savings banks
1965	64	91	84	92
1966	63	90	83	81
1967	60	92	86	80
1968	78	92	88	87
1969	49	91	82	79

Source: "Statistics of Income—Corporations," Internal Revenue Service.

Relative to commercial banks and trust companies, SLAs and mutual savings banks, a consistently smaller and more variable percentage of securities firms are profitable.[13] It is significant that during the prosperous 1965-1967 period, little more than 60% of the brokerage firms were profitable. Even during the boom year of 1968, when the ratio of profitable brokerage firms rose to 78%, each of the three other types of financial intermediaries continued to have a higher proportion of profitable organizations. In 1969, when the most recent cyclical downturn began, the ratio of profitable brokerage firms dropped precipitously while the three other types of intermediaries experienced mild declines. By comparison, the steady 90% or higher proportion of banks and trust companies reporting profits during the 1965-1969 period represents a pillar of industry stability.

Securities Industry Riskiness and Capital Problems

Variability of earnings is, of course, a key measure of risk, and in the securities industry, this is exacerbated by cyclical changes which have a relatively minor impact on other financial intermediaries. As a result, securities industry capital is costly and scarce, forcing firms into a high leveraging of equity capital and adding further to industry riskiness.

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[11] NYSE *Fact Books*.

[12] NYSE Secretary's Office.

[13] To have a consistent basis for comparing brokerage firms with other types of financial intermediaries, only corporate brokerage organizations were included. This should not introduce any bias into the figures, however, since SOI reporting brokerage firms represent the bulk of NASD members. For example, in 1969, SOI reporting broker/dealers represented 75% of that organization's membership.

The securities industry's prosition among high-risk enterprises was confirmed in a 1970 study undertaken by National Economic Research Associates, Inc. (NERA), in the course of its study of brokerage commission rates for the NYSE.[14] NERA measured risk by rate of return and the variability of returns over time. They examined all 61 Standard and Poor's industry and selected the top quartile in terms of average return on equity over the 1961-1968 period. A special study of the variability of returns of these 15 presumably riskiest industries indicated varability than the securities industry. (Variability was measured as the standard deviation in return on equity between 1961 and 1968.) The results for the 15 industries studied are presented in Table 4.

TABLE 4.—STANDARD DEVIATION OF RETURN ON EQUITY, 1961-68

Industry	Standard deviation	Industry	Standard deviation
Radio and TV broadcasting	5.9	Securities commission business	4.2
Drugs	2.6	Construction and materials handling equipment	3.3
Autos	3.4	Radio and TV manufacturers	3.0
Soft drinks	2.5	Cigarette manufacturers	.9
Packaged foods	.6	Publishing	5.9
Office and business equipment	.9	Corn refiners	1.2
Confectionery	.7	Biscuit bakers	1.6
Electric household appliances	1.9	Electrical equipment	2.5

Source: National Economic Research Associates, Inc., "Stock Brokerage Commissions: The Development and Application of Standards of Reasonableness for Public Rates," vol. II, sec. VIII–4, July 1970.

THE NEED FOR STABILIZATION RESERVES

A very strong cast for stabilization reserves can be made on the basis of tax equity alone. A second compelling argument is the need to dampen the impact of the industry's cyclical swings. The likelihood of increasingly direct competition between brokerage firms and other financial intermediaries, owing to the changing structure of the securities industry, reinforces the need for a stabilizing mechanism.

Tax Equity and Cyclicality

The relationship between the cyclical character of the securities industry and present tax policy toward the industry has not generally been recognized. The fact is, however, that cyclically induced instability is heightened by current tax treatment of the industry.

Tax preferences which favor other financial intermediaries raise their rates of return over those of brokerage firms conducting similar activities. Apart from clearly violating the principle of tax equity, this severely reduces the attractiveness of investment in brokerage firms. At the same time, the favored institutions, obtaining capital at lower cost, are able to invest in relatively less promising projects. Thus, the tax laws tend to distort the allocation of resources among financial intermediaries and reduce the over-all efficient use of capital in ways that are harmful, not only to the securities industry, but to the economy as a whole.

As indicated, the importance of the intermediary functions engaged in by brokerage firms argues for a tax policy that would dampen the effects of cyclical swings. At present, relative to other financial intermediaries, the securities industry's tax burden serves instead to magnify instability, because the earnings taxed away in prosperous years are not available to cushion losses during downturns. In effect, the industry pays a tax on its capital. Obviously, the ability to set aside reserves, to be drawn upon during deficit years, would play an important role in stabilizing the financial position of brokerage firms. Moreover, to the extent that such reserves would help attract additional outside capital to the securities industry, their beneficial impact would be multiplied.

More Competitive Business Environment

Brokerage firms have always competed for savings dollars with other financial intermediaries. However, the growing aggressiveness of such institutions as

[14] National Economic Research Associates, Inc., *Stock Brokerage Commissions: The Development and Application of Standards of Reasonableness for Public Rates,* Volume 1, Section VIII, July 1970.

banks and insurance companies, combined with the structural changes in the securities industry, are transforming the character of that competition. Bank automatic investment plans and variable insurance policies compete directly for the securities industry's traditional agency business. Continuing intense competition for the management of pension funds and other large portfolios and the ability of many institutions to gain membership on regional stock exchanges add new dimensions to the competitive environment.

As a consequence of extreme riskiness, the securities industry has always found it both difficult and costly to attract capital. The severity of the current cyclical downturn has aggravated the problem, coinciding with a quickening pace of industry change which further stresses capital-intensive activities. The pressure for additional capital has prompted most firms to continue leveraging their equity far beyond the prevailing levels in other industries, thereby further increasing the riskiness of their operations.

With the declining profitability of the brokerage business, brokerage firms have increasingly been forced to diversify into leasing, real estate and other investment activities. Many of these new areas, in which capital-rich institutions are already active, require the commitment of considerable amounts of principal capital. In the securities industry's traditional areas of business, the advent of fully competitive commission rates promises further dramatic intensification of competition.

The growing intensity of competition, overlaid on the securities industry's extreme susceptibility to cyclical business swings and its changing business mix, make abundantly clear the urgent need for more equitable tax treatment. *In the absence of constructive tax policy changes, the quality and depth of the vital intermediary services offered by brokerage firms are likely to erode. More important, failure to strengthen the U.S. capital markets may portend serious over-all consequences for our national economy.*

LEVEL OF STABILIZATION RESERVES AND THEIR TAX IMPACT

A responsible effort to develop a viable program of stabilization reserves for the securities industry must begin with the measurement of a base or portfolio of eligible intermediary activities, since reserves must be related to the value of such a base. An appropriate level of reserves can then be defined with reference to the securities industry's capital funds and in terms of the character and size of its losses in recent years. After identifying an appropriate level of reserves, their tax impact can be estimated.

Reserve Base

A reserve base composed of margin loans and corporate trading and underwriting positions is consistent with a conservative interpretation of broker/dealer intermediary functions.

Margin loans, by facilitating the trading activities of large numbers of individuals, add to the liquidity of capital markets. In this connection, it should be noted that banks are permitted to include in their reserve base loans to brokerage firms.

Long and short trading positions are both essential in market making and block positioning. Other types of trading, such as options and arbitrage positions should also be included in the reserve base. The inclusion of underwriting positions requires no additional discussion. A firm's own investment positions, however, should be excluded. The calculation of an appropriate reserve base for NYSE member firms is shown in Table 5.

The major components of the reserve base—margin loans and trading positions—seem less volatile than one might assume, so that fewer than 12 observations per component may be adequate for measuring the average annual value of the base.

TABLE 5.—NYSE FIRMS' 1972 RESERVE BASE

[In millions of dollars]

	Margin loans	Trading and investment positions in corporate securities: Long	Trading and investment positions in corporate securities: Short	Corporate underwriting positions
	(1)	(2)	(3)	(4)
January	5,700	2,336	604	112
February	6,180	2,189	497	79
March	6,620	2,415	539	23
April	7,010	2,296	562	102
May	7,200	2,244	526	107
June	7,510	2,543	526	168
July	7,660	2,471	540	136
August	7,780	2,583	525	214
September	7,800	2,326	544	86
October	7,800	2,446	512	226
November	7,890	2,801	609	222
December	7,900	3,085	672	65
Total	87,050	29,690	6,656	1,540
Average for year	7,254	[1] 2,522	555	128
Adjusted average	7,254	[2] 2,179	[2] 470	128

Note: Base for 1972 (sum of cols. 1, 2, 3, and 4), $10,031,000,000.

Source: Margin data are from a monthly survey conducted by the NYSE. The trading and underwriting positions were extracted from the monthly joint regulatory reports.

[1] Includes an average inventory of $48,000,000 for 28 specialists that filed joint regulatory reports only in January, June and December.

[2] Long and short positions are reduced, respectively, by 13.6 and 15.3 percent to eliminate investment portfolios. These adjustment factors represent the ratios of investment positions to the respective total positions reported in the 1972 NYSE income and expense reports. The adjustment, therefore, is designed to exclude investment positions of member firms from the rest of the base.

The data used in estimating a reserve base of $10,031 million for NYSE member firms in 1972 have some important properties which should be noted.[15]

The $7,254 million in average outstanding margin loans represents virtually all margin activity in the securities industry, since non-NYSE firms do very little margin business.

The Joint Regulatory Reports, initiated in 1972, contain financial data on every type of NYSE member firm. The filing requirements, however, depend on whether a firm does business with the public. Firms that carry public accounts, including most specialist firms, must submit financial reports on a monthly basis. The remaining firms are required to file only in June and December. In contrast, the Income and Expense (I&E) Reports are submitted at year-end, and only by firms that do business with the public.

Level of Reserves

The objective of strengthening the securities industry's capital base, as a key step in easing instability, provides a logical starting point for calculating an appropriate level of reserves. It is also logical to consider recent losses of brokerage firms, in attempting to arrive at an appropriate reserve level.

A first step, threfore, is to relate the level of reserves to capital funds. The NYSE's Income and Expense Reports indicate that member firms had an average of $8,712 million in capital funds during 1972.[16] If, then, the much less risky banking industry's judgment, that reserves should represent about 13–14%[17] of capital funds (i.e., equity and debt), is accepted as adequate for brokerage firms, NYSE members would have needed approximately $500 million in reserves during 1972.

The nature and distribution of losses to which the securities industry is exposed suggests, however, that reserve funds of this magnitude would cushion,

[15] In the absence of more complete industry data, all calculations and estimates apply to NYSE firms only.

[16] Because I&E Reports contain data only on firms that do business with the public, this figure understates somewhat the capital of member firms.

[17] *The Adequacy of Bad Debt Reserves, A Preliminary Study*, pp. 25–26.

but not insulate, NYSE firms from their impact. That is because losses tend to be concentrated within different types of activities over time, are unevenly distributed, and are often very large. Thus, since 1968, NYSE retail firms have suffered heavily at various times as volume declined. On the other hand, when stock prices dropped out but volume remained high, dealer firms took sharp losses on their trading positions. The occasionally staggering losses of bond houses testify to the cost of misjudging the direction of interest rate movements.

The magnitude of losses incurred by NYSE firms during the 1969–70 downturn is shown in Table 6.

TABLE 6.—DATA ON 1969-70 LOSSES OF NYSE FIRMS

[In millions of dollars]

	Aggregate losses of deficit firms	NYSE trust fund payments [1]
1969	131	7
1970	[2] 103	30
1971		32
1972		2
Total	234	71

[1] These trust fund payouts are net of repayments to member firms.
[2] Includes an estimated $14,000,000 loss on the part of Goodbody & Co. during the first three quarters of the year.

Source: NYSE income and expense reports and controller's office.

This enormous $305 million two-year deficit actually understates the real losses.[18] First, because I&E Reports are filed at the end of a calendar year, firms that merge or are liquidated during the year do not submit reports. Thus, a substantial amount of losses in 1969 and 1970 are excluded from these figures. Second, the losses of partnerships do not include imputed salaries for partners.

Concentration of losses is illustrated by the 1969 experience of deficit firms. The firms reporting losses aggregating $131 million accounted for only 25% of the gross revenue of all NYSE firms dealing with the public.

The experience of NYSE firms during the first nine months of 1973 appears to have been even more devastating than that of 1969 or 1970.

Table 7 shows that during January-August 1973, NYSE firms lost $210 million; only in September did they go into the black. However, the break-out of month-to-month aggregate losses may be more relevant for judging the adequacy of a given level of reserves, since, as noted, losses tend to be concentrated. Thus 30% of all NYSE firms reporting financial results in September 1973 indicated that they suffered net losses during the preceding 12-month peroid.

TABLE 7.—PATTERN OF JANUARY-SEPTEMBER 1973 NYSE FIRM LOSSES

[In millions of dollars]

	Aggregate losses of deficit firms	Aggregate profits and losses
January	(52.0)	(3.1)
February	(58.2)	(41.3)
March	(49.5)	(18.4)
April	(54.0)	(39.7)
May	(56.7)	(39.0)
June	(55.3)	(32.3)
July	(44.2)	(7.6)
August	(47.7)	(28.1)
September	(13.7)	56.1

Source: Joint regulatory reports.

[18] NYSE Trust Fund payments are considered a part of the losses, since the alternative would have been for member firms to write off these costs directly.

This pattern of losses implies that aggregate NYSE member firm stabilization reserves, when fully funded, should probably be considerably greater than $500 million. At the same time, it must be conceded that no basis for quantifying a higher level has been developed. Moreover, as indicated, the purpose of these reserves is not to insulate broker/dealers from losses but to reduce the instability of the industry.

It would appear reasonable, therefore, to see stabilization reserves for brokerage firms at a level of 5 percent of the value of a base composed of margin loans and trading and underwriting positions, as outlined earlier. This would mean an aggregate of $502 million in reserve funds, on a total base of $10,031 million for all NYSE member firms in 1972. That reserve fund figure would represent a conservative 13.5 percent of NYSE member firms' total capital funds of $3,712 million in 1972—well within the 13–14 percent range commonly viewed as appropriate by the banking industry.

Tax Impact of Reserves

What would be the tax impact of $502 million in reserves? The answer is complicated by the need to distinguish between the initial build-up phase and the subsequent impact. The latter will depend on the industry's overall cyclical pattern of activity, as well as on the fluctuations in specific types of activities.

The initial tax impact would depend on the profitability of brokerage firms over the build-up period and on the rate at which reserve funds are allowed to accumulate. To control the rate of accumulation, additions to reserve accounts should not exceed either 50 percent of pretax income or 50 percent of the permissible amount of reserves as of the close of the taxable year—whichever is lower.

With the additional assumption that 1972 pretax income was distributed among brokerage firms in the same way as the reserve base, it is possible to estimate the tax impact if NYSE firms had been permitted to start accumulating reserves last year. Based on the proposed limitations on additions to reserves and the $877 million earned by NYSE firms in 1972, a total of $251 million would have been placed in reserve accounts. Applying to these reserve placements the 43 percent aggregate Federal tax rate of corporations reporting financial results in the I&E Reports yields $108 million in tax revenue that the Treasury Department would not have collected.[19] (For purposes of this computation, it was assumed that this tax rate also applied to brokerage firms that are organized as partnerships.)

It should be noted that 1972 was a relatively prosperous year for NYSE firms. Thus, the initial annual tax impact of reserves introduced in the near-term future would not be likely to exceed or even equal the $108 million estimate. Thereafter, as reserves begin to approach maximum permissible levels, their tax effect would depend on the pattern of cyclical fluctuations prevailing within the securities industry. But since brokerage firm losses tend to be highly concentrated and/or associated with specific areas of business, the Treasury's revenue loss from stabilization reserves in any given year should be considerably smaller than in any peak year of the initial build-up period.[20]

These modest public costs of reserves must be measured against the public benefits of stronger U.S. capital markets at a time when their need is unprecedented. Realistic incentives to set aside funds in good years, to be drawn upon in poor years, would help stabilize an industry whose financial intermediary services are vital.

APPENDIX III

PRELIMINARY DRAFT

RESERVES FOR LOSSES OF CERTAIN SECURITIES INDUSTRY ORGANIZATIONS

(a) *Organizations to which section applies.*—This section shall apply to the following taxpayers except to the extent that such organization may be governed

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[19] The 43% tax rate was computed from the aggregate tax liability of 178 member firms that accounted for 59% of the I&E pretax income. It should be noted that the Treasury's tax loss would have been somewhat greater had non-NYSE firms been included.

[20] A byproduct of reserves would be a reduction in loss carry-overs claimed during profitable years, since losses carried forward would be lowered to the extent brokers draw down reserve accounts in deficit years. Therefore, after the build-up period, the Treasury's revenue loss may be minimal.

by the provisions of sections 585, 586, 593 or subchapter L in computing its reserve—

(1) Any broker or dealer registered as such under the Securities Exchange Act of 1934, and

(2) Any member organization of a securities exchange registered under the Securities Exchange Act of 1934.

(b) *Establishment of reserves—deduction allowed.*—Each taxpayer described in subsection (a) may establish and maintain a reserve for losses computed in accordance with the provisions of subsection (c) and there shall be allowed as a deduction to such taxpayer for the taxable year the amount of the addition to such reserve determined subsections (c) and (d).

(c) *Addition to reserves.*—The reasonable addition to the reserve for any taxable year of any taxpayer to which this section applies shall, subject to subsection (d) hereof, be the amount necessary to increase the balance of the reserve to an amount (at the close of the taxable year) determined by applying an allowable percentage to a reserve base accounts covering other than capital assets, valued on the basis of their fair market value and (iv) in the case of a specialist the amount of his inventory, valued on the basis of fair market value, together with the short positions and any part of his investment account, other than those securities which pursuant to Section 1236 have been identified as a security held for investment, which according to the rules of the Securities and Exchange Commission he is required to hold for the maintenance of an orderly market. For purposes of the computation of the reserve base, valuations shall be made on the basis of the monthly average of the fair market values of such accounts. For such purposes of this paragraph, the term "allowable percentage" means 5 percent for taxable years beginning after January 1, 1974.

(d) *Limitation on addition to reserve.*—The amount allowable under subsection (c) as an addition to the reserve for any taxable year shall not exceed the lower of (i) 50 percent of that part of the taxpayer's taxable income for the year computed without the allowance of the deduction provided by this section or (ii) 50 percent of the amount determined under subsection (c) hereof.

(e) There shall be chargeable against such reserve the amount of any loss for the taxable year sustained by the taxpayer from the conduct of the business of a broker or dealer in securities, except to the extent that such loss may be chargeable against a reserve for bad debts maintained pursuant to Section 166.

(f) The Secretary or his delegate shall define the terms "margin loans to customers", "inventories in underwriting accounts", "long and short positions in accounts covering other than capital assets" and prescribe such regulations as may be necessary to carry out the purposes of this section.

EXHIBIT A

THE IMPACT OF POSSIBLE CAPITAL GAINS TAX CHANGES ON INVESTOR BEHAVIOR STUDY NO. 1571 PREPARED BY OLIVER QUAYLE AND CO.

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A WORD ABOUT THIS SURVEY

PURPOSE

The purpose of this survey was determine, as accurately as possible and in dollar terms, the changes that would have occurred in individual investor activity and revenue to the U.S. Treasury during 1972 if any of the following changes had occurred:

1. The long term capital gains tax rate had been increased by 20% for all investors.

2. The present maximum capital gains rate of 25% for investors in the under $50,000 net gains category had been reduced to a maximum of 12.5%

3. The present maximum capital gains rate of 35% for investors in the over $50,000 net gains category had been reduced to a maximum of (a) 25% or (b) 17.5%.

4. The holding period for long term gains had been increased to one year.

5. The holding period for long term gains had been reduced to three months.

The second purpose of the study was to assess the impact on *future* individual investor behavior of any of the above changes, or a sliding scale in which the capital gains tax rate would diminish as the holding period lengthens.

THE SAMPLE

The survey sample consisted of a national cross section of individual shareowners, plus a special oversample of up-scale wealthy individuals with adjusted gross incomes of $100,000 or more for 1972. A total of 1,820 investors were interviewed during the study, 181 of which were in the up-scaled income category. Weights, based on 1971 IRS and 1970 NYSE shareownership data were applied to bring demographic segments of the sample into their proper proportions.

INTERVIEWING

All interviews were conducted in person by members of the national field staff of Oliver Quayle and Company. To maximize both investors cooperation and accuracy of investor information, each potential investor was sent a letter in advance by Mr. James J. Needham, Chairman of the New York Stock Exchange. Mr. Needham's letter (Appendix B) requested an interview be granted when the Quayle representative called and guaranteed investor anonymity. The letter did not mention the study would concern potential tax or holding period changes, but did request that the respondent (or his or her investment decision maker) have personal investment records available at the time of interview.

Interviewing was conducted from March 5 through April 20, 1973.

HIGHLIGHTS

1. Reducing the capital gains rate would have produced very significant increases in sales, capital gains, and revenue to the Treasury. If the 25% maximum rate had been cut to a 12.5% maximum, and the 35% rate to a 25% maximum, an additional $1.7 billion would have been received in tax revenues, or an increase in tax revenues of 48% over 1972. Cutting the present capital gains rate in half for all investors would have produced even more tax revenue to the Treasury—$3.2 billion more than received in 1972, or an 82% increase in taxes from long term gains.

2. If the capital gains tax had been 20% higher for all investors in 1972, sales of which capital gains were realized would have been significantly less. The Treasury would have received an estimated $858 million less in tax revenue than it actually received from long term gains.

3. If the holding period had been one year, capital gains tax revenue would have been $467 million less to the Treasury.

4. A three-month holding period would have produced only a slight increase in tax revenue—approximately $188 million.

NOTE: Capital gains and revenue estimates are projected on the base of an estimated total capital gains of 32.6 billion in 1972.

ANALYSIS

CHARACTERISTICS OF INVESTORS

The largest investor group is in the peak earning years between 35 and 54 years old (47%), followed by those between 55 to 64 years old (22%). In terms of occupation of the household head, more investors (32%) are in the professional/executice category followed by 21% who are retired, 20% in white-collar jobs, 15% in sales, and 9% in blue-collar positions. (Table A, Page 228)

Most shareowners have relatively modest incomes with adjusted gross incomes between $12,000—$19,000. Most investors also have modest stock and mutual fund holdings as well, with most portfolios valued at under $5,000.

Wealthy investors (income $100,000 and over) differ sharply from their less affluent counterparts. They are younger (54% are under 55 years of age), less likely to be retired (4%), hold down top occupational jobs (96%), and have far greater stock holdings (the median value of their stock and mutual fund holdings falls within the $500,000-$999,999 range).

1972 INVESTMENT ACTIVITY

Most investors (63%) did not sell any shares of stock during 1972. Wealthy investors were far more active with 73% reporting one or more sales. Those 35 to 54 years of age were most active, while those under 35 least active:

1972 ACTIVITY

[In percent]

	Total investors	Wealthy investors	Age: Under 35	35 to 54	55 to 64	65 and over
Sold stock	37	73	32	40	37	36
Did not sell	63	27	68	60	63	64

Of those investors selling stocks during 1972, 50% realized net long term capital gains, with this percentage significantly higher (72%) among wealthy investors (Table B, Page 229). Many of these wealthy investors realize net long term gains in excess of $50,000 (40%), but only a handful did among less affluent shareowners. A majority (60%) of wealthy investors planned to use the alternative 25% method for computing capital gains taxes, while just under a quarter did in the under $100,000 income group. (Table C, Page 229)

Since not all of an investor's stock and mutual funds could be asked about in detail, the questions about possible changes in the capital gains rate were limited to the investor's three largest holdings (in dollar terms) as of January 1, 1972. Asked about these largest holdings, 47% of investors said they did not consider selling any of them in 1972, while an additional 26% reported they had considered selling some or all of them, but had decided against doing so. About 10% of the respondents indicated they sold all of their largest holdings while 17% said they sold some during 1972. Wealthy investors were somewhat more active than all investors, 37% sellings some or all of their three largest holdings (Table D, Page 229). The total dollar value of the Capital Gains in 1972 under these circumstances would have been $32.6 billion which would have yielded $8.9 billion in tax revenues.

1972 capital gains	[1] $32, 600, 414, 500
1972 tax revenue	8, 911, 889, 600

REASONS FOR NOT SELLING IN 1972

All investors who had considered selling a major holding in 1972 but did not do so gave their reasons in their own words. Table E, Page 230, shows that the most important reasons for this nonaction were the desire to see the stock in question continue to appreciate—to hold it for long-haul or investment purposes, followed by those who didn't want to take a loss or felt the market was too depressed at that time. Few investors gave tax reasons of any kind in explaining why they had not sold a stock or mutual fund.

CHANGES IN THE CAPITAL GAINS RATE (20 PERCENT INCREASE FOR ALL INVESTORS)

Investors who sold any of their largest holdings (in whole or in part) in 1972 were read the following explanation:

"As you probably know, the maximum long term capital gains rate is 25% for most investors with net gains under $50,000 per year. The maximum rate is 35%, however, for most investors with net gains of over $50,000 per year. Now—suppose that in 1972 the capital gains tax had been 20% higher for you personally. The 25% rate would have gone to a maximum of 30%, and the 35% rate would have gone to a maximum of 42%."

For each stock sold in 1972, respondents were then asked if the issue would still have been sold under such conditions, or held, with these results:

Investors who sold part of their three largest holdings in 1972:

	Percent
Yes, would still have sold	86
No, would have held	14

[1] Projected data for all investors.

Over-all, 86% of these stocks still would have been sold if there had been an across-the-board 20% increase in the capital gains tax rate.

EFFECTS OF A HYPOTHETICAL 20-PERCENT INCREASE IN THE CAPITAL GAINS TAX, 1972

	All investors	Net change
Capital gains	$29,435,616,500	−$3,164,798,000
Tax revenue	3,554,021,300	−357,818,300

CHANGES IN THE CAPITAL GAINS RATE (TO A MAXIMUM OF 12.6% FOR THOSE NOW AT THE 25% MAXIMUM RATE AND TO A 25% OR 17.5% MAXIMUM FOR THOSE NOW AT THE 35% MAXIMUM RATE)

All investors who realized less than $50,000 in long term gains in 1972 (or no gains or losses) were asked for each of their major holdings *not* sold in 1972 what they would have done if the maximum capital gains tax had been only half as much as it actually was—a maximum of up to 12.5% instead of a maximum of 25%. Those who would have sold in 1972 at this lower rate were asked how many shares they would have sold and at what selling price per share. Investors reporting over $50,000 in net long term 1972 gains were also asked similar questions about major holdings they did *not* sell in 1972—except that a two-step reduction was posed in the capital gains tax during 1972; from a maximum of 35% to 25%, and if the stock still would have been held, what they would have done if the maximum had been 17.5%.

EFFECTS OF A HYPOTHETICAL REDUCTION OF THE MAXIMUM CAPITAL GAINS TAX TO 12.5 PERCENT FOR THOSE NOW AT 25 PERCENT AND TO 25 PERCENT FOR THOSE AT 35 PERCENT, 1972

	All investors	Net change
Capital gains	$49,161,079,800	+$16,560,665,300
Tax revenue	$5,580,416,600	+$1,668,577,000

EFFECTS OF A HYPOTHETICAL 50 PERCENT REDUCTION IN THE MAXIMUM CAPITAL GAINS TAX: TO 12.5 PERCENT FOR THOSE AT 25 PERCENT AND TO 17.5 PERCENT FOR THOSE AT 35 PERCENT

Capital gains	$59,183,876,900	+$26,583,462,400
Tax revenue	7,110,555,600	+3,198,716,000

REASONS FOR SELLING IN 1972 AT LOWER TAX RATES

Earlier it was shown that 27% of investors sold some or all of their major holdings in 1972. Under the reduced tax rates just discussed, an additional 8%, (almost a one third increase) of investors would have sold stock in 1972. These investors were asked to indicate why they would have sold under such changed conditions and their detailed answers are shown in Table F, Page 230. Almost a quarter said they would have sold to get out from under a poorly-performing investment or into a more profitable one; an equal number would have sold to realize a profite. Some 16% would have sold specifically because of the tax reduction.

REASONS FOR NOT SELLING IN 1972 AT LOWER TAX RATES

The great majority of investors would not have sold stocks held during 1972 if tax rates on long term gains had been lower. Their reasons are shown in Table G, Page 230, which shows that taxes are not an important factor in investor decision-making among individuals. Two closely related reasons account for 47% of the "no-sell" decisions—expecting the stock to grow because the company has a good future and purchasing stocks for investment rather than speculative purposes. Some 18% of investors would not have sold because the stock in question was paying good dividends, with a similar number reporting they would wait for the stock to reach the price they wanted before selling.

FUTURE CHANGES IN INVESTMENT ACTIVITY IF THE CAPITAL GAINS RATE WERE CUT IN HALF

Investors were then asked what changes they would make in their future over-all investment patterns if the capital gains rate were to be cut in half. Table H, Page 231, details their responses which are summarized in the following table.

EFFECT OF CUTTING CAPITAL GAINS TAX IN HALF

[In percent]

	Total investors	Wealthy investors	Age: Under 35	Age: 35 to 54	Age: 55 to 64	Age: 65 and over
No change	60	33	53	59	60	71
Invest more, be more active	35	63	43	37	35	26
Invest less, be less active	5	4	4	4	5	3

Most investors (60%) indicated no real change in future investment behavior with the balance saying they would be more rather than less active by a 7-to-1 margin. Wealthy investors, some 63% were much more apt to think they would be more active than other investors.

The question on future behavior buttresses earlier findings on the effect of reduced capital gains taxes in 1972; most investors would not behave differently but, on balance, there would have been more sales and realized net long term gains at a lower capital gains rate.

CHANGES IN THE HOLDING PERIOD—FROM SIX MONTHS TO ONE YEAR

All investors were asked if they had sold stocks or mutual funds in 1972 which they had held longer than six months, but less than one year. Only 8% of all investors (but 28% of wealthy investors) reported sales (Table I, Page 231). For each of the stocks sold, they were asked if the stock would have still been sold in 1972 or held instead if the minimum long term holding period had been one year. The original number of shares purchased, and purchase price per share, as well as number of shares that would have been sold, and the per share selling price, were obtained. In the great majority of cases (72%) the stock would have still been sold, while 28% would have held the stock under the longer holding period.

EFFECTS OF A HYPOTHETICAL CAPITAL GAINS TAX BASED ON A 1-YEAR HOLDING PERIOD, 1972

	All investors	Net change
Capital gains	$29,705,171,400	−$2,895,243,100
Tax revenue	3,444,667,000	−467,172,600

REASONS FOR SELLING IN 1972 IF HOLDING PERIOD ONE YEAR

The reasons given by investors who would have still sold shares in 1972 with a one year holding period in effect are shown in total in Table J, Page 231. Investors would have mainly sold because of their dissatisfaction with the stock in question, followed by those who wanted to make a profit from the sales or move out of a stock they felt had peaked.

REASONS FOR NOT SELLING IN 1972 IF HOLDING PERIOD WERE EXTENDED TO ONE YEAR

Investors who would not have sold the issues traded in 1972 (if the one year period had been in effect) were also asked their reasons, which are shown in Table K, Page 232. Investors generally indicated they purchased securities for the long term and were looking for a better tax break in the future before selling (25%), followed by those who cited their personal tax situations (22%).

FUTURE CHANGES IN INVESTMENT ACTIVITY IF HOLDING PERIOD WERE EXTENDED TO ONE YEAR

All investors were asked about future over-all investment behavior under a hypothetical one year holding period for longer term gains. The large majority of investors (71%) indicated they would not change their investment patterns; however, of those wealthy investors who said they would be influenced by the change in the holding period, 2 to 1 said they would be less active (Table L, Page 232).

EFFECT OF INCREASING HOLDING PERIOD TO 1 YEAR

[In percent]

	Total investors	Wealthy investors	Age			
			Under 35	35 to 54	55 to 64	65 and over
No change	71	64	58	79	73	81
Invest more, be more active	15	11	19	2	13	14
Invest less, be less active	14	25	23	19	14	5

CHANGES IN THE HOLDING PERIOD—FROM SIX TO THREE MONTHS

All investors were asked if they owned stocks in 1972 which they did not sell but would have sold if the minimum holding period for long-term gains had been three instead of six months. For each stock they would have sold, the original per share purchase price and number of shares purchased was obtained, as well as the number of shares they would have sold and per share selling price.

Table M, Page 232 shows that only 2% of the investors would have done any additional selling in 1972 under a three month holding period. The table below shows the effects of a three month holding period on tax revenue.

EFFECTS ON CAPITAL GAINS OF A HYPOTHETICAL 3-MONTH HOLDING PERIOD, 1972

	All investors	Net change
Capital gains	$33,118,569,300	+$518,184,800
Tax revenue	4,049,649,300	+137,809,700

REASONS FOR SELLING IN 1972 IF HOLDING PERIOD HAD BEEN ONLY THREE MONTHS

Table N, Page 233, shows the reasons given by the limited number of investors who would have sold additional stocks in 1972 under a three-month holding period. The primary reason would have been to make a profit; a distinctly secondary reason would have been to dispose of stocks that were performing poorly.

FUTURE CHANGES IN INVESTMENT ACTIVITY IF HOLDING PERIOD WERE REDUCED TO THREE MONTHS

All investors were asked about their future over-all behavior under a three month holding period for long term capital gains. Extracting from Table O, Page 233, the following pattern develops:

EFFECT OF REDUCING HOLDING PERIOD TO 3 MONTHS

[In percent]

	Total investors	Wealthy investors	Age			
			Under 35	35 to 54	55 to 64	65 and over
No change	73	58	66	58	77	72
Invest more, be more active	25	42	32	41	18	27
Invest less, be less active	2	....	2	1	5	1

In total about seven in ten stockholders did not think their future investment behavior would change, while those who did overwhelmingly indicated that they would be more active investors.

FUTURE CHANGES IN OVER-ALL INVESTMENT PATTERN WITH SLIDING SCALE FOR CAPITAL GAINS TAX AND HOLDING PERIOD

Respondents were asked to state their investment behavior if the maximum capital gains rate was geared to a sliding scale, i.e., would decrease as the holding period increased would be applicable not only to future transactions but to present holdings. The hypothetical scale presented to respondents follows:

Holding period:	*Maximum rate (percent)*
6 months	25
5 years	22.5
10 years	20
15 years	17.5
20 years	15
25 years	12.5
30 years or longer	10

Table P, Page 284, details the answers given by investors to this question. A summary of those findings shows:

EFFECT OF SLIDING SCALE, TAX REDUCED GRADUALLY OVER LONGER HOLDING PERIODS

[In percent]

	Total investors	Wealthy investors	Age: Under 35	35 to 54	55 to 64	65 and over
No change	65	47	54	61	64	74
Invest more, be more active	17	33	15	15	14	17
Invest less, be less active	18	20	31	24	22	9

Again a strong majority of all investors (65%) felt they would not behave differently in the future under such coditions, with the balance split evenly between increased and decreased activity. Far more wealthy investors thought they would increase investment actiivty (33%), with only less than half believing their over-all investment behavior would be unaffected over time by a gradual reduction in the capital gains rate.

FUTURE CHANGES IN RATES OR HOLDING PERIODS

The following table summarizes investor activity in response to possible hypothetical changes in the Capital Gains Tax.

	All investors (percent): Cut capital gains tax in half	Cut holding period to 3 months	Sliding scale—6 months at 25 percent to 10 percent at 30 years	Extend holding period to 1 year
No change	60	73	65	71
Invest more, be more active	35	25	17	15
Invest less, be less active	5	2	18	14

Investors clearly thought that cutting the capital gains tax in half would be the most effective device in the tax area that would cause them to increase their investment activity. The best measure of what investors would do in the future, however, is what they actually did in 1972 (or would have done under the potential changes they were queried about).

CHANGES IN REALIZED LONG TERM CAPITAL GAINS AND TAX REVENUE TO THE TREASURY

Using the tax computation method described in Appendix A, long term capital gains of sales from respondents (nonprojected) interviewed in the survey totaled $8,786,009, with the Treasury deriving $448,297 in tax revenue from these gains. To project these capital gains and tax figures to the entire individual investor population an independent authority's estimate of individual long term capital gains was used. They estimated that in 1972 all capital gains amounted to $82.6 billion; this was divided by the sample's long term gains of $8.7 million. The resultant projection factor (rounded) is 8,726. Multiplying the sample's actual capital gains and taxes by this figure produces the projected estimates of what total capital gains and revenue to the Treasury would have been under the different hypotheses tested.

Projected capital gains realizations and revenue estimates are based on all types of investment gains, not just corporate stock gains. No recent data are available which give a distribution of capital gains by type of asset.

For 1962, the last year for which data are available, about three fifths of long term capital gains realizations on taxable returns are estimated to come from corporate stock.[8] The 1962 figure is not projectable to 1972 since the ratio fluctuates sharply with the fortunes of the securities and real estate markets. Also, changes in the tax law in recent years undoubtedly affected the pattern of capital gains realizations.

However, it is reasonable to expect that changes in the tax on capital gains would affect the realization of gains on other types of investment assets in a manner generally similar to that for corporate stock gains realizations.

NOTE: The effective average tax rate on non-stock capital gains is higher than that on capital gains from sale of stock.

PROJECTION OF CAPITAL GAINS TAX UNDER VARIOUS ALTERNATIVE ASSUMPTIONS

	A Investors	Net change
1972 capital gains	$32,600,414,500	
Tax Revenue	3,911,839,600	
Changes:		
I. 20-percent increase in capital gains tax:		
Capital gains	29,435,616,500	−3,164,798,000
Tax revenue	3,554,021,300	−357,818,300
II. Reduce maximum tax to 12.5 percent (for those now at 25 percent) and to 25 percent (for those now at 35 percent):		
Capital gains	49,161,079,800	+16,560,665,300
Tax revenue	5,580,416,600	+1,668,577,000
III. Cut maximum tax in half to 12.5 percent (for those now at 25 percent) and to 17.5 percent (for those now at 35 percent):		
Capital gains	59,183,876,900	+26,583,462,400
Tax revenue	7,110,555,600	+3,198,716,000
IV. 1 year holding period:		
Capital gains	29,705,171,400	−2,895,243,100
Tax revenue	3,444,667,000	−467,172,600
V. 3 months holding period:		
Capital gains	33,118,599,300	+518,184,800
Tax revenue	4,049,649,300	+137,809,700

Note: Assumes all else remains constant except the indicated tax change.

[8] Sales of Capital Assets "Report on Individual Income Tax Returns" 1962—U.S. Treasury Department 1966.

TABLE A.—DEMOGRAPHIC CHARACTERISTICS OF INVESTORS

[In percent]

	Total investors	Adjusted gross income: $100,000 or more	Adjusted gross income: Less than $100,000	Age: Under 35	Age: 35 to 54	Age: 55 to 64	Age: 65 and over
Age:							
Under 35	16	2	16	100			
35 to 54	47	52	21		100		
55 to 64	22	31	28			100	
65 and over	15	15	21				100
Total	100	100	100	100	100	100	100
Occupation:							
Professional, executive, managerial, proprietor	32	96	30	37	42	23	8
Sales	15		15	15	16	18	5
White-collar, civil service, service, transportation	20		21	33	23	17	3
Labor, skilled and unskilled	9		10	9	13	7	2
Other occupations	3		2	6	4		(1)
Retired	21	4	22		2	35	82
Total	100	100	100	100	100	100	100
Adjusted gross 1972 income:							
Under $8,000	19		20	12	9	24	49
$8,000 to $11,999	22		23	29	21	22	20
$12,000 to $19,999	35		36	44	39	33	17
$20,000 to $24,999	9		10	6	13	8	5
$25,000 and over	15	100	11	9	18	13	9
Total	100	100	100	100	100	100	100
Marital status:							
Single	9	2	9	22	8	5	7
Married	73	92	73	69	81	73	55
Divorced	5	2	5	9	4	4	2
Widowed	13	4	13		7	18	36
Total	100	100	100	100	100	100	100
Total value (Jan. 1, 1972), all stocks and mutual funds (bonds excluded):							
Under $5,000	41		43	70	43	28	22
$5,000 to $7,499	9	2	8	11	9	5	10
$7,500 to $9,999	8		8	6	7	9	11
$10,000 to $14,999	9		9	3	9	10	10
$15,000 to $19,999	4		4	1	6	5	3
$20,000 to $24,999	5	4	6	(1)	6	6	10
$25,000 to $49,999	9	2	9	4	9	12	9
$50,000 to $99,999	6	6	6	4	4	10	11
$100,000 to $499,999	5	22	5	1	4	9	9
$500,000 to $999,999	2	18	1	(1)	1	3	1
$1,000,000 or more	2	46	1	(1)	2	4	4
Not stated	(1)		(1)		(1)	(1)	(1)
Total	100	100	100	100	100	100	100
Interview conducted with:							
Listed stockholder	93	82	94	94	94	94	90
Decisionmaker	7	18	6	6	6	6	10
Total	100	100	100	100	100	100	100

1 Less than 0.5 percent.

TABLE B.—1972 NET GAINS OR LOSSES—ALL INVESTORS SELLING STOCKS IN 1972

[In percent]

	Total investors selling stocks	Adjusted gross income		Age			
		$100,000 or more	Less than $100,000	Under 35	35 to 54	55 to 64	65 and over
Net gains, 1972	59	72	58	60	59	50	71
Net losses, 1972	41	28	42	40	41	50	59
Total	100	100	100	100	100	100	100

TABLE C.—VALUE OF NET GAINS IN 1972, EXPECTATION OF COMPUTING CAPITAL GAINS TAX AT ALTERNATIVE 25-PERCENT TAX COMPUTATION, EXPECTATION OF HAVING TAX PREFERENCE ITEMS IN EXCESS OF $30,000 (INVESTORS WITH NET CAPITAL GAINS IN 1972)

[In percent]

	Total investors with net 1972 capital gains	Adjusted gross income		Age			
		$100,000 or more	Less than $100,000	Under 35	35 to 54	55 to 64	65 and over
Value of net long term 1972 gains:							
Under $50,000	95	60	99	97	96	90	96
Over $50,000	5	40	1	3	4	10	4
Total	100	100	100	100	100	100	100
Alternative 25-percent tax computation:							
Yes; will use	27	60	23	11	24	48	22
No; will not use	40	12	43	54	44	26	34
Not sure	33	28	34	35	32	26	44
Total	100	100	100	100	100	100	100

TABLE D.—SUMMARY TABLE: 1972 ACTIVITY, 3 (OR LESS) LARGEST STOCK HOLDINGS

[In percent]

	Total investors	Adjusted gross income		Age			
		$100,000 or more	Less than $100,000	Under 35	35 to 54	55 to 64	65 and over
Sold all of largest holdings	10	6	10	10	11	9	8
Sold some of largest holdings	17	31	17	19	18	18	16
Considered selling, but did not sell any	26	16	26	32	23	27	27
Did not consider selling any	47	47	47	39	48	48	49
Total	100	100	100	100	100	100	100

TABLE E.—*Reasons given by investors who considered selling one or more of three largest holdings but did not do so*

	Total investors (percent)
Will wait/would wait until price reaches what I want to get for it	31
Decided not to/would not take a loss, will wait until price goes back up, get my money out	27
The market was/is depressed—not the right time to sell	18
Company has a good future—expect the stock to appreciate, holding it for growth	12
Company pays good dividends, I need them for income	9
I buy for investment purposes, not speculation	8
Just didn't get around to making a decision—need/needed advice	8
Held/am holding stock on advice of broker/bank	6
Didn't/don't need the money—no reason to sell	6
Holding it for old age/children/rainy day	6
Other reasons (less than 5 percent mentions)	15
Not sure	18

TABLE F.—*Combined table: reasons given for selling if capital gains tax had been reduced (from 25 percent to 12.5 percent, or from 35 percent to 25 percent, or 17.5 percent)*

	Total investors (percent)
Stock company performing badly, money more valuable elsewhere—better producing stock, real estate, etc	28
To realize a profit, make more money	28
I always consider the tax break	16
To diversity, balance out my portfolio	12
To offset a capital gain or loss	5
I needed the money	5
Stock had reached its peak, was fully priced	5
Market value of stock is my primary consideration, tax advantage secondary	3
All other	10
Not sure	6

TABLE G.—COMBINED TABLE: REASONS GIVEN FOR NOT SELLING IF CAPITAL GAINS HAD BEEN REDUCED (FROM 25 TO 12.5 PERCENT, OR FROM 35 TO 25 OR 17.5 PERCENT)

[In percent]

	Total investors	Adjusted gross income		Age			
		$100,000 or more	Less than $100,000	Under 35	35 to 54	55 to 64	65 and over
Company stock has a good future—expect the stock to appreciate, holding it for growth	24	36	24	16	32	19	22
I buy for investment purposes, not speculation	23	22	23	26	24	21	23
Will wait/would wait until price reaches what I want to get for it	14	12	15	8	13	19	16
Company pays good dividends, I need them for income	13	2	14	6	11	14	25
Decided not to/would not take a loss, will wait until price goes back up, get my money out	13	2	13	18	9	10	7
Holding it for old age/children/rainy day	10	2	11	5	13	10	9
Didn't/don't need the money—no reason to sell	6	10	6	7	6	5	9
Taxes are not a consideration with me in this case	6	6	6	5	6	8	3
Holdings too small to have it make much difference	6	2	6	10	7	4	5
All other (less than 5 percent mentions)	18	31	17	19	19	20	14
Not sure	5	12	5	7	6	4	3

TABLE H.—CHANGES WOULD MAKE IN OVERALL INVESTMENT PATTERN IF CAPITAL GAINS TAX CUT IN HALF

[In percent]

	Total investors	Adjusted gross income: $100,000 or more	Adjusted gross income: Less than $100,000	Age: Under 35	Age: 35 to 54	Age: 55 to 65	Age: 65 and over
Would be more active, trade, speculate, diversify more	35	63	34	41	36	35	26
Would make no difference at all to me, wouldn't make any changes	19	10	19	22	17	17	24
My plans are for long term investment, growth; not a speculator	15	14	15	16	18	13	11
I am too small/old/inactive investor to worry about it	9	....	10	6	9	11	12
My decisions are not influenced by tax considerations—have faith in my holdings	8	12	8	5	9	8	11
Depend on my holdings to supplement income—need dividends for expenses, retirement income	6	....	6	1	4	7	16
Would be less active, tend to hold longer, be more conservative	1	....	1	1	1	(1)	2
Other (would not change)	4	....	4	6	4	6	1
Other (would invest more, be more active)	1	4	1	....	(1)	1	1
Other (would invest less, be less active)	4	4	4	3	4	5	1
All other	8	2	8	5	22	10	9
Not sure	4	2	4	2	6	3	2

1 Less than 0.5 percent.

TABLE I.—NUMBER OF STOCKS SOLD IN 1972 HELD LONGER THAN 6 MONTHS BUT LESS TH

[In percent]

	Total investors	Adjusted gross income: $100,000 or more	Adjusted gross income: Less than $100,000	Age: Under 35	Age: 35 to 54	Age: 55 to 65	Age: 65 and over
Yes; sold such stocks:							
1 stock	4	14	4	4	5	6	3
2 stocks	2	6	2	1	3	2	(1)
3 or more stocks	2	8	1	1	2	2	2
Total	8	28	7	6	10	10	5
No; did not sell such stocks	92	72	93	94	90	90	95
Total	100	100	100	100	100	100	100

1 Less than 0.5 percent.

TABLE J—*Reasons for selling if the minimum holding period for long-term capital gains had been 1 year*

	Total investors (percent)
Stock was performing badly, poor stock, lost faith in company, money more valuable elsewhere	41
To realize a profit, make more money	17
Too offset a capital gain—wanted to take a loss	11
I needed the money	11
Stock had reached its peak, was fully priced	10
A speculative stock—take my profit and get out	9
To diversify, balance out my portfolio	7
Market value of stock is my primary consideration, tax advantage secondary	4
All others (less than 4 percent mentions)	4
Not sure	2

TABLE K—*Reasons for not selling if the minimum holding period for long-term capital gains had been 1 year*

	Total investors (percent)
Waiting /would wait for a better tax break	25
Tax reasons	22
Only take a capital gain when it can be offset by a capital loss	16
Will wait/would wait until price reaches what I want to get for it	13
Couldn't afford to sell, had too large a capital gain	13
Company has a good future—expect the stock to appreciate, holding it for growth, would buy—not sell	13
Capital gains do not influence my investment decisions	6
All others (less than 5 percent mentions)	8
Not sure	8

TABLE L.—CHANGES WOULD MAKE IN OVERALL INVESTMENT PATTERN IF HOLDING PERIOD EXTENDED TO 1 YEAR

[Percent]

		Adjusted gross income		Age			
	Total investors	$100,000 or more	Less than $100,000	Under 35	35 to 54	55 to 64	65 and over
Would make no difference at all to me, wouldn't make any changes	31	29	31	27	33	36	37
My plans are for long-term investment, growth, not a speculator	25	33	25	22	30	21	23
Would be more active, trade, speculate, diversify more	16	12	16	22	2	15	16
Would be less active, tend to hold longer, be more conservative	13	25	12	23	12	12	6
Depend on my holding to supplement income—need dividends for expenses, retirement income	9		9	7	6	9	17
I am to small/old/inactive investor to worry about it	6		6	2	6	5	9
My decisions are not influenced by tax considerations—have faith in my holdings	5	8	4	4	4	6	5
Other (would not change)	3	4	3	4	2	4	2
Other (would invest more)							
Other (would invest less)	2	4	2	3	7	3	
All other (less than 4 percent mentions)	5		5	7	4	3	5
Not sure	3	2	3		2	3	2

TABLE M.—STOCKS OWNED IN 1972 THAT WERE NOT SOLD BUT WOULD HAVE BEEN SOLD IF LONG-TERM PERIOD FOR CAPITAL GAINS HAD BEEN REDUCED FROM 6 TO 3 MONTHS

[Percent]

		Adjusted gross income		Age			
	Total investors	$100,000 or more	Less than $100,000	Under 35	35 to 54	55 to 64	65 and over
Yes; would have sold:							
1 stock	2	4	2	3	2	1	2
2 stocks	(1)		(1)		(1)	(1)	
3 or more stocks	(1)		(1)	1		(1)	(1)
Total	2	4	2	4	2	2	2
No; would not have sold stocks	98	96	98	96	98	98	98
Total	100	100	100	100	100	100	100

1 Less than 0.5 percent.

TABLE N.—*Reasons for selling stock if the long-term capital gains holding period had been reduced to 3 months*

	Total investors (percent)
To realize a profit, make more money	56
Stock was performing badly, poor stock, lost faith in company, money more valuable elsewhere	19
I always consider the tax break	15
Stock had reached its peak—was fully priced	7
To offset a capital gain	4
To diversify, balance out my portfolio	4
A speculative stock—to take my profit and get out	4
Not sure	4

TABLE O.—CHANGES WOULD MAKE IN OVERALL INVESTMENT PATTERN IF HOLDING PERIOD REDUCED TO 3 MONTHS

[In percent]

		Adjusted gross income		Age			
	Total investors	$100,000 or more	Less than $100,000	Under 35	35 to 54	55 to 64	65 and over
Would make no difference at all to me, wouldn't make any changes	30	29	30	26	25	37	35
Would be more active, trade, speculate, diversify more	26	43	26	32	30	18	33
My plans are for long term investment, growth, not a speculator	23	23	23	27	24	22	17
Depend on my holdings to supplement income—need dividends for expenses, retirement income	7		7		6	7	15
I am too small/old/inactive investor to worry about it	7		7	5	6	7	10
My decisions are not influenced by tax considerations—have faith in my holdings	5	6	5	2	4	4	6
Would be less active, tend to hold longer, be more conservative	1		1	2		3	1
Other (would not change)	3	2	3	7	2	2	6
Other (would invest more)							
Other (would invest less)	1		1		1	2	
All other	4		4	2	4	5	5
Not sure	2	2	2	1	3	(1)	3

1 Less than 0.5 percent.

TABLE P.—CHANGES WOULD MAKE IN OVERALL INVESTMENT PATTERN WITH SLIDING SCALE FOR CAPITAL GAINS TAX AND HOLDING PERIOD

[In percent]

	Total investors	Adjusted gross income: $100,000 or more	Adjusted gross income: Less than $100,000	Age: Under 35	Age: 35 to 54	Age: 55 to 64	Age: 65 and over
My plans are for long term investment, growth, not a speculator; scale changes not significant enough	26	18	22	28	29	23	23
I am too small/old/inactive investor to worry about it	19	2	10	3	9	8	20
Would be less active, tend to hold longer, be more conservative	18	33	17	19	30	17	17
Depend on my holdings to supplement income—need dividends for expenses, retirement income	17	20	17	32	18	14	9
Would make no difference at all to me, wouldn't make any changes	13	12	13	15	16	8	10
My decisions are not influenced by tax considerations—have faith in my holdings	7		7	1	7	6	15
Would be more active, trade, speculate, diversify more	7	10	7	4	5	12	9
Other (would not change)	10	10	10	8	11	13	7
Other (would invest more)	1	4	1		1	1	2
Other (would invest less)	2	2	2		2	3	2
All other	5	4	7	7	15	6	9
Not sure	(1)					1	

1 Less than 0.5 percent.

Senator BENTSEN. Our next witness this morning is Mr. John C. Whitehead, who is chairman of the Securities Industry Association.

