488

INVESTMENT POLICIES OF PENSION FUNDS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-FIRST CONGRESS

SECOND SESSION

APRIL 27, 28, 29, AND 30, 1970

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INVESTMENT POLICIES OF PENSION FUNDS

MONDAY, APRIL 27, 1970

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10 a.m., in room S-407, the Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representatives Griffiths, Widnall, and Conable; and Senator Javits.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling, economist for the minority.

Chairman GRIFFITHS. The Subcommittee on Fiscal Policy will come to order.

Pension funds—both private and public—are one of the major avenues through which savings of our people are channeled to investment—both public and private. As one of our witnesses today suggests, this institutional intermediary is a source of added investment funds because it gives our citizens an incentive—which might not otherwise be present—to continue to put their private and individual resources into regular savings rather than into consumption, while the pension funds provide a base for their old-age living requirements. In other words, total savings of the people are increased, and therefore, hopefully, total investment can be increased, contributing to the strength of the economy.

I need not dwell on the facts, but I would like to bring out the importance of this subject as critical to the overall savings-investment process and hence to the potential improvement of our domestic well-being. Today, public and private pension funds own $240 billion of assets, well over double the book value of assets owned less than a decade ago. Private funds, insured and uninsured—but not counting regular life insurance—now account for roughly $130 billion, compared with $50 billion at the start of the 1960's. Public funds—Federal and those for State and local employees—currently amount to over $112 billion, just about double that of a decade ago.

For the record I should like to include two tables from the SEC release of April 20, 1970, showing (table 1) the assets of private noninsured pension funds, and (table 2) the assets of all private and public pension funds.

(Tables 1 and 2 referred to by Chairman Griffiths for inclusion in the record follow:)

TABLE 1.—ASSETS OF PRIVATE NONINSURED PENSION FUNDS

[Book value, in millions of dollars; figures may not add to totals due to rounding; includes funds of corporations, nonprofit organizations and multiemployer and union plans]

Annual	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969[1]
Cash and deposits	550	660	710	770	890	940	900	1,320	1,640	1,590
U.S. Government securities	2,680	2,720	2,920	3,050	3,070	3,100	2,610	2,170	2,540	2,590
Corporate and other bonds	15,700	16,880	18,100	19,560	21,210	22,700	24,580	25,500	26,160	26,640
Preferred stock	780	760	750	710	650	750	790	980	1,320	1,740
Common stock	10,730	13,340	15,730	18,120	20,840	24,450	28,340	33,830	40,260	45,960
Mortgages	1,300	1,560	1,880	2,220	2,750	3,320	3,810	3,940	3,910	4,010
Other assets	1,400	1,590	1,800	2,120	2,510	2,820	3,430	4,110	4,450	4,740
Total assets	33,140	37,510	41,890	46,550	51,910	58,090	64,470	71,840	80,280	87,240

Quarterly	1967		1968				1969			
	3d quarter	4th quarter	1st quarter	2d quarter	3d quarter	4th quarter	1st quarter	2d quarter	3d quarter	4th quarter
Cash and deposits	1,050	1,320	1,120	1,290	1,500	1,640	1,240	1,640	1,490	1,590
U.S. Government securities	2,180	2,170	2,400	2,390	2,330	2,540	2,600	2,480	2,600	2,590
Corporate and other bonds	25,420	25,500	25,830	25,900	26,140	26,160	26,010	26,080	26,530	26,640
Preferred stock	940	980	1,020	1,250	1,210	1,320	1,460	1,570	1,710	1,740
Common stock	32,460	33,830	35,210	36,810	38,640	40,260	41,760	43,350	44,140	45,960
Mortgages	3,930	3,940	3,950	3,910	3,920	3,910	3,940	3,910	3,970	4,010
Other assets	3,780	4,110	4,190	4,270	4,350	4,450	4,360	4,530	4,570	4,740
Total assets	69,760	71,840	73,720	75,710	78,090	80,280	81,280	83,560	85,010	87,240

[1] Preliminary.

Source: U.S. Securities and Exchange Commission, release No. 2437, "Private Noninsured Pension Funds 1969," April 20, 1970.

TABLE 2.—ASSETS OF ALL PRIVATE AND PUBLIC PENSION FUNDS

[Book value, in billions of dollars; figures may not add to totals due to rounding]

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969 [1]
Private	52.0	57.8	63.5	69.9	77.2	85.4	93.9	103.9	115.3	126.2
Insured pension reserves	18.8	20.2	21.6	23.3	25.2	27.3	29.4	32.0	35.0	[2] 39.0
(Separate accounts, included above) [3]					.1	.3	.6	1.2	2.2	(4)
Noninsured pension funds [5]	33.1	37.5	41.9	46.6	51.9	58.1	64.5	71.8	80.3	87.2
Public	56.4	59.3	61.4	65.0	69.5	72.8	80.4	90.3	98.4	111.3
State and local	19.6	22.0	24.5	26.9	29.7	33.1	37.1	41.7	46.0	52.0
Federal:										
Federal old-age and survivors insurance	20.3	19.7	18.3	18.5	19.1	18.2	20.6	24.2	25.7	30.1
Federal disability insurance	2.3	2.4	2.4	2.2	2.0	1.6	1.7	2.0	3.0	4.1
Civil service retirement and disability program [6]	10.4	11.4	12.5	13.5	14.7	15.9	17.0	18.1	19.4	20.8
Railroad retirement	3.7	3.7	3.7	3.8	3.8	3.9	4.1	4.2	4.2	4.3
Total private and public	108.4	117.1	124.9	134.8	146.6	158.2	174.4	194.2	213.6	237.6

[1] Preliminary.
[2] Estimated.
[3] Separate accounts of life insurance companies, set up for specific pension plans, allow greater investment latitute than is permissible under state laws for general life insurance assets.
[4] Not available.
[5] Includes funds of nonprofit organizations and multiemployer plans.
[6] Includes foreign service retirement and disability trust fund.

Source: SEC, Apr. 20, 1970, release.

Chairman GRIFFITHS. The tables shown are most striking. Table 1 shows the striking expansion of private noninsured funds. Recognizing the phenomenal expansion on an overall basis, the absolute shift into common stocks is even more striking. These noninsured private pension funds owned $46 billion of such assets at the end of 1969 compared with less than $11 billion in 1960. On the other hand, these funds—again from table 1—hold no more of their assets in U.S. Government securities than they did less than a decade ago. These same funds have increased their mortgage holdings, but such assets are still a minor portion of their portfolios.

The value of private pension funds' assets has shown the most explosive growth in the last decade, but this growth has been more than matched by the growth of State and local pension funds, whose assets grew from less than $20 billion in 1960 to $52 billion last year. The Federal OASDI fund, which actually declined a little in the first half of the decade has been steadily climbing since 1965. And the Federal civil service program, while growing less than that of the State and local programs, has also shown an impressive growth.

At this point I am introducing four tables for the record from another release from the SEC, dated April 13, 1970. This release highlights an especially important phenomenon affecting one of our most important financial markets—the stock market. The staff informs me that big institutional investors now account for over half of the activity on the "big board" (NYSE), far and away above their influence even a few years ago. I note that pension funds (private noninsured) bought on net balance—$5 billion of common stock last year—more than the total net new issues of such stock. Three other major institutional investor classes—mutual funds, life insurance companies, and property and casualty insurance companies—bought an additional $4.5 billion of common stocks.

Note from table 4 of this second release that even though there was an impressive expansion of $4.3 billion net new stock issues last year, institutional investors (including State and local pension funds) bought a net sum of $8 billion from individuals. And this phenomenon—institutional purchases of common stocks in excess of the total supply of stocks—has been going on for some time.

(Tables 1–4 referred to by Chairman Griffiths for inclusion in the record, follow:)

TABLE 1.—PURCHASES, SALES AND NET ACQUISITIONS OF COMMON STOCK

[Covers certain financial institutions and foreigners; data rounded to nearest $5,000,000 and may not add to totals]

	1962	1963	1964	1965	1966	1967	1968	1969
Private noninsured pension funds:								
Purchases	3,205	3,760	4,375	5,585	6,610	10,035	12,285	15,230
Sales	995	1,555	2,105	2,560	3,165	5,655	7,815	10,270
Net purchases	2,210	2,205	2,270	3,025	3,445	4,380	4,470	4,960
Open-end investment companies:								
Purchases	3,695	4,010	4,770	6,530	10,365	14,925	20,100	22,060
Sales	2,720	3,230	3,885	5,165	9,320	13,325	18,495	19,850
Net purchases	980	780	885	1,365	1,045	1,600	1,605	2,205
Life insurance companies:								
Purchases	545	530	750	985	1,110	1,685	2,930	3,575
Sales	245	410	465	600	825	875	1,725	2,165
Net purchases	300	120	285	390	285	805	1,205	1,415
Property and liability insurance companies:								
Purchases	675	710	765	770	900	1,165	2,245	3,780
Sales	475	600	780	965	825	980	1,645	2,880
Net purchases	200	110	−15	−190	80	185	600	900
Total:								
Purchases	8,125	9,015	10,660	13,875	18,985	27,810	37,565	44,650
Sales	4,435	5,800	7,235	9,285	14,135	20,835	29,680	35,165
Net purchases	3,695	3,215	3,425	4,585	4,850	6,975	7,885	9,485
Foreigners:[1]								
Purchases	2,260	2,725	3,075	3,720	4,740	8,035	13,120	12,430
Sales	2,150	2,525	3,425	4,135	5,075	7,275	10,850	10,940
Net purchases	110	200	−350	−415	−335	755	2,270	1,485

[1] Reflects trading in domestic issues including preferred stock.

Sources: Pension funds and property and liability insurance companies, SEC; investment companies, Investment Company Institute; life insurance companies, institute of life Insurance; foreigners, Treasury Department; GFC release, Apr. 13, 1970.

TABLE 2.—PURCHASES, SALES AND NET ACQUISITIONS OF COMMON STOCK—1969

[Covers certain financial institutions and foreigners; data rounded to nearest $5,000,000 and may not add to totals]

	1968, October–December	1969			
		January–March	April–June	July–September	October–December
Private noninsured pension funds:					
Purchases	3,525	3,695	3,875	3,380	4,280
Sales	2,200	2,375	2,795	2,390	2,710
Net purchases	1,325	1,320	1,080	985	1,575
Open-end investment companies:					
Purchases	6,535	5,195	6,295	4,985	5,590
Sales	5,570	5,315	5,195	4,640	4,700
Net purchases	965	−125	1,095	345	890
Life insurance companies:					
Purchases	1,000	875	925	750	1,030
Sales	615	460	510	560	635
Net purchases	385	415	415	195	395
Property and liability insurance companies:[1]					
Purchases	745	775	975	940	1,090
Sales	505	520	715	880	765
Net purchases	240	250	260	65	325
Total:					
Purchases	11,805	10,535	12,065	10,055	11,990
Sales	8,890	8,675	9,215	8,470	8,810
Net purchases	2,910	1,860	2,855	1,585	3,180
Foreigners:[2]					
Purchases	4,210	3,420	3,115	2,610	3,285
Sales	3,480	2,690	2,990	2,455	2,805
Net purchases	730	725	125	155	480

[1] Revised.
[2] Reflects trading in domestic issues including preferred stock.

