

CHAPTER VII

INVESTMENT COMPANY GROWTH AND MARKET IMPACT

A. INTRODUCTION

Chapter VI examined investment performance of large mutual funds to determine the extent to which, if any, the growth of individual funds has adversely affected the interests of their shareholders. This chapter examines another important aspect of investment company growth—its impact on the securities markets, a question which concerns not only investment company shareholders but all persons interested in the viability of the nation's capital markets, the enterprises in which these companies invest and the national economy in general.

Although the size of the present investment company industry was not envisioned when the Act was passed in 1940, even then the potential market impact of investment company growth was a main concern of Congress. It manifested that concern in section 14(b) of the Act, which expressly authorizes the Commission to study and investigate "the effects of size on securities markets" as one of the problems that may arise from "any substantial further increase in the size of investment companies."

In 1958 the Commission, pursuant to section 14(b), requested the Wharton School to examine the consequences of mutual fund growth on the securities markets in terms of both industry size and the size of individual funds and fund complexes. Although the Wharton Report generally concluded that as of 1958 there was "little evidence that size per se of individual funds or companies is a problem at the present time," it classified "the impact of fund growth and stock purchases on stock prices" as one of the "more current problems in the mutual fund industry."¹

The Wharton Report's conclusions were based on studies which covered the 5 $\frac{3}{4}$ -year period from December 31, 1952, to September 30, 1958. Even though mutual fund assets grew from \$3.9 billion to \$12.2 billion during this period, the mutual fund industry of today is more than triple the size of the industry on which the Wharton Report focused.

During the postwar era other financial institutions also have experienced substantial growth and, particularly since the early 1950's, have tended to invest larger portions of their assets in equity securities. Indeed, private noninsured pension funds now almost match investment companies as important holders of equity securities. The growth of their stockholdings may hold as many significant implications for the securities markets as investment company growth.

This chapter seeks to reassess the findings of the Wharton Report with respect to the impact of mutual fund growth on the securities markets in the light of substantial growth of the industry since 1958

¹ Wharton Report X.

and the growing importance of other types of institutional investors. An examination of the market impact of mutual fund growth cannot be divorced from the overall influence of institutional investors in the securities markets, for a concern over the effects of mutual fund size is only a part of the general concern over the implications that may flow from the concentration of control over large aggregations of equity capital. Thus, section B of this chapter discusses the growing importance of mutual fund as well as other institutional participation in the stock markets. Section C discusses the question of mutual fund impact on the stock markets, while section D discusses some regulatory implications of institutional investor growth. Finally, section E discusses mutual funds and speculative activity.

B. THE GROWING IMPORTANCE OF INSTITUTIONAL INVESTORS

1. The size of institutional stockholdings

Institutional investors are a diverse group. In addition to investment companies, they include various types of insurance companies, banks, nonprofit organizations and pension funds. Equity investments are exceedingly important both to investment companies and private noninsured pension funds. The great bulk of investment company assets and over half of pension fund assets are in stocks. Stockholdings are much less important as outlets for the capital of insurance companies and nonprofit organizations, but even these institutions are relatively important participants in the equity markets.

Table VII-1 shows the yearend total assets and corporate stockholdings of various financial institutions for selected years from 1940 through 1965. It reflects the increased value of corporate stockholdings of these financial institutions during this 25-year period. At the end of 1940, corporate stockholdings of such financial institu-

TABLE VII-1.—Total assets and stockholdings of selected financial institutions and others, yearends 1940-65 ^a

[In billions of dollars]

	1940		1950		1955		1960		1965	
	Assets	Stocks	Assets	Stocks	Assets	Stocks	Assets	Stocks	Assets	Stocks
Noninsured private pension funds.....	1.1	0.1	6.5	1.1	18.1	6.1	37.1	16.5	71.4	39.7
Investment companies, total.....	2.1	1.8	5.3	4.3	13.7	12.1	23.6	20.5	47.3	41.1
(a) Open-end.....	.5	.4	2.4	1.9	8.1	7.2	17.7	15.4	38.2	33.5
(b) Other.....	1.7	1.3	2.9	2.3	5.6	4.9	5.9	5.1	9.1	7.6
Life insurance companies.....	30.8	.6	64.0	2.1	90.4	3.6	119.6	5.0	158.7	9.1
Property and casualty insurance companies.....	5.1	1.5	13.1	3.6	21.7	5.4	29.4	7.5	42.1	12.4
Banks.....	85.6	.6	192.2	.3	243.1	.8	298.9	1.0	431.3	1.9
State and local trust funds.....	9.2	(b)	23.4	(b)	36.4	.2	51.6	.6	78.8	2.2
Total, selected institutions.....	133.9	4.6	304.5	11.3	423.5	28.2	560.2	50.8	829.6	105.8
All others ^c		72.7		139.3		281.3		370.4		568.9
Total stock outstanding.....		77.3		150.6		309.5		421.2		674.7

NOTE.—Figures are rounded and will not necessarily add to totals.

^a Market value to the extent available; excludes intercorporate holdings and investment company shares; includes foreign issues outstanding in the United States.

^b Less than \$50 million.

^c Includes individuals, foreigners, personal trust funds, nonprofit institutions and fraternal organizations.

tions amounted to approximately \$4.6 billion, or 5.9 percent of the market value of all outstanding corporate stock. By the end of 1965 their stockholdings had increased to \$105.8 billion—about 15.7 percent of the value of all outstanding corporate stock. During this period, the stockholdings of these financial institutions increased at a much greater rate than did their assets. While 1965 assets were more than six times those of 1940 (\$133.9 billion to \$829.6 billion);² stockholdings were 23 times as great. At yearend 1940, corporate stocks held by these financial institutions accounted for 3.4 percent of their aggregate assets, while at yearend 1965 their stockholdings represented 12.8 percent of assets.

The "all others" category in table VII-1 includes substantial institutional holdings for which historical data are not available. Among these are the holdings of foundations, college endowments, and personal trust funds which often are managed by banks, as well as those of common trust funds which recently have emerged as important holders of common stock.