Mr. Whitehead, we are pleased to have you.

We will try to complete your testimony this morning, so if you can hold your testimony down to 30 minutes, we would appreciate it.

STATEMENT OF JOHN C. WHITEHEAD, CHAIRMAN, GOVERNING COUNCIL, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY LEON T. KENDALL, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. WHITEHEAD. Thank you, Mr. Chairman.

My name is John C. Whitehead, and I am chairman of the Governing Council of the Securities Industry Association. In my professional capacity I am a partner of Goldman, Sachs & Co. Accompanying me today and sharing in the presentation of this statement is Leon T. Kendall, president of SIA and a professional economist.

We appear before you to present our views on S. 2787 and S. 2842. We have presented to you the full text of our statement and ask that it be incorporated into the record of these hearings and we will now present this brief summary of our views.

The Securities Industry Association is the trade association of the investment bankers and securities dealers of our country. Our members function to raise the capital needed by our business corporations and governmental units and to service the Nation's investment needs of the more than 30 million individuals and institutions who own the securities of American business.

The bills that are before you today recognize the urgent need of providing positive incentives to the Nation's stockholders to invest the capital necessary to meet our country's energy needs, to achieve our environmental goals, and to create new jobs for our citizens. The principles they embody should be swiftly enacted.

These bills recognize that the present capital gains tax is now acting as a serious deterrent to individual investment. They recognize that the incentives adequate for the 1950's and the 1960's are no longer adequate for the decade of the 1970's with its capital shortages and greater risks. The evidence is overwhelming.

First, securities values have failed to keep pace with the country's growth. Most of our national economic statistics are at all-time peaks yet stock prices are lower today than in 1968.

Second, the number of individual stockholders, after growing steadily for many years, has peaked out and is now declining.

Third, for several years now individuals have been selling stocks on balance with the proceeds flowing into savings institutions.

Fourth, individual investors have also been liquidating their investments in mutual funds. After an uninterrupted period of growth for many years, redemptions of mutual funds exceeded purchases by a total of some $3 billion in 1972 and 1973.

Fifth, individuals, who a few years ago accounted for more than half of all trading activity on the New York Stock Exchange, today account for only a quarter of all activity.

Institutions, most of whom pay no capital gains taxes on their transactions, have come to dominate our markets.

Sixth, new issues of equity securities have become very difficult to sell. The number of new stock issues sold in 1973 was down precipitously from 1972, and it would appear now that, in spite of the tremendous need for capital, new equity issues in the first quarter of 1974 may be at their lowest level in a decade.

These bills recognize that the capital gains tax, particularly since it was increased in 1969 from a maximum rate of 25 percent to the current maximum rate of 36½ percent, has been a factor in reducing the flow of savings into equities. They recognize that the time has come for Congress to provide new incentives for equity investment in order not only to preserve but also to enlarge the broad ownership of American business.

Their passage would serve to create a counterbalance to the concentration of power of a small number of giant institutional investors over our securities markets and over our industrial corporations. They recognize the need to provide fresh capital to meet our country's problems. The issue is not a matter of closing a loophole which benefits the wealthy. The issue is rather to preserve and reinvigorate the very essence of our free enterprise society, to encourage risk taking by as many Americans as are willing to make investments in their own and our Nation's future.

Turning now to the individual provisions of the bill, we endorse the concept of a graduated sliding scale on long term capital gains. The present system of taxing gains on assets held for 5, 10, or 20 years at the same rates as those held for 6 months is neither logical, equitable, nor wise from a Federal revenue standpoint. The sliding scale concept recognizes that a large part of past gains are nominal, not real, since they have been the result of inflation.

It also recognizes the importance of unlocking the huge amounts of locked-in gains of those investors fortunate enough to have taken risks in corporate America in the 1950's and 1960's and who are now reluctant to sell and reinvest in more productive assets because of the high tax that would be payable on the fruits of their investment.

Finally, it recognizes that substantial additional revenues are likely to flow to the Treasury as a result of the unlocking process.

As between the two bills, we are inclined to feel that the 5-year stepdown system proposed in S. 2787 is preferable to the year-by-year stepdowns in S. 2842, since the 5-year intervals will produce a lesser yearend lock-in effect. We believe that investment decisions should be as little inhibited by tax considerations as possible.

Senator BENTSEN. Let me ask you about that, if I may interrupt.

I was interested in the two approaches, too, but finally opted in the direction of having a minimal increasing effect, year by year, thinking that surely someone would not be foolish enough to wait 1 year to take advantage of a very minimal drop. However, if they got out to the 3d and 4th year they might wait for the full 5 years to get a major drop in the tax.

Mr. WHITEHEAD. I think a logical case can be made for either system. There is what might be called a secondary lock-in effect as these stepdowns occur. Regardless of the length of the holding period, we feel there is a tendency, as the new stepdown date approaches, whenever it comes along, for a stockholder to hold back on his sale for a few months. But we feel that if he has to look ahead 5 years before a further step-down comes that he is not likely to let that tax saving affect his investment decision.

Senator BENTSEN. Suppose 3 years have passed?

Mr. WHITEHEAD. If more than 4 years have passed it begins to be significant. But there would be at least a 3- or 4-year period where it would not be consequential in his decision, whereas the year to year stepdown might result in his being constantly aware of the change, and it might hold him back. But I think it is a relatively minor point. I think a case can be made for either side.

We welcome and endorse the provisions for more equitable treatment of capital losses. The carryback and carryforward provisions of S. 2842 will provide individuals with the same type of treatment that the law now provides for corporations. It is indeed time to raise the $1,000 offset of losses against ordinary income, hopefully to $5,000, but certainly to $4,000.

We must oppose and strongly urge reconsideration of the provision of S. 2842 which provides for a gradual extension of the long-term capital gains holding period from 6 to 12 months. In our considered judgment, this change, which runs counter to the interests of the stockholders, liquidity of markets, and incentives to initial new investment by potential stockholders, would undo much, if not all, of the benefits achieved by the other provisions of the bill.

The sliding scale concept will encourage an investor at the appropriate time from an investment standpoint to sell his present securities. But this is not enough. The circle must be closed. He must also be encouraged to reinvest the proceeds in other equities. If the tax law merely encourages an investor to sell his present investments and put the proceeds into a savings account, your objectives will not have been achieved.

A longer initial capital gains holding period is a serious deterrent to reinvestment. A typical investor when he makes a new investment in securities expects and hopes to achieve a good portion of the gain in the early months of his investment. Many would simply not make that investment if the tax law locked him in with an ordinary income tax of up to 70 percent of his gain if he sold within a year. Many would feel that the cards were simply stacked too heavily against him.

Furthermore, our markets today, dominated as they are by large institutional investors, desperately need more than ever before the added liquidity which short-term traders bring to markets. A 12-month capital gains period would clearly discourage that kind of liquid trading.

Finally, we believe that such a change will result in substantial but indeterminate loss of revenue to the Government. In this respect we believe that the provisions of S. 2787, which provide for the inclusion in gross income of 100 percent of any gain if the asset was held for up to 90 days but inclusion of 50 percent of the gain if the asset was held for more than 90 days but less than a year, is clearly preferable. Such a provision, taken together with liberalized loss treatment, would truly provide a positive incentive to reinvestment of the proceeds of unlocked gains in equity securities, would encourage the much-needed inflow of new capital into equities and would increase Federal revenues.

A number of other possible incentives, which would clearly benefit the 30 million stockholders of America and enhance the ability of business and Government to raise new capital, have not been included in either bill, but deserve serious consideration and would have our strong endorsement. Several of these are worthy of mention briefly here:

(1) Special consideration for asset-holders reaching retirement age, permitting them a one-time rollover of their assets without incurring tax liability.

(2) A $1,000 capital gains tax exclusion per year when gains do not exceed 25 percent of earned income.

(3) Deductibility of brokerage commissions on stock transactions as investment expenses.

(4) A lifetime exemption for the first $50,000 of capital gains income. income.

We will now turn briefly to the sections of S. 2842 which deal with the institutional investor. We have testified previously before this subcommittee regarding the impact of institutional investors on our securities markets. We continue to share your deep concern over the tendency of large institutions to concentrate their holdings in a relatively few securities. We believe this tendency has had an adverse effect on market liquidity, has resulted in many smaller and less popular companies being denied access to equity capital, and has alerted us to the problems of increasing institutional dominance over the markets and over the companies they invest in.

S. 2842 is a timely legislative recognition and a reasonable attempt to deal with the implications of this trend. We note that the limitations it imposes apply only to pension trust assets. We would think the limitations, if the bill's objectives are to be fully achieved, might better apply to all assets over which the pension trust manager has total or partial discretionary investment authority.

We also note that divestiture is not required if appreciation in the price of the shares is the cause of the violation of the limit. We would think this exception should be modified. The problems of concentration of ownership exist regardless of whether they came about through purchase or appreciation. In our view, these two provisions as they now stand could limit the bill's potential full effectiveness. Even so, we would favor its passage as a positive indication of Congress' growing awareness and concern over the increasing dominance of the large institutions in our free enterprise society.

We recognize that the subcommittee is handicapped in its analysis by a lack of hard information. We know that institutional holdings and activity have increased dramatically in the past few years to the point where they now dominate the marketplace.

But except for the few that choose to do so voluntarily, banks, foundations, endowment and employee benefit funds and many insurance companies do not provide information on their holdings or trading activities to the public or to any government agency. Public reporting should be required of all sizable institutional investors to permit the exercise of appropriate regulatory oversight, to honor the principle of full disclosure and to provide a basis on which to base meaningful responses to many of the vital questions posed by this subcommittee. We believe that action should be taken now to provide for such disclosure.

We certainly appreciate the opportunity to appear before this subcommittee today. Our testimony, however, would not be complete without acknowledging your efforts, Senator Bentsen, to focus congressional attention on the adverse impact existing capital gains tax policies and concentrated equities ownership by large institutions are having on the 30 million individual shareholders in this country. We earnestly urge you to continue your leadership to remedy these new and very real problems of the 1970's.

We will be pleased to answer any questions you might have.

Senator BENTSEN. Thank you very much, Mr. Whitehead, for your comments. They are helpful to us.

We had some testimony yesterday to the effect that if we had this kind of holding limitations on bank trust departments, institutions might be forced into other types of investments—fixed securities rather than equities. Well, if you have a 5-percent limitation on the amount of assets that can go into one stock, I guess that means in this fellow's mind that he must limit his investments to 20 stocks.

How many stocks are in the New York Stock Exchange?

Mr. WHITEHEAD. I think there are about 1,600 on the New York Stock Exchange.

Senator BENTSEN. How about on the American Exchange?

Mr. WHITEHEAD. Another 1,000 on the American Stock Exchange, and some 6,000 or 7,000 in the over-the-counter market.

Senator BENTSEN. Well, if this is really so inhibiting, and you only have 20 that meet the investment standards, the markets are really in pretty tough shape, are they not?

Mr. WHITEHEAD. It certainly seems to me that there are a number of investments for large institutions to invest in within the equity markets.

Senator BENTSEN. Do you really think those limitations in my bill are so onerous and so inhibiting to an investment manager?

Mr. WHITEHEAD. No, sir. I think they are very mild. I think they are an important symbol of Congress' concern. But I do not believe they would have very important practical effects on the investment policies of the institutions.

Senator BENTSEN. Well, I guess you heard me say this morning, I think one of the very major problems facing this Nation is going to be providing new capital for growth of industry in this country, and that is why I think it is important that we take steps to try to encourage a free market and growth of the market.

Well, you have been very helpful, and I appreciate your testimony and your contribution to us. We will be calling on you for additional information as we go along.

Mr. Whitehead, thank you very much. We appreciate your contribution.

Mr. WHITEHEAD. Thank you very much, Senator.

[Mr. Whitehead's prepared statement, an article submitted, and Mr. Whitehead's response to a question submitted to him follow. Hearing continues on p. 257.)

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION, PRESENTED BY JOHN C. WHITEHEAD, CHAIRMAN, GOVERNING COUNCIL, AND LEON T. KENDALL, PRESIDENT

Mr. Chairman, my name is John C. Whitehead and I am Chairman of the Governing Council of the Securities Industry Association. In my professional affiliation I am a partner of Goldman, Sachs & Company. Accompanying me today, and sharing in the presentation of this statement is Leon T. Kendall, president of SIA and also a professional economist.

We appear before you to present our views on S. 2787, an Act to provide a graduated capital gains tax, and S. 2842, the Stockholders Investment Act of 1974. We appear to urge a program of new incentives in the taxation of capital gains on behalf of our member organizations (firms who do over 90% of the securities business of this nation), and the over 30 million direct investors our members serve as clients. These investors span the full range of the people of this nation. The median annual income of shareowners in 1970 was $13,500 and the largest single group (30%) were in the $10,000 to $15,000 category. Almost 19 million shareowners had stock portfolios worth less than $10,000 and they lived in just about every part of the nation. Interestingly, between 1965 and 1970 the southern states led the nation in the percentage increase in shareowners. People living south of the Mason-Dixon Line and in the states stretching from Florida to Texas accounted for 77% of the increase in shareownership since 1965. California is the top state in number of shareowners, having 3.8 million, followed by New York and Illinois. (These data are all from the 1970 NYSE Census of Shareowners.)

One further point, capital gains taxation per se is not important to securities firms themselves. The income earned by our firms in their trading and marketmaking activity is short-term ordinary income and taxed as such. We do not as organizations benefit directly from capital gains rates. We are, of course, indirectly affected by the tax policies established by your Committee. We speak to you not about our own tax problems but about our concern for the problems of our investor constituents, our clients, and the economic health of the nation. We also come to express our concern over the ability and willingness of Americans to supply the financial fuel to keep this enterprise economy progressing in a world beset by shortages of energy, food stuffs, chemicals, paper and a host of other vital goods.

Thus, our constituency is both broad and clear. We see no conflict between the small investor and the big investor and the noninvestor. In fact, we shall demonstrate there is none. All have a stake in the successful operation of the capital formation process.

A TRANSFER TAX ON CAPITAL

The capital gains tax is essentially a transactions tax on the transfer of capital. Obviously, the higher the tax, the lower the turnover. High transfer taxes must inevitably lock-in or immobilize substantial blocks of capital in the form of common stock, real estate, farm land and other equities. Capital that is locked into unsuitable investments and is unable or unwilling to move to where it is needed frustrates the economic well-being of this nation. And to the extent that holders of capital decide to buy or sell on the basis of considerations of taxation rather than economics, the capital evaluation process and the allocation of productive resources become distorted. Moreover, the growth of investment is inhibited and standards of living are endangered.

It is not an accident that few countries tax long-term capital gains and, when they do, it is usually at low rates. I believe our country is ill-served by this type of tax. This is particularly true today. With the massive needs for capital, economists predict over the next few years a transfer tax on capital could become especially onerous. As Senator Lloyd Bentsen said on the Floor of the Senate in expressing concern over the decline in stockholders, "These trends are having an adverse impact on the level of competition in our economy, and also on the ability of our economy to create new jobs and to provide the vast amounts of capital needed to meet such pressing challenges as our energy crisis."

The issue is particularly relevant to the viability of our securities markets. Our stock exchanges and over-the-counter markets are not, as many would like us to believe, a minor appendage to our economy with some of the characteristics of a Las Vegas casino. On the contrary, values which are struck on these exchanges, hour after hour and day after day, are critically instrumental in allocating the real resources of our economy to these uses most important to the American people. When priorities change, it is vital that we have a fair and impartial measuring instrument, a pricing system on corporate effort.

These valuations, which are reflected in stock prices, govern the continuously shifting structure of facilities which produce the millions of different products and services turned out by the American economy. The continuous flow of goods and services in the private sector is determined by investors' judgments on the long-term profit outlook for particular products and services. This judgment in turn derives from ever-changing consumer preferences as manifested in the demand for automobiles, appliances, TV, etc.

For example, when demand for particular goods and services declines, the result is declining profits for their producers, lower stock values and hence lower incentives to invest in new plants and equipment. It is not the immediate profit picture that affects such investments (which have a life of twenty years or more) but rather the long-term profit outlook. But it is this outlook which governs stock prices and hence is instrumental in determining the areas of greatest input of new production facilities. During the past decade, for example, the exceptionally high stock market values posted for computer companies engendered a growth rate for the industry far in excess of what would have developed were there no organized stock exchanges. This is a clear instance of how evolving consumer preferences through the complex workings of both our product and stock markets allocate capital. The oil crisis with its higher multiples on energy stocks is another case in point.

It often appears that the stock price of a company seems to move up and down in the short-run for no discernible reason. But if we average out the uncertainties, the misinformation and the irrational, which tend to be substantially offsetting, so long as markets are fair, the trend values of stock prices do in fact represent the best judgments of the discounted profit-producing potential of the company; that is, the profit-making potential of its physical assets, its marketing organization and its management. Relative stock prices have an unquestionably dominant role in the allocation of capital in the private sector of our economy. They dictate success or failure; they dictate economic life or death.

In order to achieve the most efficient continuous evaluation of stock prices, and hence the values of our existing productive assets, securities markets require liquidity. The markets function most efficiently when transaction volume is heavy. This requires that owners of stock be willing to sell when they judge a price is too high on economic grounds. Similarly, there should be no impediment to the purchase of stocks when prices are considered too low. Markets should function like a giant cross-sectional, representative public opinion poll.

Impediments to the efficiency of our securities markets are more costly to our economic welfare than is generally recognized. The current capital gains tax, I believe, has clearly decreased participation by individual investors and reduced liquidity of our stock markets. This fact combined with the concentrated buying and selling power of institutional investors concerns us greatly.

In my judgment, markets would function far more efficiently without such a transfer tax, and it is particularly important in the years immediately ahead that the efficiency of our markets improve. Great new burdens have been placed on the evaluation process by the need to reorganize physical resources to meet the shortages and needs for new capacity in basic industries like energy, chemicals and paper, which suddenly abound. Moreover, every analysis of corporate financing requirements over the next decade points to a substantial increase compared with the past ten years, in the need for new equity capital. Efficient stock markets are required to facilitate such financing.

But even on revenue grounds, there is documentation that the current capital gains tax is too high. A lower rate would free a large block of capital assets which are currently locked in and thereby increase rather than decrease federal revenues.

Accordingly, we support the objectives of S. 2787 and S. 2842 in their quest to encourage capital risk-taking by both existing and prospective investors. They would give greater liquidity and fluidity to the nation's stock of wealth and "turn in on" again to work for the people and to solve our new national needs. In the same vein, we believe that the proposals advanced by Senator Bentsen to diffuse the concentrated power of institutional investors will also serve to correct imbalances in today's market and make them more efficient measuring rods for corporate effort. Just as a "Prudent Man Rule" was adopted as a canon of sound financial investing for the public investment institutions of earlier times, so too in the 1970's, the era that saw the emergence of the pension fund as the dominant institutional investor, a "Prudent Institution Rule" is very much in order. We view Senator Bentsen's self-policing proposal as an ingenious, modern equivalent of the prudent man rule and compliment him for it. We will return to the specifics of the Bentsen and Fannin bills shortly.

CAPITAL MARKETS: A TROUBLED AREA

One of the most unique assets of the United States is its system of capital markets. Working through a delicately meshed combination of investment bankers, brokerage firms, stock exchanges and institutional investors, the American people have demonstrated a tremendous capacity to generate the savings and investment dollars necessary to fuel this economy, to provide new jobs for its youth, and to finance the needs of its people and governments. Capital is a valuable and scarce resource—one that is just as important but, at times, less understood than other resources—land and natural resources, labor and management. Capital must be mobile, that is, be in the right places at the right time. It must be efficient, that is, produce as much as it can at as little cost. In an enterprise economy it must be available in ready supply at a fair price. In addition, as we expand the mobility and fluidity of our nation's financial wealth we also enlarge the tax base of this nation. Holders of capital, along with present income earners, need incentives to forego spending now and take on the risk of investing if growth is to occur.

There are disturbing signs that the savings and investment capital of this nation is not doing the job it can, should and must do for the American people if our economy is to progress and provide more jobs and opportunities for our people and a larger tax base for our government. The willingness of Americans to take risk is atrophying at the same time that the risk of investing is increasing. Many older investors are locked in and will not turn over their savings. Others are seeking safe rather than venturesome investments. With the aid of a series of charts and graphs we will try to demonstrate the accuracy of these statements.

Chart 1. Securities values have failed to keep pace with the growth of this nation. The GNP is up, personal income is up, personal savings is at an all-time record. Yet, the Dow Jones average, representing our largest and most widely held companies (firms that in the aggregate have almost 10 million stockholders of record) is lower today than in 1968. Our investment banking members tell us job-creating new issues are harder to sell. Even companies as big and basic as AT&T express concern over the cost and supply of new funds.

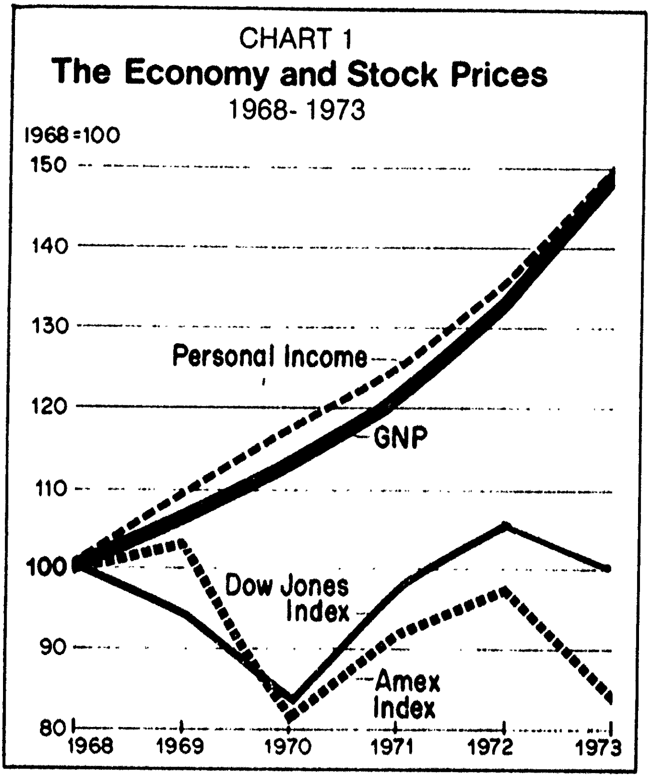


Chart 2 shows that savings deposits have been the winner of late, while direct investment in securities has been avoided. In fact, during 1971, 1972 and 1973, people actually liquidated risk assets—they sold their stocks. Were it not for purchases by individuals of bond funds and government savings bonds, the direct investment figure shown on the chart would be below the zero line in all three years.

There is disturbing evidence in the fact that the number of individual shareholders in the nation today has not only peaked out, but has declined. Surveys conducted by the Louis Harris polling organization and by Opinion Research Corporation indicate that after a decade or more of steady growth, fewer households respond affirmatively when asked if they own stocks. The New York Stock Exchange reports that in 1973 there were 800,000 fewer shareholders than in 1972, the first decline in shareholders since such data have been collected. We fear the 1974 survey will show another such decline.

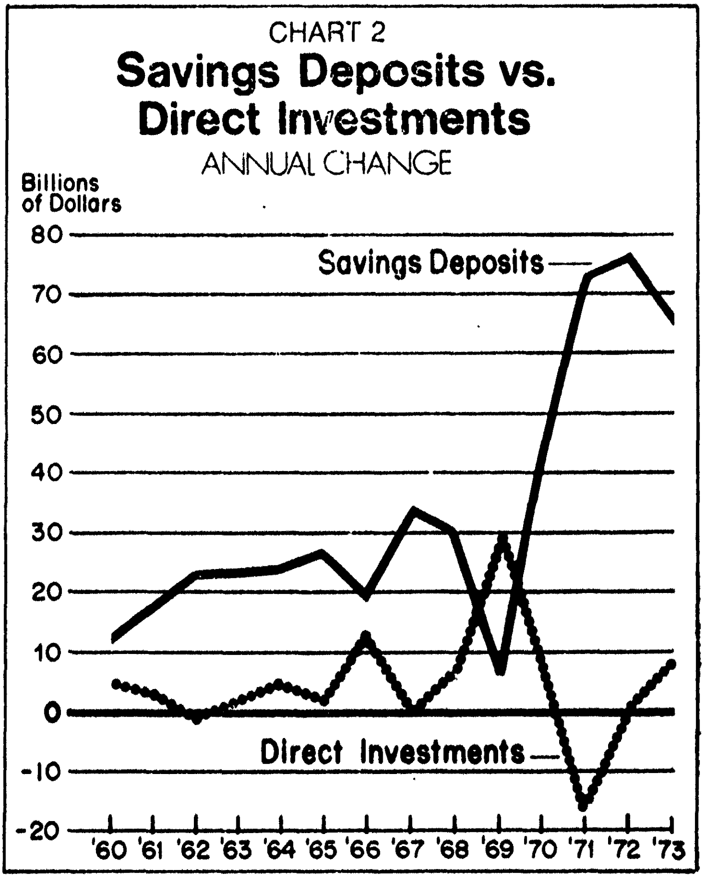


Chart 3 shows the trend of small orders, or odd-lots. The typical odd-lot purchase or sale involves $1,400. The bars at the bottom of the chart show that such orders have declined from 21% of total NYSE volume in 1960 to a modern-era low, perhaps an all-time low, of 4.8% in 1973. The upper portion indicates that small investors have on balance sold more odd lots than they purchased each year since 1066.

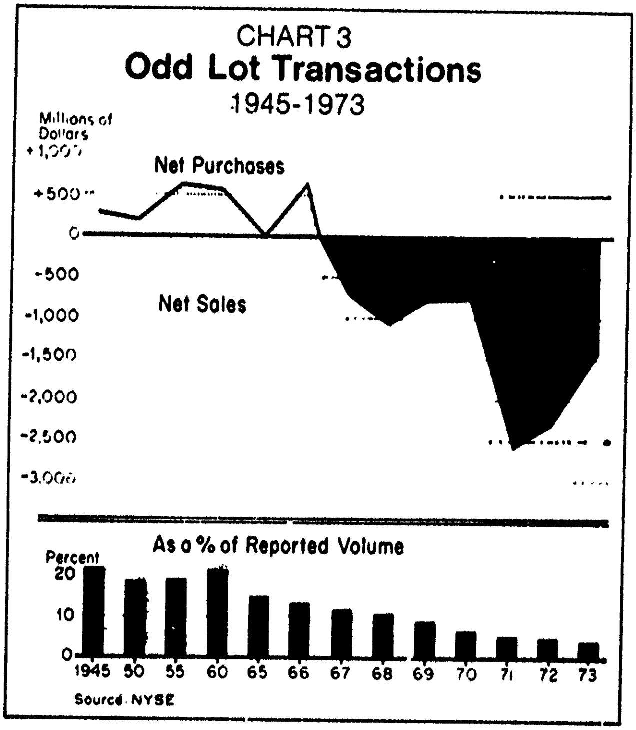


Chart 4 shows individual investors are not buying mutual funds either. After purchasing funds vigorously throughout the 1960's and for a generation before that, mutual fund holders have redeemed more shares than they purchased for eight straight quarters and 11 out of the last 12 quarters on a net basis. In 1972, mutual fund shareholders liquidated $1.7 billion of their holdings. In 1973, liquidations totaled $1.3 billion. These are but a few of the signs that the individual investor is no longer willing to take the risks necessary to make this economy progress. We believe one of the reasons for this is that incentives which once were sufficiently attractive to encourage Americans to take risks are not longer strong enough to do the job.

Let me offer a simple example. Take a man who has $10,000 and puts it into a savings certificate. He can get a return of 7.90%, or $790 a year and he'll get his insured safe $10,000 back. Now take the same man and ask him to put his $10,000 into a risk asset—common stocks. Typically, he is likely to get a dividend of closer to 3% or $300, and is asked to run the risk that his $10,000 when he wants it back might be $9,000, $8,000 or $7,000, as well as $11,000 or $12,000. To encourage a saver to take such a risk we need to give him a positive incentive—a stronger incentive than a few years ago. If he risks his hard-earned, already taxed money to help this economy create new jobs and grow, then we should recognize that such tax incentives are indeed a sound national investment as well.

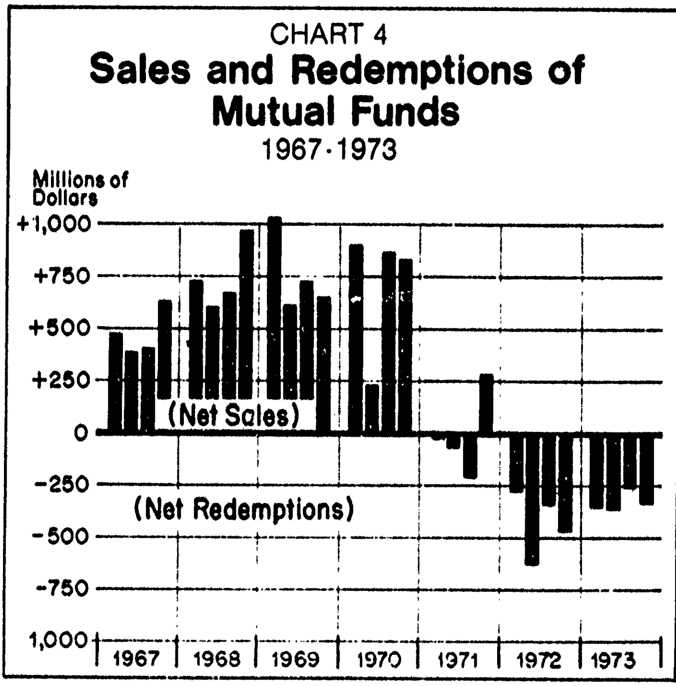


Chart 5. One factor making it difficult to sell the broad range of new securities to investors over the past 5 to 7 years has been the institutionalization of our securities markets. Large banks, insurance companies, pension funds, mutual funds, and the like, now account for an estimated 75% of public trading on the NYSE.

Individuals who, as the chart shows, were in the majority as recently as 1966, today account for only around 25% of trading. The bulk of the institutions pay no taxes or pay taxes at rates lower than individuals. In many institutionally managed accounts, buy and sell decisions are made without regard for short-term or long-term tax consequences. These institutions, typically, do not buy the new job and new tax-base creating issues of the expanding smaller companies. They also avoid "unglamorous" investment groups like public utilities. The decline of the individual investor is damaging the liquidity of our markets and the ability of small companies and larger "unpopular" companies to raise money.

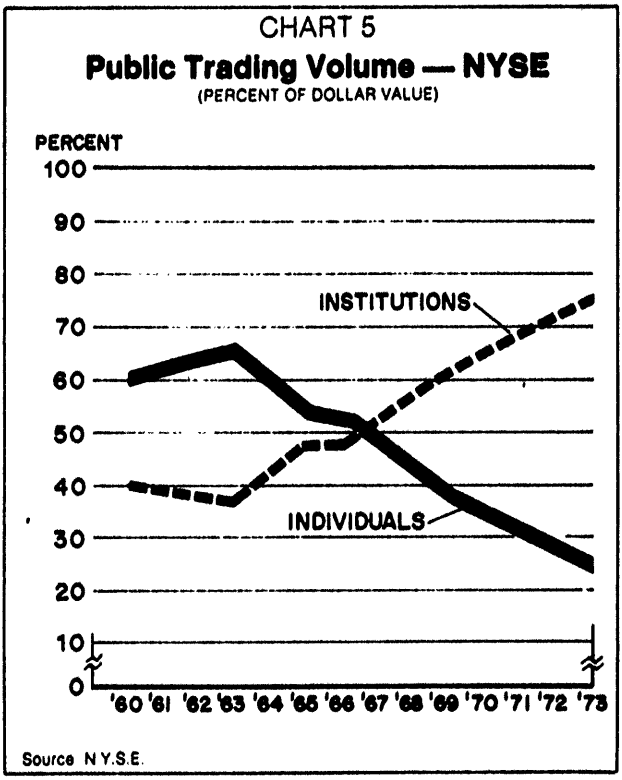


Chart 6. In the first three years of the 1970's the securities industry raised over $300 billion in new capital for business and governments. The year 1973, however, was unique in investment banking history. Typically, a year with the industrial exuberance of 1973 and spreading capacity shortages would produce a multitude of investment banking opportunities. The opposite proved true. The number of debt and equity issues in the entire year, 728, was down 60% from 1972, and in dollars, corporate financing volume was off 40%.

CHART 6

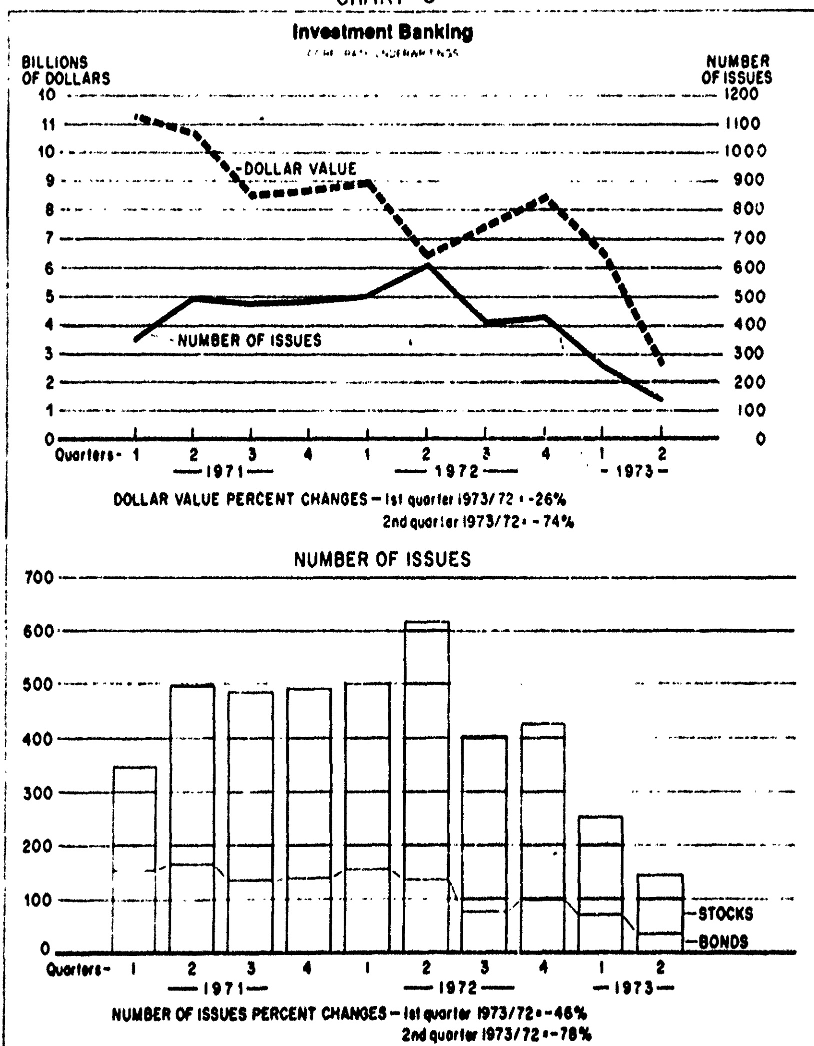


Chart 6 shows the extent of the decline. The number of new issues indicated by the bars at the bottom reached a low of 150 in the second quarter of 1973, compared with over 600 in the second quarter of 1972. The downtrend in the dollar value line says to us that at just the time when American business should have been expanding capacity to avoid the shortages that were emerging it could not because the markets would not allow it. We are saddled with shortages today in good part because people did not invest and take risks yesterday. They did not do it because the incentives to take risks were not there.

Looking ahead, the great new challenges in developing new energy reserves, oil, natural gas and atomic power, of financing the housing needs of American families, of preserving the ecological balance, of financing transit systems and other urban services in these difficult times of high interest rates will take more, not less, capital from more and not fewer people. The only group with a pool of monies enormous to meet the nation's requirements is the great mass of American households. Yet, the demand for more capital and for more diverse types of capital is encountering less willingness to take risks and a desire to preserve assets.

CAPITAL GAINS TAX: A TAX ON PROGRESS

We view the capital gains tax as a tax on progress. During the 1960s and particularly after 1969, incentives offered individual Americans through the capital gains tax became insufficient to attract them to investing. The ravages of inflation, the ups and downs of the markets, the alternative of high return secure savings deposits, all prompted investors to look elsewhere. If these trends continue, this country will simply not have the capital to overcome the shortages we face and to finance the expansion we seek. We must both make up for lost time and prepare for the future.

If these trends continue, where will the money come from to provide new plant facilities and new jobs in an expanding economy? The time has come when Congress must provide new incentives for equity investment to preserve the broad ownership of Amelrcan business and to avoid the concentration of power over our industrial capacity in the hands of a small number of giant institutional investors.

The question of the capital gains tax is not a matter of "closing a loophole" which benefits only the wealthy. The issue is preserving the very essence of our free enterprise society, encouraging risk-taking and providing incentives to encourage personal and financial growth for the benefit of all America. America's wealth cannot grow unless the personal wealth of families grows, too.

CAPITAL GAINS TAX: A TAX ON INFLATION, NOT REAL GAINS

As a result of inflation much of past gains are nominal, not real. Is it equitable to tax a gain which is the result of inflation, particularly when such gains are lumped and considered for tax purposes only in the year when that gain is realized? We think not. For example, if an investor bought $1,000 worth of stock in 1962 and sold it for $1,300 in 1973, there would be no real gain. The gain would coincide with 10 years of inflation and the tax would be a levy on inflation rather than on real gains. Some have termed inflation the cruelest tax of all. A capital gains tax which fully taxes inflation is doubly cruel.

The system of capital gains taxation should recognize the degree to which inflation has been responsible for the nominal dollar gain recorded on a capital investment over the past several decades. The table shows the effect of inflation on $100 invested in securities at different times in the past.

VALUE OF $100 INVESTMENT AFTER INFLATION ADJUSTMENT SELECTED YEARS, 1947 TO 1972

Year	Real value of $100	Inflation loss (percent)	Percent per year
1967-72	$80.60	19.4	3.9
1962-72	72.80	27.2	2.7
1957-72	67.00	33.0	2.2
1952-72	60.00	40.0	2.0
1947-72	51.30	48.7	1.9

Note: Price index: GNP deflator.

Furthermore, a system of capital gains taxation equitable for a period of 2% to 3% per year inflation, is decidedly inappropriate for a period of 4% to 6% per year inflation. (The 1973 rate was 8.8% as measured by the consumer price index.)

Consider the effects of a 4% and a 6% inflation rate on the nominal growth of capital if it continues for five and ten years:

	Assumed inflation per year (percent)	Inflation loss (percent)	Value of $100 in 1972 dollars
1972-77	4	17.8	$82.19
	6	25.3	74.73
1972-82	4	32.4	67.56
	6	44.2	55.84

If the 1973 rate of inflation were to continue for the next five years a full 84.4% of any nominal gain would be illusory and totally attributable to inflation. If it continues for 10 years, a gain of 57% would be nothing more than inflation.

UNLOCKING THE LOCKED-IN GENERATION

There is a second important reason why consideration should be given to revising the system under which long term capital gains are taxed. That is the locked-in effect. At no time in our history has the locked-in effect been more severe than it is today. The reasons are inflation and the vigorous growth of this nation over the last several decades.

There is mounting evidence that we have spawned a whole generation of individuals who are reluctant to sell or cannot afford to sell their security holdings because of the capital gains tax. These are individuals who purchased risk shares yesterday in today's growth giants, such as Sears Roebuck, Xerox, IBM, and so many other successful American corporations. They now are unwilling to sell their holdings as a consequence of the tax. Because these individuals will not sell, even though they may be inclined to do so, this capital becomes sterile. Unless and until these gains are unlocked, the government gets no revenue and these funds are unavailable for reinvestment in areas of new national need.

A PROGRAM TO ENCOURAGE CAPITAL INVESTMENT

It is our conviction that the encouragement of rsik-taking is a vital first step if our capital markets and our free enterprise system are to meet their responsibilities to the American people. Based on this conviction, we recommend the following steps:

I. A graduated sliding scale on long-term capital gains

We believe the present system of taxing gains in assets held for 20 years at the same rate as those held for six months is neither logical, equitable, nor wise from a federal revenue view. New positive incentives should be added to the capital gains tax system to unlock these locked-in dollars. This can be done by introducting the concept of a sliding scale into long term capital gains. By reducting the amount of gain to be included in taxable income as the length of time an asset is held increases, positive incentives can be given to shareholders to unlock long held assets. A scale of the type we advocate is set forth below. It coincides with the scale incorporated in S. 2787 and after Year 1, the percent inclusion declines on a five year step rate basis.

Although S. 2842 adopts the principle of a graduated rate, it does so on a year-by-year basis and at a slightly slower pace. We favor the five year step down because we believe that the year by-year step down runs the risk of introducing a new (albeit less onerous) lock-in to the taxation of capital gains—investors may in the final months of a year elect to wait for the next year to reduce by another 2% their taxable gain. While this tendency to delay a sale might also apply to the five year step-down, it would only apply in the final months of each five-year period.

PROPOSED LONG TERM CAPITAL GAINS GRADUATED SCALE

Holding period	Percent inclusion	Effective maximum tax rate[1] (percent)
0 to 3 mo	100	70.0
3 to 12 mo	50	35.0
1 to 5 yr	40	28.0
5 to 10 yr	30	21.0
10 to 15 yr	20	14.0
15 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.

Who would benefit from this approach? First, it would benefit the economy by increasing capital flows. Second, it would benefit government finances by adding new tax revenues. Third, it would benefit individual taxpayers—most of all, older citizens. And, fourth, it would improve the liquidity of our markets.

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 gain 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 $238 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.

Benefits for the Elderly.—Estimates prepared by the Research Department of the New York Stock Exchange based on Treasury data and trading information show that on a dollar value basis over one-third of equities held by individuals are owned by persons 65 years of age and older. These individuals, 65 and over, trade only modestly. They hold 38% of all individually owned equities, yet account for only 14% of the trading activity. They cannot now afford to sell. Yet, these are precisely the people who should sell to help not only the economy but also themselves. Consider this example: Take a pensioner who has accumulated equities through the profit sharing plan of Sears, Roebuck & Company. As Arthur Wood, president of Sears, testified in 1969, a typical longterm employee on retirement is likely to have a pool of Sears stock worth $100,000. The yearly dividend yield on that stock today is less than 2%, or $2,000 a year. If that pensioner could sell those securities and diversify his holdings, as he should, and purchase corporate and other bonds yielding 7% or more, he could increase his income to over $7,000 a year (and pay more taxes, too). Yet, he will not sell because of the capital gains tax.

The same problem faces a farmer, rancher or proprietor of a grocery store who labored over a lifetime to build up his business. We do not pretend to be experts in grocery economics, but a man who took a $10,000 stake 20 years ago and built it into a $100,000 operation has a very difficult decision to face at around age 65, He'd like to realize what he developed and retire, but because of the tax situation, he cannot afford it.

We offer a very specific suggestion here: We recommend that the tax code be amended to permit individuals upon attaining the age of 65 to roll-over one time any assets that qualify for long term capital gains tax treatment without incurring any tax liability. This procedure would permit retiring individuals to re-order assets they have accumulated in a manner best for their new circumstances, it would free or mobilize assets, and it would help the elderly without costing the government any revenues.

The problem of lock-in is not a problem of the elderly alone. The NYSE Shareowner Survey of 1970 indicated that of the 21.5 million direct individual investors making $20,000 or less, more than half made no transactions in 1969 and 1970, and 29%—over 6 million—had no purchases or sales for 3 years or more. Since 1970 all signs indicate that turn-over has been reduced further. Investment advisers counsel a continuous review of asset holdings. A regular review and shifting of such investment would be in the interest of both the investor and the nation. We need assets working in the right places, not hibernating in the wrong places.

Throughout this discussion of unlocking assets, we have assumed that any gains realized would be reinvested. Now we hasten to point out that this will not be so unless positive reinvestment incentives are provided. That is why we propose a redesign of the holding period and more equitable treatment of capital losses. The circle must be closed or the pool of risk capital will shrink. It would defeat the purpose of unlocking if all such assets were to leave risk investment and move to savings accounts and savings bonds or be spent. The goal is to attract new funds and to mobilize existing capital through reinvestment.

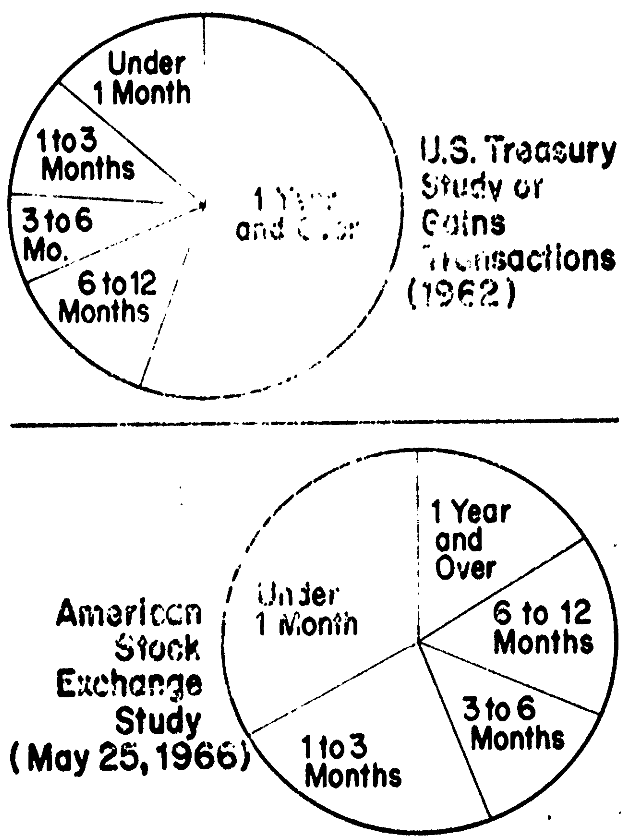
II. Modernization of the holding period

The current six-month holding period, which has been part of our income tax law since 1942, has never been a fully satisfactory demarcation point between short-term gains. In fact, any such sharp single line creates artificiality.

The most recent study by the United States Treasury on gains transactions in corporate stock by length of holding period covers returns for the year 1962. We have urged new, updated studies, but to no avail. It indicates the following: The number of gain transactions on stock held under one month (408,000) was almost as great as the total for the entire 6-to-12 month period (432,000). *See Chart 7.* Approximately three-fourths of all short-term gain transactions occurred

CHART 7

Holding Period of Securities



within three months of purchase. The New York Stock Exchange in its various public transaction studies has developed data which show as much as 20% of shares sold by individuals are held for one month or less. A 1966 study by the American Stock Exchange found that as much as 48% of the transactions in its listed securities were in the three month and under category. Thus six months may be a longer period than necessary to catch most short-term transactions.

This evidence plus our experience with investors prompts us to recommend the following:

(1) That "short term" gains be defined as those accruing from the sale of assets held for three months or less and that these be taxed fully as ordinary income making the top rate 70%.