Sources: Pension funds and property and liability insurance companies, SEC; investment companies, Investment Company Institute; life insurance companies, Institute of Life Insurance; foreigners, Treasury Department; SEC release, Apr. 13, 1970.

TABLE 3.—COMMON STOCK ACTIVITY RATES [1] (REVISED)

	Private noninsured pension funds	Open-end investment companies	Life insurance companies	Property and liability insurance companies	Total selected institution
Annual:					
1962	9.7	17.3	9.5	7.1	12.0
1963	11.0	18.6	10.5	7.8	13.1
1964	10.8	18.7	11.9	8.0	13.2
1965	11.3	21.2	13.6	8.2	14.5
1966	12.7	33.5	15.8	8.3	19.7
1967	18.2	42.3	18.5	9.9	25.8
1968	18.9	46.6	26.2	15.7	29.7
1969	22.3	49.8	28.1	26.1	32.0
Quarterly at annual rates:					
1962:					
1st quarter	(2)	16.4	8.2	(2)	(2)
2nd quarter	(2)	22.4	12.6	(2)	(2)
3rd quarter	(2)	18.9	8.1	(2)	(2)
4th quarter	(2)	17.1	10.7	(2)	(2)
1963:					
1st quarter	(2)	18.2	9.9	(2)	(2)
2nd quarter	(2)	20.1	9.5	(2)	(2)
3rd quarter	(2)	16.6	9.7	(2)	(2)
4th quarter	(2)	18.1	12.5	(2)	(2)
1964:					
1st quarter	11.9	21.9	11.0	7.3	14.6
2nd quarter	10.6	19.2	13.4	8.1	13.4
3rd quarter	10.7	16.6	9.9	6.7	12.1
4th quarter	9.6	15.8	12.7	8.9	11.8
1965:					
1st quarter	12.9	19.8	14.3	8.7	14.7
2nd quarter	11.7	20.3	15.9	7.9	14.4
3rd quarter	10.4	20.5	9.8	7.1	13.4
4th quarter	11.2	26.2	15.4	9.2	16.4
1966:					
1st quarter	12.9	31.7	16.6	10.5	19.5
2nd quarter	14.0	34.4	18.8	8.0	20.9
3rd quarter	11.7	35.1	14.3	6.9	19.4
4th quarter	13.3	34.9	14.0	9.0	20.2
1967:					
1st quarter	16.1	41.0	15.3	10.7	24.1
2nd quarter	17.9	39.4	20.6	9.9	24.8
3rd quarter	17.7	41.0	17.7	8.0	25.0
4th quarter	18.8	41.2	18.8	10.1	25.9
1968:					
1st quarter	17.4	38.6	17.8	12.1	24.4
2nd quarter	20.8	52.5	28.2	17.7	32.2
3rd quarter	19.2	45.6	26.2	14.8	28.7
4th quarter	20.3	55.7	33.3	19.4	33.8
1969:					
1st quarter	21.0	48.5	26.4	19.8	30.9
2nd quarter	23.2	55.6	28.1	26.1	34.9
3rd quarter	20.6	48.1	26.0	29.0	31.2
4th quarter	25.1	51.9	32.7	30.1	35.3

[1] The common stock activity rate is defined as average of purchases and sales divided by average market value of stockholdings, stated as an annual rate.
[2] Not available.

Source: SEC release, Apr. 13, 1970.

TABLE 4.—NET ACQUISITION OF PREFERRED AND COMMON STOCK ISSUES[1] BY FINANCIAL INSTITUTIONS AND OTHERS

[Billions of dollars]

	1961	1961	1962	1963	1964	1965[2]	1966	1967	1968	1969[3]
1. Net new stock issues	1.7	2.6	0.7	−0.2	1.4	(4)	1.2	2.3	−0.9	4.3
(a) New issues	2.7	4.5	2.3	1.9	3.7	3.2	4.2	4.7	6.1	9.3
(b) Less retirements	1.0	1.8	1.6	2.2	2.3	3.2	3.0	2.4	7.0	5.0
2. Net foreign stock issues	.1	.4	.1	−.1	−.2	−.3	−.2	.2	.3	.4
3. Net acquisitions by:										
(a) Private noninsured pension funds	1.9	2.3	2.2	2.2	2.2	3.1	3.5	4.6	4.8	5.4
(b) Investment companies:										
(1) For cash	1.0	1.6	1.1	.8	1.0	1.4	1.1	2.3	2.9	2.4
(2) Other[5]		.5	−.2	.1	−.3	−1.2	.1	.4		
(c) Life insurance companies	.4	.5	.4	.2	.5	.7	.3	1.1	1.4	1.6
(d) Property and liability insurance companies	.3	.3	.3	.2	(4)	−.1	.1	.3	.8	1.0
(e) State and local retirement funds	.1	.2	.2	.2	.3	.4	.5	.7	1.3	1.8
(f) Foreigners	.2	.3	.1	.2	−.3	−.4	−.3	.8	2.3	1.5
(g) Others[6]	−2.1	−2.6	−3.3	−4.2	−2.1	−3.9	−4.4	−7.6	−14.0	−9.0

[1] Excludes shares issued by investment companies. Figures may not add to totals because of rounding.
[2] Sale of $340,000,000 General Analine stock by Attorney General is not included in net new stock issues; however, net acquisition data do include this amount.
[3] Preliminary.
[4] Less than $50,000,000.
[5] Reflects net effects of such transactions as acquisition through tax-free exchange of shares and distribution of stock through liquidation (i.e., M. A. Hanna Co.) or antitrust order (i.e., G. M.-Christiana Securities).
[6] Includes financial institutions not classified above and individuals.

Source: SEC release, Apr. 13, 1970.

Chairman GRIFFITHS. Another vitally significant aspect of recent history has been the tendency of financial managers to turn over their stock holdings at a rapid pace. For example, mutual funds turned over their stock holdings at an average rate of 50 percent last year; in 1962, the rate was 17.3 percent. Pension funds had a lower rate, as should be expected, but I consider the average of 22 percent in 1969 as being on the high side. Back in 1962 the rate was less than 10 percent. I wonder if all this activity—and particularly the sharp increase—was really necessary to achieve the best performance. I hope you gentlemen will address yourselves late to this problem.

This morning we have with us three distinguished gentlemen who have spent the greater part of their lives in the study of the functioning of capital markets and related aspects we have under consideration today. Mr. Cohen, who will be delayed slightly, was Chairman of the Securities and Exchange Commission from 1964 to 1969, a member of the Commission since 1961, and, before that, a member of the staff almost continuously since 1942. Dr. White is currently professor of business administration at the Harvard Business School where he is engaged in teaching and research in the area of capital markets. He also served on the staff of the Commission on Money and Credit. Dr. Murray also has a long record of research and teaching in the workings of our capital markets, and currently, as executive vice president of the Teachers Insurance Annuity Association, is actively engaged in directing investment policies of that association. He has spent a great deal of his professional life in the study of pension funds.

Gentlemen, thank you for giving of your time and expertise to us this morning. Dr. White will start by giving us a review of

historical developments in the broad savings process, of which pension funds today are such an important part. Dr. Murray will follow with a more detailed examination of pension fund activities. Chairman Cohen will then give us his thoughts on some of the regulatory and legal problems which have arisen as institutional investors have burgeoned on the investment scene.

On Tuesday, Wednesday, and Thursday, we shall be looking in greater depth into the future of pension funds, legal and social aspects of pension fund investment policies, how pension funds have performed, and what might be done to improve performance.

Dr. White, you may proceed in your own way.

STATEMENT OF WILLIAM L. WHITE, PROFESSOR, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, HARVARD UNIVERSITY

Mr. White. At the outset, let me say it is a great honor and pleasure to talk with you this morning. The material I have prepared is too long to be read in its entirety and with the subcommittee's permission I would like to orally summarize my written remarks and leave the whole of my prepared statement for the formal record.

Chairman Griffiths. You certain may. Without objection, we will include your entire prepared statement in the record.

Mr. White. The past 150 years you have seen a dramatic development in financial institutions and financial markets in the United States. Sophisticated as it is, however, our financial structure provides opportunities for further improvement. By and large, we have a set of financial institutions each of which meets real but quite specialized savings needs. Moreover, many of our financial institutions have highly structured and quite inflexible choices as to the kinds of assets they may acquire. While the limited freedom these institutions have to attract saving and allocate it among investment alternatives has improved the efficiency of our financial system, there is still room for improvement.

Much current discussion of ways to deal with these deficiencies in our financial structure centers or attempts to insulate certain borrowers, notably home buyers, from the competitive forces at work in our economy, or attempts to require certain lenders to set aside their interest in the savers they serve and deal with certain of the problems of society as a whole by acquiring some assets at below market rates of return. These attempts to use regulation to interfere with market processes in an attempt to achieve short-run objectives have occurred throughtout our history. While, at the time, they may seem to have been successful, much of these earlier attempts to restrict competition are in large part the cause of many of our current problems. Rather than see them as forces to be thwarted, we should see the competitive forces in our financial markets as the primary mechanisms at work to continually improve our financial markets. It is these forces which expand the asset alternatives open to savers as well as the financing alternatives open to real investors and thereby improve the operations of our financial markets and contribute to the rate of growth of real

GNP. It is these competitive and adaptive forces that legislation and administration must foster. We must make it a central purpose to adopt forms of regulation which maximize the ability of our financial institutions and financial markets to efficiently gather and allocate savings among investment demands.

Specifically, we should enact legislation and regulation which will enable institutions to have the maximum amount of discretion over the manner in which they invest their assets which is consistent with the commitment they make to those who acquire claims upon them. Moreover, we should offer each institution a wide range of freedom in issuing different types of claims. Only in this way will we be assured that our financial institutions can efficiently allocate our Nation's savings. In addition, we should do all we can to make the instruments which are traded in financial markets as standardized and easily traded as possible. This together with a competitive environment among financial institutions will assure that our markets transform our savings into investment with a high degree of operational and allocative efficiency.

These comments may seem contrary to much of what is currently being suggested with respect to financial regulation. In the time available I propose to develop some of the history and the evolution of practice in our financial markets and institutions in order to justify these proposals.

In my oral comments, I shall touch on two broad areas. The first is an overall view of the historical developments in our financial markets and financial institutions. The second deals with some current proposals for change and has special reference to pension funds.