Most of the growth in institutional holdings of equity securities has occurred during the last decade and has been accompanied by a relative decline in the holdings of individuals and other types of investors, including personal trust funds. Thus, the \$105.8 billion of equity securities held at yearend 1965 by financial institutions was almost four times the \$28.2 billion held at the end of 1955. During this period the holdings of other investors only doubled, rising from \$281.3 billion to \$568.9 billion. While a large part of the growth of institutional stockholdings was due to the sharp rise in stock prices over the period, much of the growth represents the investment by institutions of larger portions of their new money in stocks.

Although, as table VII-1 indicates, the stockholdings of all institutional investors increased significantly, the increased share of the market supply represented by institutional holdings is due almost entirely to the increase of the stockholdings of investment companies and noninsured private pension funds. Their combined share of outstanding corporate stock increased from less than 6 percent in 1955 to 12 percent in 1965, while the share of the market supply of outstanding corporate stock held by the other financial institutions remained about the same in 1955 and 1965.

Since 1950, investment companies (open-end and closed-end) have been the largest institutional stockholders. They increased their stockholdings from \$4.3 billion at yearend 1950 to \$41.1 billion at the end of 1965. Noninsured private pension funds, the second largest institutional holder of stock, increased their stockholdings even more—from \$1.1 billion at the end of 1950 to \$39.7 billion at yearend 1965. The substantial increase in corporate stockholdings of pension funds

² The Commission staff estimated that at the end of 1965 these holdings were as follows:

[In billions of dollars]

	Assets	Stockholdings
Common trust funds.....	7.5	3.5
Foundations.....	19.2	14.1
College endowments.....	13.9	8.4
Personal trust funds.....	167.5	71.9

reflects both increased asset size as well as increased emphasis on stock investments. In 1955 only one-third of pension fund assets were invested in corporate stock. By the end of 1965 pension funds had over 55 percent of their \$71.4 billion of assets (market value) in such equity investments.

2. The volume of institutional trading

The growing importance of institutional investors also is evident from an examination of their participation in securities transactions. Table VII-2 shows for each year from 1953 through 1965 purchases and sales of common stock by four types of institutional investors — private noninsured pension funds, mutual funds, life insurance companies, and property and casualty insurance companies.³ It shows that in 1965 institutional purchases and sales of common stock reached the highest volume ever recorded. Although 1965 also was a year of record trading activity in the securities markets generally, institutional trading in recent years has increased at a much greater rate than overall trading volume. While the \$89.2 billion volume of stock sales on the major exchanges in 1965 was more than double the \$37.8 billion of sales in 1955, purchases of common stock by noninsured private pension funds during this period rose more than four times, purchases by mutual funds more than five times, and purchases by life insurance companies more than three times. During the same period, sales of common stocks by noninsured private pension funds increased nearly eight times, sales by mutual funds over six times, and sales by life insurance companies more than two times.

TABLE VII-2.—Purchases and sales of common stock ^a by selected financial institutions, 1953-65
[In millions of dollars]

	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
Noninsured private pension funds:													
Purchases.....	560	815	975	1,145	1,340	1,730	2,310	2,610	3,440	3,205	3,760	4,375	5,585
Sales.....	80	165	290	265	250	400	570	670	1,170	995	1,555	2,105	2,560
Mutual funds:													
Purchases.....	635	910	1,085	1,545	1,695	2,435	2,890	2,785	3,955	3,695	4,010	4,770	6,530
Sales.....	315	605	720	1,025	995	1,455	1,905	2,000	2,755	2,720	3,235	3,885	5,165
Life insurance companies:													
Purchases.....	115	245	230	225	255	275	360	385	605	555	575	790	970
Sales.....	35	125	175	215	205	220	240	220	370	240	405	455	575
Property and casualty insurance companies:^b													
Purchases.....										675	710	765	760
Sales.....										475	600	660	700

^aIncludes only cash transactions; g to :ref stock ivi or spli and exclude exchanges of the security for another p rslu t to conversion rights, mergers, or p of reor nization

^bNot available until 196

Note.—Figures have been rounded to nearest \$5 million.

Sources: Noninsured private pension funds and property and casualty insurance companies, SEC; mutual funds, Investment Company Institute; life insurance companies, Institute of Life Insurance with estimates by SEC for years 1963-65 for sales

stitutional stock trading tend to be concentrated in NYSE listed stocks.⁴ Although institutional trading has increased in all of the

³Data is incomplete prior to 1951.

⁴At the end of 1961, NYSE listed stocks accounted for approximately 78 percent of all stock held in institutional portfolios. NYSE Report on Institutional Shareownership (1964) 33. Other more recent data though incomplete indicate that this proportion was as high or higher at the end of 1965.

markets for NYSE listed securities, the nature and extent of the impact varies among these markets.

(a) *The New York Stock Exchange*

The New York Stock Exchange's transaction studies conducted periodically since 1952 show that the trading activities of institutional investors are accounting for a gradually increasing share of trading volume on that exchange. In the study for March 10, 1965, the trading volume of institutional investors and intermediaries was the highest recorded since the transaction studies began. These investors accounted for an estimated 31.4 percent of the total round- and odd-lot share volume during that day.⁵

(b) *The regional exchanges*

Institutional investors also have become increasingly important to regional exchanges. Although trading volume on regional exchanges is small in relation to NYSE volume, in recent years it has been increasing at a rate faster than that of the NYSE. For the most part, the increase in trading volume is limited to NYSE listed stocks which are also traded on regional exchanges.

Table VII-3 shows the trading volume at 5-year intervals for the period 1950-65 on the NYSE and the Amex and on major regional stock exchanges. In each year, regional exchange trading volume as well as volume on the NYSE and the Amex increased substantially. However, in 1955 by comparison to 1950, the increase in regional exchange volume lagged somewhat behind that of the NYSE and the Amex. Trading on both of these exchanges increased by approximately 75 percent, while regional exchange volume increased by 60.3 percent. In 1960 by comparison to 1955, the increase of 22.3 percent in regional exchange volume was ahead of the 15.9 percent increase on the NYSE but far behind the 61 percent increase on the Amex.