(2) That "intermediate term" gains (a new category) be defined as accruing from the sale of assets held between three months and twelve months and that the present 50% inclusion treatment be accorded such gains, making the maximum effective federal tax rate here 35%.

(3) That transactions involving assets held for more than one year be defined as "long term." We believe that such longer term holdings should be subject to the sliding scale rate treatment which I will describe later in this statement.

The proposed three-part division of the asset holding period would bring capital gains taxation into line with the facts of investment life. Six month holders are neither short term nor long term investors based on any data we have been able to analyze. All available evidence, plus our own investment experiment, shows most short term traders to be individuals who hold their investment positions for less than three months. The intermediate three month to twelve month tax treatment would air measurably to attract individual investors back to risk-taking once again. It would indicate that our government not only intends to remove the uncertainty among investors regarding the status of capital investment but also seeks to create positive incentives for new investment. The liberalized holding period would facilitate public offerings of newer, higher risk securities.

A recent study conducted by the Oliver Quayle organization for the New York Stock Exchange indicates how great an impact the holding period has on investor attitudes and actions. It shows that an increase of the holding period from 6 months to 12 months would reduce liquidity producing transactions. A full 28% of those intervlwed would have postponed transactions and held stock longer. A reduction in the 6 month breakpoint to three months would increase activity on the part of 25% of all investors and 42% of high income investors. Note also that the effect of a reduction of the holding period to three months would increase capital gains realizations, raising additional revenues by $138 million per year.

III. Equity in Treatment of Capital Losses

The present system of treating capital losses is inequitable, particularly when viewed alongside the treatment of capital gains. As the current market demonstrates, the opportunity for reward is balanced by the risk that values will decline as well as rise. From the point of view of the asset holder, realizing a loss on assets hurts just as much as a loss in business or a loss from casualty or theft. We need incentives to encourage investors to take their losses and recycle their remaining capital.

An investor with a long-term capitol loss can offset that loss against long-term gains, but can carry over only one-half that loss against short-term gains and is limited to an offset against ordinary income of only $1,000 per year.

Ideally, in order to encourage risk-taking, the deductibility of losses should be as full as possible. Investors should be incouraged to act on economic rather than tax logic. Individuals should be provided a very strong incentive to choose a risk asset as against insured savings account

We propose that losses incurred during the first 3 months be offset fully against gains and then against ordinary income. From 3 to 12 months, if our intermediate term concept should be adopted, we would suggest including 50% of any loss as an offset against gains, and then as an offset against ordinary income.

For longer holding periods, based on the premise that a realized capital loss is a real loss of already fully taxed dollars, we would view the 50% loss inclusion as fair.

Finally, if the Congress feels that a limit must be placed on the capacity of an investor to offset capital losses against ordinary income in any one year, we believe that the economic realities of the past few decades mandate a rise in the

$1,000 annual limit on the offset against ordinary income to $5,000. The $1,000 limit has been in effect since 1942. Since that time, inflation has eroded the dollar to where the value of the $1,000 offset in real 1942 purchasing power is approximately $350. In addition, median family income has risen by 500% during the intervening three decades—from near $2,000 to over $10,000.

COMMENTS ON SPECIFIC PROVISIONS OF S. 2787 AND S. 2842

We view with favor the introduction of a graduated sliding scale into our system of capital gains taxation as proposed by both Senators Bentsen and Fannin. This new incentive is very much in keeping with the needs of investors and the markets of the 1970's. We find the 5-year step-down interval set forth in S.2787 preferable to the annual step-down in S.2842. The 5-year step-down encompasses a longer time span between steps and therefore avoids the risk of a new type lock-in wherein individuals might forego economically desirable transactions during the latter months or weeks of each year to obtain another 2% tax benefit.

Regarding the holding period, it is evident to us that the sooner the investor can foresee the benefits of capital gains treatment, the greater the incentive to take the risk or new investment. Studies show that individuals purchasing securities typically do so because they expect the stock to rise in the early months of their ownership. With the clouds of uncertainty surrounding our national and world economy, it is harder today than any time since the great Depression to get potential investors to take that first step into new equity risks. The proposal of S.2787 to substitute a 3-month holding period is a positive response to that new reality. The lengthening of the holding period to 12 months in S.2842, albeit at a rate of one month per year over the next six years, is a step in the wrong direction.

In the treatment of losses, both bills move in the direction of providing greater incentives to get funds moving again. Equity here is needed. In addition, it is indeed time to raise the $1,000 offset of losses against ordinary income. We favor raising the limit to $5,000. The proposal of S.2842 to accord individual investors a three-year capital carry-back and a one-year carry-over is a very positive forward step. It will provide for individuals parallel treatment to that now accorded corporations. One provision of S.2842 regarding losses causes concern. The bill would apply the same sliding scale of exclusion rates to losses as to gains. If a long-term investor in Penn Central stock (perhaps an employee) had purchased 200 shares at $45 per share 15 years ago, then sold his stock at $5 per share of the actual $8,000 loss, only 20 percent of the loss or $1,600 could be used as a capital loss to offset other capital gains or against income. As stated earlier, ideally it is perfectly equitable to permit all losses to be deducted in full. A loss is a loss no matter when it is incurred. We urge this provision be dropped.

One other element of S.2842 concerns us. This is the repeal of the 25 percent alternative tax as it applies to thhe first $50,000 of net long term capital gains. The effect will be to increase the tax burden on the first $50,000 of gains for any investor whose top tax bracket exceeds 50 percent. For a person in the 70 percent bracket, the capital gains tax would rise immediately to 35 percent and, under the sliding scale of S. 2842, he would not get back to his or her present 25 percent rate status on the first $50,000 of gains for 7 to 8 years. We believe this condition dilutes the intended impact of S.2842 and join with the concerns highlighted in the testimony of The New York Stock Exchange on this point.

OTHER INVESTMENT STIMULANTS FOR THE 1970'S

The need to stimulate individual participation in corporate ownership and risk-taking has been well demonstrated. We are encouraged by the number of proposals to do this, both from individual legislators, exchanges, interest groups and individuals. Other than those cited earlier, we view the following with favor:

A $1,000 capital gains tax annual exclusion when gains do not exceed 25 percent of earned income.

Increase from $100 to $200 the dividend exclusion.

Permit commission paid on stock transactions to be deductible from ordinary income as investment expenses.

Permit a lifetime exemption for the first $50,000 of long-term capital gains income.

Such incentives in combination by increasing individual participation in equity investment would create a strong counter force to istitutional concentration and encourage markets that can be free rather than artificially constrained by stultifying rules and regulations.

Let us turn now to the sectors of S. 2842 concerned with the institutional investor.

LIMITATIONS IN S. 2842 ON CONCENTRATION OF PENSION FUND INVESTMENTS

We have testified previously before this Subcommittee regarding the impact of institutional investors in the stock market. We continue to share your deep concern over the tendency of at least certain institutions to concentrate their holdings in a relatively few securities of the country's largest companies. We believe that this development is having an adverse effect on market liquidity and is resulting in many smaller and often newer companies, which are the life blood of a continuously regenerating enterprise economy, being denied access to equity capital at reasonable prices to finance their growth. In addition, we fear investment concentration could cause the development of a Japanese-style economic-industrial complex where a handful of giant institutions control most of the larger corporations.

S.2842 is a timely legislative recognition and an attempt to deal with certain implications of this trend in the area of private non insured pension funds. The following table shows the vigorous growth in pension funds in just the past few years:

ASSETS OF PRIVATE NONINSURED PENSION FUNDS

[Billions of dollars]

Year	Book value	Market value
1966	66.17	72.80
1967	74.24	85.50
1968	83.07	96.00
1969	90.58	94.60
1970	97.01	104.70
1971	106.42	125.00
1972	117.53	150.00

In brief, it shows that pension fund assets doubled in six years—from $72.8 billion in 1966 to $150 billion in 1972. The bulk of these funds are invested in common stocks. Moreover, it appears that management of these funds is highly concentrated in the hands of a relatively few investment managers, and that many such managers have shown a tendency to concentrate their pension fund investments in a narrow spectrum of institutionally-favored stocks. S. 2842 seeks to provide a check and balance to this tendency through a modern application of the time honored prudent man investment principle.

We believe that application of such a principle to pension fund investments would serve two beneficial purposes; first, it would ameliorate the stultifying effects on the securities markets which have resulted from over-concentration in a few stocks: and second, it would assure that the door to new equity capital is kept open to smaller and newer companies. There are sound legal and historical precedents for the adaptation of the prudent man rule in the form of a "prudent institution" rule. Generally the purpose of the rule has been to require risk diversification, and therefore risk minimization, in fiduciary investments. In varying forms it has been applied by law specifically to the investment portfolios of diversified mutual funds, life insurance companies, savings banks, as well as finding statement in numerous general statutory and common law standards governing trusts and estates. (See Sauvain, *Investment Management* (3d ed. 1967) pp. 547–48, 619–23, 629). We believe that this cardinal principle in keeping with historical precedent can appropriately be applied also to this modern task, to guard against the concentration of enormous pension resources in the securities of only a few large corporations. Parenthetically, we note that there is also precedent for effecting such a requirement through the Federal tax laws. For example, mutual funds and real estate investment trusts must, among other things, satisfy certain diversification tests in order to qualify for special treatment under the Code. This approach also promises greater administrative convenience and less likelihood of market disruptions than might be the case with other approaches to the problem of investment concentration.

The survey report, "Equity Trading and Investment by Trust Departments," recently published by the American Bankers Association, disputes the claim that bank trust departments have tended to concentrate their holdings in a narrow range of investments. We are pleased to note this record for banks generally, for we have suspected that this is so. Our concern has been over the actions of those few bank managers who might be tempted to excessive concentrations. Indeed, the remedy proposed in S. 2848 is as a practical matter so mild, so in accord with sound principles of prudent investment management, that hardly any pension fund manager will be affected. However, what is significant, in our opinion, is this expression of deep concern by the Congress over the increasingly concentrated power of these institutionalized funds and of the need to set forth reasonable safeguards as to how such power can be exercised in investment markets.

Let me also state that all of us—and I certainly do—believe in the maximum freedom for investment judgment. But there are times when we believe this consideration must yield to over-riding national needs. It is of overwhelmingly greater importance to the nation to preserve the securities market and a broadly-based capitalistic system than to have a few giant investment maangers free to exercise their unfettered judgment.

We wish to reiterate a concern expressed to this subcommittee last summer regarding the need for more facts and figures on the role of institutional investors in the securities markets.

Regular and comprehensive institutional reporting was the major legislative recommendation of the SEC Institutional Investor Study undertaken pursuant to a Joint Resolution of the 90th Congress. We believe that public reporting should be required of all sizable institutional investors· This would permit the development of appropriate regulatory policy, honor the principle of full disclosure, and provide a basis on which to fashion meaningful answers to many of the vital questions posed by this Subcommittee. We believe that such action taken now would provide important new facts and insights permitting fuller understanding of the effects of all types of institutional investing on markets, capital formation and economic activity.

[From the Journal of Commerce and Commercial (New York), Feb. 5, 1974]

Where Have All the Investors Gone?

Everybody knows by now that the individual investors have been deserting the stock market in droves for several years. What everybody does not know is that this trend is depriving American business of a source of capital, resulting in its complete dependence upon debt which now is being pushed high enough to be dangerous.

There are ample grounds for disillusionment about the stock market on the part of individuals. Average yield on stocks of the best grade is far below what can be had on savings deposits alone, to say nothing of other avenues for employment of money. Glamor stocks are selling ex-glamor; growth has become something that is no longer assured. The general idea has been that this is one of those things about which nothing can be done. On the contrary, much can be done.

In 1971, 1972 and 1973 people heavily sold stocks in order to employ funds as savings. In recent years even investments in mutual funds have been cashed in faster than new investments have been made. The share of individuals in trading volume on the New York Stock Exchange has fallen from a peak of 65 per cent in 1963 to less than 30 per cent. The fact that the stocks individuals have sold have moved into institutional hands does not indicate they are adequate substitutes for the risk-taking individual investor who is now wanting out.

What can be done to remedy this situation was recently outlined by Henry H. Fowler, one secretary of the treasury we had who really worked hard at that job, and who has of late been working equally hard for the investment banking firm of Goldman, Sachs & Co., of which he is a partner. Mr. Fowler's remarks were made in a 20-page speech before the National Canners Association and his prescription got inadequate public notice.

The inadequate public notice probably was due to the fact that Mr. Fowler didn't get to the real point of his speech until he had reached Page 18 of the 20 pages it occupied. Anyhow, the point he made, was that the percentage of the long-term capital gain that is taxed as ordinary income should be reduced to 30 from 50 per cent. This would make the maximum rate 21 per cent on long-term capital gain of an individual in the top 70 per cent income bracket instead of the current 35 per cent, with correspondingly lower rates for taxpayers in lower brackets.

Mr. Fowler also would graduate downward the rate of inclusion geared to the length of the time period investments were held—for example: decrease the percentage of gain at five-year intervals up to 20 years to, say, a minimum of 10 per cent.

While this might not lure back to the stock market all the 800,000 individuals who are estimated to have quit stock investment since early in 1972, it would provide a definite incentive for those on the way out to stay in stocks and, over time, might lure some of the quitters back.

We recognize that any suggestion for easing capital gains taxation runs counter to current political philosophy seemingly adopted by Republicans, of all people, that it is better to prevent a few millionaires from getting richer than it is to provide a wide and growing stock market as a source from which business can raise capital with which to expand.

Mr. Fowler, indeed, is at pains to explain that what he proposes is nothing new; indeed, when Mr. Fowler was a struggling undersecretary of the treasury under President John F. Kennedy he worked the idea up and Mr. Kennedy incorporated it in his tax message to Congress in 1963. To quote just one paragraph from that message:

"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy."

Congress didn't buy Mr. Kennedy's proposal, and since 1963 there has been a steady exodus of the vital risk-taking individual from the stock market, which has had much to do with the current depression in the securities business and which has brought up a new specter not present in the 1963 period—the mushrooming of debt of all kinds to reckless and dangerous levels which, in the case of corporations, would have been obviated had there been an adequate market in recent years for new shares.

Maybe the ideas espoused by Mr. Fowler and sponsored by President Kennedy in January 1963 were in advance of their time. Maybe their time has now come. To us Mr. Fowler's rewriting of his prescription of 1963 seems exceptionally timely for much of what now ails our financial markets.

Question and Answer

Question. Mr. Whitehead, the tax laws can have a very real effect on the willingness of a financial institution to take risks and to compete. How would you compare the effects of the Federal tax laws on banks and market-making securities firms like your own?

Mr. Whitehead. First, banks pay taxes at much lower rates than securities firms. This places securities firms, especially as it concerns their investment banking risk-taking in new financing and their market-making, at a distinct disadvantage to banking type organizations. Figures taken from a recent New York Stock Exchange study show how much more taxes brokers pay on net income than banking organizations.

FINANCIAL INSTITUTIONS' INCOME TAX AS A PERCENT OF ECONOMIC INCOME, 1965-71

Year	Brokerage firms [1]	Commercial banks [2]	Savings and loan associations [2]	Mutual savings banks [3]
1965	40.9	23.0	15.2	3.3
1966	43.2	23.0	16.9	6.1
1967	42.3	22.0	13.2	3.4
1968	47.8	21.5	15.8	5.6
1969	46.1	19.0	17.0	4.7
1970	45.5	23.0	21.0	(4)
1971	45.6	19.0	21.0	(4)

[1] "Statistics of Income" Internal Revenue Service; 1970-71, 12 sample NYSE firms.
[2] Data for 1965 to 1967 are from Treasury study cited in (1). The 1968-71 tax ratios were calculated by Edward J. Kane, "Federal Income Tax Burdens of Commercial Banks and Savings and Loan Associations: A Study in Legislative Relations 1972," p. 6. (Kane is Everett D Reese, professor of banking and monetray economics, the Ohio State University.)
[3] "Tax Reform Studies and Proposals," pt. 3, U.S. Treasury Department, Feb. 5, 1969, p. 460.
[4] Not available.

To me these data say that securities firms paying taxes at double the bank rate would find it extremely difficult to compete head-to-head with a bank in the marketplace. Furthermore, the large super-bank is probably more richly endowed with capital, has at its disposal a large body of public deposits and has a more sizable infrastructure of additional services to offer to the potential customer. It can, if it desires, give away the brokerage to attract deposits or to sell certificates of deposit. If public policy is to have as its goal the encouragement of risk-taking by Americans and the financial institutions which serve them through the development of various types of loss reserves and other incentives for financial institutions, then, in the interest of equity, I believe that securities firms in determining their tax bill should be permitted to employ procedures comparable to those now employed by banking-type organizations.

The record of the past several years would indicate that had such a procedure been in operation, securities firms would have been able to weather much more adroitly the cyclical and volatile conditions which have afflicted our industry. Public policy and the desire for public confidence in markets and marketmakers would have been efficiently and effectively served.

Furthermore, we are led to believe that one result of the emergence of one-bank holding companies and one reason for their success is the fact that they can utilize in various ways the public tax privileges available to banking in ways that their single line competitors cannot. It may well be that the alleged efficiency of bank-holding companies is a function not so much of managerial prowess as discrepancies in tax treatment.

Senator BENTSEN. Our next witness is Mr. Thomas Corcoran, senior partner of Corcoran, Foley, Youngman & Rowe.

Mr. Corcoran, you have appeared before this committee before and you have made contributions, and we are looking forward to one this morning.

STATEMENT OF THOMAS G. CORCORAN, SENIOR PARTNER, CORCORAN, FOLEY, YOUNGMAN & ROWE

Mr. CORCORAN. My comments relate to those provisions of S. 2842 which deal with the graduated taxation of capital gains. As you have said, I have appeared before the committee before. I have asked to testify this second time only so that in the plethora of suggestions made to the committee, many of them good, sight will not be lost of the central idea which faces the Congress.

This committee is essentially trying, as has been tried by many Secretaries of the Treasury before, to find a politically feasible economic formula that would permit the continued use of the capital gains tax idea to stimulate and maintain the entire economy for the benefit of labor and capital alike in suddenly changed circumstances which require enormous amounts of capital to sustain a new technology, while a growing public sentiment, which does not appreciate its usefulness, is being raised against the entire capital gains tax conception at all.

As I listen to my friends in the capital business talk about this problem, they do not seem to understand that this is a political and not an economic problem and that pragmatically they have to face the fact that there is enormous sentiment in this country which does not understand the usefulness of the capital gains idea from the point of view of labor and from the point of view of people not in the investment business, and that that simply has to be taken into account if we are going to find any workable solution in time—and the timing, as you says, is important for a long-term sustaining of a new technology which we have to have now.

Tangentially, I participated in the first deliberations about this problem during the 1934 act. It was part of a package of the thinking about the capital market in the same year Benjamin Cohen who is here with me and myself were working with congressional committees on the so-called Stock Exchange Act. We first then faced the problem of a significant change in the economy after the depression similar to what we face today. And we first then attempted the adaptation of the tax law as well as the securities laws to a solution along the lines embodied in the principles of S. 2842. I am therefore adding as a supplement to this statement the relevant portions of the 1934 act, not arguing for it, but to put it down as the predecessor of this problem.

In my testimony before this committee on September 28, I further tentatively suggested that the maximum rate of the percentage of capital gains subject to tax should not be higher than the applicable tax on the taxpayer's current earned income—that is, higher than 50 percent. Under this formula the capital gains tax I suggested would be higher in some cases than the proposed tax on capital gains on all assets held for 5 years or less as provided in S. 2842. This is because it has been noted by opponents of the capital gains principle particularly in labor circles, that it is from that present lower tax from which S. 2842 begins its graduated reduction. Therefore the people who are opposed to the capital gains tax in principle say that even this particular version of S. 2842 constitutes a new advantage to the man with capital gains.

I offered that higher suggestion without too fervent conviction one way or the other, as a possible basis for political compromise with those who would insist to the bitter end that, even on a long-term basis, the so-called capital gains concept should be abolished and all gains taxed on the same earned income basis. Of course, specific percentages, either on rates or on base, are not sacrosanct. The Wall Street houses undoubtedly feel justified in asking for time to adjust themselves for an extension of the period from 6 months to 1 year in which, under S. 2842, gains are treated as short-term gains. But while thus doubling the stated period on the short-term gain from 6 to 12 months S. 2842 has by phasing out over a period of 6 years, tried to meet some of Wall Street's problems.

There may also be reasonable suggestions to consider lowering somewhat the percentage of gains on intermediate term holdings to moderate excessive rise in a bull market and excessive declines in a bear market by encouraging selling of long-term investment on scale up when the market for the shares is excessively high and repurchasing on a scale when the market is excessively low.

The political-economic mix this committee is trying to deal with as a practical matter is similar to that which confronted the Congress in 1934 and hte problem which President Kennedy attempted to reach at the time he sent down the recommendation which you, Mr. Chairman, quoted a moment before.[1] There is now, as there was then, a highly articulate dissatisfaction with the present tax policy on capital gains.

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[1] *See* attached statement of Henry H. Fowler, Under Secretary to Secretary Douglas Dillon in the Administration of President Kennedy and Secretary of the Treasury in the Administration of President Johnson; also, statement of Secretary of the Treasury Dillon regarding President Kennedy's 1963 tax message.

Some contend that the tax is too low, others contend that the tax is too high and there is arguable merit in both situations.

As an economic fact, the present law treating all capital gains on capital assets held for more than 6 months as long-term capital gains thereby gives inequitable favorable treatment to capital gains on capital assets held for 7 months, compared to capital gains on assets held for 5, 10, or even 20 years, which have taken the entrepreneurial risks longer. As a political factor, however, whatever opinions, whatever there may be, there is also a sentiment in this country which even opponents have to recognize as powerful. That sentiment considers the present law at least obviously, excessively favorable treatment on capital gains held for no more than 1 year. It is growing in political strength, and almost certain to grow stronger about all capital gains treatment, if there is a recession, and increased unemployment at the time of the next election. This is expressed in the slogan, "What a man earns with his hands should not be taxed less favorably than what a more fortunate man earns with his money." And that is uppermost in the thinking of the politically powerful labor interests today.

There is no point trying to deny the existence of this political fact and its relevance to what is politically possible in any administration or Congress. Even today, it appears in suggestions for new preference taxes already offered in the Senate. Even present so-called preference taxes with of course help from other factors, have pushed the tax rate on capital gains in equity investment to a point admittedly dragging on the economy. For large investors today, the effective tax, Federal and State, particularly in the large capital markets where the States have high capital gains taxes is not far from 50 percent.

Taking into account only an unavoidable secular rate of inflation of around 2 percent a year, a man who keeps his own capital in his own business for 20 years will lose 40 percent of its value in 20 years. If the present unprecedented rate of inflation continues, he could, in 20 years, lose most of its value.[2] If, on top of that risk, he then has to face paying, in taxes, 50 percent of the gains of his life work, when he wants or has to liquidate, the gamble is statistically prudently not wise and investors are acting accordingly.

The present law, therefore, deters necessary investment by being excessively harsh on capital gains on investments held for years, subject not only to business risks over such a long period, but to the secular depreciation of the dollar over the years. The whole of such gains cannot fairly be treated as current income in the year they are taken. Different considerations from those which govern short-term investment are entered into when you consider long-term investment, and what is fair for the man who risks his capital, and in many instances makes the best of his energy to develop his investment, which amounts to his own business, over a number of years. If he wants to sell after a number of years, it does not seem fair to him that gains accumulated over those years should be taxed like ordinary current income for any one year.

Therefore, to get the best energy of the people with the knack for technical development, you must provide incentive for them to give the best they can to keep them going through a period which has not

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[2] See studies of Ronald Foulis Esq. on p. 277.

kept up with the best to offer in the technological field, and the best to offer in keeping industry alive and alert, particularly when management is now completely divorced from an active stockholder's interest. Thoughtful men in the Treasury have always recognized this, and have tried to meet the problem by a form of averaging which does not work out evenly, as between individuals, and in all circumstances. The nearest approximation to fairness in this field considered feasible by the men who first considered the problem in 1934 was the device adopted of graduating the capital gains tax downward, dependent on the length of time the capital assets were held in jeopardy by the taxpayer to the presumptive benefit of the entire economy, including labor. It was a rough measure of equity, but the nearest to equity that could then, or can now, be devised. And in its section 117, annexed hereto the 1934 act which was the predecessor of the present proposal, the Treasury sought by this device to reduce controversy regarding capital gains.

In earlier testimony, I suggested that the principle of the graduation downward of the 1934 act, and of this act, should not stop at 10 years, but should be continued to the 20th year, so as to cover investment held during the average man's working life, that is, the investment of an entrepreneur not necessarily an investor in securities but more likely a man who develops his own farm, his own business, or his own home, and who hangs on to it until the end of his working life. This would involve adding the following paragraphs to the 1934 act, and a relevant change in this act: that is, "25 per centum if the capital asset has been held for more than 15 years, but not more than 20 years; per centum if the capital asset has been held for more than 20 years."

All witnesses before this committee have agreed that the country desperately needs more and more infusion of capital into equity investment to keep the U.S. economy as technologically superior to all others as we used to be and, therefore, constantly supplying newer and better jobs. This superiority in tools and equipment to keep U.S. labor the most productive in the world has been the indispensable factor for maintaining the superior American standard of living for labor, producer, and consumer alike.

But to repeat: what inducement, even now, is there for a prudent investor to make a chancy equity investment, rather than getting an 8-percent return on high-grade bonds, or 5 percent on tax-exempt securities? The point is proved by today's times-earnings market for prices for the securities of the best U.S. companies. This committee has always seen clearly that, for the overall good of the U.S. economy, that the tax law, although dependent on a public attitude favorable to entrepreneurial equity investment, should establish a clear difference, a wide ditch, between the speculative trading profits of (*a*) a taxpayer dipping in and out of capital investment on short-term speculation, and (*b*) the profits of entrepreneur investors contributing permanently to the economy with long-term investment; risking their own capital, not through 3 months, 6 months, or 1 year, in a quickie business enterprise, but through the predictable ups and downs of the 5 or 10 years necessary to establish a business on a solid basis.

The problem of Wall Street in attracting the small investor back into securities is a real problem for the street. But it is possibly too iffy in terms of time to be central to the Nation's capital problem. In the difficult competition the U.S. economy now faces, with every competitive asset it once had now shared or confiscated by others, the investor the committee is really looking for is not so much the small, but the sophisticated, comparatively large investor, whether "locked in" or otherwise. He is not likely to wait to get over an emotional scare of having been burned since 1968, and he also has substantial funds immediately to shift or invest. In most instances, that kind of investor can be expected to devote his personal attention and energy to develop his investment, whether controlling it as owner, or whether as a substantial, long-term stockholder in another's business. He therefore will watch the management as though it were his own business, with the beneficial result that the management is tighter and more efficient.

Certainly, as we now meet foreign competition, we are beginning to wonder whether absentee ownership of widely distributed securities ownership, rapid turnover of investment, and conglomerate accumulation, makes the competence of U.S. business management, the efficiency and long-view equivalent of the owner-management on which our economy grew. Considering the inroads foreign management has lately made in fields once the worldwide market for American machinery, there is indeed reason to wonder.

A favorable balance of payments necessary to import foreign raw materials will not forever last, based on temporary agricultural supremacy, since agricultural self-sufficiency is certainly the first objective present customers of U.S. foodstuffs will seek to obtain for themselves.

Now, the first attempt, in the 1934 statute, was submerged by needs of financing an expanding war economy, and wartime limitation on earned income. But the general principle embodied in it, as resurrected in S. 2842, was a politically tenable distinction between—

(*a*) short-time capital investment which, *to the public who earn their income with their hands rather than their money and the majority of Congress representing that majority of the public, feels like earned income*, and

(*b*) truly long-term investment *which the same public who earn their money with their hands rather than their money, and the majority of Congress representing that same public, accepts as different from earned income.*

The need of judgment as to where that politically tenable distinction must be drawn becomes more clearly demanded every day by the present equity investment needs of the economy, on one side, and the ideological demands on the other of an increasingly sophisticated public for what is deems "justice" in taxation.

I therefore only want to emphasize in this presentation, without presuming to make the judgment demanded of you, that whatever details are worked out in its implementation as a balance of interests involved, the central purpose of this S. 2842 is essential, that is, a clear distinction acceptable to the public in tax treatment between short-term speculative investment of capital and long-term entrepreneurial investment of capital. It is truly essential to the future functioning of the whole U.S. entrepreneurial economy by which *labor in particular*, as well as the producer and the consumer of this country, benefit. As you have said, Mr. Chairman, the time has come when, for the good of the whole economy, the investment decisions have to be investment, and not tax decisions. Tax laws are the chief instrument of public policy to encourage, and not discourage, truly investment decisions. This search for machinery for encouragement can and should be carried out fairly and equitably without giving an unfair advantage to any one group of taxpayers or without yielding to the intransigence of ideologues.

As has been brought out in other testimony, the investment industry and its service to the entrepreneurial instinct of the average American, to invest in jobs rather than keep gold in a sock, needs *conscious* protection and direction by the U.S. Government since the industry is doubtfully able to attain the unity adequately to help itself.

It is the only asset we have left in relation to our overseas competitors, who otherwise now compete equally with us for raw materials and who are the donees of our technology and our capital market. I would even hopefully dare venture that, as the balance of interests is worked out to this end, it may become clear to the investment community that the price now paid for a theoretically perfect liquidity in the national securities markets under the present 6-months rule may have been part of the reason for undesirable results in the investment markets that are more dangerous to the industry than loss of liquidity.

Perhaps for its own future good, the investment capital industry itself, now unhappily going through the grinder of self-reorganization, could consider in self-examination whether perfect liquidity is worth the price of public disillusionment and the discouragement of equity investment.

Despite our present difficulties, we do not despair about the future economy of the United States, or the maintenance against demobilization of our job-giving industrial power. We have only to realize from the oil awakening that it is going to be a different kind of an economy, and that we have to think about the future, on a long-term basis, as being different from the past, in our tax as in our other laws. If we are now a have-not-nation-to-be in raw materials—and I was very impressed by the fact that, the other day, it was estimated that in 1980, we are going to be importing even 50 percent of our most essential raw material, iron—we can compensate with an even better natural resource of concentrated scientific ability, drained from the whole world over the past 20 years by our bold scientific experiments of the last generation.[3] If we do not forget the support of basic science research, that natural resource of scientific ability can eventually invent substitutes of constantly decreasing cost, as in the past we invented nylon to replace silk, synthetic rubber for the automobile, synthetic nitrate for our farms, synthetic nonfossil fuel for everything, a prospect for ever increasing higher productive and higher paying jobs.

But, as other, better-qualified witnesses have unanimously testified, it will take capital, long-term capital in enormous quantities to reach and sustain that ever superior technology which will ever produce such industrial and job opportunities. And it will take deliberate incentive for individuals to risk the investment of their individual captal to produce such opportunities and such jobs. The real problem is how to convince the ideological opponents of any capital gains differentiation from earned income tax that the differentiation benefits them

[3] *See* President's message to Congress on incipient shortage of essential materials.

as well as the fellow whom the whole Nation needs to help the whole Nation with the investment of his capital.

What may make the difference in the availability of that sustaining, long-term capital to the economy and industrial power of the United States, and the superior American standard of living of employer and employee alike, is the accuracy of the far-seeing judgment of political economic balance, what ever its details, you are seeking in S. 2842.

Senator BENTSEN. Thank you, Mr. Corcoran. You have very eloquently stated the case. You are one of the founding fathers of the security laws in this country, and I see another one of the founding fathers in our audience, Mr. Ben Cohen.

Would it be fair to state that you are in general support of the principles of this bill?

Mr. CORCORAN. Yes, certainly.

Senator BENTSEN. You make a strong case that the American worker really has an awfully important stake in a healthy capital market. Do you think that they fully accept and understand this interrelationship?

Mr. CORCORAN. To be frank, at the present time, no, and that is why I am making this statement. But I think they can be convinced.

Senator BENTSEN. Let me ask you about the graduated capital gains tax. If it is true that you have as much as $200 billion of capital locked in because of current capital gains rates, do you think it would follow that the Government would actually increase its revenue by adopting the provision such as this?

Mr. CORCORAN. I have always understood, from what inquiries I can make, that the answer is tentatively yes. It depends upon a great many factors. But certainly, it would be no less.

Of course, there are times, Senator, when it might be to the advantage of a long-term investor, and for the advantage of the economy of the Nation, that a long-term investor stay with his investment and does not sell. For instance, take a situation where there is a raid on a company, and a bunch of proxy hunters go out and grab a lot of the floating small investor stock. It may not be to the benefit of the company to be taken over. It might be a situation where an investor who holds on to his stock will be doing a service to the country by sitting tight and not going along with a bad takeover.

Senator BENTSEN. But all of these are economic decisions.

Mr. CORCORAN. There is another situation. You read the other day, of course, in the Wall Street Journal about fear of foreign takeovers of too many American companies. From labor's point of view, a foreign investor, used to treating labor as Europeans treat labor, cannot be expected to have as favorable a labor policy as a present American owner. It might be, then, a good point for such economy consideration that a long-term investor not dump his stock but to stay "locked in."

Senator BENTSEN. Let us look at the other situation. Entrepreneurs faced with the present problems of the equity market would be more vulnerable to selling out to foreign takeovers.

Mr. CORCORAN. That is right.

Senator BENTSEN. Let me read you a quote from a previous Finance Committee report on the Revenue Act of 1938:

There is no tax under existing law, if the taxpayer transfers his money from one bank to another, but there may be a very heavy tax if he wishes to transfer his investment from one bond in one company to a bond in another company. Thus, an excessive tax on capital gain freezes transactions and prevents the free flow of capital in a productive investment. The effect of the present system, of these kinds of tax rates on capital gains, is to prevent any individual with substantial capital from investing in new enterprises, and that is unfortunate, because it adversely affects the employment situation.

That is a quote, and I agree that is right. For example, sometimes you see a man who has been in an enterprise for a long time. He would really like to sell out, but it takes an overt act and if he has a 35 percent capital gains tax, he says, "well, why should I do it and immediately decrease by assets by that much?" So, he just will not sell. And in that kind of a situation, capital does not seek its most productive usage.

Mr. CORCORAN. May I make one other suggestion? I have been listening about the problems of financing small enterprises. I agree with the need for doing something about it. I agree with the desperate need in the particular situation for encouraging it, because, Senator, with all these new substitutes that we are going to work out, we could possibly offer the opportunity for new adventures in technology. It is much more likely that the little fellow would take a chance on a radical departure in technology than a big fellow who, like an automobile company has to write off an enormous investment, as the automobile companies would with disastrous results on the balance sheet have to write off the plants manufacturing the internal combustion engine.

But from my experience there is one thing you have to be careful about. Many a small company is floated with enough money in the issuing price to give it initial capital, but without provisions for the future. The issue is put out, say, at 10. Then, it begins to work up in the market and little investors rush in. Now, if the smart investor can get out on the rise with capital gains at the end of 6 months, the fellows who are shrewd speculators say, "Well, we have had the run out of this one," and they get out. But the little fellow rides with his investment and he often rides it down below issue price so that, so far as the market record of that new issue is concerned, it has gone up, and then it has collapsed.

What that company tries for the second infusion of capital, that bad record makes it all but impossible to get that capital. That has to be thought of too. Sucking the small investor into a new enterprise is not necessarily permanently good for a new enterprise.

Senator BENTSEN. I agree, Mr. Corcoran. There is where the investment bankers must have some self-discipline in this kind of a situation.

Mr. CORCORAN. That is right.

Senator BENTSEN. But what concerns me is the political problem of making it understood to the man whose job we are trying to protect, and to the man for whom we are trying to create a new job. You read about the fellow who won the daily double, and that is dramatized, and that is high profile. But I have been out at that racetrack and I have seen all of those torn-up ticket stubs, and that fellow never makes the news. And that is why the man who takes the risk, if he is going to take it, ought to be able to keep some of it.

Mr. CORCORAN. And that is why I have thought it would not be impertinent if, for the benefit of all of the other people who have testified, I just drag this dragon right out on the table. Somebody has got to give—everybody has got to give something. Nobody can get everything he wants, if we are going to work this out.

Senator BENTSEN. Mr. Corcoran, you have been very helpful, as always.

In concluding this sound of hearings we have had a number of very prominent and very able men testify. Obviously they did not all agree with the provisions of this bill and some of them have made some very constructive recommendations for modifications. I think it has been helpful and this is the way I think the congressional hearing process ought to work.

Thank you very much. We will stand in recess.

[Mr. Corcoran's prepared statement with attachments follows:]

PREPARED STATEMENT OF THOMAS G. CORCORAN

These comments relate to those provisions of S. 2842 dealing with the graduated taxation of capital gains.

I have asked to testify a second time only so that in the plethora of suggestions offered to the Committee sight will not be lost of the central idea. The Committee is essentially trying to find a political economic formula that will permit the continued use of the capital gains tax idea to stimulate and maintain the entire economy in suddenly changed circumstances requiring enormous amounts of capital to sustain a new technology—while a growing public sentiment which does not appreciate its usefulness is being raised against the entire capital gains tax conception.

Tangentially, I participated in the deliberations about the 1934 Act which first faced the problem of a significant change in the economy similar to that we face today and first attempted the adaption of the tax law to a solution along the lines embodied in the principles of S. 2842.

I am therefore adding as a supplement to this statement the relevant portions of the 1934 Act.

In my testimony before this Committee in September I further tentatively suggested that the maximum rate on the percentage of capital gains subject to tax should not be higher than the applicable tax on the taxpayer's current earned income, i.e., higher than 50%. Under this formula the capital gains tax I suggested would be higher than the present tax on capital gains on all assets held for five years or less as provided in S. 2842. And as noted by its opponents particularly in labor circles it is that present lower tax from which S. 2842 begins its graduated reduction.

I offered my higher suggestion without too fervent conviction one way or the other as a possible basis for political compromise with those who would insist to the bitter end that even on a long term basis the so-called capital gains concept should be abolished and all gains taxed on the same income basis.

But of course the specific percentages either on rates or on base are not sacrosanct. The Wall Street houses will undoubtedly feel justified in asking for time to adjust themselves for an extension of the period (from six months to one year) in which under S. 2842 gains are treated as short term gains. But while thus doubling the stated period of the short term gain from six to twelve months Senator Bentsen has by phasing it over a period of years tried to meet some of Wall Street's problems. There may also be reasonable suggestions to consider lowering somewhat the percentage of gains on intermediate term holdings to moderate excessive rise in a bull market and excessive declines in a bear market by encouraging selling of long term investment on scale up when the market for the shares is excessively high, and repurchasing on a scale down when the market is excessively low.

The political economic mix this Committee is trying to deal with is similar to that which confronted the Congress of 1934. There is now as was then a highly articulate dissatisfaction with present taxation policy on capital gains. Some contend that the tax is too low, others contend that the tax is too high. Paradoxically there is arguable merit in both contentions.

As an economic fact the present law, treating all capital gains on capital assets held for more than six months as long term capital gains, thereby gives inequitable favorable treatment to capital gains on capital assets held for seven months compared to capital gains on assets held for 5, 10 or even 20 years which have taken entrepreneurial risks longer. As a political fact whatever opinions there is also a sentiment in the country which even opponents have to recognize as powerful. That sentiment considers the present law at least obviously excessive favorable treatment on capital gains held for no more than one year. It is growing in political strength and almost certain to grow stronger about all capital gains treatment if there is a recession and increased unemployment at the time of the next election. This is expressed in the slogan "what a man earns with his hands should not be taxed less favorably than what a more fortunate man earns with his money." There is no point trying to deny the existence of this political fact and its relevance to what is politically possible in any Administration or Congress.

Even today it provides pressure for preference taxes which with help from other factors have pushed the tax rate on capital gains in equity investment to a point dragging on the economy. For large investors today the effective tax, federal and state, particularly in the large capital markets is not far from 50%.

Taking into account only an unavoidable *secular* rate of inflation of around 2% a year a man who keeps his own capital in his own business for 20 years will lose 40% of its value in 20 years: and if the present rate of inflation continues he could in 20 years lose most of its value. If on top of that risk he then has to face paying in taxes 50% of the gains of his life's work when he wants—or has—to liquidate, the gamble is statistically prudently not worthwhile and investors are acting accordingly.

The present law therefore deters necessary investment by being excessively harsh on capital gains on investments held for years subject not only to business risks over such a long period but to the secular depreciation of the dollar over the years. The whole of such gains cannot fairly be treated as current income in the year they are taken. Different considerations from those which govern short term investment are entered into when you consider long term investment and what is fair for the man who risks his capital and, in many instances, makes the best of his energy to develop his investment which amounts to his own business over a number of years.

If he wants to sell after a number of years it doesn't seem fair to him that gains accumulated over those years should be taxed like ordinary current income for any one year. To get the best energy of the people with a knack for technical development you must provide incentive for them to give the best they can to keep them going through a period which has not kept up with the best to offer in the technological field and the best to offer to keeping industry alive and alert, particularly when management is completely divorced from an active stockholder's interest.

Thoughtful men in the Treasury have always recognized this and have tried to meet the problem by a form of averaging which does not work evenly as between individuals and in all circumstances. The nearest approximation to fairness in this field considered feasible by the men who considered the problem in 1934 was the device adopted of graduating the capital gains tax downward dependent on the length of time the capital assets were held by the taxpayer to the presumptive benefit of the entire economy including labor. It was a rough measure of equity but the nearest to equity that could then or could now be devised. In its Section 117 (annexed hereto) the 1934 Act sought by this device to reduce this controversy regarding capital gains.

In earlier testimony I suggested that the principle of graduation downward of the 1934 Act should not stop at 10 years but should be continued to the 20th year so as to cover investment held during the average man's working life as the investment of an enterpreneur not necessarily an inventor in securities but more likely a man who develops his own farm, his own business or his own home and who hangs on to it until the end of his working life. This would involve adding the following paragraphs to the 1934 Act:

> "25 per centum if the capital asset has been held for more than 15 years but not more than 20 years;
>
> "20 per centum if the capital asset has been held for more than 20 years."

All witnesses before this Committee have agreed the country desperately needs more and more infusion of capital into equity investment to keep the U.S. economy as technologically superior to all others as we used to be. This superiority in tools and equipment to keep U.S. labor the most productive in the world has been the indispensable basis for maintaining the superior American standard of living for labor, producer and consumer alike. But, to repeat, what inducement even now is there for a prudent investor to make a chancy equity investment rather than getting an 8% return on high grade bonds or 5% on tax exempt securities. The point is proved by today's times-earnings market prices for the securities of the best U.S. companies.

This Committee has always seen clearly that for the overall good of the U.S. economy the tax law, dependent on a public attitude favorable to entrepreneurial equity investment, should establish a clear difference—a wide ditch—between the speculative trading profits of (a) a taxpayer dipping in and out of capital investment on short-term speculation and (b) the profits of entrepreneur investors contributing permanently to the economy with long term investment, risking their own capital not through three months, six months or a year in a quicky business enterprise but through the predictable ups and downs of the five or ten years necessary to establish a business on a solid basis.

The problem of Wall Street in attracting the small investor back into securities is a real problem for the Street but is possibly too iffy in terms of time to be central to the nation's capital problem. In the difficult competition the U.S. economy now faces—with every competitive asset it once had now shared or confiscated by others—the investor the Committee is really looking for is not so much the small, but the sophisticated comparatively large investor "locked in" or otherwise. He is not likely to wait to get over an emotional scare of having been burned since 1968. He also has substantial funds immediately to shift or invest.

In most instances he can be expected to devote his personal attention and energy to develop his investment whether controlling it as owner or whether as a substantial long term stockholder in another's business. He therefore watches the management as though it were his own business with the beneficial result that the management is tighter and more efficient. Certainly as we now meet foreign competition we are beginning to wonder whether absentee ownership of widely distributed securities ownership, rapid turnover of investment and conglomerate accumulation makes the competence of U.S. business management the efficiency and long-view equivalent of the owner management on which our economy grew. Considering the inroads foreign management has lately made in fields once the world-wide market for U.S. machinery there is indeed reason to wonder. A favorable balance of payments necessary to import foreign raw materials will not forever last based on temporary agricultural supremacy since agricultural self-sufficiency is certainly the first objective present U.S. customers of U.S. foodstuffs will seek to obtain for themselves.

The 1934 statute itself was submerged by needs of financing an expanding war economy and war-time limitation on earned income. But the general principle embodied in it, as resurrected in S. 2842, was a politically tenable distinction between (a) short-time capital investment which to *the public feels like* earned income and (b) truly long term investment which *the public accepts as different from* earned income. The need of judgment as to where that politically tenable distinction must be drawn becomes more clearly demanded every day by the present equity-investment needs of the economy on one side and the demands on the other of the increasingly sophisticated public for what it deems "justice" in taxation.

I therefore only want to emphasize, without presuming to make the judgment demanded of you, that whatever detail is worked out in its implementation as a balance of interests involved, the central principle of this bill, i.e., a clear distinction in tax treatment between short term speculative investment of capital and long term entrepreneurial investment of capital—is essential. It is essential to the future functioning of a whole U.S. *entrepreneurial* economy by which labor in particular as well as the producer and the consumer of this country benefit. As Chairman Bentsen has said, the time has come when for the good of the whole economy investment decisions have to be *investment* not *tax* decisions. Tax laws are the chief instrument of public policy to encourage not discourage truly investment decisions and this can and should be carried out fairly and equitably without giving an unfair advantage to any one group of taxpayers.

As has been brought out in other testimony—the investment industry and its service to the entrepreneurial instinct of the average American to invest rather than keep gold in a sack needs *conscious* protection and direction by the U.S. government as the only asset we have left in relation to our overseas competitors—who otherwise now compete equally with us for raw materials and who are the donees of our technology and our capital.

But I would even dare venture that as the balance of interests is worked out to this end, it may become clear to the investment community that the price now paid for a theoretically perfect liquidity in the national securities markets under the present six months rule may have been part of the reason for undesirable results in the investment markets that are more dangerous to the industry than loss of liquidity. Perhaps for its future good the investment capital industry itself, now obviously going through self-reorganization could consider self-examination whether perfect liquidity is worth a price of public distrust and the discouragement of equity investment.

Despite our present difficulties we do not despair about the future economy of the United States or the maintenance against demobilization of our job-giving industrial power. We have only to realize from the oil awakening that it is going to be a different kind of an economy and that we have to think about the future as being different from the past in our tax as in our other laws. If we are now a have-not-nation-to-be in raw materials we compensate with an even better natural resource of concentrated scientific ability drained from the whole world by our bold scientific experiments of the last generation. If we don't forget the support of basic science research that natural resource of scientific ability can eventually invent substitutes of constantly decreasing costs as in the past we invented nylon to replace silk, synthetic rubber for the automobile, synthetic nitrate for our farms, synthetic non-fossil fuel for everything.

But as other better-qualified witnesses have unanimously testified it will take capital—long term capital—in enormous quantities to reach and sustain superior technology, and it will take deliberate incentive for the individual to risk the investment of his individual capital.

What may make the difference in the availability of that sustaining long term capital to the economy and industrial power of the U.S. and the superior American standard of living of employer and employee alike is the accuracy of the farseeing judgment of political-economic balance whatever its details you are seeking in S. 2842.

1934

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 than 10 years.

REMARKS OF HENRY H. FOWLER, PARTNER, GOLDMAN, SACHS & CO., AT ANNUAL MEETING OF NATIONAL CANNERS ASSOCIATION, JANUARY 28, 1974

LAGGING CAPITAL INVESTMENT AND CHANGING PATTERNS IN CAPITAL MARKETS

Chairman Snively, President Carey, Ladies and Gentlemen, in these doleful days of woe and Watergate, of cost push inflation followed by raw material commodity inflation, and, now, by "stagflation", with recession standing in the wings, threatening to make an unwelcome entry; of energy shortages, and oil price escalation that threatens to bring about the final collapse of an internal monetary system and the practice of international economic cooperation that have served the Free World well since World War II, converting some countries from an economics of affluence into economics of scarcity, while changing hitherto obscure deserts into new centres of money and political power in other areas; it is a bold or dull guest who selects an old fashioned subject area for discussion.

Nevertheless, I shall address my comments to some fundamentals which America seems to forget from time to time. These fundamentals have direct application to your industry as it has been described to me by your President and Dr. Van Meir. Moreover, as I shall explain later, they are also relevant to very large cross sections of U.S. industry where capacity and productivity are or threaten to become inadequate.

A return to these fundamentals is necessary if this nation is to solve the economic problems that face it and surmount the crises that threatens to undermine the very financial structure on which its economic progress has been based.

As I understand it your industry has witnessed a declining rate of investment in real terms in the last three years with the total falling below the replacement level necessary to maintain efficiency of plant and equipment. It is also faced with the need for massive investment in waste treatment facilities which, of themselves, will not add to the production capacity of the industry, as they will merely replace the hundreds of processing plants made obsolete by the regulations of the Environmental Protection Agency.

These conditions exist against a backdrop of clamor for increased food production and processing to supply increasing requirements here and abroad.

Any will of management and ownership to meet these challenges by making the required investment is confronted by the time-honored question—"Where is the money coming from?"

In the first place, they may find that the rate of inflation in the last few years and in prospect for the foreseeable future have pushed costs up so far that they have been underdepreciating the existing equipment and the profits and rate of return they have been assuming were there do not in fact exist.

Moreover, I am told that while present marketing conditions would support a sharp rise in the profitability of the canning industry, regulations of the Cost of Living Council prevent this from happening. Consequently, the return on investment in assets employed must be considered extremely low, making debt financing difficult, or if feasible at all, rates of interest are on a very high plateau and substantially exceed the rate of return. For these and other reasons, publicly held common stock of companies in the industry remains at extremely low price-earning ratios, which makes equity financing difficult and decidedly unrewarding and uninviting to the present equity owners.

At this point, may I say "Mr. Industrialist, shake hands with the securities industry on Wall Street and Main Street". Your problem is the problem of the securities industry and the problem of the securities industry is your problem.

According to an article last week in the New York Post, businesses' concern over the uselessness of the securities markets for their needs in 1973 is being translated into suggestions for bolstering the securities industry.