Financial markets and financial institutions perform an essential function in our economy. They are the mechanisms through which savings finds its way into capital formation or viewed in an alternate way, the mechanism through which the resources necessary for investment are obtained from savings. Without financial markets and financial institutions, savings would have the option of holding risky illiquid real assets or a relatively riskless, highly liquid asset money.

Financial markets and financial institutions provide a variety of financial assets which bridge the gap between these two polar kinds of assets and significantly expand the incentive to save by expanding the opportunities for portfolio diversification open to savers. Financial institutions and financial markets provide assets with a wide range of returns, risks, and liquidity. In addition to these services to savers financial institutions and financial markets provide a corresponding array of sources of finance to those engaging in capital formation. These sources enable real investors to finance their activity with funds of different maturity and different cost, and thereby offer the opportunity to lower the cost of financing real investment.

The significant development of financial intermediaries in the United States can be dated back to the middle of the 19th century.

The major sources of this transformation in the scope and structure of our financial institutions are the changes which have taken place in the patterns of household saving over this period

As the income and wealth position of the vast bulk of Americans increased substantially over this period, persistent changes occurred in their pattern of asset acquisition. The importance of the household sector to our financial markets arises from the fact that this sector of the economy generates about 70 to 80 percent of the net saving of the economy, with the business and government sectors accounting for about 15 percent and 5 percent, respectively. Since almost all of business saving finds its way directly into business investment, household saving provides almost all of the "raw material" of the new issue financial markets.

For those following the prepared statement reference to the table might be helpful as I read the rest of this.

The portfolio choice facing the household sector may be structured as follows. Each year the sector has a gross flow consisting of net saving plus capital consumption allowance. In addition, it raises finance by borrowing, for example, consumer loans or mortgages. It uses this total of funds to acquire assets, The first level choice among assets is between financial assets and real assets. Within real assets the choice is consumer durables or real estate. Within financial assets the choice is somewhat more complicated. Households may invest directly and manage their assets personally, or they may choose to invest them in a financial institution and have that institution manage and invest their funds. Within intermediated investment, the choice is between contractual savings agreements such as life insurance and pension fund reserves, or the discretionary deposit liabilities of commercial banks or thrift institutions or investment companies—mutual funds. The choices among these various possibilities depends upon the attractiveness of the yields and other features of the instruments offered and the economic tastes and preferences of the saver.

As can be seen in the table of my prepared statement, in the first 10 years of this century, households allocated about 55 percent of their total asset acquisition to real assets and 45 percent to financial assets. Within financial, about 62 percent was invested directly and about 38 percent indirectly. Within indirect investment, about one-half went to commercial banks, one-quarter to life insurance reserves, 25 percent to thrift institutions and an almost negligible amount to pension funds.

By the decade of the 1950's, much of this pattern had changed substantially. In the period from 1953 to 1962 households allocated about 65 percent of their gross asset allocation to real assets and about 35 percent to financial assets. The most dramatic change came in the division of financial asset acquisition between direct investment and indirect investment through finanical intermediaries. In this latter period, direct financial investment amounted to only about 17 percent of total financial asset allocation while indirect amounted to about 83 percent. This is in marked contrast to the roughly 60–40 split in the first decade of this century.

Within indirect financial investment, there were also dramatic changes. Commercial bank deposits fell from about 50 percent to about 24 percent. Deposits at thrift institutions rose from about 25 percent to about 35 percent: pension fund reserves grew from less

than 1 percent to over 25 percent. Thus contractual types savings plans rose from 25 percent of the total to about 40 percent, and the share of deposit type institutions fell from 75 percent to slightly below 60 percent. Commercial banks lost ground with respect to thrift institutions and life insurance reserves grew much more slowly than did pension reserves.

The primary causes of these changes seem to lie in the growth of a large body of saving units each of which had relatively small amounts to invest. These relatively small amounts to invest made diversification of individual portfolios which might arise from a pooling of risks all but impossible. Moreover, these savers had little competence or experience in selecting direct investments in which to invest. Both these features encouraged the development of financial institutions. In addition to these benefits to savers, these institutions efficiently gathered savings thereby providing more convenient sources of funds to real investors.

For most of these savers, the primary interest was to acquire certain as opposed to risky assets. In addition, as a substantial fraction of these assets had to be available to meet unpredictable contingencies, these savers placed a heavy premium on liquidity. With commercial banks not interested in cultivating the market for small savers, thrift institutions came to play the dominant role in this aspect of the savings market. As pension plans grew and offered direct competition with life insurance reserves as forms of saving, they substantially lessened the share of the savings dollar going to life insurance companies.

By the early 1950's, the implications of these changes were as follows: The U.S. financial market had developed a rather large set of highly specialized institutions. Most institutions appealed to a very limited and very specific segment of the whole savings market. Life insurance companies were almost entirely in the contractual fixed value claim market, although they gradually moved into managing the variable value or equity part of pension plans. Savings and loan associations dealt wholly with fixed value deposit claims while mutual savings banks offered that and, where permitted, some life insurance. Commercial banks offered demand deposits and competed only weakly with the thrift institutions for savings deposits. Few, if any, of these institutions offered any variable valued or equity claims to their customers.

Many of these institutions had very limited investment outlets as well. Savings and loan associations could invest only in mortgages and Government securities. Mutual savings banks could invest in those assets plus corporate bonds. For both these institutions but especially for savings and loan associations, this severe limitation on their ability to attract savings plus the severe limitation on asset acquisitions was to become a very serious problem.

In my prepared statement, some of the implications of these developments, for financial markets and savings and real investors, are explored in detail.

Now, let me move on to the implications of some more recent developments.

As a result of the pressures on financial markets which were related to the acceleration of expenditures in Vietnam, interest rates on open market instruments rose dramatically in the last 5 years. With Federal Government and corporate financing requirements up sharply and with both of these sectors raising finance in the direct debt markets, interest rates on direct debt instruments rose relative to those offered by all the institutions. Thrift institutions felt the brunt of this pressure. The contractual institutions like life insurance companies felt it to a lesser extent, although policy loans did rise dramatically. With commerical banks competing for savings deposits more aggressively than in earlier periods, many thrift institutions suffered substantially smaller deposit growth and, in some cases, even deposit outflows. With the bulk of the savings shift away from thrift institutions, and with these institutions the bulwark of the residential mortgage market, residential mortgage finance fell drastically.

Moreover, the excess demand and the associated rise in prices caused the monetary authorities to attempt to restrict bank lending. Under the pressure of reduced lending availability and a very strong business loan demand, commercial banks moved away from the municipal bond market. Thus, it was in two very socially sensitive markets that much of the financial adjustment to the excessive levels of demand had to take place.

These facts have led to many proposals to force or induce some financial institutions to buy more mortgages or more municipal securities than they would otherwise do. I think many of these proposals are wrong for three reasons. First, attempts to force institutions to invest in assets at lower than market returns deal with the symptoms of the problem and not with the problems themselves. If, in the eyes of a pension fund or a bank, mortgages are not attractive relative to corporate bonds or business loans, then the problem is to improve the relative return on mortgages or reduce the relative risks or illiquidity of these mortgages. There are the beginnings of new arrangements as well as several feasible proposals to improve the relative attractiveness of mortgages.

Second, if the problem is to provide housing finance to families who can get finance but at what we consider too high levels of interest rates, a more efficient solution would seem to lie in income subsidies for housing directed toward the needy or subsidized loans rather than to compulsion on the lender to accept a specific volume of loans at below market rates of interest.

Third, it seems patently unfair to say that the depositors in a bank, the potential recipients of pensions, or the holders of life insurance policies are to bear the burden of meeting the costs of our housing or municipal needs. Moreover, if one examines the income and other demographic features of the spectrum of the potential beneficiaries from private or public pension funds, it would seem hard to conclude that they are the appropriate group to pick to bear such a burden.

If as a Nation we are to assume the cost of providing mortgage finance in the amounts necessary to achieve our housing goals, we should specifically consider who is to pay and not decide to tax the earnings of certain groups just because they happen to hold claims on financial institutions over which we can exercise control.

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The more proper set of actions to take in regard to these very serious problems in our markets for mortgage and municipal debt are actions which center on the instruments themselves and the options with respect to the kinds of assets and liabilities open to the institutions which invest in them. There are a variety of proposals which have been advanced to improve the mortgage instrument and its municipal security. I won't deal with these in the oral part but I will be happy to come back to them if you would like.

Let me move now to the final section, implications of this line of reasoning for pension fund ligislation of my prepared statement.

Pension funds are but one of a wide variety of institutions which assist in financing this economy. They are but one of the variety of institutions on which households hold the claims which comprise a large part of their wealth. It is imperative that it always be clear that the primary responsibility of these funds is to the beneficiaries. That they can be controlled and used to meet society's needs in no way implies that they should be so controlled. Recommendations that pension funds should be induced to put a certain percentage of their money into mortgages are extremely objectionable. These proposals in effect attempt to make a gift of someone's money to someone else and may result in quite regressive transfers. Pension funds will buy mortgages if they are currently paying competitive rates. Attempts to force mortgage purchases upon pensions, trust funds and other groups can be considered as attempts to enforce investments at less than going rates. It is not clear why the poor who depend on these pension funds for some of their retirement income should subsidize homeowners or builders. Most considerations of equity would point to the reverse type of transfer payment.

In addition, pension plans form a sizable part of the total wealth position of over 30 million Americans. However, there are insufficient safeguards to protect the rights of the beneficiary. Pension rights should be vested relatively early. My suggestion would be that after a period of 5 years, vesting be made mandatory. I believe labor mobility and a more competitive labor market would be encouraged by the provision of portability of the aforementioned vested pension benefits. In adition, incomplete funding of the pension rights poses two problems. Portability is difficult if not impossible to achieve with partially funded pensions. More importantly, partial funding subjects the beneficiary to the risks that he will not receive the full payment of the benefits earned in the event that the contributing employer is unable to meet the continuing demands required by the pension agreement. Given that we have enacted legislation to foster pension plans in order to provide for retirement income, employers should be required to either fund the liabilities they assume or arrange for insurance to protect the earned benefits of their employees.

Finally, it is my view that there is a pressing need for more adequate disclosure of the investment performance of both public and private pension plans. It is only recently that the trustees of private pension plans have begun to provide their largest trusts

with relevant investment performance reports. Much of this development came from demands of the very large trustors. Those trustors whose trusts do not weigh so importantly in the eyes of the trustee still receive much less sophisticated and relevant information. Given the special interest and responsibility of the Congress in these pension funds, it would seem incumbent upon the Congress to assure that relevant performance statistics for these plans be available to both employer and employee. This information should be available for both public and private plans alike.