TABLE VII-3.—Market value of stock sales effected on the New York Stock Exchange, the American Stock Exchange, and the major regional stock exchanges, 1950-65

	Millions of dollars				Percent increase (decrease)		
	1950	1955	1960	1965	1950-55	1955-60	1960-65
New York Stock Exchange.....	18,725	32,745	37,960	73,200	74.9	15.9	92.8
American Stock Exchange ^a	1,481	2,593	4,176	8,612	75.1	61.0	106.2
Major regional exchanges:							
Boston Stock Exchange.....	244	295	272	382	20.9	(7.8)	40.4
Cincinnati Stock Exchange.....	24	33	35	72	37.5	6.1	105.7
Detroit Stock Exchange.....	86	150	155	630	74.4	3.3	306.4
Midwest Stock Exchange ^b	513	931	1,235	3,086	81.5	32.6	149.9
Pacific Coast Stock Exchange ^c	477	719	881	2,173	50.7	22.5	146.6
Philadelphia-Baltimore-Washington Stock Exchange.....	200	339	471	1,009	69.5	38.9	114.2
Pittsburgh Stock Exchange.....	24	48	28	48	100.0	(41.7)	71.4
Total major regional exchanges.....	1,568	2,515	3,077	7,400	60.3	22.3	140.5
Total major exchanges.....	21,774	37,853	45,213	89,212	73.8	19.2	97.3

^a 1950 figures are for the New York Curb Exchange which later changed its name to the American Stock Exchange.

^b 1950 and 1955 figures include the New Orleans Stock Exchange which was later merged into the Midwest Stock Exchange.

^c 1950 and 1955 figures are for the Los Angeles Stock Exchange and the San Francisco Stock Exchange which later merged to become the Pacific Coast Stock Exchange.

⁵ NYSE Public Transaction Study, Mar. 10, 1965, p. 5.

Moreover, two of the regional exchanges experienced a loss of trading volume during this period and two others increased their volume only slightly.

In 1965 by comparison to 1960, however, the 140.5 percent increase in regional exchange trading volume substantially exceeded the respective 92.8 percent and 106.2 percent increases of the NYSE and the Amex. Every major regional exchange increased its volume substantially. By far, the greatest increase was the 306.4 percent recorded by the Detroit Stock Exchange.

In a number of dually traded NYSE stocks, regional exchange activity accounts for a significant portion of total volume including the third market volume.⁶ Table VII-4 shows for 50 selected NYSE listed stocks total trading volume on the NYSE, on the regional exchanges and in the third market during the first 6 months of 1965. Regional exchange volume in these stocks ranged as high as 23.6 percent of total volume for 2 stocks, represented 20 percent or more of total volume for 8 stocks, and amounted to 10 percent or more of total volume for 42 stocks. It included 2 million shares of American Telephone & Telegraph Co. and 1.5 million shares of General Motors Corp., equivalent to 22.6 percent and 18.5 percent, respectively, of total volume in these stocks.

In large measure, the increase in regional exchange volume results from the increased utilization of those exchanges to effect large block transactions for institutional investors. Since most such transactions are prearranged, the exchange floor is used merely to "cross" the transaction rather than to locate a buyer or seller? Although there are several possible reasons for using regional exchanges rather than the NYSE to execute such transactions,⁷ the most important stems from mutual fund reciprocal and give-up practices. As noted in chapter IV, NYSE rules prohibit members of that exchange from giving to non-members any part of the cash paid for brokerage commissions on transactions executed there. By utilizing regional exchanges for executing fund transactions in NYSE listed securities, mutual fund managers are able to direct that a portion of the commission be paid as extra compensation for sales of fund shares to dealers who are regional exchange members and, under the rules of most regional exchanges, to those who are NASD members.⁹

(c) *The third market*

As noted in chapter IV, an important segment of the national securities markets is the over-the-counter market in NYSE listed stocks.¹⁰ The Special Study estimated that third market trading in NYSE stocks had grown from an estimated \$85 million volume in 1941 to \$2 billion in 1961, 3.8 percent of NYSE volume." Since

⁶ Third market volume data based on staff study.

⁷ See pp. 170-172 supra.

⁸ On a regional exchange there is less likelihood that the cross will be upset by the specialist or by orders on the specialist's book which must be given precedence. Moreover, the rules of several regional exchanges, unlike those governing transactions on the NYSE, permit members to deal on the exchange for nonmember broker-dealers without charging them minimum commission rates. Also if one side to a transaction is represented by a dual member of the NYSE and a regional exchange and the other side by a regional-only member, it is likely that the transaction will be executed on the regional exchange, in order that the regional-only member can obtain a commission on the transaction.

⁹ See pp. 169-172, supra.

¹⁰ See pp. 159-161, supra.

¹¹ Special Study, pt. 2, 873.

TABLE VII-4.—Volume on New York Stock Exchange, regional stock exchanges, and the third market for 60 selected New York Stock Exchange listed stocks,^a for the 6 months ended June 30, 1966