May I quote a few paragraphs from the article:

"More than 90% of American companies are in trouble—some of them deep trouble", warned W. R. Tincher, chairman of Purex Corporation and a member of the Committee of Publicly Owned Companies, a group of 619 of the largest corporations in the U.S. that is attempting to achieve a securities industry more responsive to the needs of business.

"They are in trouble," Tincher said at a conference last week on the crisis in the securities markets, "because they either cannot get the capital they require to meet their own and the nation's needs, or they can get it only by borrowing at very high interest rates—by incurring burdens of debt and interest charges which are a danger to their survival."

The expense of debt, which American business used in historic amounts in 1973, unsettles corporations.

"It is expensive to go into debt. It is cheaper to offer stock and American business would prefer to do just that," Donald Gaudion, chairman of the NAM, noted in a recent interview that included concern over the future of the securities market.

Few companies raised money directly from the public last year through the issue of stock.

"Overall, only 90 new issues were marketed during all of 1973, compared with 568 in 1972," according to Tincher.

American business has several suggestions for putting equity financing back into business for them, all of it revolving around legislation out of Washington.

"We need, urgently, legislation that will help corporate America gain access to equity capital. We urgently need legislation that will halt the excessive diversion of investment dollars to the stock of 20 to 50 institutional favorities. We need legislation that will encourage the distribution of equity capital investment over the broad spectrum of American economic life. We badly need tax-reform legislation that will reward and not penalize Americans who buy and sell equity securities of our companies," says Tincher. These observations quoted in the newspaper article referred to are timely.

These observers drive home the interdependence of industry and effective capital markets and the contemporary fact that changing patterns in the capital markets have created a threat to both to which national policy should be directed on a high priority-basis—by that I mean this year 1974.

There are many who will be unconcerned about the web of interlocking causes and effects just described because they have never understood or appreciated the delicate mechanism that enables the private enterprise sector of our national economy to work effectively.

There are others who brush the implicit problems away by pointing to the forecast of a substantial increase in capital outlays in plant and equipment for 1974, despite accompanying forecasts of a slowdown year in consumer spending.

But, as the Monthly Economic Letter for the First National City Bank in December analyzes the situation, there is an illusion in these rosy figures.

It notes that when the McGraw Hill survey results of a 14 per cent increase are adjusted for prices, it appears that 5–7% of the increase reflects higher costs—real growth in outlays would be only at most 9%.

The Letter continues in a more disturbing vein:

"Moreover, a look at plant and equipment expenditures over the last few years suggests that capital investment in many major industries, particularly in manufacturing, may not have kept pace with the demands of the economy, and that even a 9% increase in real spending may not rectify the situation.

Aggregate investment has been growing steadily. For the manufacturing sector as a whole, however, real capital outlays in 1972 were substantially below the level of the mid-to-late 1960's, both absolutely and relative to GNP. For 1973, manufacturing outlays are expected to be up 15% in real terms, but as a share of GNP they are well below the levels of the mid to late 1960's."

It would appear from this analysis that the canning industry is not alone with its problem but that it exemplifies a larger and more pervasive ailment that affects our national economy. As the City Bank Letter sees it:

"Capital outlays by several of the basic industry groups have shown little or no increase since 1965; all but non-ferrous metals have declined relative to GNP. Several of the basic industry groups expect to increase real outlays next year, but again, as a proportion of GNP, expenditures will be below the levels of five years ago. The only substantial increases over the period, both absolutely and relatively, have been made by utilities."

This overall situation gives rise to some basic questions. The nation is entitled to answers to these questions. The nation is entitled to some action on these answers if analysis shows, as I suspect, that the industries that have shown the poorest track record for new investment in productive assets in recent years are those in which there are actual shortages of capacity, threatened shortages, less than satisfactory rates of increasing productivity and efficiency, or relative inability to meet foreign competition in domestic or export markets.

Let us survey some of the likely causes of inadequate investment in productive facilities.

First, let us consider the effect of increased rates of inflation in recent years in giving rise to the likelihood of underdepreciation and inadequate cash flow.

In September 1970, the President's Task Force on Business Taxation, on which I served as a member, submitted a report in which it considered this question, pointing out that:

"Since cost recovery allowances are based on the *original* costs of the plant and equipment, these allowances represent a decreasing proportion of the costs of replacing such facilities as their prices rise. The adequacy of these allowances as a source of funds for financing plant and equipment outlays declined accordingly as plant and equipment prices rise." (see pp. 12)

In the analysis of the Price Index for Gross Private Fixed Investment (Non-Residential for the period since 1945, it appeared that the annual amount of underdepreciation rose from a little over $1 billion in 1945 to roughly $4.5 in 1957, declining thereafter to somewhat less than $3 billion in 1965.

With rising costs after 1965 it was estimated that the amount of underdepreciation for 1970 for non-finiancial corporations would reach $7 billion. Since that time the annual underdepreciation has been rising sharply with the continued rise in the rates of inflation.

The Internal Revenue Service does not permit depreciation based on replacement costs. As the Monthly Morgan Guaranty Survey for November put it:

"The practical result of holding depreciation write-offs below the true cost of replacing assets is that companies' reported profits are bigger than they otherwise would be."

The resulting overstatement of profits and built-in inadequate cash flow to keep facilities modernized and efficient has become even more acute as the level of inflation has reached and seems destined to continue for some time at levels unprecedented since World War II.

This suggests a timely review of the adequacy of the present rules on depreciation to cope with this problem. In 1970, the Task Force recommended a shortening of the time lag between investment and write-off as an indirect method of reducing somewhat the adverse impact of inflation on the adequacy of cost recovery allowances. By so doing it sought to avoid the administrative compliance and precedent difficulties that might have resulted if cost recovery allowances were based on a revaluation of the historical costs of production facilities on current prices. But it did conclude that "We believe that there might be substantial advantages in this approach in terms of reducing an important barrier to the desired growth in production facilties." (p. 14)

There are large and important and complex issues involved in any policy reassessment of this problem and its handling by the Treasury and the Congress. And there is no easy answer to the question as to the proper course of action for the accounting profession and its company clients in annual reports and other key documents in spelling out the differences between historical and replacement costs and their bearing on earnings and taxes. As the Morgan Guaranty Letter puts it:

"But clearly every company with any substantial amount of fairly long-lived assets which have to be replaced ought to be asking itself whether financial reporting oriented to historical costs shouldn't be supplemented one way or another. The stakes are enormous simply in terms of an environment conducive to rational tax policy. Depreciation allowances based on historical cost are potentially disastrous to on-going maintenance of plant and equipment in an age of inflation." As things now stand, each year a significant portion of the funds needed to replace capital goods is misidentified as income and taxed away by the IRS. This obviously is inimical to the growth of the nation's stock of capital goods."

Second, legal and policy requirements on environmental protection, calling for investments that do not add to productive capacity or efficiency, in the sense of increased productivity per worker, could be another contributing factor to inadequate investment, particularly in some sectors of industry.

That is not an argument that these standards should not be enforced. But it is a factor that should be taken into account with particular attention paid to the maximum utilization of tax exempt pollution control financing to minimize the drain on investment in productive facilities.

A recent analysis in the December issue of the Monthly Economic Letter of the First National City Bank provides a useful quantitative fix on the magnitudes of the diversionary drains from productive investment resulting from the pollution control legislation enacted since 1968. 1972 outlays for pollution control, tripling 1967 totals, affected particularly primary metals, paper, chemicals, petroleum and electric power.

"The most serious case is the paper industry, where such investment rose from 6% of the total industry outlays in 1967 to 23% in 1972, with nearly 48% of capital outlays projected to go for pollution control expenditures in 1973.

* * * * * * *

"To get some idea of the impact of these on total capital spending, pollution expenditures were deducted from total expenditures and adjusted for price. During 1972 the manufacturing sector as a whole, and many of the basic commodity industries—primary metals, chemicals, paper and petroleum—spent less, both absolutely and as a share of GNP, on revenue generating assets than they had in 1967. In most instances, it was one more step in a steadily downward trend in capital outlays for real 'improvements.'"

This phasing in of pollution control standards promises to be a considerable factor for the years ahead. The combined report of the Council on Environmental Quality and the Environmental Protection Agency in March 1972, estimated that meeting pollution standards over the period 1972-1980 would cost industry some $26 billion.

Incidentally, it was noted that most affected would be "vegetable and fruit canning and processing and iron foundries."

For to-day, the only useful comment on this score is to direct your attention once again to the fact that utilization of tax exempt pollution control financing can reduce the cost of borrowed monies. On the average, 2% per annum less than taxable interest rates can usually be obtained if you resort to your friendly investment banker, such as Goldman, Sachs & Co., to assist you in borrowing through the tax exempt bond route.

Pollution control financing has been authorized by statute in all states except Idaho and North Carolina. Financings may proceed immediately in all other states except Hawaii, New Jersey and Washington where the legislation is either awaiting gubernatorial signature or state Supreme Court test action.

In the states of Connecticut, Ohio, Missouri, Texas (for air pollution) and California all pollution control expenditures within the state may be grouped and financed through one bond issue.

While most industries can anticipate that the qualifying Pollution Control costs will run between 10% and 20% of the new plant cost, those plants dealing almost exclusively with bio-degradeable effluent will probably find the percentage cost somewhat less. In estimating the qualifying amount, non-product equipment (e.g. boilers) should be checked for pollution control expenditures. As a considerable gap exists between published IRS Regulations and IRS practice as reflected in private Rulings, professional help should be solicited before any expenditures are committed so that the maximum qualifying pollution control costs can be identified. As an example, an entire whey treatment (drying) plant has qualified when the financing was properly designed.

Financing through publicly marketed bonds generally results in the lowest net interest cost, and may be retired over a considerable term—25 years being not uncommon. However, as the costs of the financing may preclude issues of less than $1,000,000, companies may find a number of banks which have an interest in financing these lesser amounts, even though the terms of the loan may have to be reduced to the common 10-12 year bank term.

Now, let us turn to a *third* cause of underinvestment which presents an especial challenge to both business and finance, and, indeed, to the nation at large.

I refer to underinvestment caused by the unavailability of external capital, particularly equity capital, in sufficient quantities and on reasonable terms.

This unavailability may be nearly absolute or only in terms of market issuing prices that management and owners of existing equity in the business properly consider unacceptable.

In some sectors of industry, or in particular companies, this inaccessibility to equity markets may be due primarily to low rates of return on invested capital or other financial weakness. But there is increasing evidence that the relative inaccessibility of American industry to the equity market is due to malfunctioning of the capital markets.

Under existing conditions, these capital markets do not seem to be able to provide the equity capital needed by American industry on terms and at prices which are acceptable. Except for a small minority of companies, the common stocks of most American companies, traded on the organized exchanges or over the counter, are selling at far lower relative values, in terms of their earnings, than has been true in many years.

A glance at your morning newspaper is all the proof needed. It will show that a preponderant majority of the stocks listed on the New York and American Stock Exchanges, or over the counter, are selling at prices less than ten times their earnings. Many are being traded at three, four, or five times earnings despite encouraging growth in profits over the past few years.

Continuous reliance on debt financing, particularly under conditions of persisting high interest rates, may result in burdens of debt and interest charges which are dangerous to survival in the inevitable periods of adversity, whatever the cause. Indeed the interest rates may approach or exceed the rates of return on invested capital.

Yet last year corporate finance was largely characterized by an extraordinary amount of bank borrowing by industry in all too many instances to fund long term investment, some reluctant recourse to the long term debt market, and relatively limited resort to the raising of equity capital. This is not a sound or healthy financing pattern.

When the equity market is not accessible to industry at large on reasonable terms, the owners and managers of industry have lost a very valuable option. But so have the American people. The economy faces a huge need for new capital in the next few years. Equity capital is needed in vast amounts to provide the goods, services and jobs needed. In addition to the capital required for environmental needs and the modernization of plant to meet foreign competition, we are confronted by the unusual capital requirements for energy source development and distribution by both old and new enterprise.

And if the owners and managers of existing businesses in this rapidly competitive society lose access to the equity market, the loss of this option leaves them only with two alternatives. They may choose to sell the business, putting it in stronger financial hands by merger or acquisition, or run the risk of gradual deterioration of the business with decline in value of existing equity. They will no longer have the option of utilizing new capital to assure increasing productivity, to participate in industry growth, and to improve margins and rates of return.

This situation is not good for the company, the owners, the managers, the employees or the customers, or the country at large.

Our economc system depends for its health, vitality, vigor and dynamics on many thousands of enterprises, of all sizes and dimensions. Their continued access to equity in our capital market is a fundamental part of this system.

It is for that reason that, in my concluding remarks I bespeak your interest in the preservation and revitalization of a functioning equity market in the United States.

There are many aspects of this problem of a functioning capital market that times does not permit us to examine today. The rules under which the securities industry and the stock exchanges have functioned in the past forty years wth remarkable success until recently in providing the risk capital for American industry seem to be destined for fundamental change at the hands of the Congress, the Securities and Exchange Commission and the Department of Justice. The brokerage industry on which the nation depends for the initial distribution and secondary market exchange of securities is suffering severe financial losses. The increasing trend toward institutionalization of our securities markets, dramatically illustrated by the fact that large banks, insurance companies, pension funds, mutual funds and similar institutions, now account for more than 70 per cent of the public trading on the New York Stock Exchange, raises many new questions of financial policy.

All these aspects of the capital market we can leave today for the experts. But there is one clear and pressing danger to the capital market that presents an inescapable challenge to American business and the securities industry—the diminishing direct participation of the individual American in the equity market.

The willingness of Americans, as individuals, to put new risk capital into providing the jobs, opportunities, and an increased standard of living for all, is atrophying. Many older investors are locked into large capital gains accumulated in the past and which they hope to leave to their heirs intact. They will not turn over this capital at the price of the huge capital gains they would have to pay under existing law. Most of the younger potential investors seem to prefer the safer to the more venturesome investments.

According to recent testimony before a committee of Congress by representatives of the Securities Industry Association:

1. Savings deposits increased on a huge scale from 1968 to present, while direct investments were only a declining trend. In fact, during 1971 and 1972, and continuing in 1973, people actually liquidated risk assets. They sold their stocks presumably to put their capital into savings.
2. The purchase or sale of stocks in odd-lots on the New York Stock Exchange, the sign of the small individual investor, declined from 21% of volume in 1960 to an all time low in 1972 of 4.6%.
3. Even in mutual funds, the individual investor has tended, in the last few years, to redeem more shares than he purchased.
4. The share in trading volume of individuals in dollar volume on the New York Stock Exchange has declined from a peak of 65% in 1963 to less than 30%.

It has been estimated that the number of individual stockholders has declined by as many as 800,000 since early 1972.

These developments and others give rise to a most disturbing apprehension, namely, that the ownership of U.S. corporate securities by individual Americans is on a declining trend in either relative or absolute terms or both, for the first time in our history since this type of information has been available.

If this apprehension is correct, this trend should be a matter of increasing concern. The development of strong institutional investors in bank trust funds, insurance companies, pension plans, mutual funds and the like, which collect and invest personal savings is a great national asset. But their existence is no adequate substitute in our private enterprise system for the values that are inherent in the direct investment of the individual citizen in a particular enterprise. Institutional investors do not necessarily serve the same function as masses of individual investors.

As James M. Roche, former Chairman of the Board of General Motors and a public member of the New York Stock Exchange put it in a recent statement:

"Our system cannot flourish solely on the basis of the health and strength of 75 glamour companies or even of Fortune's 500 companies, nor can it survive without the support of individual investors. Every large corporation depends upon hundreds or thousands of small enterprises, as suppliers of components, as generators of ideas and products, as producers of income for their owners and shareholders who buy our products. Both individual investors and these smaller companies supply an essential quality to American life—a quality we can ill afford to lose.

"These small companies must depend upon the smaller, non institutional investors for equity investment, and all companies, small and large, as well as the institutions themselves, depend upon the individual investor to supply liquidity, depth and continuity to the market."

Undoubtedly, there are several significant factors at work, retarding the flow of equity investment. They include a general lack of confidence, the growing bias toward inflation in the economy, the higher rates of interest accompanying that persistently high inflation which increases the return on fixed income investment relative to common stocks which involve greater risk.

But in my judgment, the one factor that is susceptible of prompt action now, is the present capital gains tax system, which in its present form acts as a severe deterrent to equity investment instead of an incentive.

It should be substantially modified as the keystone of a program and policy to bring the individual back into the capital market, thereby helping preserve and revitalize a fully functioning equity market.

Incentives offered individual Americans to risk capital in the existing capital gains tax have become insufficient to attract equity investment. The impact of inflation on any dollar profits earned, the lack of response in the market to increased earnings per share, and the alternatives of high interest rate secure savings deposits, have resulted in making any incentive that previously existed ineffective.

Since the passage of the 1969 tax bill, increasing the maximum tax rate on long term capital gains, there have been increases in GNP, corporate earnings and average wages of between 25 to 30 per cent. But the prices of common stocks have declined and dividend increases have been held back. The 30 million common stockholders of the United States have not shared in the nation's economic gains.

My conclusion and conviction is that the percentage of long term capital gains that is taxable as ordinary income should be reduced from 50 per cent to 30 per cent. This reduction would make the maximum a twenty one per cent rate on the long term capital gain of an individual in the top 70 per cent bracket instead of the current 35 percent rate, with rates correspondingly lower on the long term capital gains of taxpayers in lower brackets.

To those who might attribute this suggestion to my present environment in Wall Street, I would point out that this was the scale which President John F. Kennedy recommended to the Congress in his Tax Message of January 24, 1963, which message I helped devise and promote as Undersecretary of the Treasury at that time. In presenting various proposals on the taxation of capital gains, President Kennedy stated:

"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy."

In addition to lowering the base rate of inclusion of individual long term capital gains into ordinary income from 50% to 30%, I would also urge a graduation downward of the rate of inclusion geared to the length of the time period held. The incorporation of this principle to include, let us say, a decreasing percentage of the gain at five year intervals up to twenty years, to say a minimum of ten per cent, would accomplish several worthwhile objectives.

It would recognize the degree to which inflation is responsible for the nominal dollar gain recorded on a capital investment held over a period of years. This inflation erosion may result in an economic loss as measured in real values with a paper gain that is taxable up to 35 per cent under present law. For example, with the rate of inflation for the ten year period 1962–72, at a cumulative 27%, an investment of $1,000 in 1962, sold in 1972 for $1,200, would result in a real loss in economic values to the investor. To include 50% of that $200 capital gain as income and tax that $100 at ordinary income rates is not equitable, and it is certainly a deterrent to equity investment.

The second and equally important reason for incorporating the downward graduated scale of inclusion, geared to the holding period, is that it is designed to counter the locked in effect of the present capital gains tax which has served to stifle the mobility and flow of risk capital from the "static to more dynamic situations" which President Kennedy sought.

There is considerable evidence that there is a whole generation of individuals who are reluctant to sell or cannot afford to sell their security holdings because of the capital gains tax. As a result this capital becomes sterile and millions of stockholders simply sit on their locked-in gains. These funds are unavailable for reinvestment, the government receives no revenue, and the capital market loses that source of potential liquidity.

Positive incentives should be put in the capital gains tax to unlock these locked-in dollars, resulting in benefit to the economy by increasing capital flows, providing new tax revenues, benefitting taxpayers, (mostly older citizens) and improving the liquidity of our markets.

The problem of the lock-in is not just a problem of the elderly or the high income group. The NYSE Shareowner Survey of 1970, indicated that of the 21.5 million direct individual investors making $20,000 or less, more than half made no transactions in 1969 and 1970 and 29%—about 6 million—had no purchases or sales for three years or more. A regular review and some shifting of these investments would be in the interest of the investor, the economy, and a more effective capital market.

This brief discussion by no means covers the entire range of present tax provisions relating to capital gains which may, upon examination, prove to be damaging to an effective capital market.

For example, the treatment of losses needs re-examination.

In conclusion, let me once more labor the obvious. There is an increasing interdependence between the businessman and the financial community. Our problems in the securities industry are intimately related to your ability to obtain adequate equity and long term debt financing on reasonable terms and in a balance appropriate to sound financial policy. Your problem in obtaining debt financing on the cheapest terms to meet the non-productive capital requirements imposed by recent laws and regulations provides a common interest. The adjustment of depreciation laws, regulations and practices to take into account any substantial underdepreciation due to persistently high rates of inflation is basic to the maintenance of a sound industrial financing structure. That structure must be capable of adjusting to the demands for increasing productivity and capacity that are surely to be placed on an industry as vital as one in the mainstream of the supply of food.

Because of these common interests, it has been a pleasure to be with you today and pool our problems.

[From Hearings on H.R. 8363 (Proposed Revenue Act of 1963), House Ways and Means Committee, 88th Cong., 1st Sess. 47–51 (1963)]

Statement of Secretary of the Treasury Dillon, Re President Kennedy's 1963 Tax Message

One of the most important phases of the tax law in which the President has recommended changes designed to release the forces of growth is the treatment of capital gains and losses.

This part of the tax system has not undergone needed basic revision since 1942. The present provisions are both inequitable in essential respects and detrimental to the mobility of investment funds and liquidity in capital markets. The broad definition of capital gains permits certain types of ordinary income to be taxed at capital gains rates, thus making it more difficult to set an appropriate rate of taxation for true capital gains.

An overhaul of these provisions can make an important contribution to a stronger economy and a fairer tax system. Reduction of tax barriers to the free flow of investment and risk capital will not only add to the strength and buoyancy of the economy but will also produce several hundred million dollars of additional revenue annually. . . .

Percentage Inclusion

The President has recommended that the percentage of long-term capital gains included in taxable income of individuals be reduced from the present 50 percent of the gain to 30 percent. In combination with the proposed individual income tax rate [reductions], this will result in capital gains tax rates ranging from 4.2 percent to a maximum of 19.5 percent, compared with an existing range of 10 to 25 percent. It will result in more equal treatment of individuals in various income groups. Unlike the present arrangement, the relative differential between capital gains tax rates and ordinary income tax rates would be the same at all levels of income.

While this would provide a reduction of 22 percent in the capital gains tax for those in the highest bracket, the reductions would be substantially greater for all other taxpayers. For instance under present law the 25 percent rate applies whenever ordinary taxable income plus capital gains exceeds $16,000 for a single individual and $32,000 for a married couple. At this same level the effective rate under the President's proposals would be only 12 percent. . . .

Independent outside surveys, our own studies, and letters and comments which are received daily from taxpayers throughout the country indicate clearly that these substantial reductions will increase taxpayers' willingness to realize capital gains and stimulate a larger turnover of capital assets.

Thus the recommended 30 percent inclusion ratio would stimulate a freer flow of investment funds and at the same time provide a more even-handed treatment of taxpayers in all income brackets.

CAPITAL GAINS OF CORPORATIONS

Corporations should share in the reduction in capital gains tax rates. In line with the reduction of general corporate tax rates, the President has recommended that the present basic structure of capital gains taxation for corporations be retained but that the alternative rate be reduced from he present 25 percent to 22 percent. The 22 percent rate corresponds to the proposed reduced corporate normal tax rate. This will simplify tax accounting for capital gains for almost half a million corporations subject only to the normal tax.

HOLDING PERIOD

The present preferential treatment of assets disposed of within a period of less than a year is difficult to justify either on economic or equity grounds. The 6-month holding period frequently qualifies purely speculative profits. It also makes it less risky to carry out various maneuvers designed to convert ordinary income into capital gains.

A longer holding period makes it possible to provide more liberal treatment for bona fide investment gains without applying unjustified reductions to income from short-term trading in securities. Moreover, the substantial reduction in ordinary income tax rates must be taken into account in considering the proper holding period, as even short-term gains will be taxed at lower rates.

It is for these reasons that the President has recommended that the holding period be lengthened from 6 months to 1 year.

EQUAL TREATMENT OF GAINS ACCRUED ON CAPITAL ASSETS AT TIME OF TRANSFER BY GIFT OR AT DEATH

Present law permits the exemption from income tax of capital gains accrued when the appreciated assets are transferred at death. The prospect of eventual tax-free transfer of accrued gains with a stepped-up basis equal to the new market value in the hands of heirs distorts investment choices and frequently results in complete immobility of investments of older persons.

The President has recommended that the proposed reduction in the capital gains tax be accompanied by the taxation at long-term capital gain rates of net gains accrued on capital assets at the time of transfer at death or by gift. This would not apply to assets transferred as charitable gifts or bequests. . . .

The foregoing exceptions and exemptions would limit any impact whatsoever of the proposal to fewer than 3 percent of those who die each year. A number of other provisions set forth relief and transition rules. . . .

OVERALL EFFECTS

Enactment of the President's recommendations for reduction and reform in the capital gains area would substantially reduce the amount of tax paid per dollar of capital gain realized. At the same time, the improved definition of capital gains, the extension of the holding period, and the taxation of capital gains at death will result in a net increase in revenue from this source of $100 million.

In addition, a substantial increase in revenue, estimated at $650 million, will be realized as a consequence of the unlocking effects of the proposals and the greater volume of capital transactions that can be confidently anticipated. The total increase in revenue from the capital gains proposal is, therefore, about $750 million per year.

WASHINGTON, D.C., *February 1, 1973.*

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee,
Longworth House Office Building,
Washington, D.C.

DEAR MR. MILLS: I have prepared the attached memorandum from the viewpoint of an individual concerned with the formation and maintenance of capital created primarily from savings. The purpose is to discuss the impact on capital of the present tax where no adjustment is made for the inroads of inflation, i.e., the taxation of "gains" which do not reflect a real increase of capital.

I have not attempted to discuss the importance of the formation of capital to the domestic economy.

I sincerely hope this memorandum may be of some value in the consideration of any change in the Internal Revenue Code concerning capital gains.

Sincerely yours,

RONALD J. FOULIS.

Attachment.

SOME THOUGHTS ON THE IMPACT OF INFLATION ON CAPITAL GAINS

One of the demands for tax reform, heard with increasing frequency, is that Congress abolish the distinction between ordinary income and capital gains. Less drastic is the advocacy of sharply increased rates of taxation on capital gains.

Any discussion of capital gains should distinguish the essential difference between the nature of *capital* and current *income* derived from labor or the use of capital. Capital is largely derived from savings out of past income and is, in turn, used to produce current income in the form of dividends, interest, rents, etc. This income is taxed in the same manner as income from other sources.[1] Capital gains do not represent income in the sense that people generally view current income. They only measure the increase in dollars over the number of dollars initially invested.

The purpose of this paper is to call attention to the fact that under the present system of capital gains taxation, "apparent gains" are taxed as well as "real gains." To limit taxation to *real* capital gains there needs to be an adjustment of that investment. There have been suggestions that the laws be amended to provide "rollover" provisions comparable to taxation of residential property. This would indeed be an improvement and would free any investments now held because of reluctance to pay a capital gains tax on a large gain. However, even under a rollover system when a capital gains tax is finally applied, unless there is some adjustment for the impact of inflation on the purchasing power of the initial investment, there may be, in fact, a confiscation of the investor's capital.

It is not contended here that capital gain should not be subject to tax but it should be recognized that in many cases a tax on capital gains is a capital levy and in a sense, *confiscation of capital* by the government. Let me explain these rather harsh words. Suppose an investor buys AAA oil stock when this stock is selling for $100 and when BBB oil stock is also selling for $100. Three years later, he loses confidence in the management of the AAA company and therefore sells the AAA stock for $200 (the then market price) and buys the BBB stock also for $200 (its then market price). Under present law, there would be a $100 long-term capital gain subject to capital gain tax although the investor neither gained nor lost anything by simply changing one investment for another very similar investment after investment prices had risen. Perhaps the example is even more dramatic if we consider a rise in consumer prices which results from inflation. Thus, assume the investor bought stock for $100 when the consumer price index

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[1] It should also be remembered that income derived from the use of capital supplied by investors to corporations is taxed when earned by the corporation. That income where paid out in the form of dividends is taxed a second time in the hands of the investors.

was $100. Three years later, he sells this stock for $150 when the consumer price index is $150. Under present law, he has a $50 long-term capital gain subject to tax although the amount of consumer goods he can now purchase with the proceeds of the sale is no greater than the amount of such goods he could have purchased at the time of the original investment. This paper points out in more detail through specific examples that even the present system results to some extent in a tax on "gains" which really represent merely increases in the price of investments or in the price of consumer goods. Accordingly, to go any further and to increase the tax on capital gains, would seriously limit the ability of investors to be rewarded for risks taken in supplying capital to the economy.

Risk is a vital factor in the investment of capital. A person seeking merely to protect the number of dollars invested against loss while obtaining income will seek low risk investments such as high grade bonds. When inflation, one of the factors to be weighed when considering risk, is anticipated, higher interest rates are demanded on such investments to offset the impact of inflation. An example of this is the substantially higher yield from bonds compared to investments in stocks in recent years. In previous periods, such as 1932–1952, the yield from stocks was higher than that from fixed obligations because of the higher risk of investment in stocks.

TABLE NO. 1.—BOND AND STOCK YIELDS

[In percent]

	1932	1942	1952	1962	1967	1972
Corporate bond yields	4.65	2.75	3.19	4.61	5.82	7.47
Common stock yields	6.25	5.20	5.56	3.37	3.20	2.71

This and other tables contained in this memorandum were contributed by Arthur Anderson & Co., an international CPA firm

The investor in equities such as common stocks, in the face of inflation, accepts a lower income from dividends because of the hope that volume of business and ensuing profits will result in a sufficient increase in the market value of his investment to more than offset the impact of inflation on the original dollars invested.

In many instances the contemplated results are achieved but the imposition of even the existing level of capital gains taxes can offset the actual increase in the purchasing power of the original dollars invested. In other instances the capital gains tax can actually reduce the purchasing power of the money received from the sale of an asset below the purchasing power of the original number of dollars invested. In other words, the capital gains tax can operate to take not only a portion of an apparent capital gain but to actually take part of the real capital originally invested when purchasing power is considered.

The following table shows the reduction in the purchasing power of the dollar in ten-year periods and also the accumulative effect of the reduction in the purchasing power of the dollar from 1942 to 1972:

TABLE NO. 2

Year	Purchasing power of $1	Percent: Reduction in purchasing power from the prior period	Percent: Cumulative reduction in purchasing power from 1942
1941	$1.00		
1951	.55	45	45
1961	.45	18	55
1971	.33	27	67

The person who pursues a program of investment in equities to provide for retirement needs can be seriously affected by the imposition of the existing schedule of capital gains taxes. Table #3, which follows, reflects investments of $10,000 at five-year intervals. With a total of $30,000 invested by the end of 1971 the investor has a taxable gain of $14,555, subject to a tax of $3,639. When the purchasing power of his original investments is adjusted for the reduction in purchasing power caused by inflation, he has a real gain of only $7,572. The result is a tax, nearly one-half of which is applicable to dollars of apparent gain which do not increase the real value of his original investments.

TABLE 3.—CURRENT TAXATION OF CAPITAL GAINS

[These computations show that, under current law, the average real gain on the capital invested in common stocks over the period 1960 to 1970 would be taxed at the rate of 43 percent ($3,639 divided by $7,572)]

Year	Initial investment, Amount	Market value at Dec. 31, 1971 [1]	Cost restated in current dollars [2]	Real gain (loss)	Inflationary gain	Taxable gain	Tax on real gain	Tax on inflationary gain	Total tax due [3]
1960	$10,000	$19,706	$13,710	$5,996	$3,710	$9,706	$1,499	$928	$2,427
1965	10,000	11,954	12,773	(809)	2,773	1,964	(202)	693	491
1970	10,000	12,885	10,500	2,385	500	2,835	596	125	721
Total	30,000	[4] 44,555	36,933	7,572	6,983	14,555	1,893	1,746	3,639

[1] The market value reflects adjustments for stock dividends and stock splits. No adjustment has been made for the issuance of stock rights. It has been assumed that dividends were not reinvested. These 2 technical factors have been ignored for simplicity and are not relevent to the immediate issue.

[2] The initial $10,000 investment has been inflated by the GNP Implicit Price Deflator to show the purchasing power of that investment in terms of 1971 dollars. The Consumer Price Index would give substantially the same results.

[3] An effective tax rate of 50 percent was assumed. These computations ignore the possible application of the alternative tax on capital gains and the minimum tax on items of tax preference. To compute the effect of these taxes requires assumptions with respect to items of taxable income and tax liability not otherwise relevant to these computations.

[4] These market values are based on the increase in Moody's Industrial Stock Index from the year of purchase to Dec. 31, 1971.

Table #3(a) shows the effect of inflation on five blue chip stocks purchased in 1960. For the first stock, General Motors, the market value exceeds the real value of the initial investment. In the next three instances, AT&T, Monsanto, and Commonwealth Edison, the market price is lower than the real value of the initial investments and the present capital gains tax actually further reduces the original purchasing power of the investments. For the fifth stock, U.S. Steel, the present market value is only $360 or a loss in original dollars of $640 but a loss in actual purchasing power of $1,011.

TABLE 3(A)

[If investments were made in the following selected stocks over the same period, the investor would incur a real loss]

Initial investment — Year	Amount	Market value at Dec. 31, 1971 [1] [2]	Cost restated in current dollars [3]	Real gain (loss)	Inflationary gain	Taxable gain	Tax on real gain	Tax on inflationary gain	Total tax due [4]
1960 (General Motors Corp.)	$1,000	$1,666	$1,371	$295	$371	$666	$74	$93	$167
1960 (AT&T)	1,000	1,000	1,371	(371)	371	----------	(93)	93	----------
1960 (Monsanto Co.)	1,000	1,200	1,371	(171)	371	200	(43)	93	50
1960 (Commonwealth Edison Co.)	1,000	1,333	1,371	(28)	371	333	(10)	93	83
1960 (United States Steel)	1,000	368	1,371	(1,011)	371	(640)	(253)	93	(160)
Total	5,000	5,559	6,855	(1,296)	1,855	559	(325)	465	140

[1] The market value reflects adjustments for stock dividends and stock splits. No adjustment has been made for the issuance of stock rights. It has been assumed that dividends were not reinvested. These 2 technical factors have been ignored for simplicity and are not relevant to the immediate issue.

[2] These market values are based on the increase in Moody's Industrial Stock Index from the year of purchase to Dec. 31, 1971.

[3] The initial $10,000 investment has been inflated by the GNP Implicit Price Deflator to show the purchasing power of that investment in terms of 1971 dollars. The consumer Price Index would give substantially the same results.

[4] An effective tax rate of 50 percent was assumed. These computations ignore the possible application of the alternative tax on capital gains and the minimum tax on items of tax preference. To compute the effect of these taxes requires assumptions with respect to items of taxable income and tax liability not otherwise relevant to these computations.

TABLE 4.—TAXATION OF CAPITAL GAINS UNDER THE TAX EQUITY ACT OF 1973 (H.R. 1040) INTRODUCED BY REPRESENTATIVE JAMES C. CORMAN ON JAN. 3, 1973

[These computations show that under H.R. 1040 inflationary gain from invested capital will substantially escape taxation. However, real gain from invested capital will be taxed at an effective rate of 53 percent thereby increasing the total amount of tax due]

Year	Cost	Market value at Dec. 31, 1971 [1]	Cost restated in current dollars [2]	Tax basis under H.R. 1040 [3]	Real gain (loss)	Taxable gain (loss) under H.R. 1040	Taxable gain (loss) under current law	Tax due under H.R. 1040 [4]	Tax due under current law [4]
1960	$10,000	$19,706	$13,710	$14,167	$5,996	$5,539	$9,706	$2,770	$2,427
1965	10,000	11,954	12,773	12,167	(809)	(203)	1,964	(102)	491
1970	10,000	12,885	10,500	10,166	2,385	2,719	2,885	1,360	721
Total	30,000	44,555	36,983	36,500	7,572	8,055	14,555	4,028	3,639

[1] The market value reflects adjustments for stock dividends and stock splits. No adjustment has been made for the issuance of stock rights. It has been assumed that dividends were not reinvested. These 2 technical factors have been ignored for simplicity and are not relevant to the immediate issue. These market values are based on the increase in Moody's Industrial Stock Index from the year of purchase to Dec. 31, 1971.

[2] The initial $10,000 investment has been inflated by the GNP Implicit Price Deflator to show the purchasing power of that investment in terms of 1971 dollars. The Consumer Price Index would give substantially the same results.

[3] H.R. 1040 allows the taxpayer to increase his tax basis by ⅙ of 1 percent of the tax basis for each full month the property was held after it had been held for 1 yr.

[4] An effective tax rate of 50 percent was assumed. Under H.R. 1040, capital gains are taxed on ordinary income. Under current law, capital gains are generally taxed at ½ the rate on ordinary income. These computations ignore the possible application of the alternative tax on capital gains and the minimum tax on items of tax preference. To compute the effect of these taxes requires assumptions with respect to items of taxable income and tax liability not otherwise relevant to these computations.

Note Table #4. H.R. 1040 introduced on January 3, 1973, would allow a taxpayer to add 4 percent of the original cost of assets to the tax basis each year as a hedge against inflation up to a maximum of 60 percent at 16 years. However, capital gains would be taxed as ordinary income. Table #4 which assumes the same investments as Table #3 shows that the effect of H.R. 1040 would actually increase the taxpayer's tax liability above the present capital gains tax.

Table #5, which is based in part on actual experience, reflects the impact of the present capital gains tax in the case of an individual who purchased a residence in 1937 and converted it to rental property before a sale in 1971. This example also reflects the impact of a rollover provision. His original residence cost $15,000 in 1937. He built an addition to the property in 1947 at an additional investment of $10,000. He sold the property in 1952 and purchased another residence at an additional cost of $5,000. Assuming net sale proceeds of $85,000 in 1971 he would have a taxable gain of $55,000. Adjusting the purchasing power of his original investment the $30,000 represents a cost in 1971 dollars of $74,795. After payment of a capital gain tax of $13,750 he would have experienced a loss in purchasing power of the investment of $3,545.

Table 5.—Sale of residence

Tax computation under current law:	
Net proceeds from sale	$85,000
Cost	(30,000)
Gain—before tax	[1] 55,000
Tax (at 25 percent)	13,750
Cost restated in current dollars: Date:	
1937	15,000
1947	10,000
1952	5,000
Total	30,000
Inflation factor:	
1937	3.182
1947	1.897
1952	1.619
Real cost:	
1937	$47,730
1947	18,970
1952	8,095
Total	74,795

[1] A taxpayer 65 years or over may exclude a portion of the gain (not to exceed $20,000) realized on the sale of a personal residence. Thus, if the taxpayer had sold his residence at age 65, he would have been taxed on only a $35,000 gain. His tax would have been $8,750 and he would have had a net real gain of $1,455.

It would take $74,795 in 1971 to make the same investments that the taxpayer has made since 1937.

Tax computation on real gain: [1]	
Net proceeds from sale	$85,000
Real cost	(74,795)
Real gain—before tax	10,205
Tax (computed above)	(13,750)
Real loss	(3,545)

[1] These computations ignore the possible application of the alternative tax on capital gains and the minimum tax on items of tax preference. To compute the effect of these taxes requires assumptions with respect to items of taxable income and tax liability not otherwise relevant to these computations.

As indicated in a footnote to Table #5 if this taxpayer had continued to use the property as a residence and was 65 years or over in 1971 his capital gain tax would have been $8,750 and his real gain only $1,455 from the use of his capital over the 34-year period.

Those investors willing to take the risk of purchasing stock in a young unproven enterprise sometimes find their investment multiplied many times over in which case the inroads of inflation may be less painful. However, many more times the investor may barely recover the initial investment and often loses it. The more careful, investor, who looks for growth in the blue chip variety of stock may find years later that he bought into a Penn-Central type situation. But in every situation for the last 30 years, the initial investment, whether it be in stock, bonds or real estate, has suffered from inflation and the longer the period of investment the greater has been the impairment of the original purchasing power.

CONCLUSIONS

The present system of capital gains taxation should be modified to permit an adjustment of the cost of capital investment in equities and reflect the change in purchasing power of the dollars invested. This could be done by the use of indices which the U.S. Treasury Department would be responsible for preparing and publishing. The length of time that an investor must hold an investment in order to receive capital gains tax treatment could be increased beyond the present six months period provided appropriate recognition would be given to the eroding factor of inflation.

The mechanism of such an adjustment could be so designed as to present no serious difficulties, i.e., for example, the adjustment in Table #5 to Restate Cost in Current Dollars.

[From the New York Times, Feb. 8, 1974]

NIXON SOUNDS A WARNING ON RAW-MATERIAL PRICES

(By Edwin L. Dale, Jr.)

WASHINGTON, February 7.—President Nixon told Congress today that nations supplying the world with important raw the oil-producing countries in radically raising world prices (sic).

But in his second annual International Economic Report Mr. Nixon said 1973—with its exploding prices of basic commodities ranging from wheat to tin and wool—"vividly brought home to us the degree to which our own economy is affected by developments elsewhere."

The United States economy, the report said, "has moved from an era of near self-sufficiency to one of rising dependence on foreign resources with a concomitant need to earn more foreign exchange to pay for these imports."

The report said it was an "oversimplification" to think that nations producing other commodities—they were not named, but such items as bauxite, copper and rubber have been mentioned in various analyses—can do as the oil countries did: form a cartel or "monopoly" and quadruple prices. It gave these reasons:

In the oil countries production cutbacks "do not significantly increase unemployment," which is not the case with extractive and agricultural industries in other poor countries.

The oil countries on the whole had large monetary reserves and "could easily accept a reduction in sales volume—especially at the new higher prices." Many other raw material producing countries "do not have enough foreign reserve assets to permit them to curtail production."

Demand for oil has been growing steadily and inexorably, while this is not true of other commodities where demand sometimes declines "in the course of a world economic slowdown," at least in the short run.

When there is sluggish demand, this put producing countries "in a poor bargaining position" and can lead to "severe competition among producers for markets."

The report contained in a statistical appendix an estimate that United States oil imports this year will cost $25-billion, up nearly $16-billion from 1973; on the assumption that current oil prices hold and that the volume of oil imported will be the same in 1974 as in 1973. This estimate of added oil import costs is slightly higher than one made earlier by the Commerce Department.

Peter M. Flanigan the chief author of the report and executive director of the council on international economic policy, told reporters that because of higher oil prices the "current account" of the United States balance of payments—essentially trade and services, but not investment flows—would probably be in deficit this year by $3 to $5-billion after a surplus of an estimated $2.7-billion in 1973.

Mr. Flanigan noted that all nations would suffer a large adverse swing in their payments, except the oil countries. But he said it was "no time for hysteria," terming the matter "a problem but a management problem."

The report said that "in addition to developing domestic resources, we must diversify our international sources of energy to the greatest extent possible so that no one country or likely combination of countries will be able to influence our policies by manipulating the supply or price of our energy."

The President said the new problems that emerged in 1973, particularly in food and energy, did not change the need for cooperation among nations.

"The new problems we face are of such enormity," he said, "that there may be a temptation ot delay further progress toward trade and monetary reform. Nothing could be more foolish . . . I consider it essential that we continue to construct a consultative framework in which new as well as old issues can be addressed. The current trade and monetary discussions provide such a frame work and also allow us to continue our long-term effort to build a more effective world economic order."

The report contained a discussion of the world food problem and found that "there is considerable disagreement as to whether the current food gap is permanent or whether we will soon be faced with a food glut." However, the report added:

FOOD NEEDS CITED

"Most agricultural experts now believe that the situation that has characterized the past several decades will continue for the foreseeable future—that is, generally adequate supplies with occasional shortages."

The report spoke sympathetically of the need for adequate world stockpiles of food to meet emergencies and contingencies such as poor crops. But it continued:

"For this kind of security the world will be best served if importing countries and private interests do not assume that the United States government can and will maintain commercial reserves adequate for all customers under all conditions.

"Means should be found for customers to share with suppliers the responsibility to maintain commercial stockpiles and assure themselves of adequate supplies. There is no reason that grain-producing countries should carry commercial reserves for all the world's potential paying customers. And there is certainly no reason why the United States and Canada should perform the lion's share of this role as they have for the postwar period."

[Whereupon, at 11:50 a.m., the subcommittee recessed, subject to the call of the Chair.]

Appendix

Communications Received by the Committee Expressing an Interest in These Hearings

20-140—74——19

Communications Received by the Committee Expressing an Interest in These Hearings

Statement of the American Bankers Association

The American Bankers Association recognizes clearly the need for and vigorously advocates the maintenace of healthy securities markets. Such markets are absolutely essential to our nation's economy. Healthy securities markets are essential to the trust industry because without them we cannot serve our customers.

The ABA fully supports the enactment of legislation which would constructively promote healthy markets.

Toward this end we advocate public disclosure by all investment managers of significant securities holdings and transactions. We support the development of a central market system in which the individual investor will be able to obtain needed broker services and will be assured the best price in any market. The market system should include the national exchanges, the third market and NASDAQ. We support competitive brokers fees and a complete separation of brokerage and money management. We support the establishment of a national securities depository system and effective regulation of depositories, clearing agencies and transfer agents to ensure efficient low-cost securities clearance and transfer. We also support additional action to eliminate the stock certificate and an SEC study of the use of nominee or street names. Bills to achieve all of these objectives are at some stage in the legislative process with some of them already passed by the Senate.

In the regulatory area we have supported additional disclosure by corporations in their financial statements filed with the SEC, and the Commission has substantially expanded financial statement disclosure during the past year. These legislative and regulatory actions will improve the ability of more individual investors to enter the market and help restore confidence so the individual will do so.

Other actions would undoubtedly assist in bringing more individuals to the market and in maintaining healthy markets but the holding limits of S. 2842 would not. But before discussing the bill in detail, the Association would like to review briefly the responsibilities and operations of trust departments which demonstrate there is no need for such limitations.

The most significant character of American trust departments is that the money and assets they invest are not theirs. It is money and assets placed in their care. The bank in no way has a beneficial interest in the assets. The bank receives a fee to manage the assets. If the investments do well, the customer profits. If the investments do poorly, the customer suffers unless the bank was imprudent in which case the bank must make up the loss. Parenthetically, it should be noted that the retention of business and the consequent profitability of a trust department depend also upon the investments doing well. Bank portfolio managers must always keep foremost in mind that the assets they are managing belong to the customers and the investments must serve the customer's needs. The same applies to the voting of proxies. They must be voted to serve the interest of the beneficiaries of the accounts in which the stocks are held.

The fact that trust assets belong to the customers means the assets cannot be invested according to the portfolio manager's personal inclinations. It means he must have sufficient information and data on the investments and the customers' needs to make reasoned judgments. The law imposes upon him a legal list or prudent man rule.

The fact also means investments cannot be used to control portfolio companies for again voting rights must be exercised to serve the beneficiaries. This prevents the exercise of potential economic power.

How do bank trustees make investment and voting decisions? Most trust departments have an investment committee of senior trust officers. This committee either establishes general investment policy or it decides which securities should be on a buy list, which should be on a sell list and which should be on a hold list. These decisions are made after the investment group of the trust department, which normally includes investment analysts, has made recommendations to the committee. Research from outside sources, such as brokerage houses, is often important to committee decisions.

After these decisions are made, it is the account portfolio managers who make the day-to-day investment decisions for each account based on the needs of the beneficiaries and the investment policy of the trust department. Thus many are involved in the investment decision making process—in-house securities analysts, other investment personnel, outside research houses, and investment committee and account portfolio managers. The voting of proxies, similarly, is handled by those who make investment decisions.

Banks compete among themselves for pension business as well as with other investment managers. Once a pension account is obtained, the bank must deliver good investment performance or suffer the consequences of the loss of business. Only managers who provide good investment performance are going to be successful. The exercise of control over portfolio companies is compatible with good investment performance.

In addition to the above restraints against self-serving actions by bank trust departments even where they exercise full discretion, there are a myriad of other restraints imposed by trust instruments and the law where the bank shares authority to invest or vote. In some instances banks may only be custodians or trustees with no authority or responsibility to do either.

The American Bankers Association last summer surveyed member banks with trust departments regarding thir equity trading and holdings. Preliminary figures were provided the Subcommittee when the association testified before it on September 27, 1978. Attached as Appendix "A" is a copy of the final report, *Equity Trading and Investment by Trust Departments*. Responding to the survey were 786 banks which manage $299.4 billion in assets or 74% of the total assets managed by trust departments in 1972 according to *Trust Assets of Insured Commercial Banks—1972* published by the FDIC. Fifty-two of the 71 trust departments that managed over $1 billion in assets responded.

The trust departments were asked the number of companies in which they held equity securities. The average number of companies in which stock was held by trust departments managing assets under $50 million was 138.3. The average number of companies for trust departments over $750 million was 2566.7.

The trust departments were also asked to list their 25 largest equity security holdings. Only 22 corporations were among the top 25 listed by more than 100 trust departments and 1848 corporations were listed by only one trust department. A table in the Appendix names the 128 corporations held by 20 or more banks. Another table names the 86 corporations held by 3 or more of the over $1 billion trust departments. The survey contains a wealth of information which shows: 1) that trades in excess of $300,000 ($500,000 is considered a block trade) are infrequently made by trust departments even by those managing over $750 million, 2) that, except in the case of trust departments under $50 million, the top 25 holdings of a trust department seldom account for more than 60% of the trust department's equity holdings, and 3) that trust department holdings are not as highly concentrated in a few high quality stocks as has been charged.

The Association would like to incorporate by reference its statement filed with the Subcommittee on September 27th, which contains additional statistical data regarding diversification of investments by bank trustees including a discussion of the investment of special purpose collective funds in smaller corporations. The Association believes the record shows clearly there is no need for limitations on holdings such as those contained in S. 2842.

Turning now to the bill, the ABA does not believe it will achieve the purposes which have been put forward as the reasons for its holding limits. In fact the limits may have opposite results.

Under current law in addition to the prudent man or legal list requirements of state law, the Internal Revenue Code requires the assets of a tax-exempt pension fund be used for the exclusive benefit of the participants or their beneficiaries. An investment generally complies with the "executive benefit" requirement if its cost does not exceed fair market value, if a fair return commensurate with the prevailing rate is provided, if sufficient liquidity is maintained to permit distributions and if the safeguards and diversity to which a prudent investor would adhere are present. What can the arbitrary 5% and 10% limits of S. 2842 add to these requirements of state law and IRS regulations?