In summarizing my comments, I would like to argue that the appropriate legislative program for financial markets and financial institutions and in particular for pension funds is a positive program for improving the efficiency of markets and institutions in attracting and allocating savings. Our efforts should be addressed at removing impediments in our financial markets and financial instruments and improving competition in our financial institutions, and not at introducing further restraints on our financial institutions, financial instruments, and financial markets.

Thank you.

Chairman GRIFFITHS. Thank you very much.

(The prepared statement of Mr. White follows:)

PREPARED STATEMENT OF WILLIAM L. WHITE

SAVINGS, INVESTMENT, FINANCIAL INSTITUTIONS, AND FINANCIAL MARKETS

The past 150 years have seen a dramatic development in financial institutions and financial markets in the United States. Sophisticated as it is, however, our financial structure provides opportunities for further improvement. By and large, we have a set of financial institutions each of which meets real but quite specialized savings needs. Moreover, many of our financial institutions have highly structured and quite inflexible choices as to the kinds of assets they may require. While the limited freedom these institutions have to attract savings and allocate it among investment alternatives has improved the efficiency of our financial system, there is still room for improvement.

Much current discussion of ways to deal with these deficiencies in our financial structure centers on attempts to insulate certain borrowers, notably homebuyers from the competitive forces at work in our economy or attempts to require certain lenders to set aside their interest in the savers they serve and deal with certain of the problems of society as a whole by acquiring some assets at below market rates of return. These attempts to use regulation to interfere with market processes in an attempt to achieve short-run objectives have occurred throughout our history. While at the time, they may seem to have been successful, much of these earlier attempts to restrict competition are in large part the cause of many of our current problems. Rather than see them as forces to be thwarted, we should see the competitive forces in our financial markets as the primary mechanisms at work to continually improve our financial markets. It is these forces which expand the asset alternatives open to savers as well as the financing alternatives open to real investors and thereby improve the operations of our financial markets and contribute to the rate of growth of real GNP. It is these competitive and adaptive forces that legislation and administration must foster. We must make it a central purpose to adopt some forms of regulation which maximize the ability of our financial institutions and financial markets to efficiently gather and allocate savings among investment demands.

Specifically, we should enact legislation and regulation which will enable institutions to have the maximum amount of discretion over the manner in which they invest their assets which is consistent with the commitment they make to those who acquire claims upon them. Moreover, we should offer each institution a wide range of freedom in issuing different types of claims. Only in this way will we be assured that our financial institutions

can efficiently allocate our nation's savings. In addition, we should do all we can to make the instruments which are traded in financial markets as standardized and easily traded as possible. This together with a competitive environment among financial institutions will assure that our markets transform our savings into investment with a high degree of operational and allocative efficiency.

These comments may seem contrary to much of what is currently being suggested with respect to financial regulation. In the time available I propose to develop some of the history and the evolution of our financial markets and institutions in order to justify these proposals. In my comments I would like to touch on six areas. The first is the importance of the process of savings and investment to our economic life, and the role that financial institutions and financial markets play in that process. The second relates the historical developments in our financial institutions and financial markets since the middle of the 19th Century. The third area deals with some of the implications of these movements for financial institutions, savers, real investors, financial instruments, and financial markets. The fourth area relates to developments in financial markets in the late 1950's and early 1960's, with some special attention to the pressures which developed in financial markets in the last half of the 1960's. The fifth area is addressed to an evalution of some of the current proposals for change in these markets. The final section deals with the special place of pension funds in our financial structure and presents some proposals for actions which I believe should be taken with respect to them.

FINANCIAL INSTITUTIONS AND FINANCIAL MARKETS IN THE UNITED STATES ECONOMY

Financial markets and financial institutions perform an essential function in our economy. Financial markets are the mechanisms through which saving finds its way into capital formation, or viewed in alternate way, the mechanism through which the resources necessary for investment are obtained from savers. Without financial markets and financial institutions savers would have the option of holding risky illiquid real assets or a relatively riskless, highly liquid asset-money. Financial markets and financial institutions provide a variety of financial assets which bridge the gap between these two polar kinds of assets and significantly expand the incentive to save by expanding the opportunities for portfolio diversification open to savers. Financial institutions and financial markets provide assets with a wide range of returns, risks, and liquidity. In addition to these services to savers, financial institutions and financial markets provide a corresponding array of sources of finance to those engaging in capital formation. These sources enable real investors to finance their activity with funds of different maturity and cost, and thereby offer the opportunity to lower the cost of financing real investment.

In addition to these direct contributions to the process of saving and investment, the existence of financial markets and a wide variety of financial assets made available in part by financial institutions enables savers to transfer their existing wealth easily and efficiently among assets by providing continuous valuation and efficient transfer. Similarly, financial markets and financial institutions provide real investors with a continual valuation of their worth and thereby a measure of their economic capacity to effectively use resources.

DEVELOPMENTS IN FINANCIAL MARKETS AND FINANCIAL INSTITUTIONS THROUGH THE 1950'S

The significant development of financial intermediaries in the United States can be dated back to the middle of the 19th Century. Building on a base of an expanding commercial banking system, there emerged on a fairly wide scale some of the most important types of financial intermediaries, particularly life insurance companies, mutual savings banks, savings and loan associations and personal trust departments. The first half of this century witnessed a rapid expansion both in the number of offices and in assets, an expansion of the scope of operations of commercial banks and the rise of several new types of financial intermediaries. In the 1920's sales finance companies and investment companies made their appearance; in the 1930's, government and

private pension funds, government lending institutions and credit unions burgeoned. In terms of 1929 dollars, assets of financial intermediaries grew from about $75 per person in 1850, to $500 per person in 1900, and to over $2,000 per person in 1952.[1]

The major sources of this transformation in the scope and structure of our financial institutions are the changes which have taken place in the patterns of household saving over this period. As the income and wealth position of the vast bulk of Americans increased substantially over this period, persistent changes occurred in their pattern of asset acquisition. The importance of the household sector to our financial markets arises from the fact that this sector of the economy generates about 70%–80% of the net saving of the economy, with the business and government sectors accounting for about 15% and 5% respectively. Since almost all of business saving finds its way directly into business investment, household saving provides almost all of the "raw material" of the new issue financial markets.

The portfolio choice facing the household sector may be structured as follows. Each year the sector has a gross flow consisting of net saving plus capital consumption allowance. In addition, it raises finance by borrowing, for example, consumer loans or mortgages. It uses this total of funds to acquire assets. The first level choice among assets is between financial assets and real assets. Within real assets the choice is consumer durables or real estate. Within financial assets the choice is somewhat more complicated. Households may invest directly and manage their assets personally, or they may choose to invest them in a financial institution and have that institution manage and invest their funds. Within intermediated investment, the choice is between contractual savings agreements such as life insurance and pension fund reserves, or the discretionary deposit liabilities of commercial banks or thrift institutions of investment companies (mutual funds), The choices among these various possibilities depends upon the attractiveness of the yields and other features of the instruments offered and the economic tastes and preferences of the saver.

As can be seen in the Table (p. 22), in the first ten years of this century, households allocated about 55% of their total asset acquisition to real assets and 45% to financial assets. Within financial, about 62% was invested directly and about 38% indirectly. Within indirect investment, about one-half went to commercial banks, one-quarter to life insurance reserves, 25% to thrift institutions and an almost negligible amount to pension funds.

By the decade of the 1950's, much of this pattern had changed substantially. In the period from 1953 to 1962 households allocated about 65% of their gross asset allocation to real assets and about 35% to financial assets. The most dramatic change came in the division of financial asset acquisition between direct investment and indirect investment through financial intermediaries. In this latter period, direct financial investment amounted to only about 17% of the total financial asset allocation while indirect amounted to about 83%. This is in marked contrast to the roughly 60–40 split in the first decade of this century.

Within indirect financial investment, there were also dramatic changes. Commercial bank deposits, both demand and time deposits, fell from about 50% to about 24%. Deposits at thrift institutions rose from about 25% to about 35%; pension fund reserves grew from less than 1% to over 25%. Thus contractural types savings plans rose from 25% of the total to about 40%, and the share of deposit type institutions fell from 75% to slightly below 60%. Commercial banks lost ground with respect to thrift institutions and life insurance reserves grew much more slowly than did pension reserves.

The primary causes of these changes seem to lie in the growth of a large body of saving units each of which had relatively small amounts of savings to invest. These relatively small amounts to invest made the diversification of individual portfolios which might arise from a pooling of risks all but impossible. Moreover, these savers had little competence or experience in selecting direct investments in which to invest. Both these features encouraged the development of financial institutions. In addition to these benefits to

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[1] Raymond Goldsmith, Financial Intermediaries in the American Economy Since 1900, National Bureau of Economic Research, 1958, Chapter IV.

savers, these institutions efficiently gathered savings thereby providing more convenient sources of funds to real investors.

For most of these savers, the primary interest was to acquire certain as opposed to risky assets. In addition, as a substantial fraction of these assets had to be available to meet unpredictable contingencies, these savers placed a heavy premium on liquidity. With commercial banks not interested in cultivating the market for small savers, thrift institutions came to play the dominant role in this aspect of the savings market. As pension plans grew and offered direct competition with life insurance reserves as forms of saving, they substantially lessened the share of the savings dollar going to life insurance companies.

IMPLICATION FOR FINANCIAL INSTITUTIONS AND MARKETS

By the early 1950s, the implications of these changes were as follows. The U.S. financial market had developed a rather large set of highly specialized institutions. Most institutions appealed to a very limited and very specific segment of the whole savings market. Life insurance companies were almost entirely in the contractual fixed value claim market, although they gradually moved into managing the variable value or equity part of pension plans. Savings and loan associations dealt wholly with fixed value deposit claims while mutual savings banks offered that and, where permitted, life insurance. Commercial banks offered demand deposits and competed only weakly with the thrift institutions for savings deposits. Few, if any, of these institutions offered any variable value or equity claims to their customers.

Many of these institutions had very limited investment outlets as well. Savings and loan associations could invest only in mortgages and government securities. Mutual savings banks could invest in those assets plus corporate bonds. For both these institutions but especially for savings and loan associations this severe limitation on their ability to attract savings plus the severe limitation on asset acquisitions was to become a serious problem.

Savers.—The limitation on the product line offered by each institution meant that savers had to deal with a wide variety of specific institutions when making their savings choices. The lack of hybrid financial claims also resulted in a rather large and quite uncontrollable gap between interest rates on open market instruments or direct debt such as government or corporate securities and the rates on deposit type claims. Equally important, the lack of wide interest in marketing shares in large pools of diversified equity portfolios to savers with relatively small amounts of wealth, centered the asset holdings of this group in debt instruments. This resulted in a wide gap between the returns available to them and the returns available to those savers for whom a large diversified position in equities was a rational and feasible portfolio policy.