Stock	Total sales (shares)	Round-lot sales on NYSE		Sales on regional exchanges ^b		Third market sales	
		Number of shares	As percent of total sales	Number of shares	As percent of total sales	Number of shares	As percent of total sales
Industrials:							
Alcan Aluminium, Ltd.....	2,161,618	1,847,200	85.5	129,804	6.1	184,615	8.5
American Photocopy Equipment Co.....	4,435,486	4,067,500	91.7	321,682	7.3	46,307	1.0
Ampex Corp.....	3,150,184	2,702,800	85.8	424,925	13.5	22,459	.7
Brunswick Corp.....	3,706,857	3,149,400	85.0	496,860	13.4	60,597	1.6
Burroughs Corp.....	4,220,601	3,413,800	80.9	676,118	18.0	130,683	3.1
Caterpillar Tractor Co.....	2,367,166	1,805,200	76.3	314,485	13.3	247,481	10.4
Celanese Corp. of America.....	1,259,384	945,600	75.1	152,204	12.1	161,580	12.8
Chrysler Corp.....	8,762,954	7,360,600	84.0	1,100,030	12.6	302,324	3.4
Columbia Broadcasting System.....	3,300,756	2,766,700	83.8	459,945	13.9	74,114	2.3
Communications Satellite Corp.....	2,856,002	2,438,800	85.4	332,856	11.6	84,346	3.0
Dow Chemical Co.....	1,193,456	878,600	73.6	158,684	13.3	156,175	13.1
Eastman Kodak Co. (old and new).....	1,327,924	992,400	74.7	110,064	8.3	225,462	17.0
Firestone Tire & Rubber Co.....	804,812	568,800	70.7	125,239	15.6	110,779	13.7
Ford Motor Co.....	6,347,154	5,080,200	80.0	886,070	14.0	380,884	6.0
General Electric Co.....	2,709,592	2,140,500	79.0	354,264	13.1	214,826	7.9
General Motors Corp.....	7,941,856	5,958,300	75.0	1,469,773	18.5	513,786	6.5
General Telephone & Electronics Corp.....	3,473,856	2,708,300	78.0	577,294	16.6	188,265	5.4
Goodyear Tire & Rubber Co.....	1,426,974	946,600	66.3	298,154	20.9	182,220	12.8
Gulf Oil Corp.....	2,113,025	1,656,700	78.4	283,889	13.4	172,433	8.2
International Paper Co.....	3,652,572	2,532,800	69.3	831,117	22.8	288,653	7.9
Kennecott Copper Corp.....	1,116,373	873,600	78.3	141,043	12.6	101,730	9.1
Minnesota Mining & Manufacturing Co.....	1,609,421	1,223,300	76.0	246,717	15.3	139,408	8.7
Mobil Oil Corp.....	1,461,172	1,035,300	70.8	272,754	18.7	153,116	10.6
Monsanto Chemical Co.....	1,324,812	1,054,700	79.6	157,802	11.9	112,310	8.5
Montgomery Ward & Co., Inc.....	1,992,851	1,367,100	68.6	470,147	23.6	155,604	7.8
National Steel Corp.....	977,763	715,200	73.1	91,820	9.4	170,743	17.5
Pan American World Airways, Inc.....	4,604,317	3,851,200	83.6	625,908	13.6	127,209	2.8
Procter & Gamble Co.....	1,363,296	957,600	70.2	287,168	21.1	118,527	8.7
Radio Corp. of America.....	8,511,096	7,106,700	83.5	1,180,665	13.9	223,734	2.6
Reynolds Metals Co.....	3,383,742	2,659,300	78.6	461,485	13.6	262,960	7.8
Royal Dutch Petroleum Co.....	2,849,624	2,163,400	75.9	362,874	12.7	323,355	11.4
Sears, Roebuck & Co. (old and new).....	2,575,922	1,891,800	73.4	458,087	17.8	226,042	8.8
Sperry-Rand Corp.....	5,493,491	4,727,500	86.1	642,949	11.7	123,041	2.2
Standard Oil of California.....	2,010,132	1,406,900	70.0	403,019	20.0	200,214	10.0
Standard Oil of New Jersey.....	5,038,606	3,956,000	78.5	707,952	14.1	374,651	7.4
Texaco, Inc.....	3,273,662	2,518,800	77.0	564,150	17.2	190,712	5.8
Texas Gulf Sulphur Co.....	7,127,842	6,509,800	91.3	532,955	7.5	85,090	1.2
Unilever N.V.....	1,186,892	842,000	71.0	26,393	2.2	318,497	26.8
Union Oil of California.....	1,984,036	1,490,400	75.2	443,531	22.4	47,107	2.4
U.S. Steel Corp.....	4,590,696	3,302,100	71.9	816,780	17.8	471,818	10.3
Westinghouse Electric Corp.....	6,180,681	5,052,900	81.8	831,132	13.4	296,649	4.8
Weyerhaeuser Co.....	951,394	693,800	72.9	126,329	13.3	131,265	13.8
Utilities:							
American Telephone & Telegraph Co.....	9,080,456	6,119,100	67.8	1,043,517	22.6	867,841	9.6
Consumers Power Co.....	536,356	376,900	64.3	100,000	17.0	109,456	18.7
Florida Power & Light Co.....	878,766	654,800	74.5	105,915	12.1	118,051	13.4
Pacific Gas & Electric Co.....	1,376,387	880,300	64.0	325,738	23.6	170,349	12.4
Southern California Edison Co.....	1,076,592	797,900	74.1	159,372	14.8	119,321	11.1
United Gas Corp.....	1,553,206	1,326,800	85.2	86,179	5.5	145,224	9.3
Finance and Insurance:							
Heller (Walter B.) & Co.....	1,005,482	706,000	70.2	71,200	7.1	228,280	22.7
Western Bancorporation.....	1,231,281	734,900	59.7	201,807	16.4	294,574	23.9

^a Consists of the most active daily-traded NYSE stocks as measured by combined volume in the regional and over-the-counter markets.
^b The figures include odd lots except for the Midwest Stock Exchange.

1961, third market volume of trading in NYSE stocks has continued to grow, but in 1965 it was relatively less important, accounting for \$2.5 billion or 3.4 percent of the \$73.2 billion NYSE sales volume.¹²

Third market trading volume thus still amounts to only a small portion of trading volume on the NYSE and is less significant than regional exchange trading in NYSE stocks. Nevertheless, third market activity accounts for a significant portion of total trading in some of the more active stocks. In 3 of the 50 stocks listed in table VII-4 third market volume exceeded 20 percent of total volume. For 19 of the 50 stocks at least 10 percent of total trading volume during this period took place in the third market.

(d) *Secondary distributions*

Since investment companies and other institutional investors have accumulated large numbers of sizable holdings of individual securities as they have grown larger, it has become increasingly necessary for them to supplement or bypass entirely the ordinary channels of the trading markets when disposing of their portfolio securities.¹³

Secondary distributions are utilized to dispose of large blocks of securities when there is an absence of sufficient buying interest in the security by other large institutional investors, and when the size of the block, relative to the normal trading activity in the issue, makes it unlikely that the securities can be sold at or close to the price prevailing in the regular trading markets without the stimulus of extra selling effort and sales compensation. Secondary distributions may be used in conjunction with the regular trading markets with portions of the block sold in the exchange markets, portions in the third market and the balance through a secondary distribution. Most secondary distributions take place in NYSE securities. NYSE rules require that exchange approval be obtained before its members participate in such a distribution.