The question of self-fulfilling prophecies has been raised. Any overt attempt by a trust department to pursue a so-called "self-fulfilling prophecy" strategy would only be self-defeating. Thus, we doubt the validity of this issue at least with respect to trust investments.

Market liquidity comes from the thousands of individual investment decisions occurring hour after hour and cannot be achieved by legislation. Banks are always looking for well managed small and medium sized firms in which to invest pension assets. The 5% and 10% limits would not accelerate this interest. In fact, they may reduce such interest. Arbitrary limits can only distort the market place.

The 5% limit on the amount of managed pension assets that can be invested in one security may adversely impact small and medium size trust departments with pension business. In fact, this limit and the other provisions of the bill may prevent some banks and other investment managers from entering the pension business, thus eliminating potential competition and liquidity.

If these limits are enacted many investment managers may find themselves "making tax decisions rather than investment decisions" in managing pension assets. They may also find themselves in an impossible position in allocating a security between various pension accounts. And, if the limit of a security is held and all accounts have a relative share, what is the pension manager to do with a new account?

The bill makes it clear that the 5% and 10% limits apply only to pension plan trusts, excluding profit-sharing, but it does not make it clear what assets must be included in determining whether the limits have been reached. Also, how would the limits apply in the case of collective funds in which both pension and profit sharing accounts participate? Would separate collective funds have to be established for each type of account?

The provision of S. 2842 authorizing investments in venture capital may cause great confusion because it establishes no identifiable investment standard. After decades of experience with the prudent man rule, it is still a difficult standard but most bank trustees believe they understand it and feel comfortable with it. The venture capital provision also raises certain implications which might deter investments in smaller companies. It might be construed to imply that any investment in a company with a capital account under $25 million is per se not prudent. Also, it might be construed to imply that any investment in excess of 1% in a company with a capital account under $25 million is imprudent.

Through special purpose funds many banks are already investing in small and medium size firms. Thus, the need for the provision on venture capital investment seems doubtful.

Regarding the capital gains provisions of the bill, our tax system is complex and it appears Congress will be looking at tax revision in a number of areas this year including capital gains and the minimum tax. Thus, the association suggests that the capital gain tax provisions of the bill be considered at the time general revision of the tax law comes before the Finance Committee.

Trust Division / THE AMERICAN BANKERS ASSOCIATION, 1120 CONNECTICUT AVENUE, N.W., WASHINGTON, D.C. 20036

Survey Report

Equity Trading & Investment by Trust Departments

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MANAGEMENT SUMMARY

The survey was conceived to bring to light for the first time data on the actual activity of trust departments in the equity securities markets. A number of charges, with varying degrees of substantiation, have been leveled at trust departments but, in truth, little authoritative data have been available.

In the trading activity of trust departments it is shown that 88.9% of all trades for the first six months of 1973 were in amounts less than $100,000. Only 2.3% of all trades reached the negotiated commission level, $300,000. More significantly, the trading statistics of the very largest departments are not very different: 85.5% were in the $100,000 or less category and only 3% of trades exceeded $300,000.

The average number of corporate stocks held by a trust department was 507. The average ranged from a low of 139 (for the very smallest departments with less than $50 million in trust assets) to a high of 2,567 for the largest departments (those with trust assets of $750 million or more).

Data requested on the twenty-five largest equity holdings of each department indicate the broad diversity of trust investment. All told the replies of 674 trust departments listed 2,325 different corporations. Only 22 corporations appeared on the lists of 100 or more trust departments, while 1,343 appeared only once.

The replies of those trust departments with $1 billion or more in trust assets were examined. The 52 responding banks in that category listed 298 different corporations among their 25 largest holdings. Only one stock, IBM, appeared on all 52 lists. The diversification evidenced far exceeds what some have charged.

In addition a tabulation of the number of cases where someone other than the bank had ultimate power of purchase or sale indicates that banks lack authority over a significant portion of the investments in their care.

TABLE 1

1972 TRUST ASSETS BY 1972 COMMERCIAL DEPOSITS

Deposit Size ($)	Trust Assets $(000)	Trust Depts. (No.)
Under 5 Million	89,521	10
5-10 Million	35,919	34
10-25 Million	2,619,251 .9	153
25-50 Million	1,636,419 .5	164
50-100 Million	6,145,099 2.1	138
100-500 Million	44,611,293 14.9	177
500 Million to 1 Billion	40,676,408 13.6	55
1 Billion and Over	203,589,386 68.0	55
TOTALS	299,403,296 100.0	786

INTRODUCTION

Bank trust departments now hold, for their customers, assets totalling more than $403 billion* in some 1.2 million different accounts. The rapid growth of trust department holdings and their size, among other factors, have led to allegations of a misuse of economic power. It has been charged that trust departments exert excessive influence over securities markets by dealing mostly in very large transactions. One criticism has been that they concentrate holdings exclusively in a small number of favorite stocks.

The intensity of the criticism has increased in recent months. During that period the individual investor has continued to shy away from the equity markets and the securities industry has suffered financial problems. Suggestions have been made--both in the private sector and in Congress--that limits be placed on the amount of stock in any individual corporation that can be held by institutional investors and further, that the amount of stock that can be sold during a certain period should be limited.

Yet, little statistical data showing trust department operations and their investments in the equity market have been available. The trust profession, the news media, and Congress have had to rely on the bank supervisory agencies, the Securities and Exchange Commission and others in government for statistical material. Most of these studies cannot be related one to another. So no overall picture of the trust business has been available.

To help clear the air about bank trust departments, and to inform the public on how they operate, the Trust Division of The American Bankers Association decided to conduct a survey.

The following discussion of survey data will detail how bank trust departments of all sizes conduct their trading and investing operations. Special attention will be paid to the larger trust departments (over $1 billion) which have borne the brunt of the allegations of undue economic power.

This survey is not to be viewed as a comprehensive analysis of the investment practices of trust departments, but it provides valuable new information that helps explain the trust business.

The American Bankers Association intends to collect and publish additional data on trust departments as the need arises.

The Trust Division would like to acknowledge the assistance of the ABA's Research and Planning staff in this survey. Per Lange, Assistant Director, designed the questionnaire and compiled the results. Assisting in the analysis and evaluation was Dr. George W. Coleman, Research Project Director.

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*Unless otherwise noted, statistics used outside those gathered in this survey are from Trust Assets of Insured Commercial Banks - 1972, Federal Deposit Insurance Corporation.

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TABLE 2

EQUITY SECURITY ORDERS - BY SIZE OF TRUST DEPARTMENT

(JANUARY 1 - JUNE 30, 1973)

ORDERS WITH A VALUE OF	Size of Trust Department ($ Million) Below 50	50 to Under 150	150 to Under 750	750 and Over	All
Under $100,000					
Number of Orders	38,406	34,966	143,130	376,104	592,606
Per cent of Total	98.7	96.6	94.5	85.5	88.9
$100,000 - $299,999					
Number of Orders	445	998	6,254	50,778	58,475
Per cent of Total	1.1	2.8	4.1	11.5	8.8
$300,000 and over					
Number of Orders	77	247	2,051	13,019	15,394
Per cent of Total	0.2	0.7	1.4	3.0	2.3
Total					
Number of Orders	38,928	36,211	151,435	439,973	666,475
Per cent is of Row	5.8	5.4	22.7	66.0	100.0
Number of Banks in size category	516	81	105	57	759

TRADING

Criticism has been leveled at trust departments for exerting excessive influence on securities markets by dealing primarily in what are known as "block trades." While a rule-of-thumb definition of block trade is one with a value of $500,000 or more, it was felt for the purposes of this survey that a separation of trades of $300,000 or more--the point at which brokerage commissions begin to be negotiated--would be more meaningful. The questionnaire asked trust departments to supply the number of equity security orders--both purchases and sales--they had placed with brokers during the first six months of 1973. This number was broken down into orders over $300,000, those between $100,000 and $300,000 and those below $100,000.

Only 2.3% of all trades by trust departments were over $300,000; most -- 88.9% -- were less than $100,000.

The trading activity of various sizes of trust departments was analyzed. The complete breakdown appears in Table 2. Most startling were the data for the largest trust departments, those with $750 million or more in trust assets. They placed a total of 439,973 orders, of which 376,104, or 85.5%, were for $100,000 or less. Orders between $100,000 and $299,999 placed by these large trust departments totaled 50,778, or 11.5%. Only 3% of the orders--or 13,019--were over $300,000.

These results lend credence also to the fact that trust departments invest the funds under their management individually rather than in a monolithic manner.

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TABLE 3

AVERAGE NUMBER OF CORPORATIONS HELD

Size of Trust Departments ($ Million)

Below 50	50 to under 150	150 to under 750	750 and over	All
138.5	528.0	1035.7	2566.7	507.4

DIVERSIFICATION

Another criticism aimed at trust departments is that they have concentrated their investments exclusively in a handful of favorite stocks. It is argued that such activity helped create the so-called two-tier market in which small and medium sized firms had difficulty obtaining needed funds.

To ascertain the extent of trust department holdings in different corporations, the survey asked for the total number of corporations in which each bank held equity securities on December 31, 1972. Table 3 shows the results. The average number of common stocks held by all trust departments was 507. For the departments below 50 million the average was 139. In the $50 to $150 million asset range, it was an average of 528 firms for each department; in the next category--$150 to $750 million--an average of 1,036 companies per trust department. The largest trust departments--those with $750 million or more in assets--held an average 2,567 companies.

TABLE 4

25 LARGEST STOCKHOLDINGS AS A PERCENTAGE OF TOTAL EQUITY HOLDINGS

Number of Trust Departments by Size ($ Million)

Per cent	Below 50	50 to under 150	150 to under 750	750 and over	All
1 - 9	24	4			28
10 - 19	35	5	9	2	51
20 - 29	71	14	10	7	102
30 - 39	54	18	26	17	115
40 - 49	41	10	19	18	88
50 - 59	52	8	13	14	87
60 - 69	29	12	13	6	60
70 - 79	38	7	11	1	57
80 - 89	31	3	4		38
90 - 99	27	2			29
100	22				22
No indication	62				62
Column Totals	486	83	105	65	739

CONCENTRATION

The questionnaire asked each bank to list its top 25 equity holdings and indicate what percentage those 25 constituted of their total equity assets. It was felt that the top 25 would be fairly representative of all equity holdings and would not place an undue reporting burden upon the respondents. This assumption was borne out by the resulting data, for, as Table 4 illustrates, in most instances the largest 25 holdings accounted for between 20% and 60% of equity holdings.

Slightly more than half of the smallest trust departments responding indicated that their top 25 holdings represented less than 50% of their equity assets. In fact, the data for this category showed the limited scope of trust investment activity in these small banks. Eighty of these departments (out of 424 who responded to the question) replied that between 80% and 100% of their total equity assets were in their top 25 holdings.

The responses from the larger institutions show that--in a great majority of cases--their 25 largest holdings represent less than 50% of total stock holdings. For trust departments of $50 to $150 million in size, 51 of the 83 trust departments responding, or 61%, indicated that their top 25 holdings represented less than 50% of total equity holdings. About the same percentage of departments in the $150 to $750 million size category said their top 25 holdings were less than 50% of the total.

Significantly, more than two-thirds of the largest trust departments--those of $750 million and over in assets--indicated that their top 25 holdings were less than 50% of the total. In only seven cases did the top reach 60% of equity holdings.

It should be noted that the 25 largest holdings of one trust department will not necessarily be the same for any other. In fact, as shown in the following tables, there is considerable difference in the holdings.

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TABLE 5A

FREQUENCY OF CORPORATIONS APPEARING IN 25 LARGEST HOLDINGS

-- All Respondents --

Number of Corporations Provided		Number of Trust Departments providing
22	corporations were held by more than	100 Trust Departments
106	corporations were held by	20 - 99 Trust Departments
121	" " " "	10 - 19 " "
198	" " " "	5 - 9 " "
104	" " " "	4 " "
145	" " " "	3 " "
286	" " " "	2 " "
1343	" " " "	1 " "
2325		

TABLE 5B

Size of trust departments supplying data in Table 5A

Trust Assets $	Number Responding
Less than 25 million	361
25 - 50 million	67
50 - 150 million	78
150 - 750 million	106
750 - 1 billion	10
1 billion & over	52
TOTAL	674

MAJOR HOLDINGS

All trust departments were asked to list their 25 largest holdings, and 674 responded. Their replies listed 2,325 different corporations. The stock of only 22 corporations was found to be held in the 25 largest holdings of more than 100 banks, but the stock of 1,343 corporations appeared in the top 25 holdings of only one bank each. See Table 5A.

Table 5C sets out the corporations whose stock appears most frequently. General Motors heads the list, appearing in the top 25 holdings of 560 banks. GM is followed by AT&T (541), Exxon (523), and IBM (437). The frequency of appearance of corporate stocks then drops sharply until the 22nd most often named, American Electric Power, appears on only 108 lists.

All told, 128 different stocks appeared in the top 25 holdings of twenty or more trust departments.

To determine the investment practices of the very largest trust departments the replies from banks with more than $1 billion in trust assets were examined. Fifty-two of the 71 departments in that category replied.

For these 52 banks the top 25 holdings numbered 299 different corporations. This indicated that trust departments not only invest but invest significant amounts in many companies beyond the favorite 50 or 70 issues. To be sure, certain high quality stocks are held more often by trust departments than others of lesser quality, but the diversification of holdings far exceeds what some critics have charged.

International Business Machines, which was fourth most popular in the list of top 25 holdings of all departments was the only security found on every list of the 52 largest departments. Eastman Kodak and General Motors were found on 51 lists. Exxon was on 49 lists, General Electric on 48, and Sears, Roebuck on 41. Xerox was on 38 lists, Texaco on 33 and Minnesota Mining and Manufacturing on 32. Tables 6A and 6B report the results.

Many stocks appeared in the top 25 of only a fourth or less of the 52 reporting banks. Standard Oil of California and Burroughs Corp. were in the top 25 of only 13 banks. American Express, Atlantic Richfield, Ford Motor Co. and Warner Lambert appeared on only 11 lists. By the time the thirty-first stock in popularity -- Polaroid -- is reached, it appears on only 10 lists. It should be noted that only the 25 largest equity holdings were listed. It is quite possible that each of the above named issues is held in each department, but not among the 25 largest holdings.

Only 86 stocks appear on 3 or more lists, while 212 issues appear on fewer than 3.

12 TABLE 5C

Corporations appearing most frequently in 25 largest holdings:

-- All Respondents --

Name of Corporation	Total No. of Banks	Name of Corporation	Total No. of Banks
General Motors	560	U.S. Steel	35
American Telephone & Telegraph	541	Continental Oil Corp.	35
Exxon Corp.	523	CPC International Inc.	35
International Business Machines	437	Pepsico Inc.	34
General Electric	393	Weyerhauser Co.	34
Texaco	378	Bethlehem Steel Corp.	34
Eastman Kodak	361	Federated Dept. Stores	33
Sears Roebuck	276	International Paper	33
Mobil Oil	197	Baltimore Gas & Electric	33
Xerox	178	Firestone Tire & Rubber	32
American Home Products	169	Public Service Electric & Gas	31
Minnesota Mining & Mfg.	163	Halliburton	31
Standard Oil Calif.	163	Purex Corp. Ltd.	31
Standard Oil Indiana	161	Aetna Life & Casualty	30
Gulf Oil Corp.	142	Texas Utilities	30
International Telephone & Telegraph	139	Nabisco Ind.	29
General Telephone & Electronics	133	Niagara Mohawk Power	29
First National City	120	Chemical N.Y. Corp.	29
Dupont, E.I.	119	Kennecott Copper	28
Merck & Co.	111	Virginia Electric & Power	28
Ford Motor Co.	110	American Can Co.	28
American Electric Power	108	Columbia Gas System	28
Philips Petroleum	59	Continental Can	28
Coca Cola	98	Ohio Edison Co.	27
Warner-Lambert	92	Ingersoll-Rand	27
Dow Chemical	90	Travellers Corp.	27
Kraftco	82	Transamerica	26
Union Carbide	82	Bank-America Corp.	26
J.C. Penney	80	Consumers Power	26
Kresge (S.S.)	78	Marathon Oil Co.	26
Proctor & Gamble	78	Lilly (Eli) & Co.	25
Pfizer	69	United Telecommunications	25
Westinghouse Electric	69	Deere & Co.	24
Goodyear	68	Allegheny Power	24
Atlantic Richfield	67	Safeway	24
Schering Plough	67	Manufacturers Hanover	24
Reynolds (R.J.) Industries	66	MLT Corp.	24
Southern Co.	62	Pennsylvania Power & Light	24
Burroughs	61	Anheuser Busch	23
American Express	59	Upjohn Co.	23
Avon	58	Union Electric Co.	23
RCA Corp.	58	TRW Inc.	23
Commonwealth Edison	57	Household Finance	23
Tenneco	55	Quaker Oats	23
Bristol Myers	56	Phelps Dodge	22
Sterling Drugs	54	Norfolk & Western Ry.	22
American Cyanamid	51	U.S. Freight	22
General Foods	50	Southern California Edison Co.	22
Chase Manhattan Corporation	48	Singer Manufacturing	22
Pacific Gas & Electric	47	Schlumberger	22
American Brands, Inc.	47	General Mills	22
Beatrice Food Corp.	45	Emerson Electric	22
J.P. Morgan	43	Massachusetts Investors Trust	21
Union Pacific Corp.	43	Santa Fe Industries	21
Caterpillar Tractor Co.	42	Standard Oil of Ohio	21
Monsanto	42	Woolworth, F.W.	21
General Public Services	40	Detroit Edison Co.	21
Gillette Co.	39	Duquesne Light Co.	21
Continental Corporation	39	Union Oil of California	20
Johnson & Johnson	38	INA	20
Philadelphia Elec. Co.	37	Public Service Co. of Ind.	20
Honeywell	37	Polaroid	20
Squibb Corporation	37	Northeast Utilities	20
Colgate-Palmolive	37		
Georgia Pacific	35		

Finally, the trust departments were asked to indicate where customers had discretion* over 60% or more of a holding. In the case of IBM, which appeared on all 52 lists, there were 10 banks where customers exercised discretion over more than 60% of the holding. Eastman Kodak, which appeared on 51 lists, was held subject to customer discretion over 60% of the holding in 13 instances.

Exxon was subject to over 60% customer discretion in 13 cases and General Electric in 9 cases. The same was true for Sears in 11 cases and for Xerox in 5. Tables 6A and 6B list the incidences of customer discretion over 60% of the most frequently held stocks.

The data show clearly that the customer--rather than the trust department alone--in many instances is partly responsible for the larger holdings of the same stocks by banks rather than the trust department's having sole responsibility.

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* Discretion, for these purposes, means the ultimate power of purchase or sale. A customer is said to have discretion in all cases except those where the bank has sole power of investment.

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TABLE 6A

MOST FREQUENTLY HELD STOCKS AMONG 25 LARGEST HOLDINGS

-- 52 Responding Banks with Trust Assets over $1 Billion --

Column A = Number of banks listing the corporation among 25 largest holdings

Column B = Number of banks reporting that 60% or more of the holding is subject to customer discretion

Name of Corporation	A	B
IBM	52	10
Eastman Kodak	51	13
General Motors	51	14
Exxon	49	13
General Electric	48	9
Sears Roebuck	41	11
Xerox	38	5
Texaco	33	10
Minnesota Mining & Manufacturing	32	6
American Tel. and Tel.	31	10
American Home Products	27	4
Merck	26	8
Mobil Oil	20	6
Standard Oil of Indiana	19	5
International Tel. and Tel.	19	5
Dupont, E.I.	19	1
S.S. Kresge	18	2
Coca Cola	17	0
Dow Chemical	17	2
Proctor and Gamble	17	3
First National City	14	3
J.C. Penney	14	2
Pfizer	14	2
Schering Plough	14	3
Standard Oil of California	13	3
Burroughs	13	0
American Express	11	1
Atlantic Richfield	11	1
Ford Motor	11	4
Warner-Lambert	11	0
Polaroid	10	0

TABLE 6B

Other Frequently Held Stocks Among 25 Largest Holdings

-- 52 Banks with Trust Assets over $1 Billion --

Corporations appearing on list of 25 largest holdings:

9 Times

Avon (1)*
Johnson & Johnson (3)
Westinghouse (0)

8 Times

Emerson Electric (1)
Halliburton (0)

7 Times

Caterpillar (1)
Disney Productions (1)
Federated Department Stores (2)
Honeywell (0)
Philips Petroleum (3)

6 Times

Gulf Oil (4)
McDonalds (1)

5 Times

Dun & Bradstreet (0)
Eli Lilly (2)
General Telephone & Electronics (2)
Schlumberger (0)
Squibb (1)
Texas Utilities (0)
Union Carbide (1)

4 Times

Armstrong Cork (0)
Bristol Meyers (0)
Colonial Penn Group (2)
Connecticut General (1)
Kerr McGee (2)
Kraftco (1)
Philip Morris (1)
Simplicity Pattern (0)
Sterling Drugs (0)
Weyerhauser (2)
MGIC (0)
Motorola (1)
Pepsico (2)
Travellers (1)

3 Times

Aetna Life (1)
American Electric (2)
AMP. Inc. (0)
Anheuser Busch (2)
American Hospital Supply (0)
Beneficial Corporation (0)
Black & Decker (0)
Corning Glass (0)
Dart Industries (1)
General Mills (0)
Hercules (2)
Heublein (2)
Household Finance (0)
INA (2)
Jefferson Pilot (1)
Monsanto (1)
NLT Corp. (1)
Smithline Corp. (2)
Texas Instruments (0)
Tampax (0)
TRW (2)
Whirlpool (1)

Total number of corporations with a frequency of occurrence of 3 and over: 86
Total number of corporations with a frequency of occurrence below 3: 212

*Number in parenthesis is the number of banks which report that 60% or more of the holding is subject to customer discretion.

APPENDIX

Appendix A

Methodology

At the request of the Trust Division the survey was conducted by the Research and Planning Department of the ABA. The following information on the design of the survey may be of interest.

The final form of the questionnaire was mailed to 4277 commercial banks that previously had informed the ABA they had a trust function or at least an interest in banks' trust activities. Since the survey was taken the bank supervisory agencies have released data showing that there were 3804 trust departments at the end of December 1972.

The 4277 banks included were selected from the Association's mailing list system.

Considering one mailing only, the rate of response was high, especially for a survey of this type. Responses were received from 1043 banks, 24.4 per cent of those included in the mailing. 786 respondents--yielding an effective response rate* of 20.7 per cent--were considered to be statistically valid. The remaining banks indicated that they had not established a trust function.

The usable 786 replies accounted for 74.2 per cent of the total 1972 trust assets ($403.6 billion) which banks had held. The 786 responding banks showed a total of $299.4 billion in trust assets.

Given the size of the response, the calculation of a battery of reliability factors seemed unnecessary.

These study results do not include figures which would have required the use of highly-detailed, possibly unreliable estimates.

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* Related to the total number of banks with trust functions, 3804, in 1972.

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202/467-4020

ASSOCIATE DIRECTORS
JAMES D. McLAUGHLIN
202/467-4027
MARY C. SMITH
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July 30, 1973

My Fellow Trust Officer:

The Commerce and Finance Subcommittee of the House of Representatives is currently considering legislation relative to institutional membership on stock exchanges and fully competitive broker's fees. The Senate Finance Committee has announced hearings on the impact of bank trust departments and other institutional investors on the securities markets. Has the individual investor been driven out of the market? The Senate Securities Subcommittee has also indicated an intent to begin a study of the impact of institutions on the securities markets.

If we are to avoid restrictive legislation it is important that we provide the Congress certain hard information. Your assistance is needed. We would greatly appreciate your completing the attached questionnaire and returning it as soon as possible. The information provided may have a significant impact on the outcome of efforts to impose new regulations on trust departments. Let me assure you that your replies will be used in statistical compilations only and no bank will be identified by name.

I know all too well that trust departments are besieged with requests of this nature. I am also aware that the information requested will, in many cases, require extensive effort on your part. Were it not for the great importance of this information to our entire industry I assure you we would not make this request. Your cooperation will be greatly appreciated.

Cordially yours,

Stetson B. Harman

Stetson B. Harman
President

THE AMERICAN BANKERS ASSOCIATION 1120 CONNECTICUT AVENUE, N.W. WASHINGTON, D.C. 20036

If you have any questions, phone:

James D. McLaughlin (202) 467-4027
Associate Director, Trust Division

CONFIDENTIAL

Please indicate the name and title of the individual completing this questionnaire:

____

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TRUST DEPARTMENT SURVEY

PLEASE REPORT INFORMATION FOR YOUR ENTIRE DOMESTIC COMMERCIAL BANK SYSTEM

1. Excluding custody accounts, please indicate your bank's TRUST ASSETS as of......

	BILL.	MILL.	THOU.	HUND.
a. . . .December 31, *1971*	$			
b. . . .December 31, *1972*	$			

2. Please indicate the number of equity security orders your bank's Trust Department placed with brokers:

ORDERS WITH A VALUE OF	NUMBER OF ORDERS *1973* Jan. 1 - June 30
a. Under $100,000	
b. $100,000 - $299,999	
c. $300,000 and over	

3. Please indicate the total number of corporations in which your bank held equity securities as of December 31, 1972: ________ NUMBER

4a. Considering the dollar value, what percentage of your Trust Department's total equity assets (EXCLUDE CUSTODY ACCOUNTS) is represented by the top 25 largest equity holdings?

Top 25 holdings as a percentage of trust assets ________%

4b. Excluding custody accounts, please list below your Trust Department's 25 largest equity holdings (as of December 31, 1972) by name of corporation represented by each holding. Also check the appropriate box (✓) to indicate if a significant portion (60% or more) of any of these holdings is held subject to customer's discretion.

	NAME OF CORPORATION	60% OR MORE IS SUBJECT TO CUSTOMER'S DISCRETION	
1.	____________	YES ☐	NO ☐
2.	____________	YES ☐	NO ☐
3.	____________	YES ☐	NO ☐
4.	____________	YES ☐	NO ☐
5.	____________	YES ☐	NO ☐
6.	____________	YES ☐	NO ☐
7.	____________	YES ☐	NO ☐
8.	____________	YES ☐	NO ☐
9.	____________	YES ☐	NO ☐
10.	____________	YES ☐	NO ☐
11.	____________	YES ☐	NO ☐
12.	____________	YES ☐	NO ☐
13.	____________	YES ☐	NO ☐
14.	____________	YES ☐	NO ☐
15.	____________	YES ☐	NO ☐
16.	____________	YES ☐	NO ☐
17.	____________	YES ☐	NO ☐
18.	____________	YES ☐	NO ☐
19.	____________	YES ☐	NO ☐
20.	____________	YES ☐	NO ☐
21.	____________	YES ☐	NO ☐
22.	____________	YES ☐	NO ☐
23.	____________	YES ☐	NO ☐
24.	____________	YES ☐	NO ☐
25.	____________	YES ☐	NO ☐

We would sincerely appreciate your completing this questionnaire and returning it to the ABA in the enclosed envelope within two weeks

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., February 19, 1974.

Hon. LLOYD BENTSEN,
Chairman, Subcommittee on Financial Markets,
U.S. Senate, Washington, D.C.

DEAR MR. BENTSEN: Attached is the statement of the Tax Division of the American Institute of Certified Public Accountants concerning the hearings held on February 5–6, by the Financial Markets Subcommittee on S. 2842, The Stockholders Investment Act, and S. 2787, a bill to provide a graduated system of capital gains taxation.

We recommend some modification of the present system of capital gains taxation, while urging that continued recognition be given to our country's great needs for capital formation and the retention of incentives for investment. To accomplish this we recommend:

Extension of the basic hodling period for capital gains treatment from six months to one year;

Adoption of a sliding scale of exclusions to create incentives for taxpayers to sell securities and reinvest in others; and

Liberalization of the present laws with regard to capital losses.

The Institute's statement and its conclusions are the result of a study which the Tax Division has been conducting for the past 3½ years. We intend to make our full study available shortly, and will send you a copy of it as soon as it is completed.

We understand that your subcommittee may be holding additional hearings and would hope that we would be given the opportunity to testify at that time. Meanwhile, we request that the enclosed statement be included in the written record of the February 5–6 hearings.

If you or members of your staff have any questions regarding our statement or would like to discuss it with us, we would be pleased to co-operate in any way we can.

Sincerely,

ROBERT G. SKINNER,
Chairman, Division of Federal Taxation.

STATEMENT OF THE DIVISION OF FEDERAL TAXATION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The American Institute of Certified Public Accountants is the sole national organization of professional CPAs. It was established in 1887 and currently has approximately 100,000 members.

We are pleased to present the following comments and recommendations regarding proposed legislation designed to encourage investments in the stock market by providing a graduated capital gains tax and a limitation on stockholdings.

AICPA Position

In any discussion of major tax reform, capital gains is one of the items most often discussed. Some modification of the present system seems appropriate, but in our view it is essential to the health of our economy and the welfare of our citizens, that recognition continue to be given to our great needs for capital formation and the retention of incentives for its investment.

To accomplish our objectives we recommend:

Extension of the basic holding period for capital gains treatment from 6 months to 1 year;

Adoption of a sliding scale of exclusions to create incentives for taxpayers to sell securities and reinvest in others; and

Liberalization of the present laws with regard to capital losses to permit individual taxpayers to carryback unused losses and to permit a greater offset against ordinary income.

Background

For approximately the last 3½ years, the Tax Division has been conducting a study into many facets of capital gains taxation. In the course of that study, a number of prior studies, going back over 20 years, were reviewed. In addition, the evolution of the United States tax statutes governing capital gains was reviewed. Finally, the treatment of capital gains by other major industrial countries was considered. The net result of our consideration of the various issues involved in this subject is that we believe that continuation of a tax system that recognizes the special nature of capital gains is essential to our economy.

Several basic points are involved in this area of taxation including:

1. The need for the formation of capital, and the willingness of persons who own capital to take the risks inherent in investing it.
2. The impact of inflation on assets held for a long period of time.
3. The desirability for equity in our tax system, and the fair treatment of all taxpayers.
4. Concern over the increasing complexity of our tax system, and the simplification that might be achieved if present distinctions between capital gains and other types of income were eliminated.

Need for Capital Formation and Investment.—Much has been said and written about our country's needs for capital investment during the next few years, but this cannot be overemphasized. Over a year ago, a number of economists estimated these needs to be in excess of $100 billion per year for the foreseeable future. These estimates were made well before our current energy shortage reached its present level. A recent estimate of domestic and worldwide energy demands indicated a capital requirement of about $1.35 trillion by 1985. The economists who made this estimate expressed serious doubts (in which we concur) that industries involved in energy development could generate these funds internally. Aside from shortages of energy, we now see shortages of other basic materials in all sectors. We presently have the highest percentage of obsolete industrial facilities of any leading nation. We are dedicating a smaller percentage of our gross national product to the replacement and expansion of productive facilities than any other major industrial country. Environmental expenditures will be very large. Without the input of capital to meet these needs, our economy is vulnerable to stagnation.

Traditionally about two-thirds of the capital needed for replacement and expansion of plant facilities has been generated from retained earnings and from capital recovery provisions such as depreciation and the investment credit. The balance must come from new sources, such as the sale of corporate securities. It is in this latter area that our capital gains tax system is essential.

To develop capital in the hands of individual citizens for investment, funds must come from savings or from the conversion of other forms of capital. In one sense, all new capital must come from savings. For the most part, savings are derived from income sources after the payment of one level of taxation.

Even our present system of taxation acts to retard the formation of capital (through double taxation of corporate earnings) and the conversion of existing capital to provide funds for investment in new ventures (through capital gains taxation of gains on sales of existing assets). Furthermore, present estate and inheritance taxes decrease the pool of accumulated capital when assets pass from one generation to another. Increases in the present scheme for taxing capital gains can only worsen the problem.

Economists have estimated that current rates of capital formation—for the most part savings—are falling short of our needs to the extent of at least $5–15 billion per year. It is quite likely that our deficiency is greater today than a year ago. In view of this critical shortage, the AICPA does not favor repeal of the present basic system for taxing capital gains since this would make capital accumulation far more difficult.

Impact of Inflation.—Another major factor in the consideration of our capital needs is the effect of inflation. All of us have experienced personally greatly increased prices in our daily lives. Inflation affects all segments of our economy and is particularly erosive to assets held for substantial periods of time. From 1957 to 1972, the consumer price index increased over 50%. In the last five years the increase has been nearly 30%. Data recently released for 1973 indicates approximately an 8½% increase.

If a person invested $100,000 in a corporate security 15 years ago and sold it today for $160,000 he would be approximately even in terms of real value or purchasing power. However, under our present capital gains tax structure he could incur a tax on the sale of more than $15,000. This means that in terms of real capital available today for investment, there is less available than 15 years ago. In effect, this represents a tax on capital and not a tax on income.

Equity in Our Tax System.—In a self-assessment tax system like ours, equity and fairness among taxpayers are both desirable and essential. The real issue is balancing equity with other important factors in our system.

Proponents of tax reform often say that, to achieve greater equity, each dollar of income should be taxed in the same way regardless of its source. Stated another way, a dollar earned by a person's labor should not be taxed at a higher rate than a dollar earned on capital. Upon analysis, this seems to be an oversimplification leading to an erroneous conclusion.

Under our present system of corporate-shareholder taxation, corporate earnings are taxed first to the corporation and again when distributed to shareholders. The combination of top corporate and individual tax rates means that out of an initial dollar of corporate earnings, less than 16 cents may be available to the shareholder for investment. In other words, to generate a dollar for investment, more than $6.25 of corporate earnings must be realized. Furthermore, once that dollar is invested, any earnings from it will be subject to regular taxation. Because of this multiple taxation effect, it seems inappropriate to compare income realized on the sale of an investment with income earned by labor.

Simplification.—Without question, much of the complexity of our present tax law is created by special rules applicable to capital gains. If these rules were completely abolished, considerable simplification could be achieved. However, in our view, the price for this simplification, in terms of its detrimental effect on capital formation, would be much too high. Our capital needs are so great that continuation of the present system is essential even though it results in some complexity.

Recommendations

With this background on the major factors considered, the AICPA has developed a Tax Policy Statement that suggests some modifications in the present system for taxing capital gains. A copy of that Statement will be submitted shortly. The following recommendations are contained in the Statement:

1. The basic holding period for capital gain treatment should be extended to 12 months. The present rules permitting a six-month holding period for long-term gains permits preferential treatment of speculative gains that do not seem justified.

2. To partially recognize the effects of inflation while at the same time creating incentives for taxpayers to sell securities and reinvest in others, a sliding scale of exclusions is suggested. The longer a taxpayer holds an asset, the larger the exclusion of gain realized on its sale. In this regard, the increasing exclusion percentage each year should be gradual enough to avoid the so-called "lock-in effect" where taxpayers tend to hold assets longer than desirable to achieve a greater reduction in tax. For example, an exclusion scale for individual taxpayers starting at 50% after one year and increasing by 5% each year thereafter, to a maximum of 80% after seven years, might be appropriate. The taxation of capital gains to corporate taxpayers (presently a flat 30% rate) should be adjusted accordingly.

3. Present rules on capital losses should be liberalized to:

(*a*) Permit taxpayers to offset in full net capital losses (after applying the appropriate exclusion factors) against other income, and if such losses exceed other income, then the normal operating loss carryback rules should apply; or

(*b*) Permit individuals the right to carry back unused capital losses for three years, just as corporations may now do; and

(*c*) Permit a greater offset against ordinary income for capital losses than the present $1,000 level, which has been part of our tax laws for over 30 years (our recommendation is an allowance of $5,000).

4. Narrow the definition of capital assets.

In addition, other relatively minor suggestions are proposed and these will be covered more fully in the policy statement that we referred to previously.

STATEMENT OF THE AMERICAN LIFE INSURANCE ASSOCIATION TO THE SUBCOMMITTEE ON FINANCIAL MARKETS OF THE SENATE COMMITTEE ON FINANCE ON S. 2842 [1]

This statement is submitted by the American Life Insurance Association ("Association") on behalf of its 361 United States and Canadian life insurance company members. Of these members, approximately 257 United States life insurance companies maintain assets in their separate and/or general accounts that support pension reserves. The total amount of these assets, as of the end of 1972, was approximately $52.3 billion of which $42.5 billion, or 83 percent, were in general accounts and $9.8 billion were in separate accounts.

[1] This statement is addressed only to the first four sections of S. 2842.

S. 2842, by its terms, does not appear to include in its ambit pension funds managed by life insurance companies. We infer, however, from the fact sheet released on the Bill and from statements by Senator Bentsen on the floor of the Senate that this exclusion was not intended. Accordingly, we are pleased to have this opportunity to comment on S. 2842, and we preface our comments with a general statement of our understanding of the intent of the Bill.

S. 2842 would impose a penalty tax on pension managers who possess discretionary authority over pension trust accounts and invest more than 5 percent of the aggregate assets of such accounts in the securities of any corporation which has a capital account of more than $25 million, or invest such assets in more than 10 percent of any class of security of any such corporation. These prohibitions are asserted to arise from a concern that institutional investors dominate the securities markets and concentrate their investments in a "small number of select companies." In answer to this concern, this Bill is intended to provide safety for pension accounts by fostering further diversification; to prevent a small number of large institutions from achieving control over the entire economy; to limit the money a pension manager "can pour into the market to bolster the price of any particular stock"; to help provide greater liquidity; and to encourage institutional investor interest in small and medium size companies.

We recognize that the concerns giving rise to this Bill have been frequently expressed. We would also agree that if those concerns are well founded, remedial action of some type might be indicated. We respectfully submit, however, that there are insufficient facts presently available to permit such a determination. We further question whether, in any event, this Bill would provide an appropriate remedy. For these reasons, we do not favor its enactment.

I. THERE ARE INSUFFICIENT DATA AVAILABLE TO SUPPORT THE NEED FOR THIS TYPE OF LEGISLATION

Our first general objection to the Bill stems from the total absence of data periodically collected from all institutional investors which would demonstrate or tend to demonstrate that institutional assets in general or pension assets in particular are presently concentrated, and whether such concentration, if any, is either imprudently or improperly made in "a small number of select companies". In the absence of such data, critics have focused instead upon a so-called two-tier market, the existence of which has been cited repeatedly as dispositive evidence of concentration and discriminatory favoritism on the part of institutional investors. However, if the two-tier market, in fact, proves the existence of concentration in "a small number of select companies", the rapid deterioration, if not disintegration, of that market in recent months provides equally satisfactory proof of the converse.

Quite clearly, the absence of the necessary data prevents a refined definition of the problems with which S. 2842 is concerned.[2] For example, with respect to the question of the degree to which concentration and control exists the following quotation from *Disclosure of Corporate Ownership*[3] is pertinent:

"In the first instance much more detail on the holdings of particular institutions is needed to determine the role which their holdings permit them to play. In some cases a bank or other institutional investor holds complete fiduciary power, with full voting rights and authority to buy and sell securities. At the other extreme, it has purely custodial or agency responsibilities, with no rights to vote stock or to buy or sell. There are considerable variations in between. Not only is it important to learn the legal rights pertaining to the exercise of authority in handling stocks by various institutional holders, but fully as important is the need to ascertain how these rights are actually exercised. . . ." (p. 133)

Likewise, in the absence of supportive data, the suggestions underlying S. 2842 that there is an absence of liquidity in the market and that pension managers "bolster" the prices of particular stocks are no more than suggestions. Contrary views also have been advanced and explained. In the report *Public Policy for American Capital Markets* ("Capital Markets Policy")[4] prepared for the Depart-

[2] The proceedings pertaining to this Bill to date contain references to some figures for broad categories of money under management but no figures for pension assets alone, the focus of the Bill.

[3] *Disclosure of Corporate Ownership*, prepared by the Subcommittees on Intergovernmental Relations, and Budgeting, Management, and Expenditures of the Committee on Government Operations, United States Senate, December 27, 1973.

[4] *Public Policy for American Capital Markets*, prepared by James H. Lorie for submission to the Secretary and the Deputy Secretary of the Treasury, February 7, 1974.

ment of the Treasury, the basic conclusions of which are supported by the Department, Professor James H. Lorie states that upon "careful examination, none of the allegations regarding the harmful consequences of institutional investing seem valid." Thus Dr. Lorie finds, among other things, that (1) "the present structure of stock prices is not markedly different from that prior to the great increase in the relative importance of institutional investors" (p. 12); and (2) "the market has not become less liquid: the demands upon the liquidity of the market have become greater" (p. 13). Indeed, Dr. Lorie states that "it could be argued that the liquidity has been increasing at the same time that institutionalization has been increasing" (p. 13). A copy of the section, "The role and impact of institutional investors" of *Capital Markets Policy* is attached hereto as an appendix.

In addition to the foregoing, the absence of data also severely handicaps the development of a remedy for the alleged conditions to which this Bill is addressed. Partiality by institutional investors for what may be called "blue-chip" securities is neither a new nor a continuous phenomenon. Nor is this Bill the first legislative effort addressed to this phenomenon.

For example, in 1940, the Congress, after lengthy hearings, concluded an exhaustive examination of one group of institutional investors. Among the findings of this examination and of the hearings, which resulted in the Investment Company Act of 1940, was the fact that mutual funds, then a $401 million industry, were invested almost entirely in "blue-chip" stocks. Along with this finding was the concomitant recognition by Congress that there were many legitimate reasons why such institutional investors limited their investments primarily to "blue-chip" companies.[5] To foster the allocation of resources to venture capital situations and to other lesser-sized companies without impinging upon the investment discretion of mutual funds and their managers, and without endangering the savings of the beneficiaries of these funds, Section 12(e) was written into the 1940 Act.[6] While this section has not proven to be a panacea, its concept, if combined with appropriate tax incentives, may remain meritorious and deserve reconsideration.

In our opinion, the deficiency in data that S. 2842 suffers is particularly unfortunate in light of the fact that it soon may be corrected. During the 93d. Congress, two bills, S. 2234 and S. 2683, were introduced to require reporting and disclosure by a broad universe of institutional investment managers. The results of such reports would provide a meaningful base for remedial legislation, if any is necessary.

The need for institutional investor disclosure legislation as a basis for the consideration of remedies, if any are necessary, has been recognized and its enactment recommended by the Securities and Exchange Commission in its *Institutional Investor Study Report*, by the Twentieth Century Fund in its study *Mutual Funds and Other Institutional Investors*, and most recently in the report *Disclosure of Corporate Ownership*. The American Life Insurance Association is already on record before this Subcommittee in endorsement of disclosure legislation.[7]

II. STATE LAWS IMPOSE QUANTITATIVE AND QUALITATIVE RESTRICTIONS ON LIFE INSURANCE COMPANIES

Our second general objection to S. 2842 stems from the fact that it fails to recognize that life insurance companies are already subject to quantitative regulations generally comparable to those proposed by the Bill. Further, life in-

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[5] Thus, the Investment Company Act does not require an investment company to be diversified. Section 5(b)(1) of that Act provides a statutory definition of "diversified" in order to set a standard for disclosure, but a company may, with equal ease, be non-diversified under Section 5(b)(2).

[6] Generally, Section 12(e) provided for the establishment of a "venture capital" company, the stock of which would be sold exclusively to investment companies. With the proceeds from the sale of its stock, the venture capital company would then "engage in the business of underwriting, furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, and reorganizing companies or similar activities . . ." It should be noted that an investment medium such as that proposed by Section 12(e) may alleviate the problems associated with the economies attendant to institutional investing (e.g., the cost of investigating a potential investment, of following an investment once it is made, and of purchasing a block sufficient in size to justify such expenses).

[7] Hearings before the Subcommittee on Financial Markets of the Committee on Finance, U.S. Senate, 93d Cong., 1st Sess., on "The Impact of Institutional Investors in the Stock Market", Part I, p. 246.

surance companies are also subject to state restrictions which prohibit investment in any company not meeting certain qualitative standards. In view of these state restrictions, as discussed below, life insurance pension managers should be excluded from S. 2842.

Life insurance company general account reserves represent obligations to make future payments upon the happening of a specified event, e.g., death, or in the case of pensions, retirement. Accordingly, the entire reserve stands behind each liability. State law, for obvious reasons, prohibits the allocation of particular assets to particular liabilities. Thus, a general account's reserves represent commingled obligations owed to beneficiaries or owners of fixed-benefit life policies, fixed annuities, endowment plans and pension plans, and such accounts are composed of the commingled assets necessary to honor these future obligations. Because the assets funding a general account's reserve are commingled, it is impossible to "trace assets" and determine which securities in the account or what percent of such securities support pension obligations. The assets in separate accounts, which simultaneously may fund a number of pension plans and possibly variable annuities purchased by individuals, generally are commingled also.[8]

To ensure that a company's assets are at all times adequate to meet its obligations, state laws impose quantitative restrictions on the investments of life insurance companies domiciled and, in some cases, doing business in the state. Inherent in these quantitative restrictions is recognition of the fact that prudence in investment necessitates diversification, and the concomitant effect of this required diversification is, of course, a prohibition against the concentration of investments. These restrictions apply to all insurance company assets, not just pension assets.

Within this context, S. 2842 would impliedly preempt numerous and effective state quantitative restrictions without any data which would suggest, much less substantiate, the Bill's implicit presumptions that (1) life insurance company pension accounts are imprudently concentrated, notwithstanding state law, and (2) that state law requirements are at such material variance from the proposed legislation as to necessitate federal regulation and preemption. Further, S. 2842 would impliedly repeal these state laws notwithstanding that, as shown below, their repeal would not contribute to the Bill's objective—to wit, the dispersion of managed pension monies to small companies.

As noted above, the states impose, subject to certain "leeway provisions", qualitative restrictions as well as quantitative restrictions on life insurance companies. These qualitative restrictions, too, are designed to ensure that a life insurance company's assets are fully adequate to meet its present and future liabilities. As an example of these restrictions, the qualitative requirements of the State of New York for life insurance company general accounts provide that the issuer of common stocks must satisfy an earnings test for a seven-year period preceding the date of acquisition of the stock; also, the stocks, with certain limited exceptions, must be registered on a national securities exchange. Further, all obligations and preferred stock, if any of the issuer must be eligible for investment. In this regard, for an interest-bearing obligation to be eligible for purchase, the issuer of such obligation must have had earnings that average, for each of the preceding five years, one and one-half times its average annual fixed costs and not less than one and one-half times its actual fixed costs for one of the past two years.[9]

Because of the qualitative restrictions imposed by state law, life insurance companies cannot invest in securities determined to entail inappropriate risks for the thousands of individuals to whom these managers owe a fiduciary duty. Thus, even if the quantitative restrictions in S. 2842, to the extent they may differ from state law, were substituted for the states' quantitative restrictions, the qualitative limitations of state law, by their definition of prudence, would still limit the investment discretion of life insurance companies. Thus, the result of S. 2842 would likely be merely to increase insurance company investments in nonequity securities such as bonds and mortgages.

For these reasons, life insurance companies should be exempted from S. 2842.

[8] A very small percent of pension assets managed by life insurance companies are in "separate" separate accounts, that is, accounts established exclusively for one employer's pension fund.

[9] For a complete summarization of New York's qualitative and quantitative restrictions for general and separate accounts, see, Hearings before the Subcommittee on Financial Markets of the Committee on Finance, at p. 257, *supra*, fn. 7.

III. INSTITUTIONAL INVESTORS ARE NOT THE CAUSE OF THE PROBLEMS TO WHICH THIS BILL IS ADDRESSED

Our third area of general concern is the failure in S. 2842 to recognize that institutional investors, including pension managers, are not the molders of the national economy. Thus, attributing to pension managers the asserted inaccessibility of small and medium-size companies to equity capital overlooks certain fundamentals.

The importance of the national economy in explaining the stock market and investment phenomenon here under consideration is underscored in *Capital Markets Policy, supra.* Thus Professor Lorie, in concluding that "institutions cannot reasonably be blamed for the ills which are sometimes attributed to them", (p. 14):

"There are more plausible explanations of the difficulties that have been blamed on institutional investors. Much of the general, substantial decline in the prices of common stocks since 1968 can be explained on the basis of normal economic relationships. As the rate of inflation increased, the expected rate of inflation increased, with a consequent increase in nominal interest rates. And predictably and naturally, as the nominal cost of debt capital rose, the cost of equity capital rose. In the absence of a general expectation of rapidly rising profits, the increased cost of equity capital has been reflected in declining price-earnings ratios. Although some stocks have much higher price-earnings ratios than others, this has always been true. Institutional investing is not plausible as an explanation of a phenomenon which existed before institutional investing became so important."

In conclusion, the concerns underlying S. 2842 appear to be more appropriately attributable to general economic conditions rather than to pension managers in particular or institutional investors in general. In any event, these concerns can neither be verified nor defined in the absence of the data that an institutional disclosure act would provide. Moreover, in the absence of such data, appropriate remedies, if any are needed, cannot be thoughfully evaluated. Life insurance company pension mangers are, by virtue of state law requirements, already substantially within the perimeters that S. 2842 would impose. Because the imposition of federal restrictions might impliedly repeal state law without any concomitant furtherance of the Bill's primary purpose, duplicative regulation should be avoided. Accordingly, life insurance company pension managers should be exempted from S. 2842.

APPENDIX

C. THE ROLE AND IMPACT OF INSTITUTIONAL INVESTORS

1. Some general remarks

For the past 25 years, institutions have rather steadily increased the volume and proportions of financial assets which they own directly or manage on behalf of others and the proportion of the volume of trading of financial assets for which they account. Many people now blame institutional investors for a variety of ills which are believed to afflict our capital markets. Some contend that institutional dominance of securities trading (which at present is most prevalent in securities listed on the New York Stock Exchange) has adversely affected the liquidity of the markets and increased price volatility. Furthermore, there is concern that the institutions have concentrated their holdings in an ever-narrowing group of favorite stocks ("first tier" stocks). As a consequence, stocks in the "second tier" have low price-earnings ratios which have discouraged corporations from raising capital through issuing equity securities. (This concern has abated in recent months, as price-earnings ratios of so-called "first tier" stocks have declined relative to ratios of other stocks. The present structure of stock prices is not markedly different from that prior to the great increase in the relative importance of institutional investors.) Finally, some people believe that institutions have acquired an undesirable degree of economic power through their management of large volumes of securities.