Borrowers.—In some sectors of the capital market, borrowers were served by only a small set of institutional lenders. Thrift institutions with their volatile savings deposits were the primary source of single family mortgage finance. Builders of income producing properties had a more varied market both in terms of numbers of institutions and in terms of the savings markets they tapped, with commercial banks, life insurance companies, and pension plans as lenders. The market for municipal securities was dominated by banks buying shorter maturities, and individuals buying longer maturities, although fire and casualty companies also played some role in this market.

Instruments.—With many states having quite different regulations with respect to foreclosure or the recording of mortgages, conventional mortgages were financial instruments which were very diverse and non-standard. These diversities required lenders to demand higher rates of return as they were not offered any option to sell these securities in any secondary market. Only those mortgages which were insured by the FHA or VA had a secondary market. Moreover, this diversity among the terms of specific mortgages still offered some rationalization for limiting the ability of thrift institutions to originate mortgage loans to a 50 or 100 mile radius of their home office. The tax-exemption features of municipal securities made them attractive only to the two institutions with high marginal tax brackets, commercial banks and fire and casualty insurance companies, and to individuals. For most of these individuals, the relevant investment alternative to the municipal security was not another debt instrument, but rather an investment offering an equity rate of return.

Markets.—The result of these institutions with their specialized sources of savings and limited outlets for investment was that one major financial market, the mortgage market, was burdened with limited ability to compete for saving whenever interest rates rose. Moreover, the lack of a secondary market for conventional mortgages made it impossible for these institutions to sell some of their existing assets to provide for liquidity at these times. Another market, the municipal market, suffered from a lack of potential investors on reasonable terms. The corporate bond market was primarily a new issue market with very little secondary trading while the stock market was almost entirely a secondary market with very little new issue volume. Only the government security market seemed to have an active new issue and secondary market in which many investors could participate.

DEVELOPMENTS IN THE LATE 1950'S AND EARLY 1960'S

Institutions.—The latter part of the 1950's and the early 1960's saw a series of developments which accelerated the pace of financial development in the United States. More financial institutions began to show broadened interests in entering the savings market. Life insurance companies moved aggresively into the uninsured pension business. Commercial banks showed considerable interest in the market for savings deposits. For example, The Chase Manhattan Bank developed the slogan of "You have a friend at the Chase." Mutual funds continued their rapid growth as they continued to satisfy a growing demand for a prudent chance at the returns available from equities. However, neither savings and loans nor mutual savings banks showed any interest in expanding the kinds of fixed value claims they would offer. Although early in the 1960's some mutual savings banks did begin to consider offering a mutual fund. Pension funds continued to grow dramatically. The private plans moved aggressively into equities while the public plans moved out of tax-exempt securities and into taxable government and corporate issues.

Savers.—The options open to savers with relatively small amounts to invest improved as mutual funds began to offer returns on equity portfolios which were greater than those available on deposit type savings accounts while at the same time less risky than if these savers had bought equities directly. Moreover, returns on deposit type accounts moved up relative to other interest rates as commercial banks entered this market more aggressively. These trends continued as some life insurance companies began to sell variable annuity plans and were showing signs of moving to provide straight equity management services in the form of mutual funds. As family income levels continue to rise and equity claims continue to become a sensible part of the portfolios of more and more savers, we can expect a continuation of the very rapid growth of these institutions dealing in the equity market. Just as when they had smaller amounts of wealth and savers chose to use institutions to manage their savings held in the form of fixed value claims, savers are likely now that they have larger amounts of wealth to use institutions to manage an ever growing fraction of their savings in variable priced claims (equities).

Borrowers.—More flexible institutional practice also increased the options open to borrowers. Life insurance companies began to accelerate the pace of private placement of debt issue for corporations. Much of the savings which commercial banks attracted with their increased interest in and payments on time and savings deposit accounts found its way into the municipal market and to a more limited extent into the mortgage market. Term loan to business expended as the lending policy of banks became much more aggressive and adaptive to business needs for intermediate term funds. Little change occurred in the options open to home buyers, however. There were no new entrants into the single family home mortgage market and life insurance companies came to concentrate their mortgage interest mainly on income producing properties and large tract developments.

Instruments.—No change took place in the mortgage instrument. There was little if any action taken to bring about variable rate mortgages or incorporate any of the attempts to standardize the instrument or to create a secondary market in them.

MORE RECENT DEVELOPMENTS

As a result of the pressures on financial markets which were related to the acceleration of expenditures in Vietnam, interest rates on open market

instruments rose dramatically in the last five years. With Federal Government and corporate financing requirements up sharly and with both of these sectors raising finance in the direct debt markets, interest rates on direct debt instruments rose relative to those offered by all institutions. Thrift institutions felt the brunt of this pressure. The contractual institutions like life insurance companies felt it to a lesser extent, although policy loans did rise dramatically. With commercial banks competing for savings deposits more aggressively than in earlier periods, many thrift institutions, suffered substantially smaller deposit growth and, in some cases, even deposit outflows. With the bulk of the savings shift away from thrift institutions, and with these institutions the bulwark of the residential mortgage market, residential mortgage finance fell drastically.

Moreover, the excess demand and the associated rise in prices caused the monetary authorities to attempt to restrict bank lending. Under the pressure of reduced lending availability and a very strong business loan demand, commercial banks moved away from the municipal market. Thus, it was in two very socially sensitive markets that much of the adjustment to the excessive levels of demand had to take place.

These facts have led to many proposals to force or induce some financial institutions to buy more mortgages or municipal securities than they would otherwise do. I think many of these proposals are wrong for three reasons. First, attempts to force institutions to invest in assets at lower than market returns deal with the symptoms of he problem and not with the problems themselves. If, in the eyes of a pension fund or a bank, mortgages are not attractive relative to corporate bonds or business loans, then the problem is to improve the relative return on mortgage or reduce the relative risks or illiquidity of these mortgages. There are the beginnings of new arrangements as well as several feasible proposals to improve the relative attractiveness of mortgages. Second, if the problem is to provide housing finance to families who can get finance but at what we consider too high levels of interest rates, a more efficient solution would seem to lie in income subsidies for housing directed toward the needy or subsidized loans rather than to compulsion on the lender to accept a specific volume of loans at below market rates of interest. Third, it seems patently unfair to say that the depositors in a bank, the potential recipients of pensions, or the holders of life insurance policies are to bear the burden of meeting the costs of our housing or municipal needs. Moreover, if one examines the income and other demographic features of the spectrum of the potential beneficiaries from private or public pension funds, it would seem hard to conclude that they are the appropriate group to pick to bear such a burden.

If as a Nation we are to assume the cost of providing mortgage finance in the amounts necessary to achieve our housing goals, we should specifically consider who is to pay and not decide to tax the earnings of certain groups just because they happen to hold claims on financial institutions over which we can exercise control.

The more proper set of actions to take in regard to these very serious problems in our markets for mortgage and municipal debt are actions which center on the instruments themselves and the options with respect to the kinds of assets and liabilities open to the institutions which invest in them. There are a variety of proposals which have been advanced to improve the mortgage as an investment vehicle. These measures are too complex and detailed to be treated in the limited space available. We need a uniform code for all states which would improve and homogenize the mechanics of mortgage lending. Ceilings on mortgage rates, either state usury statutes or FHA–VA ceilings, should be eliminated thereby insuring everybody an opportunity to compete for funds by paying the going market rate on investments. If as a matter of national policy we desire to provide housing to those who can't afford the higher rates, then direct subsidies should be utilized to care for the lower income groups.

With respect to municipal securities we should accelerate attempts to develop Federal financing agencies which will complement the existing public issues of tax-exempt securities by acquiring tax-exempt securities priced to yield tax-exempt rates and issue taxable Federal securities to raise the needed funds. The Federal tax revenue raised in this way will go a long way toward offsetting the operating loss of such agencies. In addition, it will limit the extraordinarily large tax shields now centered on individuals with large amounts of income. Most importantly, however, such a change would allow

the municipal market to compete with the full range of taxable securities on an equal footing. Such taxable federally issued securities would legitimately compete with corporate bonds or direct Treasury issues in the portfolios of public pension funds, or life insurance companies or mutual savings banks (and hopefully savings and loan associations). They would also be available to individuals as an alternative to other direct taxable assets or claims on financial institutions.

With respect to the thrift institutions we should encourage them to expand the range of liabilities they offer in order to make claims they issue more attractive to savers. We should expand their ability to acquire assets so that they will be able to construct portfolios which offer the levels of return and flexibility of cash flow necessary to issue competitive liabilities.

IMPLICATIONS FOR PENSION FUND LEGISLATION

Because of the subcommittee's specific interest in the implication for financial markets of the growth of pension funds, I wish to address my closing remarks to this specific issue.

Pension funds are but one of a wide variety of institutions which assist in financing this economy. They are but one of the variety of institutions on which households hold the claims which comprise a large part of their wealth. It is imperative that it always be clear that the primary responsibility of these funds is to the beneficiaries. That they *can* be controlled and used to meet society's needs in no way implies that they *should* be so controlled. Recommendations that pension funds should be forced to put a certain percentage of their money into mortgages are extremely objectionable. These proposals in effect attempt to make a gift of someone's money to someone else and may result in regressive transfers. Pension funds will buy mortgages if they are currently paying competitive rates. Attempts to force mortgage purchases upon pensions, trust funds and other groups can be considered as attempts to enforce investments at less than going rates. It is not clear why the poor who depend on these pension funds for some of their retirement income should subsidize wealthy home owners and builders. Most considerations of equity would point to the reverse type of transfer payment.

Pension plans form a sizeable part of the total wealth position of over 30 million Americans. However, there are insufficient safeguards to protect the rights of the beneficiary. Pension rights should be vested relatively early. My suggestion would be that after a period of five years, vesting be made mandatory. I believe labor mobility and a more competitive labor market would be encouraged by the provision of portability of the aforementioned vested pension benefits. In addition, incomplete funding of the pension rights poses two problems. Portability is difficult if not impossible to achieve with partially funded pensions. More importantly, partial funding subjects the beneficiary to the risks that he will not receive the full payment of the benefits earned in the event that the contributing employer is unable to meet the continuing payments required by the pension agreement. Given that we have enacted legislation to foster pension plans in order to provide for retirement income, employers should be required to either fund the liabilities they assume or arrange for insurance to protect the earned benefits of their employees.

Finally, it is my view that there is pressing need for more adequate disclosure of the investment performance of both public and private pension funds. It is only recently that the trustees of private pension plans have begun to provide their largest trusts with relevant investment performance reports. Much of this development came from demands of the very large trustors. Those trustors whose trusts do not weigh so importantly in the eyes of the trustee still receive much less sophisticated and relevant information. Given the special interest and responsibility of the Congress in these pension funds, it would seem incumbent upon the Congress to assure that relevant performance statistics for these plans be available to both employer and employee. This information should be available for both public and private plan alike.