The Special Study found that secondary distributions off the exchange as well as other NYSE plans for disposition of large blocks of securities were assuming growing importance. From 1942 through 1955 the number of shares sold each year through all block distribution methods by all investors ranged from 2.5 million to 7.8 million.¹⁴ Since 1955, however, these methods have been utilized to sell larger numbers of shares, ranging from 7.2 million in 1957 to 28.7 million in 1965.¹⁵ While sales of NYSE stocks through secondary distribution and other block distribution methods amounted to less than 2 percent of the total share volume of that exchange during these years, the number of shares involved in individual secondary distributions is usually large in relation to regular trading volume in the stocks involved.¹⁶

¹² In 1965, third market sales of all stocks traded on national securities exchanges equalled \$2.6 billion or 2.9 percent of the \$89.2 billion of sales on all the exchanges.

¹³ Wharton Report 14.

¹⁴ The NYSE also has adopted several other special plans for sales of large blocks. The most popular of these is the exchange distribution plan. See NYSE Rule 393. Like a secondary distribution, an exchange distribution involves the active solicitation of prospective purchasers by the participants. Unlike the secondary distribution, the public orders accumulated in connection with an exchange distribution are "crossed" with the block on the floor of the exchange at a price within the prevailing bid and offer and the selling compensation paid by the seller is the equivalent of a double minimum commission or more. No commission is charged to buyers.

¹⁵ NYSE Report on Institutional Shareownership (1964) 39; NYSE Fact Book (1966) 20.

¹⁶ Special Study, pt. 2,845.

(e) Transactions in over-the-counter corporate securities

The securities of nearly all banks and insurance companies as well as those of many large industrial and utility companies are exclusively traded in the over-the-counter markets. Although institutional investors invest substantial amounts in these securities, data as to the aggregate holdings of over-the-counter securities by institutions are unavailable. However, one survey showed as of yearend 1965 that 475 investment companies (open-end and closed-end), whose combined assets were \$45 billion, owned \$517 million in stock of 50 industrial and utility companies, \$1.8 billion of 50 insurance company stocks and \$477 million of 25 bank stocks.¹⁷ And, of course, many investment companies also held other over-the-counter stocks.

Nor do available data show the total value of transactions in these markets or the relative proportions of all purchases and sales of such securities by institutional investors.¹⁸ The limited information available indicates only that mutual funds and other institutional purchasers are important participants in the over-the-counter securities markets.

3. Mutual funds as institutional investors

Mutual funds are similar to other types of institutional investors in that they represent relatively large concentrations of buying and selling power. However, in at least one significant respect they are unique as institutional investors. The inflow and outflow of capital to institutions such as pension funds and insurance companies generally are determined by contractual and actuarial arrangements—often long-term arrangements—and the decision to invest in securities is made not by the suppliers of the capital but by the institutions' professional managers. For mutual funds, on the other hand, the inflow and outflow of capital in large measure rests on the investment decisions of large numbers of public investors to commit their resources to the securities markets. Such decisions directly affect the capital inflow and outflow of mutual funds, virtually all of which are continuously seeking new capital through sales of shares and all of which are obligated to redeem outstanding shares at any time.

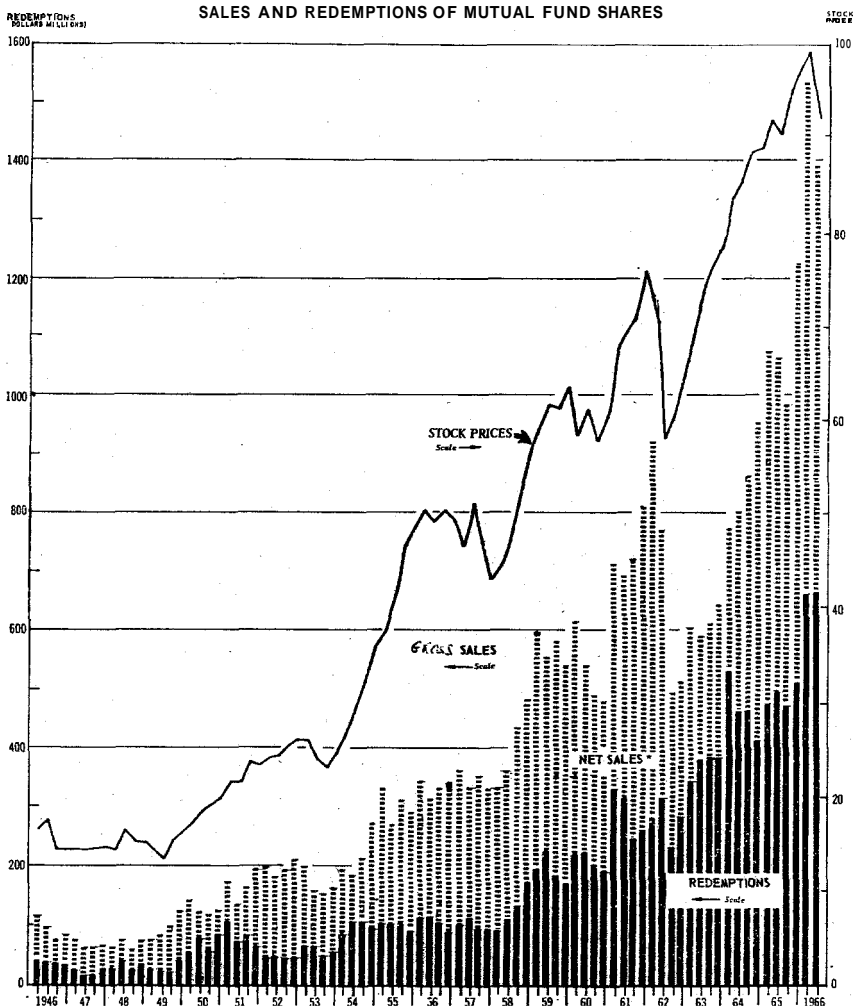
Thus, the net inflow of money to mutual funds is more closely geared to market fluctuations than that of other types of institutional investors. Chart VII-1, at page 284, *infra*, which shows the relationship between stock prices and sales and redemptions of fund shares since the end of 1945, indicates that during most of the post-World War II period mutual fund net inflow has generally followed cyclical movements in stock prices. The substantial upward trend of fund net inflow during this period reflects the willingness of public investors to participate in equity markets characterized by substantial and continued long-term price rises.