As a result of these concerns, various proposals have been made to restrain the freedom of institutional investors. These include placing restrictions on institutional trading, imposing limitations on institutional holdings, and requiring the disclosure of institutional trades and holdings. We do not believe that any of these proposals for regulating institutional investing are justified with the possible exception of requiring periodic disclosure of holdings. Upon careful examination, none of the allegations regarding the harmful consequences of institutional investing seem valid. Moreover, many of the difficulties of our securities markets, which have been attributed to the institutional investors, have stemmed from other causes, such as the general state of the economy.

It is alleged that institutions have diminished the liquidity of our stock markets. The liquidity of an asset is measured by the degree to which large quantities of it can be sold quickly without much impact on its price. Because institutions typically hold relatively large amounts of individual assets and because they have become increasingly important as owners, managers, and traders of financial assets, trades involving relatively large volumes of individual securities have become much more frequent. Although such trades may have a larger impact on the price of an asset than smaller trades, there is no evidence that large trades now have a larger impact than they did formerly when institutions were of less importance. The market has not become less liquid; the demands upon the liquidity of the market have become greater.

In fact, it could be argued that liquidity has been increasing at the same time that institutionalization has been increasing. The dollar volume of trading has been rising dramatically. The dollar volume on the New York Stock Exchange in 1972 was over four times as great as the volume ten years earlier. It seems hard, tough logically possible, to argue that liquidity has been declining when the dollar value of stocks changing hands has been rising so dramatically.

When security prices change because of a temporary imbalance between orders to buy and orders to sell, the main sufferer is the investor responsible for that imbalance. The investor who places a large block of stock on the market and depresses its price bears the main costs. Other investors, recognizing the causes of the decline in price, would purchase the security at an advantageous price and thereby cause the price to return to its equilibrium level. The self-interest of institutional investors will cause them to be cautious in placing unreasonable demands on the liquidity of the market. No issue of public policy is involved.

Another complaint often voiced is that the institutions concentrate their holdings in relatively few securities, causing their price-earnings ratios to be "too high" relative to securities which do not enjoy institutional favor. International Business Machines Corp. is perhaps the most favored institutional holding. Incidentally, International Business Machines Corp. is the stock on the New York Stock Exchange which has provided the greatest total returns during the past 50 years. This return derived from the extraordinary success of the company rather than any artificial inflation of its price relative to its earnings.

People who believe that institutions buy and sell in concert are particularly upset about the rising importance of institutional investing. An analysis of the data of the SEC's "Institutional Investor Study of 1971" indicates that parallel trading by institutions is not more common than such trading by individuals. The notion that the news that a particular institution is buying or selling would cause other institutions to adopt similar courses of action seems invalid in view of the fact that institutions deal with each other in much greater volume than with individuals. The news that institution A is selling a security is more often than not offset by the news that institution B is simultaneously buying that security. The success of a communications system such as Instinet or Aut Ex which permits institutions to transact directly with each other, is some evidence that institutions do not blindly play the game of "follow the leader," but buy and sell to and from each other.

As stated above, when institutions or individuals simultaneously react to new information about a security which changes perceptions of its value, their behavior should cause the price to change rapidly and even dramatically when the perceived change in value is large. Those who have concern about such sudden, large changes feel that the public interest would be served by legally prohibiting such price changes to create the illusion that the change in value had not taken place. Such an illusion would be costly to the public and contrary to an important objective of public policy, namely, efficiency in setting the price of securities. It is in the public interest for the prices of securities to adjust very rapidly to changes in their inherent value. If institutions promote and facilitate such adjustments, they are to be encouraged and commended rather than the reverse.

Some believe that the increased relative importance of institutional trading has increased the volatility of the stock market. It is curious that the volatility of the institutional favorites has typically and, also on the average, been less than that of other stocks. It is also curious that the volatility of the American Stock Exchange, where institutional investing and trading are relatively unimportant, has been greater than that of the New York Stock Exchange where most of the institutional interest is focused.

There has also been concern that some institutions have come to manage too large a volume of assets. Some feel that there is an undesirable degree of concentration of economic power in the hands of the large institutional investors. This power is of two sorts. The first is power over the companies whose securities are controlled; the second is the power over the prices of the securities themselves.

Before considering these concerns, it is worthwhile to consider the degree of concentration which exists. The largest institutional investor manages approximately $26 billion of assets. About $20 billion are invested in common stocks. This represents about 2 percent of the value of all common stocks, although the proportions of the stocks of some companies are obviously much greater. By the time the 10th largest institutional investor is reached, the volume of holdings is less than $10 billion. The 10 largest institutional investors combined manage less than 15 percent of the value of all common stock. This degreee of concentration does not automatically seem alarming. Those who feel alarm have yet to demonstrate the harmful consequences which they fear. It would be alarming if the largest investors colluded or followed identical policies without collusion or if some specific harm could be shown to result from institutional management of significant amounts of corporate securities. There is no evidence of such behavior or of such consequences.

From 1958 to 1968 the market was generally rising, trading volume was rising, the brokerage industry was prosperous, the relative importance of institutions as owners, managers, and traders of stocks, was increasing rapidly, and there were few complaints about institutional investing. Since 1968, stock prices have generally been declining, trading volume has been erratic, and there have been widespread losses and failure in the brokerage industry. Institutional investors have received much of the blame. No one has satisfactorily explained why the rapid rise in the importance of institutional investing had such apparently benign effects prior to 1968 and such harmful effects subsequently.

There are more plausible explanations of the difficulties that have been blamed on institutional investors. Much of the general, substantial decline in the prices of common stocks since 1968 can be explained on the basis of normal economic relationships. As the rate of inflation increased, the expected rate of inflation increased with a consequent increase in nominal interest rates. And predictably and naturally, as the nominal cost of debt capital rose, the cost of equity capital rose. In the absence of a general expectation of rapidly rising profits, the increased cost of equity capital has been reflected in declining price-earnings ratios. Although some stocks have much higher price-earnings ratios than others, this has always been true. Instiutional investing is not plausible as an explanation of a phenomenon which existed before institutional investing became so important.

Financial distress in the brokerage industry has been caused in part by declining stock prices, in part by widely fluctuating volume, and in part by other causes. It is true that the rise of institutional investing has probably caused the New York Stock Exchange to lose ground relative to the third market, regional exchanges and the fourth market. But. some of the competitive advantages of the New York Stock Exchange's competitors seem to have their source in rules of the New York Stock Exchange which the New York Stock Exchange itself could change.

The foregoing suggests the conclusion that institutional trading does not seem to have caused the difficulties which are sometimes attributed to it. As a consequence, some of the prescribed remedies seem unnecessary, and, also contrary to the public interest.

What are some of these remedies and what would be their effects? One remedy would be to limit the percentage by which a stock price could change in a given day. This remedy is designed to diminish short-term volatility which is often attributed to institutional trading. Limitation of price changes is contrary to the public interest. When prices change as a consequence of changed perceptions regarding the value of a company, market efficiency requires that the charges take place rapidly. If investors are unwilling to pay more than $45 per share for a stock, no loss is avoided and no wealth is preserved by stopping all transactions when the price declines to $48. If the highest bid is $45, the stock is worth $45 by the only test which one can imagine imposing. Preventing transactions from taking place at $45 imposes costs on those who wish to transact at that price and confers no offsetting benefit on anyone else.

It has also been suggested that the volume of a security which any investor can buy and sell in a given time period be limited. The purpose of this restriction also is to diminish short-term price volatility. Limiting price changes directly is a relatively efficient way to achieve an undesirable objective. Limiting the volume of sales or purchases by a single investor is merely an inefficient means to achieve the same undesirable objective.

Some have suggested that the volume of assets managed by a single institution be limited to some maximum. Before imposing new regulations, it would seem desirable to establish some evidence of the evils or dangers which would be elminated. That case has not been made. It is possible that the volume of assets managed by some institutions will ultimately become so large that the case can be made for imposing a maximum, but recent trends do not suggest that that condition will soon exist.

It has been suggested that the proportion of a company's stock which can be controlled by a single institution be limited. Ten percent has been suggested as an appropriate maximum. The purpose of such a maximum would be to limit the amount of control which an institutional investor can exert over a company whose stock is owned or managed. In this connection, it is moderately amusing to recall that during the 1930's and 1940's there was widespread concern regarding the disenfranchisement of the individual investor which resulted from the wide dispersion in the ownership of stocks of individual companies. Such widespread ownership, it was alleged, effectively disenfranchised the owners and gave management unchecked reign. Now that ownership has become somewhat more concentrated because of the rise of the institutional investor, there is concern that the shareholders will use their franchise and exert an influence over management. Before a maximum is set on the proportion of a company's stocks which an institution can own or manage, there must be a better demonstration than has been made so far of the harmful consequences of enfranchising the investor.

It has been suggested that institutions make periodic disclosures of their holdings. Some have even suggested that institutions disclose not only their trades but their intentions to trade. Although little harm and possibly some good could come from periodic—say, quarterly—disclosure of holdings, harm to those whose assets are managed by institutions would certainly result from disclosure of intentions to trade. Unless one can demonstrate that placing institutional investors at a disadvantage relative to others is in the public interest, it is hard to imagine any benefit from such required disclosure of transactions which would not be more than offset by the harm to those investors who use institutions to manage their funds.

In summary, institutions cannot reasonably be blamed for the ills which are sometimes attributed to them. Therefore, the regulations which have been proposed for institutional investors to remedy the ills discussed above seem unnecessary and in some instances harmful to the public interest.

Comments of American Textile Manufacturers Institute, Inc.

The present system of taxation of capital gains in the United States raises significant questions concerning tax equity. The high prevailing rate of inflation in this country has resulted in the creation of large amounts of "illusory profits" upon the sale of capital assets. Thus, from an economic standpoint, the vast majority of gains realized from the sale of capital investments are taxed too heavily.

Furthermore, the incidence of taxation on capital gains in the United States is relatively high when compared to the other major industrialized nations of the world. Incentives for capital investment are extremely important if U.S. businesses are going to maintain a competitive position in the world markets. While concepts such as the investment tax credit and accelerated depreciation are certainly steps in the right direction, they do not go far enough in stimulating investment in capital facilities and equipment. Moreover, the recent growth in the rate of inflation has thoroughly distorted the concepts of capital gain and recovery of basis.

The introduction of S. 2842 and S. 2787 stems in large part from a recognition of the seriousness of the problem. The approaches of these two bills in dealing with the inflation problem are, in general, meritorious and we support their enactment. Nevertheless, it is important to note that neither bill would apply to the capital gains and losses of corporations. Apparently the sponsors of these bills believe that the capital gain issue is strictly a problem faced by individuals.

On the contrary, let me assure you that the capital gains problem is no less critical for corporations than it is for individuals. Inflation is as much a fact of life for corporate investors as it is for individuals. Furthermore, nonparallel treatment of capital gains may result in significant dislocations in the capital markets, if the relative suitability of corporate versus individual investment depends to a great extent on varying holding periods. Accordingly, the American Textile Manufacturers Institute, Inc. (ATMI), recommends that the provisions of S. 2842 and S. 2787 be expanded to include corporate taxpayers.

In considering the substantive provisions in the two bills. ATMI believes that the extension of the minimum capital gains holding period to one year in S. 2842 would be more desirable than the approach of shortening the period as would be accomplished in S. 2787.

The concept of a one-year capital gains holding period, particularly for corporations, is more consistent with the long-term effects of inflation. While bunching of income does not present the same problems for corporations as for individuals, a one-year holding better recognizes the comparability of earned income and *short-term* capital gain, but with an appreciation for the disparity between these two types of income which occurs as the holding period of the capital investment increases beyond one year.

As far as graduated holding periods are concerned, the more gradual the decline in the tax rate, the less that taxes play an important factor in the timing of investments. S. 2787, which provides for decreases in rates every five years, may produce too sudden a reduction in rates to eliminate the notch effect which currently exists in the law. In fact, the graduations in holding periods in S. 2842 may actually be too large to completely eliminate any notch effects. Perhaps a rate which declines quarterly or even monthly might be more appropriate.

In addition, neither bill discusses whether any modifications would be made in the mechanics of computing carryovers. ATMI submits that a continuation of the tracing approach which exists in the present law would be too difficult to apply to graduated tax rates.

Accordingly, ATMI recommends that all carryovers of capital gains and capital losses be translated into equivalent dollars. For example, if a taxpayer incurred a capital gain of $100,000 which would be 40% includible in income and a capital loss of $100,000 which would be 50% deductible, such taxyear would have 10,000 equivalent dollars of capital loss available for carryover. Such an approach would be far simpler than the current carryover rules which require the segregation of long-term and short-term gains and losses.

Both bills would also grant individuals the right to deduct up to $4,000 of capital losses against ordinary income. At present, corporations are not permitted to deduct any capital losses against ordinary income. ATMI can think of no persuasive policy justification for treating corporate taxpayers less favorably than individuals in this area.

In considering the appropriateness of a dollar limitation on capital loss offsets against ordinary income, it is important to note that capital gains and losses would be reduced to equivalent dollars under ATMI's proposed approach. As a result, net captial gains and losses would have been adjusted to a level which should make them roughly comparable to ordinary income. This assumes, of course, that the graduation in rates has accurately compensated for the effects of inflation and the value of tax deferral on unrealized appreciation. Based on this assumption, however, capital losses of both individuals and corporations restated in equivalent dollars should be allowed to offset ordinary income to the same extent as would ordinary losses.

In conclusion, ATMI supports the concepts embraced in S. 2842 and S. 2787. Nevertheless, ATMI believes that the principles proposed therein should be made equally applicable to corporations.

Statement of Robert L. Augenblick on Behalf of Investment Company Institute

The Investment Company Institute, of which I am President, is the national association of the mutual fund industry. Its membership consists of 392 mutual funds, together with their 167 investment advisers and 118 principal underwriters. Our member funds have assets of about $46 billion, representing over 90% of the assets of all U.S. mutual funds, and have about 8½ million shareholders.

We appreciate this opportunity to express our views with respect to S. 2842. Our comments are directed to two of the bill's major provisions. We take no position with respect to the other provisions of the bill.

We are concerned because under the bill as presently drafted (1) the diversification requirements for the assets of pension funds would drive smaller and medium sized pension funds away from investigating in mutual funds, and (2) the provisions with respect to a graduated capital gains tax would be damaging to mutual fund shareholders and would be inconsistent with longstanding tax treatment of mutual funds, unless the proposed graduated capital gains tax is applied to securities transactions by the mutual funds themselves. We do not believe it was the intent of the bill to reach these results.

A mutual fund is the popular name for an open-end investment company organized under the Investment Company Act of 1940. A mutual fund combines the monies of large numbers—often many thousands—of people with similar investment objectives and invests it in many different securities which are carefully selected and continuously supervised by professional managers, thereby offering to the public investor the advantages of diversification of investments under professional management. Mutual funds continuously offer their own new shares to the public and stand ready to redeem their outstanding shares at their current asset value.

Mutual funds are closely regulated by the Securities and Exchange Commission under federal law and also by state securities administrators under the laws of practically every state. On a federal level, mutual funds are subject to the disclosure and other provisions of the Securities Act of 1933, sale of their shares is subject to regulation under the Securities Exchange Act of 1934, and their structure and operation are regulated in detail under the Investment Company Act of 1940.

THE DIVERSIFICATION REQUIREMENTS FOR PENSION FUND ASSETS

Section 2(a) of S. 2842 proposes to amend Part I of subchapter D of chapter 1 of the Internal Revenue Code to add a new Section 408 which would, among other things, penalize a pension fund manager having discretionary investment authority if he invests more than 5% of the value of the pension fund assets under his management in the equity securities of any corporation with a capital account of over $25 million or invests such pension assets in more than 10% of any class of equity securities of any corporation.

This penalty provision, read literally, would appear to apply if the percentages were overstepped by a pension manager's investment in the securities of a mutual fund in corporate form (most mutual funds are corporations). We doubt that such result was intended and suggest that the bill be clarified so as to provide the exemption set forth below.

The bill, as presently drafted, would probably have the unfortunate and unintended result of turning small and medium size pension funds away from mutual funds as an investment medium. Those who control the selection of investments for a small, and often a medium size, pension fund normally lack investment expertise. They are attracted to one or more mutual funds as an investment for a major portion or all of their pension fund assets because mutual funds offer them professional management as well as diversification of investments and therefore lessening of investment risk. It is thees advantages which led employee pension plans to have outstanding investments of about $500 million in mutual funds at the end of 1972.[1] This is, of course, a pittance compared to the size of pension fund assets managed by banks or invested in insurance company annuities.

If the officers or directors of smaller pension funds are faced with a requirement that they can invest no more than 5% of pension fund assets in a mutual fund, they will have to select twenty mutual funds should they desire to keep the pension monies invested in mutual funds. Since most mutual funds are reasonably diversified, the bill would merely pile one requirement of diversification on another. Furthermore, this requirement would impose on these officers or directors the burden that a mutual fund assumes when pension assets are invested in the mutual fund, namely the exercise of professional judgment to achieve diversity of investment. Having decided initially to avoid active investment man-

[1] This is estimated. Investment Company Institute 1973 Mutual Fund Fact Book, p. 49, reports an aggregate of $1,493,000,000 invested in mutual funds by both pension and profit-sharing plans at year-end 1972.

agement, they will naturally seek from some entity other than a mutual fund professional advice as to the investments to be selected. If they go to a bank for advice the bank will naturally recommend its own unincorporated pension fund. It is in most cases unlikely that a bank pension manager, or a private investment counsellor for that matter, would wish to forego all or a part of the advisory fee by recommending a mutual fund. The result would follow that some portion of the pension monies which would otherwies be invested in mutual funds would be diverted to a competing form of money management—a result which would plainly be anti-competitive in its effects in that it would promote concentration rather than relieve it.

Moreover, to the extent that some trustees of pension plans might decide to manage their assets themselves rather than invest in 20 mutual funds, this would be contrary to the beneficial purposes of the pension reform bill, H.R. 4200, which recently passed the Senate. The detailed study which formed the background for this bill indicated that many of the problems in the pension area lay in the lack of professionalism with which substantial amounts of pension assets were being managed.

It is apparent that the investment of all or a major portion of a pension fund's assets in a mutual fund would satisfy each of the five reasons[2] cited by Senator Bentsen (Cong. Rec. Dec. 20, 1973, pp. S-23523-24) for the diversification requirements of S. 2842, particularly considering the numerous corporate issues held by a mutual fund, the fact that mutual funds do not invest for purposes of control, and the present diversification requirements imposed by federal and state law.

First, with respect to the diversification of a mutual fund's portfolio, we have compiled data from a publication called "Spectrum 2, Investment Company Portfolios, Third Quarter, 1973" (published by Computer Directions Advisers, Inc.). The data were compiled from reports of 242 mutual funds with assets of $25 million or more as of the end of the third quarter, 1973. Funds with all types of investment objectives except bond and preferred stock funds and income funds are included in our sample (because these latter funds invest little or nothing in common stocks and are therefore not relevant to the purposes of S.2842 they were excluded from the sample). The dollar value of assets covered by the funds in our sample amounted to $53.3 billion at the end of third quarter, 1973. This sum represents about 94 percent of the assets of all funds with assets of $25 million or more. The data shows:

(1) The average number of stocks held in the common stock portfolios of funds with $25 million or more in assets (excluding bond and preferred stock and income funds) was 54.7 issues at the end of the third quarter 1973.

(2) Slightly more than one half of the 242 funds in the sample have 50 or more issues in their portfolios.

(3) The largest number of stocks in a fund's portfolio was 144; the lowest number of issues was 13.

Secondly, with respect to Senator Bentsen's point about preventing a small number of institutions from achieving too much control over our economy, it is clear that mutual funds generally do not invest with a view to controlling a portfolio company. The Institutional Investor Study[3] report of the SEC, dated March 10, 1971, stated as to mutual funds that "if they lose confidence in management they tend to sell their holdings in a company rather than to attempt to influence or control management decisions." In similar manner, the Federal Communication found in 1968[4] that "as a matter of general policy they [mutual funds] do not hold stock for the purpose of exercising or influencing such control. More than 90 percent of the prospectuses of mutual funds state that the fund may not under any circumstances invest in securities for the purposes of management or exercise of control." These stated policies are, of course, enforceable under both federal and state law, and a violation could give rise to substantial liabilities.

Thirdly, as a matter of federal law, to qualify as a "diversified company" under the Investment Company Act of 1940, Section 5(b)(1) of that act requires that with respect to 75 percent of its assets the investments of the investment company must be "limited in respect of any one issuer to an amount not greater in

[2] Summarized, these reasons are: (1) the extent to which concentration of institutional investment affects the safety of pension funds, (2) desirability of preventing a small number of institutions from achieving too much control over our economy, (3) limiting the money a pension manager can pour into the market to bolster the price of a particular stock, (4) greater liquidity in the market provided by the holding limitations, and (5) encouraging institutions to invest in many well-managed small and medium sized companies.

[3] House Document No. 92-64, 92d Cong., 1st Sess., Summary Vol. p. 125.

[4] FCC Report and Order concerning amendment of multiple ownership rules, Docket No. 15627, adopted June 12, 1968, par. 11.

value than 5 per centum of the value of such [diversified] management company and to not more than 10 per centum of the outstanding voting securities of such issuer." Moreover, blue sky regulations of certain major states impose even stricter limitations on diversifications. Indiana, Michigan, Minnesota, Missouri and Wisconsin have a Statement of Policy that a mutual fund may not invest more than 5 percent of its total assets in the securities of any issuer. In addition to having such a restriction, Ohio, Maine and New Hampshire have a regulation providing that a mutual fund may not acquire more than 10 percent of the securities of any issuer.

We therefore suggest that the 5 percent and 10 percent limitations contained in S. 2842 should not apply to a mutual fund which is a "diversified company" as defined under the Investment Company Act of 1940. This can be accomplished by adding the following language at the end of the subsection defining "security" on line 11 of page 4 of the bill

The term "security" does not include any security issued by a registered management investment company of the open-end diversified type, as defined in Section 5 of the Investment Company Act of 1940, as amended, or issued by a unit investment trust, as defined in Section 4 of such Act,[5] which invests exclusively in the securities of such a company.

THE CAPITAL GAINS TAX PROVISIONS OF THE BILL SHOULD BE AMPLIFIED SO AS TO APPLY TO MUTUAL FUNDS AND THEIR SHAREHOLDERS

The bill provides for a sliding scale of capital gains tax based upon the length of time that securities are held. However, Section 5(c) of the bill (at page 11) restricts the availability of such sliding scale of tax to a taxpayer "other than a corporation". Since most mutual funds are in corporate form, the advantageous scaling down of capital gains tax would not appear to apply to securities transactions by the fund. This would be extremely disadvantageous to present mutual fund shareholders, would discourage investors from investing in mutual funds in the future, and would be contrary to the established tax treatment of mutual funds as contained in Subchapter M of the Internal Revenue Code.

For many years mutual funds have been able, for tax purposes, to elect to be treated as a conduit through which the capital gains and ordinary dividend and interest income of the fund is not taxed at the fund level but is passed through to the shareholder of the fund who is taxed on what he receives from the fund. In other words, the fundamental theory of Subchapter M is substantially to treat mutual fund shareholders as if they directly owned the securities in the fund portfolio.

Section 851 of the Internal Revenue Code permits a mutual fund registered under the Investment Company Act of 1940 to elect to be treated as a "regulated investment company" for tax purposes on certain conditions including, among other things, that (1) at least 90% of its gross income is derived from dividends, interest and gains from the sale or other disposition of stock or securities, (2) less than 30% of its gross income is derived from the sale or other disposition of securities held for less than 3 months, and (3) with respect to at least 50% of the value of its total assets at the close of each quarter of the taxable year, no more than 5% of such value is invested in any one issuer and such value is not invested in more than 10% of the outstanding voting securities of any one issuer.

Section 852 of the Internal Revenue Code provides that the shareholders of a regulated investment company may receive "pass through" tax treatment. The "ordinary" income which is distributed to shareholders is not subject to corporate tax at company level but is taxed to the shareholder in his own income tax return. Nor are long-term capital gains subject to corporate tax at the company level if the mutual fund distributes them currently to its shareholders as "capital gain dividends". In that event, these capital gain dividends are taxed to its shareholders as long-term capital gains. If not so distributed they are taxed to the fund at the corporate capital gains tax rate. As to the latter, another election

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[5] Section 4 defines a unit investment trust as "an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust." A unit investment trust normally invests in the shares of a single mutual fund and is a method for the sale of shares of such fund. A unit investment trust does not appear to be a corporation and as a technical matter the investment of pension funds in a unit trust would not appear to be subject to the diversification requirements of S. 2842. However, for the sake of clarity we think reference to a unit investment trust should be included in our suggested amendment.

under Section 852(b)(3)(D) is permitted which need not be discussed here.

An investor has the choice of investing directly in operating companies whose stocks are publicly traded, or of pooling his funds with those of many other persons by investing indirectly through the medium of a regulated investment company. In making this choice he must weigh the advantages of diversification of risk and professional management advice and supervision afforded by the investment company against the expense of such management and any substantial differential in federal income taxes. Subchapter M is designed to minimize tax consideration as a factor in the investor's decision.

Were it not for Subchapter M, these tax considerations would be of special significance. If the individual invests directly in operating companies he will face the normal layer of corporate income taxation imposed on the operating company, and the additional layer of income tax upon dividends which he receives and capital gains he may realize on the sale of his stock. If, however, he invests indirectly through the investment company, and if income taxes on dividends and capital gains had to be paid by the investment company, the individual would be faced with the burden of still another layer of taxation.

From the standpoint of federal tax policy, the investment company thus presents a situation wholly different from that of ordinary business corporations. It represents, in general, an intermediate layer between the investor and the entities whose securities it acquires with the investor's funds. It does not compete with those entities but merely provides an alternative means for investing in them. Consequently, if the use of the investment company substantially increased the federal tax burden on the shareholder, the investment company could not survive as an investment medium for the individual, for he would be forced to invest directly instead of through the investment company. The bill in its present form, by seemingly denying sliding scale capital gains treatment to securities transactions of the fund, even when the gains are distributed as capital gain dividends to its shareholders and taxed to them, would result in just such an increased federal tax burden on the mutual fund shareholder compared to his direct investment in a business corporation.[6]

We do not believe that the bill was intended to deviate from the present philosophy of tax treatment of mutual funds, particularly in a way which would operate to the disadvantage of the mutual fund shareholder.

We believe that the intended purpose of reducing capital gains is in the national interest, and we will be glad to work at any time with the staff of this Subcommittee to help formulate appropriate language in the bill (1) to permit the sliding scale of tax on capital gains to apply to securities transactions by the fund based on the fund's holding period, particularly when such gains are distributed currently to their shareholders and taxed to them as capital gain dividends.

McLEAN, VA., *February 15, 1974.*

Senator LLOYD M. BENTSEN,
Chairman, Financial Markets Subcommittee,
Senate Committee on Finance,
Washington, D.C.

DEAR MR. CHAIRMAN: I have learned with interest of your introduction of S. 2842 and of the opportunity to submit statements in regard to it for inclusion in the record. I request that this letter and its enclosure be made part of the official record concerning this bill.

I enclose for this purpose a copy of my letter of February 28, 1973, to Chairman Wilbur Mills of the House Ways and Means Committee, identifying myself and my interest on the subject of equity in the taxation of capital gains. I should like to supplement this by some points which I feel are germane to the bill you have proposed. For the reasons of tax equity set out at length in my letter to Chairman Mills, which I shall not burden you by repeating here, I am in hearty agreement with the principle set out in S. 2842 for the increase on a sliding scale of the percentage of capital gain to be *excluded* from gross income in accordance with the length of time the asset has been held. The limitation of 80%, however, seems questionable since it in effect establishes a 15-year cut off and ignores the large losses in the purchasing power of the dollar before

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[6] We believe the bill might create a similar problem for (a) shareholders of real estate investment trusts (see Sections 856–858 of the Internal Revenue Code), (b) shareholders of so-called "Subchapter S" corporations (see Sections 1371–1379 of the Code), and (c) perhaps partnerships and shares in "common trust funds" (see Section 584 of the Code). The proposed new Section 1202(d) (page 12 of the bill) deals with a similar problem in relation to estates and trusts and their beneficiaries.

1959. An inspection of the Department of Commerce Consumer Price Index reveals an increase from 53.9 to 87.32 between 1945 and 1959, an erosion of purchasing power at least comparable to that which occurred between 1959 and 1974. There would seem then to be no just basis for extending more protection to those who acquired assets during the last 15 years than for those acquiring in earlier years who have suffered even more. To accomplish strict equity it would be necessary to deflate all capital gains by first applying a correction for some recognized official price index. If this cannot be done at least the 80% maximum exclusion should be raised to 95%, otherwise a most unfair discrimination particularly against older citizens will be created.

Capital Loss Treatment.—Raising the maximum regular income against which capital loss may be charged off from $1000 to $4000 as proposed in S. 2842 is most commendable both from the standpoint of equity and as tending to unlock frozen capital. However, application of the same sliding scale to capital losses as to capital gains would be (i) inequitable, (ii) practically undesirable, and (iii) inconsistent with the general scheme and purpose of the Bill. *Inequitable because instead of affording some protection against the effects of inflation it would multiply those effects.* A holder who has a loss has already had the tax effect of his loss reduced by the fall of the dollar's purchasing power. Rising prices already impose a sliding scale reducing the percentage of *real* loss which may be applied against tax. The dollars invested ten or fifteen years ago represent greater value than an equal amount realized today and, of course, far greater value than a smaller number received today. For example, a *nominal* one thousand dollar loss in 1972 on an asset purchased in 1962 would actually have been a loss of $1350 in real purchasing power. Instead of tempering the wind to the shorn lamb the tax system *already* aggravates the situation by allowing a deduction of only half the *nominal* loss. In the example considered the $500 deduction allowable is in terms of real purchasing power only 36% of the loss. If the property had been acquired in say 1950, the loss in real terms would be $1740 and the percentage deductible less than 29%.

S. 2842 in § 1202(b) *by applying a sliding scale of increasing percentages of exclusion to losses would make the unfortunate loser's position even worse.* He would be put under constantly increasing pressure to take his loss as soon as possible. While this might be fine for stock brokers it would be most unfair to the investor in a concern in possibly temporary difficulty and to the management thereof. It would work a hardship on individual securities holders involved in corporate reorganizations, often requiring years of negotiations and legal proceedings and could increase the difficulties of the reorganizers. It would be unfair to investors forced to realize on assets, sound in the long run but temporarily depressed in value due to business cycle fluctuations, wars, foreign political action and the like.

If it is indeed felt desirable as you have so eloquently pointed out to incourage investment and risk taking by changes in the laws governing capital losses then not only should there be *no* sliding scales limiting capital loss deductions but the present 50% limit should be eliminated or at least sharply reduced. While the suggestion that capital losses should be treated in the same way as capital gains has a superficial attraction, careful consideration discloses a vast difference requiring different rules. Whereas inflation creates the illusion of *greater* gains than actually exist calling therefore for greater exclusion of gains from tax it masks and conceals the extent of losses and makes them seem less severe than they really are. Consequently, a tax system to encourage risk taking should *expand, not contract,* deductibility of losses. This is resognized in S. 2824 by *increasing* the *amount of income* which may be offset by capital loss. But this step in the right direction would be negated by *decreasing* the *amount of loss* which may be so used.

Indeed, sizeable long term losses such as might be incurred by a holder of defaulting bonds would receive severer treatment under § 2842 than under existing legislation. As now drawn, the capital loss scale in effect provides that "To him that hath shall be given: To him that hath not shall be taken away even that which he hath." I am sure that no such result is intended. It is to be hoped that this anomaly may be corrected by striking out § 1202(b) and eliminating the 50% loss limit in existing legislation.

One further thought on the capital loss provisions of S. 2842. Carry back of losses for three years is not only *permitted* but mandated. For individual taxpayers this would involve preparation of amended returns for the years in question which for many could be burdensome. Could not carry back be *permissive* rather than mandatory giving the option to carry the loss forward as well as back?

Faithfully yours,

RUSSELL H DORR.

McLean, Va., *February 28, 1973.*

Congressman Wilbur D. Mills,
Chairman, Ways and Means Committee,
Washington, D.C.

Dear Mr. Chairman: I know that you and your Committee are in the midst of examining the principal aspects of present personal income tax system with a view to determining its appropriateness and fairness. I am venturing in this connection to enclose a memorandum concerning the problem of achieving tax equity in the taxation of long term capital gains in the face of the serious decline in the dollar's purchasing power which has occurred over the past 30 years and which, as you have so strongly pointed out recently, is likely to continue for some time to come. I suspect that in view of the intimate knowledge of the subject discussed possessed by you and your colleagues and able staff the ideas set forth are unlikely to be new to you. However, I have not noted in other presentations to the Committee in this connection clear reference to the problems of (a) double taxation, (b) taxation of capital gains at *higher* rates than other income, and (c) the creation of *disincentives* to investment. I believe that my memorandum may perhaps be of some use to the Committee in pointing out these dangers.

I should like to assure you that the enclosed paper was prepared by me personally. It was not stimulated or subsidized in any way by any group or organization though I am, of course, fully aware that many others of my acquaintance share the same views.

I am a retired lawyer, banker, and government servant living in McLean, Virginia. A private pension which has no cost of living adjustment and investment securities accumulated out of savings over many years are an important part of my present financial resources. The problems I have outlined are therefore perhaps more real to me and persons like me than to many younger men. I trust that it is not to much to hope that they will not for that reason be overlooked by your Committee.

Very truly yours,

Russell H. Dorr.

Department of Commerce—Consumer Price Index, 1967=100

1941	40.4	1959	87.32
1945	53.9	1960	88.63
1946	58.5	1961	89.58
1947	72.03	1962	90.63
1948	66.9	1963	91.77
1949	71.32	1964	92.97
1950	72.07	1965	94.45
1951	77.8	1966	97.27
1952	79.57	1967	99.97
1953	80.19	1968	104.18
1954	80.47	1969	109.83
1955	80.27	1970	116.31
1956	81.45	1971	121.26
1957	84.22	1972	125.27
1958	86.52		

Capital Gains Taxation and Inflation

Renewed consideration of the issue of fair taxation of capital gains comes at a time when inflation looms inescapably in the national consciousness. In that simpler day when our income tax laws took their basic shape economic sophistication was not as widely diffused as today, and the notion of compensatory adjustment for radical changes in price levels was largely confined to academic circles. The Congress felt it sufficient at that time to define gain or loss for tax purposes merely as the difference between purchase and sale prices. During the past 30 years, however, a deep erosion of the dollar has occurred. As shown by the attached tabulation of the Department of Commerce, Consumer Price Index, its purchasing power is less than a third of what it was in 1941. This basic fact of life has become familiar to all of us whether in government or business, in the classroom or courtroom, in the hospital, or on the assembly line or on the farm. As a result the purchasing power of millions of trade union members is protected by cost of living clauses in wage contracts. Government pensioners are similarly protected. Price escalation clauses abound in industry and public utilities in many states are permitted to raise their rates automatically to cover increases in fuel costs.

Up to now the tax system has not made allowance for the shrinking value of the dollar. Where long term capital gains are concerned this has become a serious oversight. Many such gains are realized only over periods of years far longer than the normal 3-year labor contract term of industrial or construction contracts or even the life expectancy of the average government pensioner. A long span of years often passes between the time the young person makes his first investments in securities or land or a house and the date when he sells these as an incident of reducing his scale of living or in support of his retirement. Yet it is obviously over such substantial periods of 20 to 40 years that the effects of inflation and erosion of the dollar are most severely felt. As an example, examination of an equity portfolio accumulated by an unusually successful investor over the past 40 years, with which I have had occasion to become familiar, shows nominal losses in only 4 cases out of 50. *But* when costs are adjusted for the decline in the dollar, 14 or 30% of the 46 apparent gainers showed a loss in real terms. The tax which they would attract if sold would come straight out of the original capital invested *despite the fact that tax has already been paid once on these funds.* And, of course, the real gain on the other transactions is far less than the apparent one.

It is true that the present tax laws afford some partial relief to the long term investor through (a) the taxation of apparent capital gains at a more favorable rate (though as noted hereafter, even the present system frequently results in a confiscation of capital which has already been taxed once) and (b) by allowing capital gains unrealized at death freedom from *income* though *not* estate tax. In the latter case particularly, a certain rough justice is done by the present system. Its detractors, who include some of the most economically sophisticated of our citizens, seem, if the public prints are to be believed, to forget all about the Cost of Living Index when they come to this issue).

Now that the issues of "tax equity" and "equal treatment" have been raised it seems time to make sure that those who perform the socially useful function of refraining from immediate consumption to devote some of their funds to productive investment and to providing for the future *receive* equity and at least equal treatment. (This paper will not deal with the important question of whether special tax incentives are not indeed appropriate to induce a sufficient number of individuals to postpone consumption, to accept low dividend rates (often less than savings bank interest) and the plowing back of profits, to continue to furnish capital to untried or high risk enterprises and so forth. It is perhaps sufficient at this point to stress that, as will be demonstrated presently, there is real danger that *some proposals now put forward would not only remove incentives but would impose severe disincentives to investment.*)

If there is any question of taxing capital gains at full income rates the matter of distinguishing real from illusory gains becomes of vital significance. Only if that is accomplished can serious injury to the economic system and serious injustice to individuals be avoided. It is hardly necessary to remind this well-informed Committee that millions of individuals in all walks of life have been saving against the time when they can no longer earn and must instead rely on savings to supplement pension payments, Social Security and so forth. Some of these people are well to do. Many others, however, are of comparatively modest means who have denied themselves during their productive years in order to avoid later burdening their young families. Their savings importantly include equity shares and real estate. Some of these holdings are, of course, of recent origin. Many others, however, as all of us can attest from personal experience and acquaintance go back for 25 to 40 years or more. They reflect savings made out of after tax income in dollars worth more than three times what they will buy today. Any tax which does not take fully into account this change in the value of the dollar and permit full recoupment of this already taxed income is in effect double taxation. The Congress has taken care to avoid this in regard to contributory pension and profit sharing plans. Can it take a different attitude toward individual savings which have built up the economy while accumulating resources against retirement needs, education of the rising generation and other family requirements which typically motivate so many long term personal investment?

Set out below is an illustration of how capital gains taxation at full rates would work out in the case of two actual long term equity investments which have come to my attention, were these to be now liquidated by two hypothetical taxpayers, one in the 24% bracket, one in the 36%.

In anticipation of future needs the purchase was made in 1938 out of current income after taxes of 280 shares of Sperry Rand Corporation. (A predecessor corporation was actually involved). At that time the consumer price index was around 40. Various stock splits, mergers and so forth produced an adjusted cost basis in 1938 dollars of $4.15. The company prospered and in 1973 its stock is selling at about $45 a share. In order to meet living expenses let us suppose that a now widowed owner whose current taxable income is $8,000 decided to sell 100 of his 280 shares. His apparent gain would be 100×$45=$4,500−100×$4.15 =$415 or $4085. Under present law he would pay on half of this amount a federal tax of 25% or $510.62 (plus in most states an additional state tax.)

Under a System of Taxing Capital Gain at Full Income Rates his liability would be:

25% on 2,000 or	$500.00
27% on 2,000 or	540.00
29% on 85	24.65
Total	$1,064.65

Consider now the *real* income received by our retired taxpayer from liquidation of part of his investment. In 1972 the Consumer Price Index reached 125.27 which equals 313% of the 1941 figure. The cost of these share in today's dollars therefore is not $4.15 but $12.99. The *real* gain per share is $32 *not* $40.65; the total gain $3200 *not* $4065. A tax of $1064 on this $3200 would be at an average rate of 33%, a rate 7 points or 27% higher than the $824 which would be paid on $3200 of other income. Hardly "equal treatment."

Suppose now that our taxpayer encounters disaster which compels him to liquidate in one year not 100 shares but all 280. Under a system of taxing capital gain without adjustment and at full rates the tax on this normally 24% bracket taxpayer would be as follows:

Apparent gain $11,382 (280×40.65)

20.00 at 25%	$500.00
20.00 at 27%	540.00
20.00 at 29%	580.00
20.00 at 31%	620.00
20.00 at 34%	680.00
13.82 at 36%	497.52
Total	3,417.52

The *real* gain after adjusting for the Cost of Living Index would be $8963 on which the tax as calculated above would amount to over 38% as against the 30% which would be taken from an equal addition of another type of income.

If our taxpayer were in a higher bracket the treatment of his capital gain as ordinary income without adjustment would result in a rate of tax on a comparatively modest real gain which many would regard as staggering. If our taxpayer was normally at the top of the 36% bracket his tax in the above example would run as follows:

2,000 at 38 percent	$760
2,000 at 40 percent	800
4,000 at 45 percent	1,800
3,382 at 50 percent	1,691
Total	5,051

or over *56%* of his real gain as against 44% on an equal amount of real income from another source.

Had our hypothetical 24% bracket seller been compelled to liquidate one of his less fortunate long term investments, say 50 shares of Uniroyal preferred acquired in 1936 at a price of $86 and sold at the recent price of $106 his apparent gain would have been $20 per share or $1000. On this he would pay if the full income rate of 25% were applied, $250, even though in *real* terms he had sustained a *loss* not a profit. (Real cost 313% of 86 or $269 per share versus a realization of $106.) It is true that the present method of determining taxable capital gain already accomplishes this dubious result in many cases. But at least the law now attempts *some* mitigation by applying a lower rate. Applying a *higher* rate in such cases would compound the injustice and be a move away from, not toward, the "tax equity".

ADJUSTMENT UNDER H.R. 1040 INADEQUATE

HR 1040 (January 3, 1973) clearly recognizes *in principle* the inequity which would follow from applying full tax rates to long term capital gains. It provides for an adjustment of cost to take care of the inflation during the last 15 years. In this respect it is highly to be commended. However, since an intent deliberately to discriminate against investors who have held for longer than 16 years can hardly be assumed, one can only conclude that the draftsman overlooked the extent to which the dollar had lost value prior to 1957 and was unmindful of the great number of situations where property acquired more than 16 years ago is still held

Between 1945 and 1956 there was a decline of 51% in the dollar's purchasing power. Using the same examples previously described as to the sale of 280 shares of Sperry Rand but applying the HR 1040 adjustment results in a tax of $996 and tax rate on *real* gain of 31% for those in the 24% bracket and of $4730, 52.7% for those in the 36%. A simialr increase in income from other than capital gains to the the two taxpayers would be taxed at 26% and 44% respectively.

To accomplish the simple justice to the long term investor which HR 1040 recognizes is called for, but which it does not accomplish, removal of its 16-year limitation on cost adjustment is essential.

The adjustment scheme of HR 1040 has the further defect that while it is fair for the 16 years just past there is no way of telling whether it would be too high or too low in *future* years. It is true that the Congress could always modify the adjustment but changes would be burdensome and undesirable and almost certainly lag far behind the necessities of the situation.

CONCUSION

The difficulties and inequities discussed above could most easily and automatically be avoided by providing that in determining gain or loss the original cost shall be ajusted by reference to the Cost of Living Inedx or other suitable official price index. Any modification of the present system of income or estate taxation should provide for this.

STOCKTON, CALIF., *January 28, 1974.*

Senate Finance Committee,
Subcommittee on Financial Markets,
U.S. Senate Office Building,
Washington, D.C.

PUBLIC HEARING ON SENATE BILL NO. 2842

Subject: Tax incentives to encourage small investors to invest in the stock market.

Introduction

My name is Emile R. Jardine. I am a certified public accountant. I reside in Stockton, California, where I conduct a professional C.P.A. practice with other certified public accountants under the firm name of Emile R. Jardine & Co., CPAs. I have been engaged in the practice of public accounting and income tax service and estate and gift tax services for the past 28 years. My experience has encompassed considerable areas of accounting, taxation, economics, and appearance before legislative committees on matters concerning taxation.

I am a past president of the San Joaquin Chapter of the California Society of Certified Public Accountants, and have been chairman of the Chapter Committee on Taxation and a member of the State Society Committee on Taxation for over 20 years from 1947 to 1967.

I appear before this Sub-Committee uarticularly in support of any tax incentive to encoruage small investors to invest in the stock market.

Argument in support of the bill

There are three most essential characteristics which differentiate the taxation of capital gains from the realization of ordinary income:

(1) In a free capitalistic economy which separates the free world from regimented totalitarianism there must be investment of risk capital to promote and further an expanding productivity in free enterprise, in which the United States is the world leader;

(2) An essential difference exists between the realization of capital gains and earned income—that is, no income results from capital gains until the appreciation in value is realized as a result of the sale or exchange of the capital asset; and

(3) The U.S. dollars has lost over 70 per cent of its true value since 1939 as a result of inflation, and consequently the result has been the partial taxation of the inflation itself, which has contributed nothing but a substantial unearned increment in the value of the invested capital. The net result is that the investor receives back his 100% 1939 dollar in a 30% 1974 dollar, which is less than the 50% long term capital gain deduction.

The realization of capital gain from true long-term investment is not in essence a "tax preference".

The investor in productive property is the key man to the expansion of the free world free enterprise system of government. Thus, there must be an incentive to encourage the investment of and turn over in risk capital in an expanding free enterprise system, lest it develop a stagnating economy by freezing transactions and preventing the free flow of and the reinvestment of capital into productive investments.

This subject was given careful study by the 75th Congress in 1938 after the testimony of numerous expert witnesses and economists. The result is clearly summarized in the following excerpt from the Senate Finance Committee Report on The Revenue Bill of 1938—Senate Report No. 1567, 75th Congress, 3rd Session, Calendar No. 1636:

SENATE FINANCE COMMITTEE REPORT ON H.R. 9862—REVENUE BILL OF 1938, CAPITAL GAINS AND LOSSES

* * * "The committee is convinced that at the present time transactions are prevented by the capital-gains tax and that the result has been a material hindrance to business and a considerable loss of revenue.

"There is an essential difference between income derived from salaries, wages, interest, and rents and income derived from capital gains. It is always to the advantage of the taxpayer to receive the first class of income, no matter what the rate of tax as long as it is less than 100 per cent. On the other hand, the tax in respect of capital gains is optional—the taxpayer is not obliged to pay any tax unless he realizes a gain by the sale of the asset.

"There is no tax under existing law if a taxpayer transfers his money from one bank to another, but there may be a very heavy tax if he wishes to transfer his investment from a bond in one company to a bond in another company. Thus, an excessive tax on capital gains freezes transactions and prevents the free flow of capital into productive investments.

"The effect of the present system of taxing capital gains is to prevent any individual with substantial capital from investing in new enterprises. This is most unfortunate, because it adversely affects the employment situation." * * *

Recommendation

Provide an incentive for the investment of and turn over in risk capital by lowering the percentages of gain to be reported upon the sale or exchange of capital assets held for exceptionally long periods of time.

I appreciate sincerely the opportunity to appear before this honorable committee and express my views and professional opinion on this matter.

Respectfully,

EMILE R. JARDINE, C.P.A.

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES,
Washington, D.C., February 1, 1974.

HON. LLOYD BENTSEN,
Chairman, Subcommittee on Financial Markets, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The Executive Committee of this Association has noted with interest your sponsorship of the Stockholders Investment Act and your announcement of the hearings to be held February 5 and 6 by your Subcommittee on Financial Markets with respect to the Act.

Our Executive Committtee heartily endorses your efforts to attract individual stock investors to the securities markets, one of your announced purposes being to increase "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."

As you know, the SBIC program came into being as a result of the enactment of the Small Business Investment Act of 1958, its principal purpose being "to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization . . ."

It is thus clear that you and we in the SBIC industry have common goals, namely to assist new or small firms to acquire the capital they need to survive and compete.

We are proud of the accomplishments of the SBIC program to date. In this connection we enclose a document entitled "Background Paper on SBICs in 1974" which outlines those accomplishments and suggests areas in which the SBIC program might do even more to accomplish its promise.

We also enclose a reprint from the *Congressional Record* of October 30, 1973 setting forth comments by Senator Sparkman on his introduction of two bills to improve the legislative climate for SBICs. You will note that one of the bills, S. 2629, in now before the Senate Finance Committee. It would amend the Internal Revenue Code with a view to encouraging additional private investment in SBICs.

We earnestly hope that you and your colleagues on the Finance Committee will lend your support to S. 2629 when it is taken up by the Committee.

It is respectfully requested that this letter and the enclosures be incorporated in the record of your hearings scheduled for February 5 and 6.

It is also requested that representative of this Association be afforded an opportunity to appear before your Subcommittee on Financial Markets whenever further hearings are scheduled on the Stockholders Investment Act.

Respectfully submitted.

CHARLES M. NOONE,
General Counsel.

Enclosures

STATEMENT BY HANS RANDOLPH REINISCH, PRESIDENT, NATIONAL SHAREHOLDERS ASSOCIATION

In the four years since April 1970 the New York Stock Exchange, with the blessings of the Securities and Exchange Commission, imposed a surcharge and two commission increases upon the nation's small investors while permitting institutional investors, including pension funds, to benefit from sharply lower commissions by means of negotiated rates. Thus, in effect, the NYSE and the SEC have hastened the exodus of the small investor from the stock market by accentuating the disparity between the declining commission costs enjóyed by pension funds and other institutional investors and the rising commissions being born by individual investors. On one hand institutional investors have been saving in excess of $500 million a year in commissions while the notorious surcharge alone cost the small investors more than $300 million a year.

In this protracted bear market the small investor has become extremely conscious of the cost of buying and selling stocks despite assertions to the contrary by the NYSE. Commissions went up most for low priced stocks, traditionally the ones bought by small investors on the American Stock Exchange. Thus for the small investor to have made money at all stocks had to go up much more than before the repeated commission increases of the past four years.

Blaming pension funds which represent the savings of millions of American workers, for the demise of the small investor, herefore, seems manifestly unfair to me.