In summarizing my comments, I would like to argue that the appropriate legislative program for financial markets and financial institutions and in particular for pension funds is a positive program for improving the efficiency of markets and institutions in attracting and allocating savings. Our efforts should be addressed at removing impediments in our financial markets and

financial instruments and improving competition in our financial institutions, and not at introducing further restraints on our financial institutions, financial instruments, and financial markets.

GROSS ACQUISITION OF ASSETS—HOUSEHOLD SECTOR (PERCENTAGE ALLOCATION)

	1900–12				1953–62			
Real assets	55.6				65.8			
Durables		63.9				71.0		
Nondurables		36.1				29.0		
Financial assets	44.4				34.2			
Direct investment			62.0				17.0	
Mortgages				8.7				41.2
Government securities				−1.5				4.4
State and local securities				6.5				25.2
Corporate bonds				33.5				8.0
Corporate stock				52.8				21.2
Indirect investment			38.0				83.0	
Currency and demand deposits				49.3				23.5
Deposits at thrift associations				26.3				35.0
Life insurance reserves				24.3				13.9
Pension funds				.1				27.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Data for 1953–62 from Federal Reserve System, "Flow of Funds Data."
Data for 1900–12 from Raymond & Goldsmith, "Study of Saving," adjusted to conform to levels of "Flow of Funds Data" in 1945.

Chairman GRIFFITHS. Mr. Murray?

STATEMENT OF ROGER F. MURRAY, EXECUTIVE VICE PRESIDENT AND CHAIRMAN, CREF FINANCE COMMITTEE, TEACHERS INSURANCE & ANNUITY ASSOCIATION AND COLLEGE RETIREMENT EQUITIES FUND

Mr. MURRAY. Thank you, Madam Chairman.

The timeliness of this hearing is readily apparent from the troubled state of the American economy. The process of relieving inflationary pressures and dispelling inflationary expectations is proving to be a painful and severe testing of the effectiveness of our institutional arrangements for the execution of economic policy. Also the stakes are high; have we the ability to direct our tremendous vitality toward realization of our goals of a rising standard of living, in all its dimensions, for all Americans?

Recent experience has again established the central role of the saving and investment process and the functioning of the capital markets in realizing our potential for a high rate of real economic growth. Recurrent crises have occurred when the deficiency of savings has become acute relative to pressing demands for public and private investment. Massive shifts occurring in the process of allocating resources through the capital markets have unbalanced growth and severely rationed the funds available to those sectors not situated favorably to bid aggressively for the deficient savings flow.

It is most appropriate, therefore, to look at the future of public and private pensions as a major savings source in the years ahead. Most of the time, unfortunately, we become so involved in the details of specific arrangements that we fail to see retirement income programs in their very significant role as major factors in the gathering of savings and the commitment of funds to real investment.

Research has demonstrated that pension programs actually have a kind of multiplier effect because households covered under public and private pension plans tend to save just as much in other forms as do other households similarly situated except for the lack of pension coverage.[1] That is to say, because people do not substitute pension saving for saving in other forms, pension saving becomes a net addition to personal saving. Without the tremendous growth in public and private programs other than OASDI, therefore, personal savings would have been significantly lower over the past two decades. Furthermore, since it appears that old-age survivors, and disability insurance programs tend to reduce personal saving on balance, the substitution of social security for voluntary employee benefit programs would have made the shortage of savings even more acute.

Unfortunately, however, the past lift given to the saving ratio is losing force. In the next decade benefits will be rising much more rapidly than contributions as plans become more fully funded and more mature. The substantial rise in interest rates, moreover, has made possible a materially higher level of benefits per dollar of contributions. What lies ahead is a period in which retirement saving rises in absolute amounts but at decreasing rates.

It would be good economics to spur all efforts to extend pension coverage as widely and as liberally as possible with the use of tax incentives and the employment of the facilities of all our financial institutions.

The flow of funds supporting future retirement benefit promises to employees of private industry, State and local governments, and nonprofit institutions reached some $16 billion last year, about 30 percent of all of the private domestic sources of funds in the capital markets. This total was allocated about two-fifths to fixed-income investments and three-fifths to equities, continuing the growth in the role of common stock and real estate holdings in pension fund asset structures. Major factors in recent years have been the substantial increases in life insurance company separate equity accounts for insured plans, the rapid rise in common stock investments by State and local government systems, and the emerging importance of variable annuities.

This is a prompt response to market forces as the demand for equity capital to finance business growth has grown rapidly. To illustrate the point, as recently as 1964–65, equity capital raised through net sales of common stock and retained earnings provided 65 percent of the total increase in long-term capital provided to nonfinancial corporations to finance plant and equipment outlays and working capital needs. Retained earnings alone were ample to margin the 35 percent raised by borrowing. In 1968–69, in contrast, flat retained earnings, even when supplemented by many more stock issues, were sufficient to cover only 50 percent of total capital raised. Increasingly, new stock issues, convertible bonds, and bonds with warrants have had to be employed to maintain balanced capital structures and to avoid a more serious deterioration in the quality of

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[1] This is one of the major findings discussed in the author's Economic Aspects of Pensions: A Summary Report, National Bureau of Economic Research, New York, 1968.

debt. The current $1.5 billion of bond with warrants financing by the Bell System is a striking example of the trend.

The loss of liquidity and large floating debt of corporations indicate the need for a high level of long-term bond financing for some period ahead. Providing the equity base for this borrowing in a period of severe squeeze on profits is a serious problem, even when relieved by the flow of pension fund savings into equities. The cost of equity capital has risen much more than the cost of debt, as evidenced by the 25 percent decline in broad averages of stock prices. The current high cost of sustaining the level of business investment as a major source of productivity gains and economic growth is a serious problem; but the capital markets are working effectively because savings are being attracted to the area of high expected returns.

It is quite natural, of course, that pension funds should be attracted to the market for equities, whether common stocks or real estate ownership. Both types of assets are essentially illiquid by the accepted definition of liquidity: The ability to convert an asset into cash on short notice without risk of material loss. Individuals and institutions with liquidity requirements are inhibited in their ownership of equities and must demand a materially higher return from them. A pension fund, with its long-time horizon, protracted period of predictable growth, and absence of liquidity needs, on the other hand, is practically the ideal holder of equities. The absence of statement problems and ability to use the total return approach to measuring results are important collateral factors.

Since State and local retirement systems are now the most rapidly growing pension funds, it is not surprising that they are the financial institutions most rapidly increasing investments in common stocks. What is surprising is that it has taken them so long to develop balanced portfolios. I have worked on this problem in two States, Ohio and my home State of New York with some success; but change takes place gradually and it is difficult to throw off the yoke of archaic statutory restrictions. Despite the clear evidence that it it impossible to legislate sound investment management, these trappings of the distant past are only being slowly removed. It is perhaps just as well for the peace of mind of the average taxpayer that he does not know what these arbitrary and ill-considered statutory restrictions have cost him in the past for the provision of retirement benefits for State and local government employees.

Since the large State-administered retirement systems are the giants of the pension field and are still growing rapidly, they, and not the pension funds of industry, will be the major determinants or changes in capital market flows in the years ahead. The indications are that they are becoming much more responsive to yield differentials and changing demands upon the capital markets. Over the past 7 years, I have had an opportunity to study the operations of the New York State teachers retirement system and currently serve as chairman of an investment advisory committee which makes policy recommendations to the board. It has been extremely gratifying to see the improvement in asset management in this $2.5 billion

system as relief has been obtained from detailed restrictions on investment management.

From more than 20 years of close observation and intensive study of the entire pension field, it seems to me that certain lessons of experience are clearly before us to be learned.

1. The highly developed capital markets of the United States are extraordinarily efficient in allocating resources among the most productive uses.

2. Attempts to legislate investment restrictions have usually served to reduce efficiency, not to protect the beneficiaries.

3. To the extent that pension funds have been administered under the "Prudent Man Rule," by contrast, they have made a major contribution to the responsiveness of the capital markets to dynamic changes in the economy. Compartmentalization of the markets has been largely eliminated and innovation in the design and marketing of securities has been stimulated.

My conclusion then is very simply that there should be no interference with the efficient workings of the market structure. But this does not imply that the public interest in private pensions should be slighted or even ignored. On the contrary, much more detailed disclosure of operations to the pension plan participant is essential as part of a comprehensive program for the enforcement of the highest standards of fiduciary responsibility.

My personal preference is strongly for the establishment of a separate and distinct Pension Commission at the Federal level, charged with three separate responsibilities: (1) Enforcement of strict disclosure requirements, (2) assuring the highest standards of fiduciary responsibility, and (3) development and extension of pension coverage. Despite lip-service frequently given to the desirability of expanding coverage, improving the reliability of pension promises, and strengthening the diversity of retirement benefit programs supplementing social security, it seems to me that the urge to regulate has displaced the more vital urge to extend and improve benefits, It took more than a decade to extend less-than-equal treatment to the self-employed and their employees because of the stubborn opposition of the Treasury Department. Yet Keogh Act coverage is now possible for another five to 10 million individuals.

Currently we face the reality of the need to increase Federal taxes in order to create forced savings to achieve the level of public and private capital formation to meet the needs of an expanding economy and an improving quality of living. Should we not also use the now thoroughly tested and socially desirable public and private pension structure to generate saving through the voluntary choice of the participants? It would be good economics and good fiscal policy to put a genuine effort behind the extension of coverage to an even broader segment of our citizens.

Let me illustrate with a specific example of what might be done. Suppose that every individual, as long as he was not covered by a public or private plan, could arrange to have his employer place up to, say 10 percent of his wages, not in excess of some specified ceiling, in a retirement savings account in a mutual savings bank. This would

be a blocked account, payable only at death or for the purchase of an annuity at retirement. The employee would not be taxed on his employer's contribution and could add his own after-tax dollars to the retirement savings account. He would only be taxed on retirement income benefits when received. It could be a fixed dollar account or a portion could be in a variable savings account invested in equities. There would be no expense because these institutions specialize in handling small savings. They have savings bank life insurance departments equipped to handle annuities at very low cost.

Of course, legislation would be required and it would take time to develop coverage in volume, but the banks have an incentive to promote such accounts as a source of funds for their mortgage lending operations. Savings bankers have already organized a low-cost mutual fund, known as the "Fund for Mutual Depositors," which could be used to fund variable savings accounts. The desirable features of full funding and immediate vesting are built into such a program. The employee could hold a half-dozen jobs not covered by group pension plans and still stand to accumulate meaningful retirement benefits.