The continued inflow of new capital into mutual funds has been reflected in the increasing importance of the funds as institutional investors. During the 25-year period from 1940 to the end of 1965

¹⁷ Vickers *Over-The-Counter Favorites, An Analysis Ranking by Value the Over-Thecounter Stocks Most Popular With Professional Management*, 10th issue (Dec. 31, 1965).

¹⁸ The Special Study conducted a survey of all over-the-counter transactions on Jan. 18, 1962, which was believed to be a typical trading day. The data showed that transactions by public customers other than individuals, which group consisted primarily of institutions, accounted for 9 percent of the *number* of over-the-counter shares purchased and sold on that day, but for 21 percent of the *value* of shares of over-the-counter stocks traded. Special Study, pt. 2, pp. 543-544 and 732 (app. VII-A, table 9).

CHART VII-1



Sources: Sales and redemptions of mutual fund shares are quarterly data supplied by the Investment Company Institute and exclude miscellaneous share issues from sales, stock prices are monthly averages of daily figures for the 500 common stocks in the Standard & Poor's composite index.
 * (Net sales equal total sales less redemptions.)

mutual funds increased their holdings of common and preferred stock from \$400 million at the end of 1940, or 0.05 percent of the estimated market value of all outstanding corporate stock, to \$33.5 billion, or 5 percent of the value of all corporate stock outstanding at the end of 1965.¹⁹ Mutual funds have also increased their relative share of institutional stockholdings from 9 percent in 1940 to approximately 32 percent of all such holdings at the end of 1965.

Mutual funds have the highest portfolio turnover rates of all institutional investors. Table VII-5 shows for the period 1960 through 1965 the turnover rates of common stocks on the NYSE and those

¹⁹ See table VII-1, p. 276, supra.

held by open-end investment companies, noninsured private pension funds and insurance companies. During 1965 the turnover rate of open-end companies was 18.7 percent, exceeding for that year and for each other year during the period the turnover rates of all common stocks listed on the NYSE. Portfolio turnover rates of open-end investment companies also have been consistently more than double those of noninsured private pension funds and of property and casualty life insurance companies. In each year during the period they also exceeded by a wide margin the turnover rates of life insurance companies.

TABLE VII-5.—Annual turnover rates ^a of common stockholdings by selected financial institutions and on the New York Stock Exchange, 1960-65

[In percent]

	1960	1961	1962	1963	1964	1965
Noninsured private pension funds.....	4.5	6.2	4.6	6.5	7.0	7.1
Open-end investment companies.....	14.7	16.4	14.7	16.6	16.8	18.7
Life insurance companies.....	7.3	10.2	5.9	9.3	9.1	10.0
Property and casualty insurance companies.....	(b)	(b)	5.9	7.2	6.9	6.5
New York Stock Exchange ^a	12.4	15.2	12.9	14.5	13.6	14.5

^a

^b

For this reason, mutual funds figure more prominently in the trading market than the dollar value of their holdings would indicate. The NYSE study of institutional trading during five days in October 1963 showed that mutual funds accounted for approximately 18.6 percent of institutional volume during that period.²⁰ Although private noninsured pension funds are larger holders of equity securities than mutual funds and in recent years have been heavier net purchasers, their share of institutional volume during the five days studied was 17 percent.

Mutual funds also tend to engage in larger size transactions than do other institutions. The NYSE's studies of institutional trading indicate that the average size of institutional transactions on that exchange increased from 200 shares in 1960 to 256 shares in 1963.²¹ The increase was largely due to mutual funds. Although the average size of transactions by closed-end investment companies, insurance companies, commercial banks and trust companies had also increased from that of the 1960 study, the increase in the average size of mutual fund transactions in the 1963 study was much greater. The average mutual fund transaction amounted to 550 shares in the 1960 study, but in the 1963 study it had increased to 1,148 shares—more than double that of any other class of institutional investor except closed-end investment companies.²²

²⁰ NYSE Report on Institutional Shareownership (1964) 56.

²¹ Id. at 48-49. The term "transaction" as used in the studies referred to all executions of a single order carried out on one day. Execution of a single order on different days was treated as more than one transaction.

²² Id. at 48. Closed-end companies' transactions averaged 619 shares in the 1963 study as compared with an average 444 shares during the 1960 study.

Mutual funds have been largely responsible for the increased volume of regional exchange transactions in NYSE listed securities. They tend to use regional exchanges to a far greater extent and to trade in the third market considerably less than other institutional investors, since the third market, unlike the regional exchanges, does not offer opportunities for using brokerage as extra compensation for sales of mutual fund shares.²³

Mutual funds also account for a large portion of secondary distributions. In 1965, 67 of the 116 secondary distributions of NYSE listed stocks involved dispositions of securities by mutual funds. Eight funds accounted for 42 of these distributions. One fund alone effected 10 secondary distributions during that year, while three funds belonging to one complex accounted for 15. In most instances, the secondary distributions were used to dispose of securities which had been held in fund portfolios for relatively long periods of time. However, all of the securities sold in five of the distributions and at least a portion of the securities sold in 12 distributions had been acquired within the same quarter or the two quarters prior to the distribution.

C. MUTUAL FUND IMPACT ON STOCK MARKET MOVEMENTS

1. Introduction

The growth of the mutual fund industry during the post-World War II period has taken place in a general economic climate that has been particularly conducive to equity investments. Expansions have been strong and recessions relatively mild. An inflationary psychology has prevailed through most of the period and expectations of capital gain through future growth of corporate earnings have played an increasingly important part in determining stock prices.