Also, during these past four years, investor confidence has been further weakened by a series of scandals such as Penn Central, Investors Overseas Services (I.O.S.), Equity Funding, Four Seasons Nursing Centers, Commonwealth United, Weis Securities, etc. Misrepresentations, questionable accounting and outright fraud significantly accelerated the small investor's departure from the market place. The fact that meaningless penalties have been imposed on those engaged in corporate fraud has not helped public confidence either. Totally unrealistic and inflated earnings forecasts by corporations and brokers for such industries as franchisers, leasers, home builders, REITs (Real Estate Investment Trusts) and land developers further helped to undermine investors confidence. Mr. C. V. Wood's McCulloch Oil Co. is an example of a land developer restating sharply lower earnings as a result of belatedly adopting realistic accounting practices.

I realize that morality and integrity cannot be legislated. However, I do not think restricting pension fund investments to 5% in a particular stock is the way to restore investor confidence. Why not penalize banks whose trust departments manage pension funds? Let us at this time also remember that the small investor has absented himself from the over-the-counter market and the Amex despite the fact that these markets have not been dominated by institutional trading activity. And since the sharp plunge of Levitz Furniture Corp. stock has been used as a prime example of improper institutional trading activity it might be pointed out that this came about not because of pension fund selling but because of sellling by T. Rowe Price, a mutual fund (Wall Street Journal, February 14, 1974). Furthermore, it should be noted that sharp price declines more often than not occur because of inactivity or a lack of bids and not necessarily because of institutional selling.

It is not surprising that corporate executives and securities industry spokesmen have enthusiastically endorsed S. 2842 since this measure demands not the slightest reform effort by corporations and stock exchanges.

Senator Lloyd Bentsen, however, is to be commended for taking the initiative in liberalizing small investor tax loss carry forwards and the graduated capital gains tax. This is a significant step which, however, should be accompanied by fundamental corporate reforms.

It seems to me that if the Senate Finance Committee finds it appropriate, for example, to penalize pension funds by imposing a special tax if they invest more than 5% in a particular stock, then the Committee should find it equally appropriate to require corporations and stock exchanges to undertake reforms and share the burdens of restoring investor confidence or else be subject to a penalty tax.

Specifically, I propose reforms in the following areas where abuses have significantly eroded investor confidence over the years;

(I) Publicly owned corporations must—

(1) Hold annual meetings at times and places convenient to a majority of individual shareholders.

(2) Adopt cummulative voting so that individual shareowners can more readily elect at least one or two of their number to the Board of Directors.

(3) Prohibit the voting of proxies by management unless specifically authorized by the shareowner.

(4) Give up the practice of issuing stock options to executives and directors since this is a raid on the corporate treasury that dilutes earnings at the expense of the shareholders.

(5) Not split stock unless it is over $100. a share. Excessive stock splitting sharply increases small investor commissions and needlessly contributes to the back office paper volume. For example, once a $90. stock splits two for one the commission goes up for a $9,000. purchase from $74.75 to $132.25 or nearly double the previous commission (instead of 100 shares of a $90 stock you now have to buy 200 shares of a $45 stock). Corporations like to split stock to get on the "most active" list and to attract institutional interest. And brokers encourage this silly practice because they realize this results in a doubling of their commissions even though the dollar amount involved remains the same.

(II) The nation's stock exchanges and in particular the NYSE and Amex should require:

(1) Points 1 through 5 enumerated above to be adhered to by all listed companies if they wish to remain listed on the various exchanges.

(III) Pension and mutual funds should institute the following:

(1) Provisions should be made that would enable individual participants in pension and mutual funds to instruct the fund managers how to vote on key issues that come up at the annual meetings of corporations in which the funds have a position. This might be done in the form of an annual survey which could apply to issues before numerous annual corporate meetings. (Individuals who invest their savings in corporate America, whether they like it or not, do assume a moral obligation for the policies of the corporations from which they expect capital gains and dividends.)

(IV) This Committee might also urge the *Federal Reserve Bank* to adopt a corollary to Regulation T which requires investors to pay for their stock on time. Why not have a special Federal Regulation requiring brokers to remit investors' cash proceeds on time? It is the present one-sided kind of regulation favoring the broker that has forced the small investor off the market place.

In previous testimony before the Securities and Exchange Commission and the House Subcommittee on Commerce and Finance I urged that companies which violate certain Federal regulations and laws regarding the environment, product safety, hiring and promotion, etc., should be "suspended" from trading or "delisted" until they correct their violations. This would force both institutional and individual investors to take a more activist stance in determining corporate policies since no one wishes to see his stock suspended or delisted. My above suggestions are designed to help investors to become more constructively involved in corporate affairs.

In conclusion I do wish to express the hope that I will be given an opportunity to testify at this Committee's next round of hearings.

CUMBERLAND ADVISORS, PTY.
Vineland, N.J., January 21, 1974.

Re Senate Bills numbered S. 2787 and S. 2842.

Hon. RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR: We would like to take the opportunity to express support for the concepts in the above-captioned proposed legislation, those concepts being:

1. The encouragement of the return of individual investors to the stockmarket.
2. The breakdown of the "two-tiered market" as currently biased by institutional favoritism.
3. The promotion of venture capital investment, particularly in smaller and newer companies, by relaxing limitations on certain types of trusts.

We specifically favor:

1. The decremental reduction of long-term capital gains taxes on capital investment items (to include but not be limited to securities and real property) and
2. Increasing the maximum allowable amount of net long-term losses in excess of short-term gains which an individual can deduct against ordinary income.

For the individual investor the supported legislation will realign the reward of capital investment to a level more commensurate with the risk thereby assisting the capital formation process. This legislation will further enhance the mobility of capital, thus adding much needed liquidity to the securities markets while allowing the investor to at least partially recognize the inflationary portion of capital gain without the present deterrent.

The capital requirements of the 1970's are enormous due to the energy crisis, the environmental goals, and the impending expansion of productive capacity with new plant and equipment expenditures. The United States must avoid becoming like the United Kingdom, which is now suffering from the lack of capital investment due to a prolonged period of capital gains taxation at the highest rate in the world.

The capital requirements of this decade must be met. It is therefore respectfully submitted that the above-captioned legislation be considered with a sense of urgency.

Very truly yours,

DAVID R. KOTOK.

STATEMENT OF ANDREW G. RACZ, CHAIRMAN, RACZ-ROONEY RESEARCH DIVISION OF A MAJOR MEMBER FIRM OF THE NYSE, INC.

Dear MR. CHAIRMAN: May I first of all thank you for giving me the opportunity to present my further viewpoints for your hearings. Let me also state clearly that the views expressed in the following pages are entirely my own and do not represent those of my colleagues or my firm. (As for clarification all corporate figures cited are quoted from Standard & Poors.)

What has been discussed four or five months ago as an issue of future reform for the financial markets has by now transformed itself to become an issue of national importance. The sudden emergence of the Energy Crisis is focusing more attention on the inefficiencies of the two tier market, even more forcibly than anybody had thought before the October War.

Sometime around late October, President Nixon declared its Administration's intention to make the U. S. self-sufficient in energy by 1980. Let us, therefore, concentrate on some of the underlying financial figures which might make this suggestion feasible, if, at all. Let us analyze the availability of equity capital that could make it possibel to render the U.S. a country such as envisaged by our President in this decade. May I select a few salient policy programs?

THE ISSUES

1. As it is envisaged today the American offshore drilling industry would require approximately 100 semi-submersible rigs to be manufactured by the next eight years. At the current prices of $30 to $40 million per rig, this would require a total capital expenditure of up to $4 billion by companies such as SEDCO, Santa Fe International, The Offshore Company and their competitors. According to my calculations, an additional $2 billion would be needed for support and service equipment. Based on the experience of the oil industry, the offshore drilling operators charge approximately 1% every day as operating cost for running a drilling equipment. What this amounts to is that a $40 million drilling rig would command a daily operating revenue of $40,000. It is equivalent to saying that $4 billion worth of new equipment at today's operating cost would require $40 million daily expenditures by the oil industry; which on a yearly basis with 300 working days $12 billion extra operating expenditures to be expended by companies like Exxon and Mobil Oil by the year 1980. This staggering figure does not take into account inflation!!

What we have to keep in mind is that the major offshore drilling companies would be required to raise during the next six to eight years the astronomical figure of approximately $6 billion for hardware. Let us now analyze whether it is at all possible. One of the largest offshore drilling companies, SEDCO Inc., which is listed on the New York Stock Exchange, has a total net worth of only $105 million. It has a long term debt of $140 million and the market value of all the securities outstanding is $500 million. If we assume that SEDCO accounts for approximately 6 percent of the total industry volume, then roughly speaking in the rest of the decade it would have to raise approximately $500 million. This step would require for SEDCO to double its capitalization and raise its net worth by at least three fold.

This is a hypothesis—which is very difficult to come true.

2. An equally important issue is the question of coal gasification. The cheapest coal gasification plants is manufactured by Koppers Company, listed on the NYSE. It can build a small-scale gasificaton plant based on a German model at a price of approximately $50 million. The market value of Koppers securities is at today's market prices are somewhat less than $300 million. In the next five to six years the U.S. probably needs 10 to 20 such plants, (in order to comply with President Nixon's plan) at a total cost of $500 million to $1 billion. All the other coal gasification plants cost a minimum of $300 million. Moreover, the Koppers' coal gasification plant that could be built within 12 to 18 months, the larger models would require a waiting period of at least two to three years.

Question? How can Koppers selling around eight time earnings raise even $100 million, to fulfill possible orders. If a large equity offering is impossible, should Koppers leverage itself through debt assumptions to risk its actual corporate survival?

3. One of the largest pipeline companies that has been for years active in research and development of coal gasification plants in Texas Eastern Tranmission. This company has a net worth of $500 million, long term debt of $1 billion. Texas Eastern services 85 utilities in 13 states, has a permissible rate of return of 7½ percent. The company states that to counter the worsening shortage of fuel, it participantes in domestic exploration programs, in synthesizing gas from naphtha and is building a coal gasification plant to be completed by 1976. It is also working on various plans to import liquefied natural gas (LNG) from USSR. In 1971 capital expenditures for Texas Eastern was $111 million and in 1972 over $150 million. In order to finance such expansion, the company sold 2 million shares in March, 1971, an additional 1 million shares in February 1972. Furthermore, in 1973 the sale of $60 million debentures and 1½ million additional shares were completed. I would like to emphasize that the price of Texas Eastern Transmission has recently declined from $61 to $42. Obviously further large-scale financing at current price levels is getting prohibitive! Thus, equity financing for TET is becoming more and more difficult just at a time when our nation is in bad need of building large scale coal gasification plants.

4. In most of the statements of President Nixon, members of the Cabinet and Mr. William Simon, the nation's energy chief, more emphasis has been placed on coal than on any other fossil fuel. The U.S. has over 80 percent of the world's coal reserves. The table below represents some interesting facts.

KENNECOTT COPPER CORP.

[In millions of dollars]

	1971	1972
Total revenues	1.067	1.165
Net income	85.0	87.4
Internal cash flow:		
Net income	85	87
Depreciation	73	78
Deferred taxes	15	25
Total	173	190
Capital expenditure:		
Property plant	121	109
Capitalized mining cost	41	50
Increase mine development cost	8	11
Total	170	170
Dividends	58	33

Note: Shares outstanding, 33,000,000; Market value of securities, 1,300,000,000; Employees, 30,400 in 1971 and 29,100 in 1972.

Kennecott Copper owns Peabody Coal, the nation's largest coal producer that has mined 66 million tons of coal in 1972, 72 million in 1973 and it is estimated that it will mine and deliver over 80 and possibly 85 million tons in 1974. It is worth recalling that the American coal industry in 1973 has produced somewhat less than 600 million tons of coal and Mr. Simon hopes that in 1974 this could be improved by 100 million tons, a figure which several coal experts have not accepted as being feasible. Since Kennecott accounts for approximately one eighth of American Coal output, this company is of vital importance for the future of the U.S. Yet, as we have illustrated, with the figures for 1971 & '72 Kennecott has reinvested almost its entire cash flow into expansion; property, plants and in particular in opening and modernizing new coal mines. Kennecott pays a meaningful dividend which was equivalent in 1971 to $58 million and was cut in 1972 to $33 million. Being a cyclical stock it commands a price/earnings ratio of less than 10 and without payment of dividend, the multiple could actually fall further. It is interesting to note that the company with the largest coal production in the world has a total market value of $1.3 billion, a figure which I will compare to the market value of some other companies. It is also interesting to note that between 1971 and 1972 the employment of the company has declined from 30,400 to 29,100.

5. I would now like to concentrate on five securities that represent five so-called institutional favorites that are among those 50 or 100 stocks that compose what is now popularly called the first tier market. (See table II.)

There are various comparisons which I would now like to make.

a. All of these five companies had uninterrupted earnings growth over the last five years. Their net profit margin in 1972 averaged about 14.8 percent.

b. All five companies serve directly the consumer. The market value of each one of these corporations at their respective high's in 1973 exceeded the market value of Kennecott. Some like Avon by a ratio of 6:1, and Proctor & Gamble with a ratio of 8:1. Yet only Proctor & Gamble employed more people than Kennecott, 47,000 people, and Avon that actually employs a number of low-income salespeople had 25,000 on the payrolls.

1972 FIGURES

	Net— Income (millions)	Net— Margin [1]	Cash flow [2] (millions)	Capital expenditure (millions)	Capital expenditure as percent of cash flow [3]	Market value of securities [4] (billions)	Number of employees
Avon Products	$125	12.4	$138	$34	24	$7.8–$2.8	25,100
Chesebrough-Ponds	27	7.0	30	18	60	1.4– .9	11,600
Pepsico	72	5.1	106	57	53	2.2– .8	40,000
Procter & Gamble	302	7.7	380	271	71	9.8– 6.8	47,000
Revlon	38	8.5	44	15	34	1.1– .7	15,500
Total	594		658	395		22.3 12.0	139,200

[1] Average net margin: 8 percent.
[2] Cash flow—Net income and depreciation.
[3] Average corporate spending on corporate expenditure as aggregate cash flow: 60 percent.
[4] 1973–74 high—current price.

c. Living in a shortage economy, let us now look at the degree in which these companies solve our problems and create jobs. The above five companies had a combined net income in 1972 of $594 million compared with Kennecott's operating earnings of $85 million. Yet they invested only $395 million in capital expenditures, a percentage of their total cash flow of approximately 40% whereas Kennecott has invested approximately 90% of its total cash flow to increase and modernize its production facilities.

d. The combined market value of the securities of the above five companies at the heights of 1973 was roughly $22.3 billion. At today's prices they represent a combined value of $12 billion. Since all of the securities have been heavily owned by pension funds and bank trust departments, the disappearance, or hopefully the temporary disappearance of $10 billion, in the course of approximately one year represents the elimination of savings of this figure.

e. I would now like to make a further comparison. Whereas the above three companies with a total net income of $594 million employed 139,200 people a ratio of 4,3 :1, Kennecott with an operating income of $85 million employed 29,100 people—a ratio of 2,8 :1. The discrepancy is obvious ! ! !

f. Another interesting point at this stage should be made. The abnormal market value accorded to the above-mentionel five securities at the peak of their price in 1973 created price/earnings ratios of 30 even 40. In other words there were portfolio managers who believed that the savings of individuals, pension funds and other trust accounts would be well guarded in companies that have shown the above-mentioned constant growth rate. Let me now point out an issue of social responsibility. The $10 billion decline in the market value of these five securities of course has gone, at least temporarily. If the above corporations have sold $2 billion worth of securities, which at the peak of the market represented 10% of their market value, the above mentioned figure of $2 billion would have created 1 million jobs for one year ($20,000 per person) or 200,000 jobs for a period of five years! 200,000 jobs, more than the total number of employees they had in 1972 (139,200 employees) ! ! !

g. It is therefore obvious that institutional favorites have become a storage for savings just at a time when the U.S.A. badly needed those savings dollars to invest in capital intensive and energy producing entities such as drilling equipment, pipelines, coal gasification plants or the opening and servicing of safe coal mines all over the nation.

h. To appreciate the figures in a different format, the controversial Trans Alaska Pipeline System (TAPS) even at currently inflated prices would only cost $4.5 billion or about ⅕th of the market value of the above mentioned five institutional favorities, the very companies that invested in 1972 a total of less than $400 million to create new jobs or to improve their product lines. May I respectfully remind the Subcommittee that the TAPS is supposed to deliver the very 2 billion barrels of oil today that is so urgently needed because of the Arab Oil Embargo. This oil shortage is, of course, known not only to investors but to every citizen of the U.S.A.

6. When we talk of excess profit tax on oil companies, I would also like to make an interesting comparison that may re-direct the attention of investors and members of the Senate to the aberration created by the two tier-market. The largest oil company in the world Exxon Corporation in 1972 had a net income of $1.5 billion. It had a capital expenditure program of $2 billion. Recently it was announced that for 1974 Exxon will spend $6.1 billion for increased exploration, for the construction of pipelines, refineries and other equipment needed for servicing the energy needs of the U.S. and those countries in which Exxon operates. Thus, even if Exxon's profit trebles under the current tax system to $4.5 billion by 1974, which I don't think will happen, it will not cover from depletion allowance and from net income a capital expenditure program envisaged for 1974 and 1975. The result, of course, would be increased borrowing. Simultaneously, I would like to bring to the attention of the subcommittee a well-known "institutional favorite" whose revenues are less than $200 million but derives approximately $80 million of its revenues from the manufacture of a luxury household item with a pretax margin of approximately 30%. The company of which I am speaking of has always enjoyed a price/earnings ratio of over twenty, and occasionally a ratio of 30–35. Yet nobody criticized its exhorbitant profit margins at the time when the same household item with a certain amount of simplicity is widely available by various competitors at the price of approximately ⅓ or certainly less than ½ than what is charged by the above-mentioned company.

7. I would now like to compare certain figures of a well known international cosmetics-consumer oriented company with that of Rohr Industries, a company that pioneered in mass transprtation as early as 1967. Rohr is known for building the San Francisco Bart System, The Washington, D.C., metropolitan transportation system and represents over 50% of the nation's intra-city bus market.

1972 FIGURES

	A well-known international cosmetics-consumer company [1]	Rohr Industries [2]
Revenues	$138,000,000	$374,000,000
Net income margin	21,500,000	6,400,000
Cash flow	25,500,000	13,300,000
Capital expenditure percent of capital expenditures to cash flow	6.7	10.7
Debt outstanding	None	$55,000,000
Number of employees	2,700	10,000
Market value of securities:		
1973-74 high	$1,800,000,000	$92,000,000
Today's prices	$1,300,000,000	$72,000,000

[1] Year ended December 1972.
[2] Year ended July 1973.

Let the figures speak for themselves: Rohr, being almost three times as large as the previous company, has a market value of today's price levels of approximately 1/20th as the cosmetic concern. The company under consideration is a well-known institutional favorite, held widely by pension funds, banks and insurance companies. It employs approximately 2,700 people whereas Rohr with almost 3 times as big a sales volume, 10,000 people. Rohr's capital expenditure is about 1.5 times that of the company—the institutional favorites under consideration. Rohr has a debt of $55 million; the other company has none. According to a recent study done by my department, in each of the last six years Rohr has lost money in mass-transit despite the fact that it has been one of its foremost pioneers. It is committed to a course which represents one of the solutions to the transportation needs of all citizens of the U. S. Selling at approximately 10 times earnings, Rohr is not in a good position to raise money on the equity market. With already large debt structure, the raising of any meaningful amount of capital can hardly be considered beneficial to the current stockholders.

The answer therefore is a legislative solution. At the time of writing President Nixon has just proposed a $16 billion plan to aid mass transit, a six year program of which Rohr would be an obvious beneficiary. In particular, in his State of the Union message President Nixon proposed a 50% increase in Federal assistance to urban mass transit for a total o $1.4 billion and $700 million to aid the construction of buses. This money, however, and let this be said loud and clear, comes from the taxpayer!

The Government of the United States just as the institutions has no money. The government spends the taxpayers' money, collected each year, from corporations and individual citizens and the institutions invest the savings of individuals in lieu of the discretionary power delegated to them by various corporations, trusteeships and unions. *If the savings of people* are invested in the first-tier market and those savings *are not available to solve the nation's urgent problems, the two-tier market today is becoming not only a financial but a social failure.*

8. The final and what is almost a theoretical issue is how to convert the savings locked into high flyers or so-called first-tier class of stocks to those cyclical companies that create more employment and solve the nation's needs for the 1970's. I am not an economist but unless these large companies will raise additional capital based on their high multiples and attract the investors' dollars and they in turn would re-invest in areas of national concern the nation has nothing but to gain by having the first tier stocks lose their multiples. This is equivalent with the disappearance of people's savings. This is a destructive, not a constructive process. If the appearance of the two-tier market has created paper values we must stop its decline to eat away the savings that have been placed into high multiple stocks in the past 5 to 8 years.

9. Lastly, may I round up the total picture. The American brokerage industry, in 1973, has earned the well-publicized figure of $50 million for its partners and stockholders. Brokerage is one of the most cyclical industries! It is inconceivable that such an industry would put back more than 25–25% of its pretax earnings into research. If $10 million is reinvested by brokerage companies into research activities, this would be equivalent to saying that at a $50,000 rate 2,000 security analysts would be employed in securities research and corporate finance. The $50,000 would include the salaries of the analysts, secretarial expenditures, travel, entertainment, and research material as well. Obviously, the American securities industry with 30 million investors cannot function with 2,000 security researchers. This is equivalent to saying that investment banking is heading toward a catastrophe, a catastrophe that has become well-publicized by the recent dissolution of the nation's third largest brokerage company.

Conclusion

The weakening of the investment banking industry is indirectly giving greater and greater power to the commercial banking industry which has recently started to expand its own research functions. In fact, some of the larger banks are now selling their own research services to other smaller banks. While I do not wish to say that this is not an honorable enterprise, it is also recognition of more power acquired by commercial banking systems in the investment field.

This is reversion back to 1912, to the famous Untermeyer Commission which has broken up the House of Morgan, and separated the functions of the commercial and investment banking industries. I would like to finish my testimony by repeating the reknown scene with J. P. Morgan, who having saved the country in 1911 from a banking crisis had to take the witness stand. In the hearings it emerged that J. P. Morgan acted in the most unselfish manner. In the critical three weeks of 1911 he had the power to mould the entire American banking world, and had power over the welfare of the country. Was the concentration of such power in a great country like the United States satisfactory? J. P. Morgan, understanding that he was living through the most important moment of his life objectively answered; "*Not entirely*".

I would now like, in closing to paraphrase the previous remark. There is no question that those institutional portfolio managers who were proponents of the two-tier market, and channelled their investments into selected and well-run companies had nothing but the best intentions. J. P. Morgan had good intentions too! But the state of affairs in the United States financial markets has been disturbing now for years. It was already an urgent issue in the summer of 1973. With the emergence of the Energy Crisis, with the forced and hurried transformation of the U.S. economy from consumer into a shortage or rather shortage solving economy, the state of affairs of our financial markets—according to the immortal statement of J. P. Morgan—"*is not entirely satisfactory.*"

Respectfully submitted.

ANDREW G. RACZ.

Suggestions for Investment Restrictions in Respect to Assets of Private Pension Plans

(Submitted by Norman H. Tarver, Toronto, Canada)

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INTRODUCTION

Personal information

As a resident and citizen of Canada, I have been for more than 45 years a salaried employee of a Canadian life insurance company, the Manufacturers Life Insurance Company, which company has been licensed in the United States for about 70 years; has almost 50 branch offices in the United States from coast to coast and does over half of its total business in the United States. In addition to conducting a regular life insurance operation, Manufacturers Life has long been involved in the private pension plan market in the United States, Canada, United Kingdom and elsewhere around the world. In addition, my employer has had a long and successful experience in the annuity field. Manufacturers Life ranks in the top 20 life insurance companies in the United States.

Personally I have been involved with private pension plans for almost 30 years, in the early years mostly with Canadian plans but, for over 10 years, almost entirely with United States plans. I am a member of the Americans Pension Conference and have served on committees of the American Life Insurance Association in connection with private pension plans, especially in respect to pension legislation.

I am not an actuary, attorney or accountant but rather a person with long practical experience in private pension plans. Also, I am the author of a standard textbook on the Tax Deferred Annuities which are available under the terms of Section 403(b) of the Internal Revenue Code. Over the past 7 years, the New York monthly trade magazine, "Pension & Welfare News", has published a series of my articles discussing pension reform legislation. In March, 1972, "Best's Review" the leading monthly trade magazine of the life insurance industry published my article on "Preservation of Pension Benefits".

Although such is my background, I wish to emphasize that in presenting this brief I am doing so purely as an individual. I am not presenting it on behalf of my employer nor on behalf of any association or organization.

I believe whole-heartedly in the present Social Security System and at the same time in the basic philosophy of the private pension plan system. However, I also believe that the latter system can and should be improved. This brief is submitted with a view to presenting my thoughts in respect to some improvements.

No doubt, some one will ask, "Why should Tarver, a Canadian, write a brief?" One reason is that I am very much interested in the social aspects of private pensions: I have worked with them for about 30 years and with over 45 years of employment I am quite conscious of what a retirement pension means. Probably a reason that is more meaningful is that I have had long exposure to the regulation of private pension plans on both sides of the border.

Bill S. 2842

This Bill would make changes in the Internal Revenue Code in two areas. First, it would amend the Code to apply restrictions on investments used for the assets of private pension plans. Second, it would amend the Code in respect to capital gains taxation.

I agree that it is desirable to impose restrictions on the investments used for pension plan assets and am generally in favor of the first part of Bill S. 2842. I would like to make some suggestions in that connection, having in mind primarily the question of solvency of private pension plans. I realize that the first part of Bill S. 2842 has not only this question in mind but also the question of the general good of the economy of the nation. Perhaps the two questions are not too far apart what is good for the private pension plan system should be good for the economy of the nation and visa versa.

I am not commenting on or submitting suggestions in respect to the second part of Bill S. 2842.

Previous submissions

In the past 2 years I have submitted briefs to various Committees of the Senate and the House, as follows:

Mry, 1972: "Proposal for the Improvement of the Private Pension Plan Ssytem", distributed to members of the House Ways and Means Committee in respect to Bill H.R. 12272.

June, 1972: "Proposals for the Improvement of the Private Pension Plan System", submitted to Hearings held by the Senate Labor Subcommittee in respect to Bill S. 3598.

May, 1973: "Proposals for the Improvement of the Private Pension Plan System", submitted to Hearing held by the Senate Subcommittee on Private Pension Plans in respect to Bill S. 1179.

September, 1973: "Some Comments on Revised Bill S. 1179 as Reported out by the Senate Finance Committee", distributed to members of the Senate Finance Committee.

September, 1973: "Some Comments and Suggestions in respect to the Retirement Income Security for Employees Act as appended to Bill H.R. 4200", distributed to members of the House Ways and Means Committee.

Several of these briefs discussed the question of restrictions on investments of pension plan assets along the general lines of the comments and suggestions outlined later in this brief.

Pension Reform Legislation

At the date of the preparation of this brief, pension reform Bill H.R. 4200 has been passed by the Senate and a Bill is being developed in the House (combining H.R. 2 and H.R. 12481). The final contents of the Bill that will no doubt become law in due course are not yet fully known. However, it is very likely that the final Bill will contain only a limited provision in respect to the regulation of the investments of the assets of a private pension plan. This limited provision is discussed later in this brief.

Canadian Private Pension Plan System

In the introduction to his book, "Canadian Regulation of Pension Plans,"[1] Frank M. Kleiler, Deputy Assistant Secretary for Planning and Evaluation, U.S. Department of Labor, made this statement:

"Most pension plans in Canada are regulated by laws which prescribe minimum standards of vesting and funding and which are designed to provide safeguards against risks of speculative investments, lack of diversification and excessive investments in the securities of the corporations which employ participants in the plans. This report is concerned primarily with these laws and their administration. Proposals for legislation of this kind have been developed in the United States. Perhaps the United States can learn from Canada's experience."

It is my hope that this brief will add something in the way of suggestions to Mr. Frank M. Kleiler's excellent book, which gives background information.

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[1] "Canadian Regulation of Pension Plans" by Frank M. Kleiler, Deputy Assistant Secretary for Planning and Evaluation, Department of Labor, Washington, D.C. 1970, published by the U.S. Department of Labor, Washington, D.C. (Mr. Kleiler retired at the end of 1973.

REGULATION OF INVESTMENTS UNDER PRIVATE PENSION PLANS

Present situation

At the present time, a vast amount of money has accumulated in private pension plans, more than $160,000,000,000. This vast amount is growing so rapidly that it is expected to total about $300,000,000,000 by 1980.

Of the current amount, approximately $56,000,000,000 is in the hands of life insurance companies and is being invested under the regulations that are applied to life insurance company investments by State Insurance Departments. Also a considerable proportion of the funds invested by life insurance companies are regulated by the S.E.C. under the terms of the Investment Company Act of 1940.

The moneys that are not being invested by life insurance companies are almost entirely invested without any regulations being applied to them. A limited portion of these moneys are invested in mutual fund companies which do come under the scrutiny of the S.E.C. Also a very much more limited proportion involves the investing of employee contributions in equities, which proportion is then under the scrutiny of the S.E.C.

However, many, many billions of dollars are being invested without any regulation having to be complied with. This looseness has already resulted in some dishonest management of pension plan funds and also some foolhardy management, both of which have caused and are causing serious harm to the interests of plan participants.

By way of contrast a somewhat similar industry, the mutual fund investment companies, which has accumulated assets of about $50,000,000,000, is strongly regulated by S.E.C. and N.A.S.D.

Comparison

To give a picture of the relationship of two industries that are involved in the accumulation of savings and to compare them with the private pension plan system, the following table has been prepared.

For the life insurance industry, figures for 1905 are shown because that year was just prior to the Armstrong investigation. The mutual fund industry became subject to the Investment Company Act of 1940 in such year. The earliest figures available for the assets of the private pension plan system are dated 1950. The latest figures available for all the various savings areas are those for 1971. Figures for 1972 are also shown for the life insurance and mutual fund industries but figures for non-insured pension plans for 1972 are not yet available.

COMPARISON OF ASSETS OF VARIOUS SAVINGS AREAS

Savings areas	1905	1940	1950	1969	1970	1971	1972
Life insurance companies:							
Total assets	$2,706,000,000	$30,802,000,000	$64,020,000,000	$197,208,000,000	$207,254,000,000	$222,102,000,000	$239,730,000,000
Number of policyholders	22,000,000	134,000,000	202,000,000	351,000,000	355,080,000	357,479,000	365,184,000
Assets per policyholder	$123	$229	$317	$562	$584	$622	$656
Mutual fund companies:							
Total assets	(1)	$447,959,000	$2,530,663,000	$48,290,733,000	$47,618,100,000	$55,045,328,000	$59,830,646,000
Number of accounts	(1)	296,056	938,651	10,391,534	10,690,312	10,900,952	10,635,000
Assets per account	(1)	$1,513	$2,696	$4,647	$4,454	$5,050	$5,656
PRIVATE PENSION PLAN SYSTEM							
Insured plans:							
Total assets	(1)	(1)	$5,600,000,000	$37,900,000,000	$41,175,000,000	$46,400,000,000	$56,300,000,000
Number of participants	(1)	(1)	2,755,000	10,120,000	10,980,000	11,480,000	12,435,000
Assets per participant	(1)	(1)	$2,033	$3,745	$3,750	$4,042	$4,206
Noninsured plans:							
Total assets	(1)	(1)	$6,500,000,000	$90,700,000,000	$97,000,000,000	$106,400,000,000	(1)
Number of participants	(1)	(1)	7,500,000	23,540,000	23,900,000	24,500,000	(1)
Assets per participant	(1)	(1)	$866	$3,853	$4,059	$4,343	(1)
All private plans, total:							
Total assets	(1)	(1)	$12,100,000,000	$128,600,000,000	$138,175,000,000	$152,800,000,000	(1)
Number of participants	(1)	(1)	10,255,000	33,660,000	34,880,000	35,980,000	(1)
Assets per participant	(1)	(1)	$1,180	$3,820	$3,961	$4,247	(1)

[1] Not available.

Sources: 1971 and 1972 "Life Insurance Fact Books," published by the Institute of Life Insurance, 277 Park Ave., New York; 1970, 1971, and 1972 "Mutual Fund Fact Books," published by the Investment Company Institute, 1775 K St. NW, Washington, D.C.; and "Employee Benefit Plan Review, Research Reports," published by Charles D. Spencer & Associates, Inc., 222 West Adam St., Chicago, Ill.

Regarding the preceding table, several significant components can be made:

(a) At the time of the Armstrong investigation which was followed by the introduction of stringent investment restrictions for the life insurance industry, the assets per policyholder were only $123 whereas the assets per participant in 1971 are $4,343 under non-insured plans whose investments are still almost entirely unregulated.

(b) The assets per participant in non-insured pension plans is growing far more rapidly than either of the other savings areas. From 1960 to 1971, the growth in assets per individual were as follows:

	Percent
Life insurance assets	96
Mutual fund assets	87
Insured pension plan assets	99
Noninsured pension plan assets	402

(c) There seems little doubt that in a short time, the assets per participant in non-insured pension plans will be larger that the assets per mutual fund account, if it has not already happened. When that happens, the assets per individal will be larger in the non-insured pension plans than in all the other savings areas compared.

(d) It probably won't be long before the total assets in the private pension plan system will equal the total assets in the life insurance industry (a considerable portion of which is pension plans, of course). In 1971 the total assets of the life insurance industry (other than those held for private pension plans) equalled $175,702,000,000. The assets of the private pension plans (inclusive of the private pension plan assets held by life insurance companies) equalled $152,000,000,000, of which $106,400,000,000 were not subject to investment restrictions (except for a limited portion that is in mutual fund shares).

Pension fund management

A recent issue (August, 1971) of the monthly magazine, "Institutional Investor" was devoted wholly to a discussion of the management of pension plan funds. To a limited extent it discussed funds in the hands of the life insurance companies, banks and mutual fund companies but mostly it discussed other funds. The Editor-in Chief, Gilbert E. Kaplan, when summing up the contents of this special issue made this statement:

"If one carries away a single impression of the whole management scene from a reading of the articles in this issue, it is of a field of growing scope, complexity and importance, but one that is being approached, too with a new sense of responsibility. Most corporations are coming to grips with the reality that they are ultimately the ones—not the trustees—who are accountable for the funds' performance. If pension fund money is a giant that could get out of hand, at least there is evidence that the problems are not being ignored. Indeed, I believe that there is reason to think they may be handled with a new sense of professionalism."

It is more than a little frightening to have the Editor-in-Chief of an important national magazine refer to the possibility of pension funds being "a giant that could get out of hand." No doubt a sense of professionalism is developing. The question is: Will it develop fast enough and will it spread far enough through the vast range of pension and profit sharing funds that the situation will not get out of hand?

Competition

The leading article[2] in this special issue was introduced with this comment:

"The competition, then, is keen and getting keener. At the new little firms, everybody seems eager, bright, articulate, with a great record to pull out of his briefcase. The big counseling houses and the asset management arms of the brokerage houses are going after pension money with renewed vigor. The big banks are gearing up to fight back and the smaller banks are eagerly looking to get a piece of the action. Insurance companies are rousing themselves in the hope of regaining what they lost to the banks twenty years ago."

Competition is good, of course, because it keeps the money managers alert. However, the drive for better and better performance can get out of hand, especially where there is no regulatory controls to take into account. The trend could develop toward more and more speculation, which is the kind of development that has occurred in the past in other areas.

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[2] "Prospecting the Hottest Investment Frontier", by Everett Martin, Senior Editor, in August, 1971, issue of "Institutional Investor".

Dishonesty

Hearings conducted by the Congress have already developed evidence that some pension funds have been dishonestly administered by plan trustees.

No doubt there are many cases that have not been brought to light of dishonest management of pension plan savings.

Imprudence

In the special issue of the Institutional Investor referred to above, the author of one article[3] made this comment:

"Performance goals should be high enough to challenge the portfolio manager to achieve a good return, without being so high as to encourage imprudent investments. Although everyone should seek the best investment managers, executives should guard against taking foolish risks in pursuit of unrealistically high performance records."

Life Insurance Industry

The investing of life insurance company assets has for many years been strictly regulated. This regulation resulted from a situation that is not too unlike the situation that pertains today in the private pension plan area. The following excerpts from a book on the subject of life insurance company investments[4] are of interest:

"The investments of life insurance companies in the United States are governed by the investment laws of the fifty states and the District of Columbia. The purpose of these laws is to specify appropriate areas and to establish standards for the investment of life insurance company funds, with a view to ensuring the financial soundness of the company and protecting the interest of the policyholder by preventing improper practices or speculative excesses. Accordingly life insurance investment laws take the form either of prohibiting certain investments or of prescribing the permissible categories of investments which may be made subject to certain limitations. For the major classes of investments the state laws typically stipulate the quality standards which must be met, together with the maximum percentage of assets which may be placed in a particular class of invesetment either in the aggregate or as issued by one issuer.

"No discussion of life insurance investment regulation would be complete without mention of the Armstrong ivestigation which took place in New York in 1905. As a result of various practices which had come to light at that time in the operation of certain life insurance companies, a full-scale investigation was conducted by a committee of the New York State Legislature, with Charles Evans Hughes as its counsel and dominant figure. Prior to the Armstrong investigation life insurance companies were allowed wide latitude in their investment policies. When it was disclosed that their investments had led to financial control of banks, railroads and other corporations in which company directors and officers had a financial interest, severe limitations were imposed on investment policy to correct this situation."

There is no question whatsoever that the regulation of life insurance company investments that has been developed over the past 60 years has been very good for the policyholders, the life insurance industry and the economy of the country.

Pension Benefits Act of Ontario[5]

Under the terms of this Act and very similar Acts in force in 3 other provinces, the investments of the funds of more than 80 percent of all plans in Canada are subject to strict regulatory requirements. Under Sections 22(1)(c) and 25(c) of the Act and Section 14(1) through (12) of the Regulations, investments must be confined to any of the following securities:

(a) The same list of securities that a life insurance company may invest its regular funds in under the federal Canadian and British Insurance Companies Act, which list is very much like that included in the Insurnace Law of the State of New York, generally considered to be the strictest insurance law in the United States:

(b) Real estate situated in Canada and only for the purpose of income and only to the extent of 7 percent of the total funds of the plan;

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[3] "Expanding the Actuary's Role in Pension Fund Management" by William A. Dreher, William A. Dreher & Associates, Inc., New York, Actuarial and Investment Consultants, published in August, 1971, issue of "Institutional Investor".

[4] "Life Insurance Companies as Financial Institutions", 1962, a monograph prepared by the Commission on Money and Credit, Prentice-Hall, Inc., Englewood, N.J.

[5] An excellent description of this Act is contained in the book referred to in footnote (1).

(c) A pooled, segregated or mutual fund investing in only the securities in (a) and (b);

(d) An investment company investing in only the securities in (a) and (b).

Also, not more than 10% of the total fund of a plan may be invested in or loaned to any one corporation, partnership, association or person. Several other restrictions are imposed in addition to the chief ones given above. (See Section 14 of the Regulation in Appendix C).

In order to enforce the requirements of the Pension Benefits Act, including the investment requirements, the Act contains these provisions in Section 26:

(1) Every person who contravenes any provision of this Act or the regulations or who obstructs an officer or agent of the Commission in the performance of his duties is guilty of an offence and on summary conviction is liable to a fine of not less than $200 and nor more than $10,000.

(2) Where a corporation is guilty of an offence under this Act, an officer, director or agent of the corporation who directed, authorized, assented to, acquiesced in, or participated in the commision of the offence is a party to and guilty of the offence and is liable on conviction to the punishment for the offence whether or not the corporation has been prosecuted or convicted.

Income Tax Act of Canada [6]

This Act does not impose any investment restrictions on registered (qualified) *pension plans* but as described above the provincial Acts do impose restrictions on pension plan investments.

However, the Income Tax Act of Canada does impose certain restrictions on the investments under *deferred profit sharing plans*, which are not regulated by the provincial Acts. The restrictions that apply to deferred profit sharing plans are as follows:

(a) The trust funds must not be invested in the notes, bonds, debentures or other similar obligations of the employer or an associated company;

(b) The trust funds must not be invested in the shares of a corporation at least 50% of the property of which consists of notes, bonds, debentures or other similar obligations of the employer or an associated company;

(c) Not more than 10% of the cost of the assets of a plan may be invested in foreign property (otherwise a tax of 1% per month is levied on the excess);

(d) No loan may be made to an employee.

Internal Revenue Code

Under the terms of Section 503(a)(1)(B) of the Code, a qualified plan is not permitted to engage in any of the following "prohibited transactions":

(a) The plan may not lend any part of its funds without the receipt of adequate security and a reasonable rate of interest to any of the parties described below;

(b) The plan may not make a substantial purchase of securities or any other property for more than adequate consideration from any of the parties described below;

(c) The plan may not sell a substantial part of its securities or other property for less than an adequate consideration to any of the parties described below;

(d) The plan may not engage in any transactions which results in a substantial diversion of its funds to any of the parties described below.

The parties referred to above are:

(1) The creator of the plan (i.e.—the employer);

(2) A person who has made a substantial contribution to the plan;

(3) A member of the family of a party or person in (1) and (2);

(4) A corporation controlled 50% or more by a party or person in (1) and (2).

Fiduciary responsibility under pension reform bills

Section 511 of Bill H.R. 4200 as amended by the Senate on September 19, 1973, would amend the "Welfare and Pesion Plans Disclosure Act" to require the fiduciary who exercises control over the moneys in a pension plan to discharge his duties under the prudent-man-rule. In addition, the fiduciary would be prohibited from engaging in certain transactions, in particular transactions involving a party-in-interest.

Bill H.R. 2 as developed by the House Education and Labor Committee would add an "Employee Benefit Security Act" for the Labor Department to administer in addition to the "Welfare and Pension Plans Disclosure Act". Under this new Act, the fiduciary who exercises control over the moneys in a pension plan would also be required to discharge his duties under the prudent-man-rule.

[6] See footnote 5.

In addition, a fiduciary under Bill H.R. 2 would be required to diversify the investments so as to minimize the risk of large loss, unless under certain circumstances it should be prudent not to do so. Although the fiduciary must normally diversify investments, Bill H.R. 2 would not spell out specific requirements in respect to diversification.

Requiring diversification is quite desirable, of course, and is a move in the right direction. However, I suggest that it would be better to set out the details of what would be deemed to be diversification.

Prudent-man-rule

It would seem that abiding by the prudent-man-rule could actually result in lack of prudence. For example, if 24 out of 25 investment managers should have selected the shares of a particular company for their portfolios, surely the 25th investment manager could easily claim he was following the prudent-man-rule in also selecting the same shares and yet doing so might be quite imprudent for him, because such concentration on the shares of one company could have unduly built up the price of such shares. The prudent action might be for some or all of the 24 investment managers to move out of the issue (if they could do so without undue loss) rather than for the 25th manager to move in.

I suggest that the prudent-man-rule is not sufficient control on the actions of an investment manager.

Mandatory vesting and mandatory funding

All of the Senate Bill H.R. 4200 and the House Bills H.R. 2 and H.R. 12481 would require both mandatory vesting and mandatory funding.

The purpose of mandatory vesting is to make sure than an employee withdrawing from a plan will have a pension benefit credited to him, if he fulfills specified requirements. The purpose of mandatory funding is to make sure that funds are contributed to the plan to provide the vested benefits. It would seem illogical to require mandatory vesting and mandatory funding and still permit the accumulated funds to be dissipated in some fashion, willfully or foolishly.

I feel that, if the law requires mandatory vesting and mandatory funding, the law must also impose restrictions on the investing of the funds in the plan. The Ontario Pension Benefits Act requires mandatory vesting and mandatory funding and since it also imposes strict controls on investments, obviously the Government of Ontario was convinced that such controls were a logical step to take.

Plan termination insurance

Plan termination insurance is a very important element of pension reform legislation. In fact, many persons consider it the most important element for securing fulfillment of pension provisions.

In order to make sure that the vested pension benefits are as well protected as possible in event of plan termination and that the insurance benefits are reduced to the smallest amount, it is essential that the pension fund assets be maintained on the highest level possible. Dissipation of pension fund assets could have a serious effect on the plan termination insurance program.

To protect the pension fund assets and the plan termination insurance program, I feel that the law must impose investment restrictions on such assets.

Suggested restrictions

I am not suggesting restrictions as stringent as those imposed on pension funds in Ontario nor as stringent as those imposed on life insurance industry generally but I do suggest that restrictions similar to those that apply to mutual fund companies and separate accounts of life insurance companies should be imposed on the investments of the following plans:

(1) Qualified pension plans;
(2) Qualified profit sharing plans;
(3) Keogh H.R. 10 plans;
(4) Individual Retirement Accounts;
(5) Tax sheltered 403(b) annuity plans.

The following restrictions are suggested in respect to 95% of the total assets of a plan, when the investing is done fully and directly by an investment manager:

(a) Investments must not be concentrated in particular industries or a group of industries and no more than 25% of the assets of the plan may be invested in any one industry.

(b) Not more than 5% of the voting securities of any one issuer may be acquired.

(c) No purchase of securities may be made if, as a result of such purchase, more than 5% of the total value of the assets of the plan would be invested in the securities of any one issuer.

(d) No purchase of warrants or options to purchase securities may be made if, as a result of such purchase, more than 2% of the assets of the plan would be invested in all such warrants and options.

(e) Not more than a total of 20% of the total value of the assets of the plan may be invested in real estate.

(f) No loan of funds or other assets of the plan may be made, except through the acquisition of a portion of an issue of bonds, debentures or other evidence of indebtedness which are publicly distributed.

(g) No purchase or sale of commodities or of commodity contracts may be made.

(h) No money may be borrowed by the plan.

(i) All common stock investments must be in stock which is listed or admitted to trading on a securities exchange registered under the Securities Exchange Act of 1934 or which is publicly held and has traded in the over-the-counter market and as to which current stock market quotations are readily available, except as provided in (j).

(j) The purchase of securities which cannot be resold to the public without registration under the Federal Securities Act of 1933 (i.e. restricted securities) is permitted but must be limited to not more than 10% of the assets of the plan.

(k) Purchases of securities may not be made on margin.

(l) Short sales of securities may not be made.

(m) No investments in the securities of a corporation may be made for the purpose of exercising control or management.

(n) Purchase must generally be made for investment purpose and not for short-term trading purposes.

In addition to the above restrictions, the terms of Section 503(a)(1)(B) of the Internal Revenue Code which are described above should be maintained.

Leeway clause

In respect to the 5% of the total assets of a pension plan that would not be regulated by the restrictions described above, I suggest that the investment manager be given freedon to invest it as, when and how he sees fit, without having to take into account the prudent-man-rule.

I suggest that the limit of 1% proposed in the "leeway clause" in Bill S. 2842 is too small. For a small-sized plan, 1% of total assets would not permit a manager to make an investment of worthwhile size. For a large plan, requiring 95% of the assets to be invested under the restrictions proposed above would seem to be adequate protection of the assets of the plan.

Permission to invest up to 5% of the assets in unrestricted securities should be very useful for the development of the economy of the nation. Also, such permission could perhaps open the way to quite worthwhile investments for the fund. At the same time, the loss to the fund in the event of a poor investment would not be unduly severe.

Under Federal securities law, a diversified mutual fund is permitted a "leeway" of 25% of the total assets of the fund. Under State insurance laws, life insurance companies permit various "leeways". For example, New York State, which has probably the most stringent investment restrictions for life insurance companies, permits a "leeway" of 4% of the total assets of a company and a "leeway" of 7% of the total assets of a separate account of a life insurance company. Under the Ontario Pension Benefits Act referred to above, there is a leeway" of 1%. However, life insurance companies in Canada, which are regulated by a set of restrictions like those in the Ontario Pension Benefits Act, have a "leeway" of 7% of total assets.

All in all, a "leeway" of 5% for pension plan assets seems to be a reasonable allowance.

Mutual funds, separate accounts and other life insurance products

In lieu of investing directly in securities under the restrictions defined above, an investment manager for a pension plan should be permitted to invest part or all of its assets in shares of a mutual fund company or in units of a life insurance company's separate account, both of which are diversified investment companies operating under regulations administered by the Securities and Exchange Commission.

Also, the investment manager should be permitted to invest all or part of the plan assets in "fixed-dollar" insurance company products.

The restrictions defined above should be applicable to only the part of the plan assets that are not invested in mutual fund shares, separate account units or fixed dollar insurance company products.

Since a mutual fund company is a diversified investment company, 25% of its assets may be invested without restrictions. Similarly, a portion of the regular assets of a life insurance company and a portion of its separate account may usually under State insurance law be invested without restrictions. Even so, I suggest that the "leeway" securities involved in mutual fund shares, separate account units or life insurance contracts should not be considered as part of the "leeway" securities referred to above. The "leeway clause" should, I suggest, apply and have reference to only the portion of the plan assets not invested in the vehicles just referred to.

Purpose of Investment Restrictions

As will be realized, the purpose of these suggested restrictions are as follows:

(1) To attain as much plan solvency as possible through diversification;

(2) To avoid the plan becoming involved in the control and/or management of a corporation;

(3) To maintain considerable liquidity;

(4) To avoid undue speculation;

(5) To avoid the assets of the plan being used for other than the primary benefit of the beneficiaries of the plan;

(6) To encourage the investment of a reasonable portion of the assets of private pension plans in enterprises that will help the economy of the nation.

Supervision of Restrictions

Including the investment restrictions described above in the Internal Revenue Code would mean that the regulation and supervision of the restrictions would be within the jurisdiction of the Internal Revenue Service or perhaps jointly of the Labor Department and such Service.

At this time, it appears that the regulation and supervision of the mandatory participation, vesting and funding requirements that will be included in the new pension reform laws will be carried on jointly by the Labor Department and the Internal Revenue Service. Also, it appears that the plan termination insurance program will be administered by the Labor Department. If these dual supervisory and regulatory procedures are included in the new laws, then it would seem logical to provide for the investment supervisory and regulatory procedures to be a dual operation also.