This will illustrate, I hope, how steps to release the energies of our financial institutions for the extension of pension ceverage could stimulate the growth of systematic provision for old age. Surely, one of the goals which all of us share is the reality of independence, security, and dignity for our older citizens.

Thank you.

Chairman GRIFFITHS. Thank you very much, Mr. Murray. We will now hear from Mr. Cohen.

STATEMENT OF MANUEL F. COHEN, ATTORNEY, WILMER, CUTLER & PICKERING, AND FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. COHEN. Madam Chairman and members of the subcommittee, I am honored by this opportunity to appear before you and to testify concerning the investment policies and certain other activities of pension funds, an extremely important and still growing element in our economy. During my tenure at the SEC, I had a strong interest in pension funds as an investment vehicle and, while I am not qualified to speak on the technical economic questions to which these hearings are primarily directed—and, I might add, to which my two distinguished colleagues have already addressed themselves—I do have a few general observations.

As this subcommittee is no doubt aware, for some time now institutional investment has been growing at a faster rate than direct investment by members of the public. Just last week the New York Stock Exchange announced that institutional investors now account for more than 50 percent of all trading on the exchange—other than trading by member firms for their own accounts which continues to be a substantial amount—and represents 60 percent of the dollar value of such trading.

Private uninsured pension funds have for some time been the fastest growing of the various types of institutions. Even more signifi-

cant, however, is the fact that this growth has come primarily through increased investment in common stocks. During 1969, for example, the assets of private noninsured pension funds increased by $7 billion of which $5 billion represented an increase in holdings of common stock, a new record and up 11 percent from the previous year. At the risk of restating certain facts to which I understand our Chairman has already spoken, I should note that the two types of institutions which are currently having the greatest impact on the markets are the pension funds and the mutual funds.

But the effects of these two groups on the markets are quite different. During 1969, according to figures recently released by the SEC, private noninsured pension funds purchased approximately $15 billion in common stocks and sold approximately $10 billion, meaning that on total transactions of $25 billion they made net purchases of $5 billion. The mutual funds, on the other hand, made net purchases of only $2.2 billion on total transactions of more than $41 billion. Thus, while the pension funds provided over twice as much net buying power to the market as did the mutual funds, the mutual funds accounted for considerably more overall activity.

While the pension funds had a relatively lower rate of turnover in 1969 than did the mutual funds, their turnover rate still showed a substantial increase over 1968. Activity by pension funds in the stock market rose from 18.9 percent in 1968 to 22.3 percent in 1969. Fourth quarter activity reached 25.1 percent, a new record. In 1962, by contrast, the activity rate was 9.7 percent. It was less than 4 percent in 1957. The 1969 activity rate for mutual funds was approximately 50 percent. These estimated percentages, and I should emphasize they are preliminary and estimated percentages, are derived from a recent statistical release of the Securities and Exchange Commission which, for the purposes of the record, defines the activity rate as "the * * * average of purchases and sales divided by average market value of stock holdings, stated as an annual rate."

The increasing investment of pension funds assets in equity securities is a development worthy of close examination by this subcommittee. Many of the workers whose hopes for an adequate retirement income rest on the success of these funds are not only unsophisticated with respect to the intricacies of the equity markets, but may have only the dimmest idea of the extent to which their fortunes and their futures are tied to the vicissitudes of those markets. Events of the past year illustrate a fact which, before the current "bear" market, many people had apparently forgotten—that stock prices can go down as well as up. I believe there are serious dangers if people seeking retirement income are led to believe that investments in common stocks are essentially equivalent to fixed income securities, but simply offer a much higher rate of return. It is in this connection particularly that I wholeheartedly endorse the increased disclosures—including information on investment assets and transactions—that would be required, and the standards of fiduciary responsibility that would be imposed, by the Employee Benefits Protection Act legislation currently pending before the Congress.

I am particularly concerned at indications that the so-called performance fad has spread from other types of investment media to administrators and managers of pension funds, whether private or administered by insurance companies. While short-term trading may have its place for certain types of investors and, in the view of some, may under certain circumstances have a constructive influence on the market, there are serious questions as to the appropriateness of such activity for those entrusted with the savings of people whose investment goals are measured in decades rather than weeks or months and who may have little or no control over the timing of their retirement. The current "bear" market may already have left, in its wake, disappointment and worse for recent retirees. Moreover, if current proposals for early vesting, for portability, and for more effective funding eventuate, as I believe they should, the relevant considerations would undoubtedly become more critical in this area. This seems all the more urgent as the rate of unemployment, among those who have not as yet attained retirement age, continues to creep upward. Indeed, the consequences of declining stock values may also impede management's actions, and increase concern by unions, with respect to labor force retirement. These considerations are beyond the areas in which I can claim any expertise.

The effects of investment decisions by pension fund managers on the markets, and on the corporations whose securities comprise their investment portfolios, are additional areas which deserve exploration. Although the statistics discussed earlier indicate increased market activity by the pension funds, and movement into relatively more speculative forms of investment, pension funds tend to be, as my colleagues have pointed out, long-term holders of securities, and their equity investments are highly concentrated in a relatively small, select group of issues. I hasten to emphasize that these policies may well be, on balance, in the best interests of the beneficiaries of the funds, despite the questions I have raised. Nevertheless, they have important consequences for the operation of our financial markets and for the beneficiaries of these funds. Specifically, the investment concentrations of pension funds may have the effect of placing an unwarranted "premium" on the market prices of "blue chip" securities: may, as pension funds continue to acquire, on a net basis, substantial amounts of such securities, affect the liquidity of the market by immobilizing huge blocks of such securities for long periods of time: and may create unfortunate distortions, from the standpoint of economic policy and allocation of savings, by giving dangerous advantages to the largest and best established corporations in obtaining new capital for growth and expansion.

As with institutional holdings generally, little is presently known about the degree to which, if at all, the immense voting power of pension funds is employed to exert control over the management policies of portfolio companies, and if so, with what objectives. There is a trend toward "passing through" to fund participants and beneficiaries the voting power over portfolio securities. This trend, subject to appropriate controls, may, in the view of some, be

a healthy one from the standpoint of reducing the effects of institutional investment which concentrates economic power in relatively few hands. Others suggest, however, that diffusion of the voting power serves only to insulate administrators, theoretically more sophisticated, and because of claimed concentration potentially more effective, from exercising an effective influence for the benefit of all beneficiaries who are and undoubtedly would be unable to act at all because of the diffusion and lack of sophistication in these areas.

Several situations have come to the attention of the SEC in recent years which suggest that, on occasion, the buying power of pension and profit-sharing funds has been employed by corporate management to affect the market price of the company's stock, particularly where the issuer-employer was obligated to issue a variable number of shares to acquire other companies, dependent upon the market price for those shares during a predetermined period. While I have no indication that such practices have been limited to such objectives, it is, of course, essential in the public interest that any such activity be stopped. The Securities and Exchange Commission has been diligent in this area but its ability to deal with the problems is limited by the manpower and budgetary resources available to it. The Employee Benefits Protection Act currently pending before Congress would have a salutary effect in this area also, by imposing a 10 percent limitation on investments by pension funds (other than profit-sharing funds) in securities of the employer corporation and its affiliates, as well as, in a broader sense, and in my view perhaps the most important sense, by its establishment of fiduciary standards to guide the conduct of fund managers, standards which in too many cases do not now exist as a practical matter. I am sure the members of this subcommittee have seen the statement of Secretary of Labor George P. Shultz. and the appendix to the statement, recently given before the House General Labor Subcommittee in H.R. 16462, the Employee Benefits Act in the House version, which details other questionable activities by those who control or manage pension funds.

In terms of their impact on the securities markets, the investment activities of pension funds unquestionably share many of the attributes of institutions generally. One of the most important characteristics of investment activities of institutions is their tendency to buy or sell in relatively large quantities. The impact of block transactions is heightened by the fact that sophisticated analyses by the profesional managers of institutions often lead to the same investment decisions at roughly the same point in time, thus further intensifying the likelihood of imbalance in the markets. Seemingly erratic behavior of the market in response to such pressures obviously holds the potential for injury to individual investors and to smaller institutional investors.

Detailed study and analysis of these and other questions posed by the rapid growth, and probable dominance in the near future, of institutional investment are currently being undertaken by the Securities and Exchange Commission pursuant to Senate Joint Resolution 160. The institutional investor study is investigating not only the

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problems posed by institutional investing generally, but will also provide a basis for evaluation of some of the questions outlined above which are of particular concern as they relate to private pension funds. The data assembled by this exhaustive study should afford a much clearer understanding than has been possible until now of the significance of past and prospective trends in investment by pension funds and other institutional investors their effects on the securities markets and the need, if any, for further Government concern and regulation.

In closing, I would like to speak briefly about the legislation currently pending before Congress, to which I have already alluded. I believe that extensive overhauling of the Welfare and Pension Plans Disclosure Act to provide greater protection for plan participants and beneficiaries is long overdue. I had the pleasure to serve as a member of a Presidential Committee established some years ago to evaluate the structure and operations of pension funds and to make recommendations for reform. The findings and the recommendations of this Committee were reflected in a number of bills introduced during the last administration. Some related only to increased disclosure requirements and standards of fiduciary responsibility. Others also would have dealt with the more controversial problems of portability, vesting and funding.

In light of certain statements recently made and widely circulated, I believe it is important to stress that, throughout its deliberations, an important underlying premise of that Committee was that public policy would be well served by encouraging pension plans, private pension plans; there was never any thought of imposing rigid and unworkable standards which would hinder the continued healthy growth of these plans. I am certain that the pending legislation sponsored by the current administration is equally founded on a philosophy of encouraging similar development of this growing institution, consistent with protection of the national economy and the millions of individuals throughout the country whose interests are at stake. In establishing for the first time a national standard of fiduciary responsibility for fund managers, in prohibiting a number of specific abuses which have arisen in the administration of private pension plans, in enlarging and enhancing the usefulness of information made available to fund participants and beneficiaries, and in providing for— and this is very important—effective enforcement, both public and private, this legislation represents an important step forward deserving of widespread support. It must and should be enacted into law promptly, I believe it enjoys the support of all political elements in our country and of nearly all students of the problems.

I would also favor adoption of the vesting, funding, portability, and plan termination insurance provisions of a number of more comprehensive bills. I refer to S. 2167, introduced by Senator Javits, as illustrative of that type of proposed legislation. Recommendations in most of these areas were also made by the Presidential Committee on which I had the privilege to serve, and were the subject of several bills introduced in the last Congress. Such additional

safeguards for plan participants and beneficiaries continue to have my full support; and as I heard it this morning, I believe they have the support of my colleagues. I note that Secretary Shultz has indicated that the Departments of Labor and Commerce are concerned with these issues and that they are undergoing intensive study. This is most hopeful even if these issues have been under study for many years now. Millions of plan participants may never receive a pension under the present structure of pension plans but these studies which I understand are now in full swing should not delay consideration of the less controversial provisions found in the current administration bill. In my opinion, the most urgent task facing the Congress in this area at present lies in the essential improvement of the Welfare and Pensions Plan Discloslure Act in the areas covered by that bill.