Thus, the stock market during most of this period has been characterized by long-term rising price movements and at least until 1962 by rising price-earnings ratios. Under these conditions, the primary investment of mutual fund portfolios—common stocks—appreciated substantially more than most other types of investment, and the flow of individual savings into the funds increased steadily under the impetus of highly effective selling efforts of the industry.

An assessment of the impact of mutual funds on the stock market is complicated by the multitude of forces affecting that market at any given point in time and by the fact that most of the available evidence is in the form of aggregate data or data covering very short time periods. Separating out the effect of mutual fund activity with any precision on the basis of the limited data available is therefore impossible. Moreover, the long-run impact of mutual funds on stock prices may be different from that over short-run or intermediate term (cyclical) periods. There also are difficulties simply with the definition of "impact." No one would argue that the activities of mutual funds or other institutional investors should not have any effect on the floating supply or price movements of common stock just as do the activities of other investors. However, because of their sheer size and their prominence in the market, the activities of mutual funds as well as of other institutional investors can have a much more profound effect on the volume of transactions and on market prices,

²³ See pp. 175-177, *supra*.

not only directly through their own buying and selling programs, but also indirectly through the effects of their activities on the investment decisions of others. For these reasons, despite the absence of comprehensive data, it is appropriate and, indeed highly important, to determine on the basis of the Wharton Report's findings and the other available evidence whether the impact of mutual funds on the stock markets merits serious concern.

2. *Mutual funds in rising markets*

The Wharton Report examined the impact of mutual funds on stock prices over a 5¼-year period from the beginning of 1953 through the first nine months of 1958, a period generally characterized by rising stock prices. Although the Wharton Report noted that the long-run impact of mutual funds on price movements in the stock market was difficult to measure in precise quantitative terms, it found evidence that the substantial increase in the funds' net purchases of common stock was one of the factors that had contributed significantly to the increase in the general price level of stocks during the period.²⁴

The Wharton School's conclusion that there was a mutual fund market impact was based on three premises: First, though a substantial portion of the money devoted towards the purchase of mutual fund shares might otherwise be invested in the stock market, the mutual fund industry has been successful in tapping sources of money not heretofore channeled into equity securities. The infusion into the stock market of this additional capital increases the demand for stock and causes prices to rise. Second, the rise in stock prices thus induced arouses the interest of other classes of investors who, in turn, invest additional capital in the market and add to the demand for equity securities. Third, the selling efforts of the mutual fund industry, which tend to emphasize the advantages of stock ownership, generate additional investor interest in the stock markets."

The Wharton Report's conclusions with respect to mutual fund impact on market price movements corresponded to those contained in a report of the staff to the Senate Committee on Banking and Currency covering the impact of institutional investors on the stock market during the period January 1953 to October 1955. That study also concluded that mutual funds contributed to rising market prices during this period, pointing out that net acquisitions by mutual funds were greatest "in the first quarter of 1954 when the price rise was gathering momentum, in the fourth quarter when the price rise was at its sharpest, and in the first quarter of 1955 when stock prices were at their 16-month peak."²⁵

Since 1955, stock market prices have continued to rise on balance. Investment companies and other institutional investors, as substantial net purchasers of stocks during this period, have contributed to this trend. Table VII-6 shows for the period 1955 through 1965 the net purchases of common and preferred stock by investment companies as well as other financial institutions. During every year of this period investment companies were net purchasers, increasing—though not consistently—from \$0.5 billion in 1955 to \$1.4 billion in 1965.

²⁴ Wharton Report 23.

²⁵ *Id.* at 361.

²⁶ "Institutional Investors and the Stock Market, 1953-55," Staff Report to the Senate Committee on Banking and Currency, 84th Cong., 2d sess. (1956), p. 16.

TABLE VII-6.—*Net acquisitions of preferred and common stock issues^a by selected financial institutions and others, 1955-65*

[In billions of dollars]

	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
1. Net acquisitions by—											
(a) Noninsured private pension funds.....	0.7	0.9	1.1	1.4	1.7	1.9	2.3	2.2	2.2	2.2	3.1
(b) Investment companies:											
For cash.....	.5	.7	.8	1.2	1.1	1.0	1.6	1.1	.8	1.0	1.4
Other ^b.....							.5	-.2	.1	-.3	-1.2
(c) Life insurance companies.....	.1	-.1	(c)	.1	.2	.3	.4	.4	.2	.5	.7
(d) Property and casualty insurance companies.....	.2	.3	.2	.1	.3	.3	.3	.2	.2	.2	.2
(e) Other institutions ^d.....	.1	.1	.1	.1	(e)	.2	.3	.4	.5	.5	.6
(f) Total (items 1(a) through 1(e)).....	1.6	1.9	2.3	2.9	3.3	3.6	5.2	4.0	3.9	4.1	4.8
2. Net acquisitions by others ^e (item 3 less item 1(f)).....	-.3	-.6	-.4	-.8	-.9	-1.9	-2.6	-3.3	-4.1	-2.7	-4.5
3. Net new domestic issues.....	1.9	2.5	2.7	2.1	2.4	1.7	2.6	.7	-2.2	1.4	(c)

^a Excludes net shares issued by investment Companies.^b Reflects net effect of such transactions as the acquisition through tax-free exchange of shares, distribution of stock either through liquidation, e.g., M. A. Hanna Co., or under antitrust order, e.g., General Motors-Christians Securities.^c Less than \$50 million.^d Includes State and local trust funds, mutual savings banks, and fraternal organizations.^e Includes foreigners, individuals, personal trust funds, nonprofit institutions, and certain large publicized investments by nonfinancial corporations.^f Sale of \$340 million of General Aniline stock by the Attorney General is not included in net new issues; therefore, item 3 does not represent the sum of items 1(f) and 2 in 1965.

NOTE.—Figures may not add to totals because of rounding.