My basic philosophy is that all supervisory and regulatory operations in respect to all pension and profit sharing plans should be conducted by a new agency, an Employee Benefit Plan Commission. This philosophy is discussed in the briefs that have been submitted to various Congressional Committees. If such a Commission were established to take over all pension plan operations from the Labor Department and almost all such operations from the Internal Revenue Service, then the supervision of investment regulation should be carried on by such new E.B.P. Commission.

Reporting Procedures

It is to be hoped that the reports that will need to be filed in respect to the investments held by a pension plan will be quite simple. I suggest that it is not necessary for each plan to report each year a detailed listing of its investment portfolio. Instead I suggest that each year an actuary or other responsible person be required to certify that the investments held in the plan portfolio are within the restrictions specified in the law.

Perhaps every 5 years, the actuary or other responsible person should be required to submit a detailed listing of the investment portfolio. The law, however, should permit the regulatory authorities to require a detailed listing whenever it is felt necessary to have such a list. Also, the law should provide for a severe penalty for the filing of a fraudulent statement.

Appendices A and B are examples of the form and instruction used by the Pension Commission of Ontario. It will be noted that at the foot of Page 2 of Form 1 the person signing the form certifies that "the investments . . . have been administered in accordance with the Act and Regulations". Use of this certificate plus the right to call for a detailed listing of investments when deemed desirable have considerably simplified the work of the Commission and the plan administrators and have nevertheless proved to be adequate. I recommend the adoption of a similar procedure.

Conclusion

Investing the assets of a plan within the scope of the restrictions proposed above would still provide a wide range of investment avenues for the manager of the investment portfolio. At the same time, the possibility of foolish, imprudent or dishonest transactions would be considerably reduced. Certainly the effect of such an improper transaction if it occurred would be limited because of the diversification requirements. Thus the probability of the funds being on hand when needed by the plan for it to honor its commitments would be considerably enhanced.

Moreover, imposing these investment restrictions should avoid the danger of some elements of the private pension plan system ever finding themselves in the bad position that some elements of the life insurance industry were found to be in back at the beginning of this century. Certainly it would appear just as desirable socially to protect the beneficiaries of pension plans as it is to protect the beneficiaries of life insurance policies.

APPENDIX "A"

FORM 2 — The Pension Benefits Act, 1965
The Pension Commission of Ontario
ANNUAL INFORMATION RETURN

For Commission Use Only

ONTARIO

1. Employer's Name

2. Head Office Address

3. Mailing Address

4. Name, Title or Agreement No. of Plan

5. Certificate of Registration Number — C

5. (i) 2 6

6. a) End of Plan Fiscal Year under review — Day .... Month .... Year ....

b) Number of months in this plan Fiscal Year — 12 months ☐ Other ....

6. a) 7 12
b) 13 14

7. Employed Plan members as at the fiscal year end under review

(a)

	Male	Female	Total
Ontario	....	....	....
Quebec	....	....	....

(b)

	Total		Total
Alberta	....	British Columbia	....
Manitoba	....	Newfoundland	....
New Brunswick	....	Nova Scotia	....
Prince Edward Island	....	North West Territories & Yukon Territory	....
Saskatchewan	....		

(c) Total employed Plan members in Canada ....

7. (ii)
a) 7 11; 12 16; 17 21; 22 26; 27 31; 32 36
b) 37 41; 42 46; 47 51; 52 56; 57 61; 62 66; 67 71; 72 75; 76 80
c) (i) 15 20

8. (a) Were any amendments made to this pension plan or fund during the fiscal year under review? Yes ☐ No ☐

(b) If "yes", have the amendments been submitted to the Commission? Yes ☐ Attached hereto ☐

8. a) 21

For Commission use only

Amount of remittance ....

Cashier Stamp

Receipt sent

No. ....

Check Control ....

Form PCO 1-1/66

APPENDIX "A"

FORM 2 — The Pension Benefits Act, 1965

9. Amount of Special Payments paid into the pension plan or fund for the fiscal year under review to liquidate INITIAL UNFUNDED LIABILITIES existing at initial registration or created by amendment, or to liquidate DEFICITS discovered by actuarial valuation.

Amount paid for plan fiscal year $ ....

....

....

....

9. (6) 22 29

10. Amounts paid into the pension plan or fund for the fiscal year under review for CURRENT SERVICE with respect to service during the plan fiscal year or as additional voluntary contributions, if any, made by members. Please enter figures for members IN CANADA ONLY.

(a) Total members' contributions, if any, including additional voluntary contributions $ ....

(b) Employer's contribution for Current Service net of withdrawal credits, etc. $ ....

(c) Remarks ....

....

....

10. a) 30 37

b) 38 45

11. (a) Have the above amounts paid into the pension plan or fund under Questions 9 and 10 been determined in accordance with the formulas given in the last Cost Certificate filed with the Commission?

Yes ☐ No ☐

(b) If the answer to (a) is "No", please explain ....

....

....

11. a) 46

b) 47 48

CERTIFICATE

I hereby certify that to the best of my knowledge and belief,

a) the contributions paid to the plan have been at least equal to those required under the Regulation; and

b) the plan and the investments thereof have been administered in accordance with the Act and Regulation; and

c) the details entered on this information return are true and correct.

....
Signature

....
Name (printed)

....
Title or Position

Date .... 19 ....

APPENDIX "B"

INSTRUCTION SHEET
for the completion of the
ANNUAL INFORMATION RETURN FORM 2

REQUIREMENTS FOR FILING:

A. WHO MUST FILE:

i) The Annual Information Return must be filed by the employer with respect to every pension plan registered in Ontario.
(Arrangements are being made with other designated provinces that only one return and one fee is required for each pension plan).
"Designated province" means a province or territory of Canada that is designated by regulation as a province or territory in which there is in force legislation substantially similar to The Pension Benefits Act, 1965.
Please refer to section 20 of the Regulation for names of designated provinces.

ii) Multi-employer Plans: Only one Annual Information Return is required for a multi-employer plan if signed by a person authorized by the employers.

B. FILING DATE:

Not later than six months following the end of the Fiscal Year of the Pension Plan

C. EXPLANATION OF QUESTIONS:

If the space under any question on the form is insufficient, please enter additional information on a separate sheet (please be sure that the company's name and registration number of plan appear on any additional papers submitted).

Question 1 — Employer's Name.
This should be the officially registered name of the company or association or the name of the owner if not a registered employer.
In the latter case the "business name" of the employer should be included in the replies to Question 2 or 3.

Example: 1. Employer's Name: John Smith
2. Head Office Address: Super Cleaners, 123 Main St., etc

Question 5 — Certificate of Registration Number.
All pension plans that have been approved by the Pension Commission of Ontario have been assigned a Certificate of Registration on which appears the "C-number" referred to by this question.
If Certificate of Registration has not yet been received, please do not enter anything here

Question 6(a) — End of Plan Fiscal Year under review.
In the case of most insured plans, this is usually the day before the renewal date of the master group contract. In the case of plans which do not imply or specify a fiscal year, the end of the plan fiscal year would be presumed to be December 31 each year.

Question 9 — Amount of Special Payments.
In the case of an insured plan funded by level premiums to retirement age for each individual member, the amount of special payments may not be identifiable. In such event this question may be answered by "included in 10(b)" and the total Employer contribution to the plan entered in question 10(b).

D. FEES:

i) The Annual Information Return for each plan should be accompanied by a remittance payable to the Treasurer of Ontario covering the fee applicable.

ii) The amount of the fee is determined by the total number of employed members of the plan in designated provinces* at the end of the plan fiscal year under review.
(See Question 6 (A)
For example, for a pension plan with 80 Ontario members, 10 Quebec members, 15 Alberta members and 5 Saskatchewan members the fee payable, based on a total of 110 members would be $50.00

iii) Scale of Fees:

Total employed members in designated provinces	Annual Fee payable
0 — 9	$ 5.00
10 — 49	10.00
50 — 99	25.00
100 and over	50.00

* Ontario, Quebec, Alberta and Saskatchewan.

E. CERTIFICATION AND MAILING:

When all the questions have been answered, the Annual Information Return must be signed by the employer (owner, authorized officer of a corporation, association or agency) and mailed to

THE PENSION COMMISSION OF ONTARIO
454 UNIVERSITY AVENUE
TORONTO 2, ONT. Telephone: 365-1622

THE PENSION BENEFITS ACT

REGULATIONS

Reg. 654, *R.R.O.* 1970 *as amended.*

GENERAL

[¶ 32-701]

1. [Definitions].—In this Regulation,

(*a*) "accountant" means a public accountant licensed under *The Public Accountancy Act* or having such other qualifications as may be accepted by the Commission;

[¶ 32-702]

(*b*) "actuary" means a Fellow of the Canadian Institute of Actuaries;

[¶ 32-703]

(*c*) "experience deficiency" when applied to a pension plan, means any deficit, determined at the time of a review of the plan, that is attributable to factors other than,

(i) the existence of an initial unfunded liability, or

(ii) the failure of the employer to make any payment as required by the terms of the plan or by the Act or this Regulation;

[¶ 32-704]

(*d*) "fully funded" when applied to a pension plan, means a pension plan that at any particular time has assets that will provide for the payment of all pension and other benefits required to be paid under the terms of the plan in respect of service rendered by employees and former employees prior to that time;

[¶ 32-705]

(*e*) "government" means Her Majesty in right of Ontario, an agent of Her Majesty, a municipality as defined in *The Department of Municipal Affairs Act* and a metropolitan municipality and the local boards thereof;

[¶ 32-706]

(*f*) "initial unfunded liability" means the amount by which on the 1st day of January, 1965, or the date on which the plan qualifies for registration, or subsequently as the result of an amendment, the assets are required to be augmented to ensure that the plan is fully funded;

[¶ 32-707]

(*g*) "provisionally funded" when applied to a pension plan, means a pension plan that at any particular time has not assets sufficient to make it fully funded but has made provision for special payments sufficient to liquidate all initial unfunded liabilities or experience deficiencies; and

[¶ 32-708]

(*h*) "special payment" means a payment or payments made to or under a pension plan for the purpose of liquidating an initial unfunded liability or experience deficiency in accordance with section 2.

[¶ 32-709—32-714] Reserved

[¶ 32-715]

2. [Registration]. — (1) An application for registration of a pension plan shall be in Form 1 [page 2975-37].

[¶ 32-716]

(2) [*Employer's contributions*]. — Every pension plan submitted for registration shall include a provision for funding which shall set forth the obligation of the employer to contribute both in respect of the current service cost of the plan and in respect of any initial unfunded liabilities and experience deficiencies.

[¶ 32-717]

(3) [*Payment of liabilities*].—The employer shall pay currently into any plan or fund providing pensions for his employees,

(*a*) all current service costs, including any contributions made by employees;

(*b*) where the plan has an initial unfunded liability, special payments consisting of equal annual amounts sufficient to liquidate such initial unfunded liability over a term not exceeding,

[Sec. 2(3)—continued]

(i) in the case of an initial unfunded liability existing on the 1st day of January, 1965, in any pension plan established before that date, twenty-five years from that date, and

(ii) in the case of an initial unfunded liability resulting from an amendment to a pension plan made on or after the 1st day of January, 1965, or resulting from the establishment of a pension plan on or after the 1st day of January, 1965, fifteen years from the date of such amendment or establishment or the number of years to the anniversary of such date in 1989, whichever is the greater;

(*c*) where a pension plan has an experience deficiency, special payments consisting of equal annual amounts sufficient to liquidate such experience deficiency over a term not exceeding five years from the date on which the experience deficiency was determined.

[¶ 32-718]

(4) [*Payments*].—Payments in respect of current service shall be made not later than 120 days after the end of the fiscal year of the pension plan to which they relate.

[¶ 32-719]

(5) [*Amount of special payments*]. — The minimum amount of a special payment required to be paid in a fiscal year of a plan with respect to each initial unfunded liability or experience deficiency shall be the annual amount required to liquidate the outstanding balance of each initial unfunded liability or experience deficiency during the balance of the period originally applicable thereto under subsection 3.

.01 Historical comment

S. 2(5) was amended by O. Reg. 452/73, s. 1(1), effective July 31, 1973.

[¶ 32-719a]

(6) [*Transfer or withdrawal*].—Notwithstanding the terms of a pension plan where additional pension benefits are created on or after the 1st day of January, 1965 with respect to service prior to the date of an amendment to the pension plan or the establishment of the pension plan and such additional pension benefits are being funded by means of special payments, the administrator of the pension plan shall not, after the 1st day of January, 1969, transfer or withdraw funds from the pension fund to purchase annuities for retired, retiring or terminating members or other beneficiaries with respect to such additional pension benefits except to the extent that the aggregate amount of such funds transferred or withdrawn from the pension fund does not exceed the aggregate of the special payments made and the accruals thereon in respect of such additional pension benefits plus any surplus in the fund.

[¶ 32-720]

(7) [*Special payments*].—A special payment shall be made not later than thirty days after the end of the fiscal year to which it applies.

[¶ 32-721]

.01 Historical comment

S. 2(8) was revoked by O. Reg. 452/73, s. 1(2), effective July 31, 1973.

[¶ 32-722]

(9) [*Insured plan*].—Where an insured pension plan established before the 1st day of January, 1965 is funded by level premiums to retirement age for each individual member, it shall be deemed to meet the requirements of subclause i of clause *b* of subsection 3.

[¶ 32-723]

(10) [*Variation of special payments*]. — Where a plan has an initial unfunded liability and the requirements with respect to special payments under this Regulation differ from those under the legislation or regulations of any designated province to which the plan is also subject, the Commission may permit an appropriate variation from the requirements of this section with respect to the special payments required.

[¶ 32-724]

(11) [*Fiscal years*]. — Unless otherwise provided in the plan, the fiscal year of a pension plan shall be deemed to be from the 1st day of January to the 31st day of December and, except on such basis as may be approved by the Commission, no fiscal year of a pension plan shall exceed twelve months.

[¶ 32-725]

(12) [*Surplus*].—Where the report of a person authorized by section 5 discloses an amount of surplus under the plan, any future payments for current service required to be made to the fund or plan may be reduced by the amount of surplus, or subject to subsection 5, the amount of surplus may be applied to reduce the outstanding balance of any initial unfunded liability or experience deficiency.

.01 Historical comment

S. 2(12) was amended by O. Reg. 452/73, s. 1(3), effective July 31, 1973.

[¶ 32-726]

(13) [*Plan administered for government employees*]. — Where a pension plan is administered for the employees of a government, the special payments in respect of an initial unfunded liability existing on the 1st day of January, 1965 may be limited to the annual amount required to prevent any increase in such liability.

[¶ 32-727]

3. [Initial report].— (1) Within sixty days after the date of establishment of the plan the employer shall submit a report of the person authorized by section 5 certifying,

(*a*) the estimated cost of benefits in respect of service in the first year during which such plan is registered and the rule for computing such cost in subsequent years up to the date of the next report;

(*b*) the initial unfunded liability, if any, for benefits under the pension plan as at the date on which the plan qualified for registration; and

(*c*) the special payments required to liquidate such initial unfunded liability in accordance with section 2.

[¶ 32-728]

(2) [*Insured plan*]. — Where an insured pension plan is funded by level premiums extending not beyond the retirement age for each individual member, the report may certify the adequacy of the premiums to provide for the payment of all benefits under the plan in lieu of the matters required to be certified under clauses *a*, *b* and *c* of subsection 1.

[¶ 32-729]

4. [Review reports].—(1) The employer in respect of a registered pension plan shall cause the plan to be reviewed and a report prepared by a person authorized by section 5 not more than three years after the date of the establishment of the plan and at intervals of not more than three years thereafter.

[¶ 32-730]

(2) [*Report contents*]. — The report shall certify,

(*a*) the estimated cost of benefits in respect of service in the next succeeding year and the rule for computing such cost in subsequent years up to the date of the next report;

(*b*) the surplus or the experience deficiency in the pension plan after making allowance for the present value of all special payments required to be made in the future by the employer as determined by previous reports; and

(*c*) the special payments which will liquidate any such experience deficiency over a term not exceeding five years.

[¶ 32-731]

(3) [*Filing*].—The employer shall file the report with the Commission upon its receipt together with such additional information as the Commission requires.

[¶ 32-732]

(4) [*Amended reports*].—Where the Commission is not satisfied that the report has been prepared using assumptions which are adequate and appropriate and methods consistent with the sound principles established by precedence or common usage within the actuarial profession, the report shall be amended so as to be acceptable to the Commission.

.01 Historical comment

S. 4(4) was amended by O. Reg. 452/73, s. 2, effective July 31, 1973.

[¶ 32-733]

5. [Persons making reports]. — The reports and certificates referred to in sections 3 and 4 and subsection 2 of section 9 shall be made by an actuary, except that reports and certificates in respect of,

(*a*) a pension plan under which all benefits are determined on a money purchase basis and purchased from an insurer on or before retirement;

[Sec. 5—continued]

(*b*) a pension plan underwritten by a contract or contracts with an insurance company, other than such a contract operating on a deposit administration of segregated fund principle;

(*c*) a pension plan underwritten by a contract or contracts issued under the *Government Annuities Act* (Canada); or

(*d*) a pension plan under which the solvency does not in the opinion of the Commission substantially depend on actuarial probabilities,

may be made by an accountant or a person authorized by the insurance company or by the trust company, or by the Annuities Branch, Department of Labour (Canada) administering the plan.

[¶ 32-734]

6. [Annual return].—(1) The annual information return required under subsection 4 of section 18 of the Act shall be in Form 2 [page 2956] and shall be furnished by the employer to the Commission annually not later than six months following the end of the fiscal year of the pension plan.

[¶ 32-735]

(2) [*Certification*]. — The employer shall certify in Form 2 [page 2956] that all contributions required with respect to the fiscal year have been paid into the pension plan.

[¶ 32-736]

7. [Solvency requirements].—Every pension plan shall be deemed to be solvent if it is fully funded or provisionally funded.

[¶ 32-737—32-750] Reserved

[¶ 32-751]

8. [Registration fees].—(1) Upon application for registration of a pension plan pursuant to subsection 1 and subsection 2 of section 18 of the Act, or upon the filing of an annual information return pursuant to subsection 4 of section 18 of the Act, a fee of one dollar shall be paid in respect of each member of the pension plan in Ontario and in respect of each member of the pension plan in a designated province reported to be on the payroll of the employer, but the total fee payable shall be not less than five dollars and not more than two hundred dollars.

.01 Historical comment

S. 8(1) was amended by O. Reg. 230/73, s. 1, effective April 18, 1973.

[¶ 32-751a]

(2) [*Idem*]. — Where the Commission administers a pension plan pursuant to an agreement made with the Government of Canada under subsection 2 of section 10 of the Act, upon application for registration of the plan pursuant to subsection 1 or 2 of section 18 of the Act or upon the filing of an annual information return as required by subsection 4 of section 18 of the Act, a fee of one dollar shall be paid in respect of each member of the plan, but the total fee payable shall not be less than five dollars and not more than two hundred dollars.

.01 Historical comment

S. 8(2) was added by O. Reg. 452/73, s. 3, effective July 31, 1973.

[¶ 32-752]

9. [Registration information].—(1) Every pension plan filed with the Commission for registration shall be accompanied by a certified copy of the trust deed, insurance contract, by-law, collective agreement on pensions or other documents under which such plan is constituted.

[¶ 32-753]

(2) [*Documents amended*].—Where a registered pension plan or a relevant portion of any document under which the plan is constituted is amended, the employer shall immediately file with the Commission a copy of the amendment and such additional information as the Commission requires to determine if the plan as amended continues to qualify for registration, and in the case of an amendment that affects contributions or creates or changes an initial unfunded liability, the employer shall also file with the Commission a report similar to the report required by subsection 1 of section 3.

[¶ 32-754]

(3) [*Special reports*].—The Commission may, at any time upon reasonable notice, require an employer to obtain and file such special reports as the Commission requires.

[¶ 32-755]

(4) [*Reasons for rejection*].—Where the Commission does not accept a plan for registration or cancels a certificate of regis-

tration, the Commission shall state the reasons for rejection or cancellation in the notice sent to the employer under section 20 of the Act.

[¶ 32-756]

10. [Plan contents].—(1) Every pension plan shall define the benefits provided by the plan, the method of determination and the payment of benefits, conditions for qualification for membership in the plan and the financial arrangements made to ensure provisional or full funding of benefits under the plan.

[¶ 32-757]

(2) [*Uniform formula*].—The formula for the pension benefit for each year of future service shall be uniform, except to the extent that the Commission approves such increments in the formula as it considers reasonable.

[¶ 32-758]

11. [Discontinuation of Plan].—(1) Notwithstanding the terms of the plan, where a pension plan is terminated or wound-up, no part of the assets of the plan shall revert to the benefit of the employer until provision has been made for all pensions and other benefits in respect of service up to the date of such termination or winding-up to members of the plan and for all benefits to former employees, pensioners, dependants and estates, and the provisions of section 14 shall apply to any funds held for the purpose of effecting such provision.

[¶ 32-759]

(2) [*Cessation of contributions*]. — Except as provided in subsection 3, suspension or cessation of contributions to a pension plan shall be construed as a termination of the plan.

[¶ 32-760]

(3) [*Benefits associated with new plan*].—Where contributions to a pension plan cease on or after the 1st day of January, 1965, as the result of the adoption of a new plan, the original pension plan shall be deemed not to have been terminated or wound-up under this section or under subsection 7 of section 21 of the Act and the benefits of the original plan shall be deemed to be benefits associated with the new plan in whole or in part in respect of service prior to the establishment of the new plan, whether or not the assets and liabilities of the original plan have been consolidated with those of the new plan.

[¶ 32-761]

(4) [*Report by actuary*].—Upon the termination or winding-up of a pension plan the administrator of the plan shall file with the Commission a report prepared by an actuary setting out the nature of the benefits to be provided under the plan and a description of the methods of allocation and priorities for determining the full or partial benefits of the members thereof, and no assets of the plan shall be applied toward the provision of any such benefits until the Commission has approved the said report, provided that, pending such approval, the administrator of the plan may pay as they fall due any periodic payments to persons entitled thereto and may pay any refunds of the employee contributions to persons entitled thereto.

[¶ 32-762]

(5) [*Adjustments of deferred life annuities*].—For the purposes of subsection 7 of section 21 of the Act the actuary shall in his report prepared under subsection 4 reduce the amounts of the additional pension benefits to which any person may otherwise be entitled to such extent as will in his opinion prevent unfair impairment of the other pension benefits accrued under the plan, provided that the aggregate value of any additional pension benefits already paid and proposed to be paid after such reduction, to the extent that such additional pension benefits form part of deferred life annuities provided for in section 21 of the Act or of any life annuities arising therefrom, shall be not less than the value, as estimated by the actuary, of the special payments made in respect of the additional pension benefits forming such part.

[¶ 32-763]

(6) [*Partial termination*].—Where a pension plan is terminated or wound-up in part, the rights and interests of those employees and former employees thereby affected shall be not less than those to which such employees and former employees would have been entitled if the whole of the pension plan had been terminated or wound-up on the same date as such partial termination or winding-up.

[¶ 32-764—32-769] Reserved

[¶ 32-770]

12. [Calculation of annuity].—(1) The commuted value of a deferred life annuity

[Sec. 12(1)—continued]
shall be calculated in a manner acceptable to the Commission.

[¶ 32-771]

(2) [*Level premium contracts*].—Where a plan is insured by individual level premium contracts, the deferred life annuity referred to in clause *a* of subsection 1 of section 21 of the Act may, in the case of a contract issued prior to the qualification date, be equal to the paid-up annuity under the contract arising from contributions made for service on and after the qualification date if the special payments required with respect to such deferred life annuity under the contract have all been paid or shall continue to be paid.

[¶ 32-772]

13. [Supplemental annuity]. — Where a pension plan provides for a supplemental or minimum make-up annuity that is not on the average a substantial portion of the total annuity of the employees retiring under the plan, the supplemental or minimum make-up annuity may, with the approval of the Commission, be excluded in computing the pension benefit under subsection 1 of section 21 of the Act.

[¶ 32-773—32-789] Reserved

[¶ 32-790]

14. [Investments]. — (1) This section applies notwithstanding the provisions of any pension plan or any instrument governing the plan.

[¶ 32-791]

(2) [*Canadian and British Insurance Companies Act*].—The funds of a pension plan may be invested and loaned only in investments and loans in which a company may invest and lend under subsections 1, 2, 5, 6 and 10 of section 63 of the *Canadian and British Insurance Companies Act* (Canada), as amended from time to time, and the restrictions and limitations contained therein apply.

[¶ 32-792]

(3) [*Arrangement exchanging assets*]. — Where a pension fund owns securities of a corporation and as a result of a *bona fide* arrangement for the reorganization or liquidation of the corporation or for the amalgamation of the corporation with another corporation, such securities are to be exchanged for bonds, debentures or other evidences of indebtedness, or shares not eligible as investments under subsection 2, the pension fund may accept and hold such bonds, debentures or other evidences of indebtedness or shares.

[¶ 32-793]

(4) [*Other investments or loans*]. — The funds of a pension plan may be invested or loaned in investments or loans not authorized by subsection 2 or 3, including investments in real estate or leaseholds, subject to the following provisions:

1. Investments in real estate or leaseholds under this subsection shall be made in Canada and only for the production of income and may be made either alone or jointly with another plan and the fund or plan may hold, maintain, improve, develop, repair, lease, sell or otherwise deal with or dispose of such real estate or leaseholds, but the total investment of a fund under this subsection in any one parcel of real estate or in any one leasehold shall not exceed 1 per cent of the book value of the total assets of the fund.
2. This subsection shall be deemed not to enlarge the authority conferred by subsections 1 and 2 of section 63 of the *Canadian and British Insurance Companies Act* (Canada) to invest in mortgages or hypothecs and to lend on the security of real estate or leaseholds, and not to affect the operation of sub-paragraphs iii, iv and v of paragraph *l* of subsection 1 of the said section 63.
3. The total book value of the investments and loans made under this subsection and held by the fund, excluding those that are or at any time since acquisition have been eligible apart from this subsection, shall not exceed 7 per cent of the book value of the total assets of the fund.

[¶ 32-794]

(5) [*Loans*].—The funds of a pension plan shall not be lent to,

(*a*) the wife or a child of the employer or, where the employer is a corporation, a director or officer of the corporation or his wife or child;

(*b*) a corporation of which more than one-half of the shares of the capital stock are owned by the wife or a child of the employer, or any combination thereof, or, where the employer is a corporation, by a director or officer of the employer corporation or his wife or child, or any combination thereof;

(*c*) an officer or employee of the fund or plan or an administrator or trustee of the fund or plan or an officer or employee of an administrator or trustee of the fund or plan or a union representing employees of the employer or an officer or employee of the union, or the wife or child of any of them; or

(*d*) the wife or child of an employee of the employer or an employee of the employer except on the security of a mortgage on the residential property of an employer's employee or the spouse or child of such employee primarily for his or her own use.

[¶ 32-795]

(6) [*Proportional limitation on investment*].—The funds of a pension plan shall not be invested or loaned if the result of the investing or loaning would be that more than 10 per cent of the book value of the total assets of the fund are invested in the assets of or loaned to any one corporation, partnership, association or person, including investment in shares, bonds, debentures or other evidences of indebtedness, loans by way of mortgage or otherwise and investment in real estate, plant or equipment occupied or used by the corporation, partnership, association or person.

[¶ 32-796]

(7) [*Conflict of interest in accepting benefits*].—All investments and deposits of the funds of a pension plan and all loans made out of a pension fund shall be made in the name of the fund or plan, and no officer or employee of the fund or plan, no trustee or administrator or officer or employee thereof, no employer, officer, or employee thereof, no association of employees and no union, officer or employee thereof shall accept or be the beneficiary of, either directly or indirectly, any fee, brokerage, commission, gift or other consideration for or on account of any loan, deposit, purchase, sale, payment or exchange made by or on behalf of the pension fund.

[¶ 32-797]

(8) [*Mutual funds*].—In addition to the investments and loans authorized by subsections 2 and 3, the funds of a pension plan may be invested in,

(*a*) a pooled, segregated or mutual fund; or

(*b*) the shares of a corporation,

(i) whose assets are at least 98 per cent cash, investments and loans,

(ii) that does not issue debt obligations, and

(iii) that obtains at least 98 per cent of its income from investments and loans,

if the pooled, segregated or mutual fund or the corporation is limited in its investments to those a pension plan may make under this section and is subject to the limitations and restrictions of this section.

[¶ 32-798]

(9) [*Investment according to subsection 8*].—Where the funds of a pension plan are invested in accordance with subsection 8, subsection 6 does not apply to such funds.

[¶ 32-799]

(10) [*Additional securities*].—A pension fund or plan may take additional securities of any nature further to secure the repayment to the fund of any loan or investment, or further to secure the sufficiency of any of the securities in or upon which such fund or plan is authorized to invest or lend any of its funds.

[¶ 32-800]

(11) [*Period to conform*].—Where, on the date the fiscal year of a pension fund ends next following the 4th day of August, 1964, the loans and investments of a pension fund do not conform in whole or in part to the provisions of this Regulation, they shall be brought into conformity within five years of the end of such fiscal year.

[¶ 32-800a]

(11*a*) Where the Commission is of the opinion that five years has been insufficient to bring any loan or investment mentioned in subsection 11 into conformity with the provisions of this Regulation, it may extend the time therefor to such date as it considers appropriate.

[¶ 32-801]

(12) [*Corresponding provisions of designated province*].—Where the provisions of this section differ from the corresponding

[Sec. 14(12)—continued]

provisions under the legislation of a designated province, the Commission may, in the case of a plan having plan members in such designated province, accept in whole or in part such corresponding provisions.

[¶ 32-802]

15. [Profit sharing plan excepted]. — A profit-sharing plan that has been accepted for registration by the Minister of National Revenue for Canada before the 1st day of January, 1965 under the *Income Tax Act* (Canada) and that provided at the time of such acceptance that each member may take his entire interest in the plan in a cash sum when he ceases to be an employee whether by retirement or other termination of employment may, with the approval of the Commission, be excepted from the Act and the regulations.

[¶ 32-803]

16. [Transfer of pension benefit credit]. —(1) A transfer of a pension benefit credit arising from a deferred life annuity under section 21 of the Act to the administrator, insurer or trustee of another pension plan or to a registered retirement savings plan, or to an insurer on the winding-up of a pension plan may be made only where the transferee agrees to administer the amount of deferred life annuity established by the pension benefit credit transferred as a deferred life annuity under the Act.

[¶ 32-804]

(2) [*No cash or loans or assignment clause*].—Except to the extent permitted by subsection 4 of section 21 of the Act, no policy or contract or benefit description issued by a transferee mentioned in subsection 1 to an employee shall contain any cash or loans or assignment clause.

[¶ 32-805]

17. [Disability]. — For the purposes of subsection 5 of section 21 of the Act, mental or physical disability means a disability that is likely to shorten considerably the life expectancy of an employee or former employee.

[¶ 32-806]

18. [Administration of funds]. — (1) Where the funds of a pension plan are not administered by a government, they shall be administered under *the Government Annuities Act* (Canada) or by a life insurance company, a corporate trustee, individual trustees or a society established under *the Pension Fund Societies Act* (Canada).

[¶ 32-807]

(2) [*Consent for payment of funds*].—Except as provided in section 11, no funds shall be paid out of a pension plan to an employer unless consent of the Commission is obtained.

[¶ 32-808]

19. [Plurality of members]. — Where a plurality of the members of a pension plan is employed in a designated province, such plan may be excepted, subject to agreement with the designated province, from registration, audit and inspection under the Act, and for the purpose of ascertaining where the plurality of the members is employed, members not employed in Ontario or a designated province shall not be counted.

[¶ 32-809]

20. [Designated provinces]. — The following provinces and territories of Canada are designated as provinces or territories, as the case may be, in which there is in force legislation substantially similar to the Act:

1. The Province of Alberta.
2. The Province of Quebec.
3. The Northwest Territories and Yukon Territory.
4. The Province of Saskatchewan.

[¶ 32-810]

21. [Excepted plans]. — The following pension plans are excepted from the application of the Act and the regulations:

1. Pension plans under which annual retirement allowances are granted or purportedly granted under section 239 of *The Municipal Act* or section 45 of *The Schools Administration Act*.

[¶ 32-811—33-300] Reserved

[The next page is 8081.]

AMERICAN STOCK EXCHANGE, INC.,
New York, N.Y.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

DEAR SIRS: The American Stock Exchange, Inc. ("Amex") is pleased to have the opportunity to submit its views concerning S. 2842, entitled "The Stock holders Investment Act of 1973," which was introduced by Senator Bentsen on December 20, 1973.

On July 26, 1973, Paul Kolton, Chairman of the Amex, in testimony before the Senate Subcommittee on Financial Markets, proposed consideration of a legislative program designed to deal with the tendency of institutional investors to concentrate their holdings in a relatively small number of issues, and to help win back the individual investor to the equity markets, in order to preserve the efficiency and fairness of these markets. This program included, among other things (1) increased disclosure by institutions of their holdings and their transactions, (2) limitations on the amount of stock of any particular company which an institution is permitted to hold, and (3) tax incentives designed to encourage risk-taking by individual investors.

The first of these proposals—institutional disclosure—is the subject of legislation currently under consideration by the Senate Subcommittee on Securities. The second and third areas—limitations on institutional holdings and tax incentives—are the subject of S. 2842.

The Amex generally supports the basic thrust of this legislation. It believes that S. 2842, with certain modifications and additions suggested in this letter, would be a significant step toward implementing a national policy designed to strengthen the securities markets and to encourage individual investors to participate in them to a greater extent, in order to facilitate the financing of American business and improving the national economy.

Limitations on Pension Fund Investments

S. 2842 provides that a pension plan would not qualify for favorable tax treatment unless the plan requires that the assets of the fund be held by a pension manager who is subject to certain investment restrictions. These restrictions would limit a pension manager from (1) investing more than 5% of the aggregate discretionary pension assets under its control in the securities of any one company, and (2) using such discretionary assets to acquire more than 10% of any class of security of any one company.

These limitations would not apply retroactively, and pension managers would not be required to dispose of current stockholdings in order to meet the limitations. Pension managers—but not the funds themselves—exceeding the limitations would be subject to penalty taxes, except where any excess holdings result exclusively from market fluctuations. Further, the limitations would not apply to investments in companies with capital of under $25 million.

The Amex supports these provisions of the bill, since they would tend to encourage institutions to spread their investments among a larger number of companies and will help avoid the effects of a "two-tier" market, which has focused great attention on institutionally favored stocks. The investment limitations imposed by the bill would also tend to protect beneficiaries of pension plans from the risks involved in excessive concentration of pension investments. Moreover, as one observer has noted, the percentage limitations on holdings and purchases contained in S. 2842 would only make legally binding on pension managers a policy already followed in the best bank trust departments.

Venture Capital Pension Funds

The bill provides that a pension fund manager may invest up to 1% of the assets of any pension plan in companies with capital of less than $25 million, without regard to any federal or state law imposing liability for losses resulting from risky or speculative investments (other than prohibitions against wrongful conduct, such as self-dealing or fraud). This provision would, in the words of Senator Bentsen's summary of the bill, "facilitate the flow of a limited amount of pension investments to new or expanding companies which present greater than normal risks but offer the opportunity for greater than normal returns." We note that the summary of the bill also makes it clear that this "leeway clause" would not imply that investment in all companies with less than $25 million capital are high-risk investments.

The Amex supports this provision, for two principal reasons: First, it could tend to reverse the trend of large institutional investors to concentrate on a small number of major companies, and the market distortions which result from this; and, second, it could assist smaller companies, including many whose securities are listed on the Amex, in obtaining needed capital.

We would suggest, however, that this provision be modified to permit an additional exemption for up to 2% of pension fund assets invested in securities of companies with capital of between $25 million and $50 million. It may be noted, in this connection, that the median capitalization of companies whose securities are listed on the Amex is approximately $26 million. Thus, while enactment of the provision in its present form could help provide a flow of capital to a number of Amex listed companies, a large number of medium-sized companies would not benefit. We believe the suggested modification could benefit such companies, without unduly jeopardizing the safety of pension fund assets.

If, for any reason, the Subcommittee on Financial Markets determines that enactment of this provision is not feasible, we would recommend, as an alternative, that consideration be given to incorporating into the bill a change in the definition of "prudence" recommended in the recently published report prepared by Professor James A. Lorie for the Department of the Treasury.[1] In this report Professor Lorie suggests that "The riskiness of an asset should be judged not in isolation but by the way its purchase would affect the riskiness of a portfolio." Professor Lorie points out that such a change would lead to greater portfolio diversification, with the result that "stocks in many small companies, which would be deemed imprudent or excessively risky under current legal standards, would be considered acceptable investments under more enlightened modern standards."

Graduated Capital Gains Tax

S. 2842 would replace existing capital gains rates with graduated capital gains rates which would decrease annually over a holding period of a capital asset, so that the maximum rate would be about 14% for assets held 15 years.

The Amex generally supports a graduated capital gains tax, since it would not only give tax relief to many holders who are, for all practical purposes, locked in by the present capital gains rate, but would also at the same time actually increase government revenues by unlocking these securities while providing additional liquidity to the market.

The Amex is, however, concerned about the possible negative impact of certain features of the capital gains provisions contained in the bill.

First, the bill would extend the present holding period for capital gains from six months to 12 months. This extension would be phased-in by means of a one-month increase in the required holding period each year, until it reaches 12 months for the taxable year beginning January 1, 1980.

Second, capital losses would be subject to the same sliding-scale treatment as are capital gains over the holding period of the capital asset. Thus, only 20% of the total loss realized on assets held over 15 years would be deductible against capital gains.

Third, S. 2842 would repeal the alternative tax which permits an investor to apply a 25% tax rate to the first $50,000 of net long-term capital gain. This would have the effect of immediately increasing the tax on the first $50,000 of capital gains for many investors.

The Amex opposes these three provisions, which would seem to be inconsistent with one of the stated purposes of S. 2842: to encourage individuals to invest in securities; and furthermore, they would tend to actually decrease market liquidity.

In addition, the Amex urges the Subcommittee to restore the 25% maximum rate which prevailed prior to 1970 on all long-term capital gains. In this regard, an independent study conducted for the New York Stock Exchange found that a reduction in the maximum tax rate from 35% to 25% would encourage capital gains realizations and produce additional federal tax revenues of approximately $1.8 billion.

Liberalized capital loss treatment

S. 2842 would amend the Internal Revenue Code so as to increase from $1,000 to $4,000 the amount of capital losses which an individual is permitted to deduct annually against ordinary income. The Amex supports this provision,

[1] "Public Policy for American Capital Markets," February 7, 1974, (pp. 16–17).

which appears to be fully justified by the fact that per capita disposable income has increased approximately fourfold since 1942 when the $1,000 capital loss deduction was enacted.

Provisions not included in S. 2842

The Amex recommends that two additional tax incentive provisions be included in S. 2842.

The first would increase the dividend exclusion from personal income tax from its present level of $100 to $200. Such a step seems realistic in view of current inflationary trends, and, further, would demonstrate that as a matter of public policy the Congress is prepared to encourage the small investor to participate in the markets.

The second would provide that commissions paid by investors be treated in the same way as other investment expenses, and not as par of the purchase or sale price of a security, as they are treated under the present tax code. Such an amendment would enable investors to deduct all of their commissions paid against ordinary income (subject to tax rates up to 70%), rather than subtracting these costs from capital gains (subject to a 50% deduction and thus to tax rates up to 35%).

We hope that these comments will be helpful to the Subcommittee in its consideration of these proposed legislative provisions.

Sincerely,

NORMAN S. POSER.

STATEMENT BY NORMAN B. TURE, PRESIDENT, NORMAN B. TURE, INC., ON BEHALF OF AMERICAN COUNCIL ON CAPITAL GAINS AND ESTATE TAXATION

GRADUATION OF TAX ON CAPITAL GAINS WITH LENGTH OF HOLDING PERIOD

In testifying before the Subcommittee on Financial Markets of the Committee on Finance on September 24, 1973, I addressed the related questions of (1) the impact of the present tax structure on individual saving and investment and (2) the consequences of that tax impact on the efficiency of U.S. financial markets. There is no need to burden the record of the Subcommittee's hearings with a full restatement of my analysis and recommendations, but I should like to take the liberty of briefly summarizing the principal elements of that analysis in this testimony on behalf of the American Council on Capital Gains and Estate Taxation.

Well developed and efficiently operating financial markets are essential for the effective functioning of any advanced and diversified economy depending largely on private enterprises for the conduct of business in free markets. One of the major requirements for efficient performance by financial markets is widespread and active participation by individual savers-investors. For some time past, however, the major financial markets of the United States have been marked by thin and dwindling participation by individuals and by market results which disproportionately reflect the portfolio management activities of a relatively small number of large institutional investors.[1] Since the investment requirements and strategies of these investors may well differ significantly from those of the vast majority of individual savers, the market results may also differ significantly from those required for efficient allocation and use of the economy's production capability and distort the consumption-saving choices of the private sector.

One of the factors contributing to the reluctance of individuals to invest directly in corporate equities and impeding their participation in financial markets is the anti-saving bias of the existing tax system. The nature and sources of this bias were described and illustrated in my testimony of September 24, 1973. I respectfully call the attention of the Subcommittee as well to my study *Tax Policy, Capital Formation, and Productivity*, prepared for the Committee on Taxation, National Association of Manufacturers (January 1973) and my testimony to the Committee on Ways and Means, U.S. House of Representatives, February 5, 1973, for further exposition and illustration of the anti-saving tax bias. In very summary terms, that bias derives principally from including in the current year's income tax base the amount saved in the current year and in subsequent years' tax base the returns to that saving. Since the amount saved is the capitalized value of the future returns on the saving, this income tax treatment taxes the same income flow twice. In contrast, income used for consumption

[1] In every year since 1961, individuals have, on balance, reduced their holdings of corporate equities. Cf. The 1974 Economic Report of the President, p. 273.

is taxed only initially. This basic tax discrimination against saving is greatly increased by the separate taxation of corporate profits, by the taxation of capital gains, by State income taxes, by State and local property taxes, and by Federal estate and gift taxes and State inheritance taxes.

There is a large inventory of constructive tax revisions which would reduce, if not entirely eliminate, the present tax bias against saving and capital formation. (For a detailed inventory of such proposals, please refer to my NAM study cited above and to my *White Paper on Long Range Tax Policy and Balanced Growth*, prepared for the Special Committee on Long Range Tax Policy and Balanced Growth of the Chamber of Commerce of the United States, October 1972). One major item in that inventory is revision of the tax treatment of capital gains and losses.

The present tax treatment of capital gains and losses not only adds substantially to the differentially heavy tax burden on saving but also significantly impairs the efficient allocation of saving among alternative uses. In doing so, it represents a serious impediment to effective operation of financial markets.

A capital gain, by definition, is the market's capitalization of an anticipated increase in the earnings attributable to an asset or property. In the usual case, the income out of which the saving necessary for the acquisition of the property was made was taxed as it was accrued or realized, and the earnings of the property similarly were taxed as they materialized. So, too, will the increase in the future earnings of the asset be taxed as they are realized. Taxing currently the capitalized value of these additional future earnings obviously is to impose a surcharge on the taxes that will be paid when the future earnings come along.

Coming on top of the disproportionately heavy load of individual and corporation income taxes on saving, the tax on capital gains significantly increases the cost of saving relative to consumption. And through the operation of the capital markets, the increase in the relative cost of saving which results from taxing capital gains leads to an across-the-board increase in the cost of saving and of capital formation.

The significance of this tax-imposed increase in the cost of saving should not be ignored. Had the tax system discriminated less harshly against saving and capital formation during the postwar period, the entire economy would have benefitted from a more rapid increase in total production capacity, greater real output, and a higher rate of advance in labor's productivity and real wage rate.

"If capital services had increased 50 percent more rapidly than the actual trend rate" . . . i.e., at an annual rate of 5.55 percent rather than 3.7 percent . . . "for example, gross output of the business sector would have increased 4.19 percent faster than its actual trend rate of growth and would have been 12.0 percent greater than its trend value for 1967. The marginal productivity of labor and the real wage rate would have increased at an average annual rate of 2.79 percent, compared with the trend rate of increase of 2.2 percent, and would have been 11.9 percent more than its trend value in 1967." [1] The anti-saving, anti-capital formation bias of our tax system, to which the present tax treatment of capital gains contributes significantly, costs us all dearly.

But this is not the sole adverse effect of taxing capital gains. 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 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 alernative 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—a wholly unrealistic proposition, 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.

Tax changes to ease the existing discrimination against saving will not necessarily, of themselves, reverse the trends of the past few years in the securities markets nor assure the financial climate most conducive to vigorous, innovative private enterprise. But constructive changes in the tax laws would surely make an important contribution to a higher rate of private saving, particularly by in-

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[1] Ture, *Tax Policy, Capital Formation, and Productivity*, op. cit., p. 19.

dividuals, to greater participation by them in the financial markets, and therefore to more efficient functioning of those markets.

Constructive tax revisions are those which will reduce tax interference in the choices of businesses and households as to how they obtain and use their income and wealth. Given the enormous demands for additional capital to be faced in virtually every sector and by every industry in the economy of the coming years, if the Nation is to maintain and advance productivity and living standards and to extend more fully the benefits of that advance to the poor, constructive tax policy will have to give top priority to reducing the present tax bias against saving.

A good place to begin is to eliminate entirely the taxation of capital gains. Few other advanced industrial nations apply their income taxes to capital gains. To be sure, in the context of U.S. income tax history, this would be a drastic step. But properly viewed, i.e., as a heavy tax surcharge on the returns to saving and as an excise on shifting the allocation of saving, the taxation of capital gains affords few benefits to justify the cost it entails in terms of the lost capital formation, lost productivity, and lost real output for the economy as a whole.

In the current climate of opinion, realism requires recognition of the fact that complete elimination of the present tax on capital gains must be viewed as a long-range objective. In the interim, considerably less drastic changes can be made which would mitigate the adverse effects of capital gains taxation.

One such change which has received careful attention would graduate the tax on capital gains downwards with the length of time the capital assets had been held. I was happy to have had the opportunity to respond last fall to several inquiries from the Subcommittee concerning this proposal. The gist of my replies was that a downward graduated tax on capital gains would raise no significant compliance, enforcement, or administration problems and that it would in all likelihood result in a substantial unlocking of long-held capital assets. Moreover, implementation of the proposal would ver likely generate substantial additional tax revenues, although this effect would be far more pronounced in the early period following adoption of the revised tax than subsequently.

To the extent that the average effective rate of tax under the downward graduated rate structure were less than at present, moreover, this revision would somewhat mitigate the existing tax bias against saving. It should also induce somewhat greater individual investment in corporation securities and such other capital assets of which an important attribute is the relative ease with which they may be sold or exchanged. Hence, enactment of this proposal should contribute to fuller participation by individuals in the financial markets and to improved efficiency in the operation of these markets. Considerations of tax neutrality, however, militate against confining the proposed tax treatment solely to securities. All capital assets owned by individuals should be eligible, except that downward graduation should not replace the existing "roll over" treatment for gains on personal residences.

Quite different answers to the Subcommittee's questions are appropriate insofar as corporate income taxpayers are concerned. For the corporate taxpayer, compliance problems would often be substantial, particularly in cases in which acquisitions, mergers, and reorganizations have occurred and the determination of holding periods, other than more or less than six months as under present law, would be difficult.

On substantive grounds, a far more serious problem would arise. Application of downward graduation to corporate taxpayers would differentiate the net-of-tax value of the capital assets owned by corporations on the basis of holding period and accordingly it would distort the market's valuation of the corporation's equity. Thus, if two corporations, A and B, held identical portfolios of capital assets but A had held such assets much longer than B, the capitalized value of the potential tax on the liquidation of A's portfolio would be less than that with respect to B's. This difference in potential taxes would certainly be reflected, other things being equal, in the market's valuation of the two company's stocks. Yet these differing valuations would reflect no real difference between the companies' pretax earning capacities, but merely differences in their status under the downward graduated capital gains tax.

An additional substantive difficulty in applying the downward graduating system to corporations stems from the fact that a substantial portion of the capital gains realized by corporations result from the disposition of property used in the corporation's trade or business and do not represent gains on portfolio transactions. Such property is generally disposed of when there is opportunity for replacing it with more modern and productive production facilities. Such replacements should not be impeded by tax considerations. Indeed, one of the principal justifications for the enactment of the tax treatment of gains and losses upon the disposition of such property detailed in Sec. 1231 of the Internal Revenue Code was to reduce tax barriers to such dispositions on a timely basis. In many cases, such dispositions would take place, apart from tax coniderations, some considerable time before the elapse of the holding period at which a step down in the capital gains tax rate would occur under the proposal. And for a significant amount of such property, the typical holding period under the present tax provisions is short enough that the proposed downward graduation of the capital gains tax rate with holding period would be of little benefit, if, indeed, it did not increase tax. For some other types of property, e.g., timber and land, the optimum time for their disposition as determined by sound business considerations is likely to differ materially from the holding period at which a step down in the tax would be provided under the proposal. The downward gradation of rates, therefore, might well induce retention of such property beyond the time when it would be most economic to dispose of it.

For corporate taxpayers, the price consideration should be to reduce existing tax deterrents to timely disposition and replacement of uneconomical or obsolete production facilities and to avoid increasing tax barriers to modernization of plant and equipment. Given this consideration, a highly constructive interim revision would be to reduce the present rate of tax on all corporate capital gains, say, to a flat rate of 25 percent. Moreover, any such interim change should not alter the existing Section 1231 determinations of gain or loss.

I should like to emphasize that these suggestions are offered as interim measures, not as ultimate solutions. A complete overhaul of the tax system to eliminate the tax discrimination against saving or to reduce it to a minimum would eliminate automatically many of the current problems arising in the tax treatment of capital gains. Pending any such thorough-going revision, intermediate measures to reduce the weight of existing taxes on capital gains warrant endorsement by the Congress.

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