Although the Wharton Report focused mainly on the market impact of mutual fund growth, it recognized that the steadily increasing infusion of capital into the equity markets by pension funds and other institutional investors also played a major role in raising the level of stock prices during the 1953-58 period. Since 1955 noninsured private pension funds have overshadowed investment companies as net purchasers of corporate stock, substantially increasing their net purchases from \$0.7 billion in 1955 to \$3.1 billion in 1965. For the entire period, their net purchases of stock almost doubled those of mutual funds and amounted to more than half of all institutional net stock purchases. Thus, it is likely that the pension funds have been an even more important factor than investment companies in this trend.

3. Mutual funds in declining markets

Since movements in stock prices during the post-World War II period have been characterized by a strong uptrend, opportunities to study the impact of mutual funds in declining markets have been limited to short-term and intermediate declines occurring against a background of economic, psychological, and institutional forces which have been directly or indirectly responsible for the long-term underlying trend. Under these circumstances the Wharton Report's examination of mutual fund impact on stock market prices during the period 1953-58 yielded relatively little evidence of their impact in declining markets. The report did point out, however, that within the relatively major periods of market decline (periods extending three to four months) occurring during 1953-58 there was no indication that

mutual funds had channeled a different proportion of their net inflow into common stocks than they did during the periods of market rise. For shorter periods of market decline (three months or less), the report found some evidence that a smaller share of fund net inflow had been funneled into common stocks. The decrease in the proportion of fund inflow going into common stocks during short market declines was more marked than the corresponding increase during market rises.²⁷ This conclusion of the Wharton Report corresponds to the finding of the staff report to the Senate Banking and Currency Committee that, "In 1953 (a year of generally declining prices) the open-end investment companies showed a downward trend in net purchases."²⁸

Since 1958, there have been three periods of sharply falling stock prices—February–June 1962, May–June 1965, and February–October 1966, all of which occurred during periods of rising economic activity and subsequent to extended periods of rising stock prices. Studies of mutual fund trading, although limited in scope, have been conducted for two of these periods.

The Special Study, in its examination of the 1962 market break, found that mutual fund stock purchases exceeded sales by only a small margin from September 1961 until March 1962. However, the net purchases of the funds accelerated from March 1962 through May 1962, and in this respect their activity was similar to other institutions. The funds did their heaviest buying in the week ending May 25, 1962, just before the "break." But during the week of the "break," while other institutions increased their purchases and reduced sales, the funds curtailed their purchases slightly and increased their sales by a substantial amount compared to the previous week.²⁹

During the second quarter of 1962 mutual funds increased substantially their purchases of common stock, but in the third quarter they became net sellers of common stock for the first time in the post-World War II period. During this quarter of 1962, stock prices rose sharply for part of this period but after Labor Day they fell back to their late June low.

During the 1966 market decline mutual funds again became net sellers of common stock during the third quarter. Their trading activity shifted from net common stock purchases of \$605 million in the first quarter of 1966 to net common stock sales of \$264 million in the third quarter.

The available data indicate that in the third quarters of both 1962 and 1966, the shift in the funds' position from net purchasers to net sellers of common stock was due more to the discretionary investment decisions of fund managers than to the pressures of shareholder redemptions.

Chart VII-1, page 284, indicates that, during the market break that took place during the first six months of 1962 and during the quarters prior to and following the break, sales of fund shares exceeded redemptions by a substantial margin for the industry as a whole, even though a minority of individual funds were from time to time in a net redemption status. The smallest margin occurred in February 1963, when redemptions amounted to 69 percent of sales.³⁰ During

²⁷ Wharton Report 366367.

²⁸ "Institutional Investors and the Stock Market, 1953-55," Staff report to the Senate Committee on Banking and Currency, 84th Cong., 2d sess. (1956) 16.

²⁹ Special Study, pt. 4, 845.

³⁰ Sales do not include capital gains distributions taken in shares.

the third quarter of 1966 when the funds were net sellers of common stock, sales of fund shares again substantially exceeded redemptions. While net sales of fund shares declined from \$876 million during the first quarter to \$562 million in the third quarter, the decline was substantially less than the change in mutual fund net common stock acquisitions between the first and the third quarters.

An examination of monthly redemptions for 107 funds during 1961-63 indicates that during the market decline the number of funds in a net redemption status did not increase substantially.³¹ The data showed that during 1961 the number of these 107 funds in a net redemption status declined from 34 in April to 15 in December, the month in which stock prices peaked. The number of funds in a net redemption status fluctuated between 15 and 21 through May 1962, and in May, the fifth month of decline in stock prices, only 17 of these 107 funds had redemptions exceeding sales. During June, the last month of the 1962 market decline, the number of funds in a net redemption status rose to 24, but it was still below the level prevailing in the spring of 1961. By the end of 1962, the number in a net redemption status had risen to 32, edging up in succeeding months to as high as 41 in June 1963.

The only evidence on the behavior of mutual fund investors in an extreme and extended market decline pertains to the 1929 decline. A Commission study of the experience of 49 open-end companies during the period from 1927 to 1936 showed that redemptions exceeded sales in only two quarters (one in 1931 and the other in 1932) and then only by small amounts.³² However, applicability of that experience to the mutual fund industry of today may be of limited value.

4. Mutual fund impact on markets for particular securities

(a) Price impact

The Wharton Report noted that during the period 1953-58 the market activity of mutual funds had a more significant impact on prices of individual securities than on price movements in the stock market as a whole. The report noted that the 30 common stocks most favored by the funds during this period " * * on the average rose considerably more in price than the stock market as a whole."³³ Analysis of monthly price movements for the 30 stocks during the period 1953-58 indicated "a significant positive correlation between market prices and preceding fund net purchases."³⁴ Moreover, the

³¹ The 107 funds accounted for more than 90 percent of industry assets at the end of 1960. The number in a net redemption status (redemptions exceeding sales) were:

	1961	1962	1963
January.....	20	21	29
February.....	26	15	31
March.....	34	21	32
April.....	34	16	34
May.....	30	17	36
June.....	23	24	41
July.....	18	22	32
August.....	22	28	36
September.....	21	33	40
October.....	17	30	41
November.....	18	31	39
December.....	15	32	26

³² Investment Trust Study, pt. 2, pp. 242-243.

³³ Wharton Report 22.

³⁴ *Id.* at 384.