As Secretary Shultz stated. "a further delay would be a disservice to the millions of Americans who depend on these benefits and who have been quite properly upset by disclosures of fiduciary abuses in certain welfare and pension plans." He also stated that "the current picture is one of inadequate, weak and unrealistic safeguards and remedies." In this connection it is important to recall that the assets of welfare and pension plans, I'm advised, exceed $130 billion and this figure is estimated to double by 1980.

Thank you very much.

Chairman GRIFFITHS. Thank you, Mr. Cohen.

I would like to ask both Dr. White and Dr. Murray, who both object to any legislative restrictions on investments, if they otherwise generally agree with Mr. Cohen or do you have some objections to some of his suggestions or his criticisms?

Mr. COHEN. Madam Chairman, while they are thinking about how they want to respond to that, I did not think that I was in disagreement with these gentlemen. They spoke to a subject or two to which I did not address myself.

Chairman GRIFFITHS. Yes, I understand.

Mr. WHITE. I think that there are lots of things that Mr. Cohen said with which both of us will agree. However, I am not quite so concerned as Mr. Cohen is about the move to equity on the part of institutional investors, partly because I see it as an attempt on the part of individuals with smaller amounts of wealth to buy the management services which are provided by the institutional investors. That is, in large part, the individuals who currently hold equities directly are rather wealthy and sophisticated individuals. Continually as more and more of our family units get amounts of savings or wealth, and as they accumulate it for their retirement, they are going to find it sensible to add equities to their portifolios. Up to now it has been primarily deposits in institutions or pension fund reserves or life insurance policies. More and more they are going to want to add some equities to their portfolios. Just as in the 1920's and the 'teens when individuals began to acquire savings and they put their money into thrift institutions and commercial banks and life insurance companies and let them manage it for them. I think they are going to put their money into institutions who help them manage their equities.

So more and more you will see institutions coming to dominate the market primarily because of the saver's interest, that is, the savers will want to have the institutions manage their equities for them.

So it would not surprise me at all that as more of the individuals who are in the stock market are individuals with small amounts of wealth, you would get them acting through their intermediaries, through their institutions, and less and less of the activity taking place by those individuals who are direct. You could conceivably have a time when the numbers in terms of activity would be quite different, would continue this trend toward managed investments—institutionally managed investments, your pension funds doing it for you, your mutual savings funds doing it for you or mutual trust funds doing it for you—rather than have the individual forced to pick his own securities and subject himself to the problems of managing a very small portfolio.

So I see increased institutional activity really not as a threat but as a necessary concomitant to individuals holding equities through institutions who provide management services for them.

Chairman GRIFFITHS. Do you have something you would like to add, Dr. Murray?

Mr. MURRAY. I was going to say that I think I find myself in substantially complete agreement with Mr. Cohen's recommendations on the whole subject of disclosure and fiduciary responsibility enforcement, and similar problems. When you get to improvements in funding and vesting standards, we are in a very complicated area. While I am thoroughly in support of both of those trends and developments in the private pension field. I do recognize that these are complicated problems.

One of the purposes that I believe a separate pension commission could serve very effectively would be to mount the kind of technical studies required in order to develop the best method of consistently improving the quality of vesting provisions and funding arrangements for private pensions.

Chairman GRIFFITHS. Thank you.

I would like to ask you, Mr. Murray, in this New York State teachers' retirement system, where you point out in your statement that you have improved the management of the fund, can you tell us, one, how much additional money the fund now makes, and, two, what does it cost to make it?

Mr. MURRAY. In the rapidly changing financial markets of recent years, it is hard to fix a precise figure on the improvement in return, but there can be no question that the earning power, the productivity of that system, has been increased on the order of a percentage point and more over recent years and, of course, on a $2½ billion fund, this represents a substantial improvement in its earning power used to improve benefits or to reduce the cost of existing benefits, either one. There has really been a total transformation in the operation of these large State-administered funds, in the last decade and more, with great improvement in efficiency.

The additional cost of achieving these gains has really been nominal. They have added professional people to their staff. I am sure the payroll is higher but by very nominal amounts relative to the improvement in earning power.

The main gains have been achieved as a result simply of gradual changes in the statutory regulations that historically were highly restrictive on the areas of investment available to the State-administered systems.

Chairman GRIFFITHS. I think it would be interesting to see exactly what would the position of the fund have been if the regulations had remained, as opposed to what is the position of the fund now, as opposed to what is the position of the general investors in that exact area? And further, what is the cost?

I would like also to know if you could select the largest block of stock that the fund has bought or sold in the past five years and tell us, and I certainly do not expect you to do it now, but supply for the record the information as to what happened to that stock within the next 72 hours after the purchase or, say, did the market go up or down and by how much after a large sale or a large purchase?

Mr. MURRAY. I should be glad to obtain that information.

Chairman GRIFFITHS. I would be interested in seeing it.

(The following information was subsequently supplied for the record by Mr. Murray:)

TEACHERS INSURANCE & ANNUITY ASSOCIATION OF AMERICA,
COLLEGE RETIREMENT EQUITIES FUND,
New York, N.Y., May 26, 1970

Hon. MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy,
Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR MRS. GRIFFITHS: In response to the questions which you raised at hearing on April 27, I have obtained from the New York State Teachers' Retirement System the information outlined below.

On the subject of the largest single stock purchase, I am informed that this was 100,000 shares of Texaco, Inc. acquired by the System on October 8, 1969 at a price of 31. On that particular day, 218,100 shares traded on the New York Stock Exchange in a price range of 30½ to 31¼. The closing price that day was 30¾. During the next three trading days the price range of Texaco on the New York Stock Exchange was as follows:

Date	High	Low	Close
Oct. 9, 1969	31	30⅜	30⅞
Oct. 10, 1959	32¼	30⅞	32¼
Oct. 13 1969	32½	32	32½

As I interpret these data it would appear that this block purchase had little effect upon market prices possibly because of the efficiency of member firms who deal in large blocks as a part of their regular activities.

The other question which you raised at the Hearing is more difficult to answer because of the problem of separating the effect of generally rising interest rates on portfolio yields from the effects of changes in statutory provisions relating to permitted investments. However, the following figures on investment yields of the New York State Teachers' Retirement System support my statement to the trend.

[In percent]

	Yields for years ended—				
	June 30, 1969	June 30, 1968	June 30, 1967	June 30, 1966	June 30, 1965
Bonds	4.92	4.54	4.31	4.18	4.00
Stocks	3.11	3.11	3.28	3.33	3.14
Mortgages	5.54	5.37	5.46	5.18	5.40
Education building annex	4.23	4.23	4.24	4.24	4.24
Combined	4.85	4.57	4.47	4.34	4.29

These yields are computed on an annual average basis excluding any gains or losses and without the deduction of any expenses. They do illustrate the extent to which the relaxation of investment restrictions has permitted the System to take advantage of investment opportunities offering high returns. Actually, there is an understatement of the improvement in yield to the extent that the current return from dividends is treated as the return on stock investments. One is entitled to expect that the total return from the equity investments will substantially exceed the dividend yield because of the reinvestment of retained earnings.

I mentioned the New York State Teachers' Retirement System as an example of the enlightened investment management policies of some of the state and local government retirement systems. While this is a particularly good illustration of the improved efficiency of portfolio management. I hope that I made it clear that quite a number of state administered systems have greatly improved the productivity of their funds as obsolete restrictions on investment discretion have been relaxed during the recent years. This is an extremely significant development in retarding the very rapid rise in the cost of liberalizing retirement benefits for public employees.

Again, I should like to express my appreciation for the opportunity to participate in your Hearings on this vital area of economic activity.

Sincerely yours,

ROGER F. MURRAY.

Mr. MURRAY. The State teachers' retirement system has a fairly even flow of funds. I would be surprised when we had all the figures that they had made really large purchases at any one point in time. As is characteristic of a State-administered fund, the flows are fairly predictable and fairly even, and they are normally operating with a purchase program of 25 to 30 stocks to spread out the buying of individual issues.

Chairman GRIFFITHS. Now, I would like to ask you also, each of you, you have pointed out the rapid growth of the funds. May I ask you, in your judgment are the pension funds inflationary? Are they stabilizing? Or are they anti-inflationary?

Mr. MURRAY. Could I answer that first?

Chairman GRIFFITHS. Yes.

Mr. MURRAY. I would argue that they are anti-inflationary in the form of their contribution to lifting the level of savings in the economy. What bothers me, as I said in my statement, is that I see looking down the road for the next decade and more that this impetus to savings, which is so crucially important in a period like the present, will gradually diminish as the systems mature and as their benefit payments continue to rise quite sharply. And, of course, the benefit payments we know are spent by retired individuals who, in a perfectly sensible way, are not apt to be substantial savers.

Chairman GRIFFITHS. Would any of the rest of you care to comment?

Mr. WHITE. Yes, I agree with Roger, that in fact by stimulating savings they in fact tend to provide finance and resources for investment and really——

Chairman GRIFFITHS. You feel that this overcomes the fact that they also stimulate increased prices and increased taxes. All pension funds do. If Mr. Reuther succeeds in getting every UAW worker paid $500 a month, and they are almost being paid that, I assure you you are going to pay for it in those cars you buy.

Mr. WHITE. But the presumption would be that he will either get wages paid currently or he will get contributions to the pension funds paid later.

Chairman GRIFFITHS. But it still——

Mr. WHITE. If in fact I can defer—if in fact it is attractive to the workers to defer certain of their compensation now, to receive it later, then between the now and the later it is not—it is resources over which they have——

Chairman GRIFFITHS. All through the whole time it is prices, you and I are paying for it in the price of the car.

Mr. COHEN. May a non-angel dare to tread where angels walk? I think the question of inflation, and I say this with some trepidation, has its effect in a number of areas. To the extent that savings which might otherwise be discretionary in the sense that the individual could choose to buy a new car or put it in the savings bank or invest it otherwise, there is no question that a pension plan, whether negotiated by a union or fixed by management without the benefit of union assistance, does suck up some of that discretionary income or savings. There is no question about that. I think, however, certainly in the area of management-labor activities, that after a while this is understood by everyone, including the most unsophisticated employee, and while he is very happy to participate in a pension plan. he certainly does not want his discretionary income reduced by a great deal. So there are threads going both ways, although I think on balance I agree with my colleagues.

There will come a time as Dr. Murray has pointed out when the outflow may be as great as the inflow, and at that time we may learn for the first time what the ultimate effects will be. But there are other forms of inflation.

Now, in my remarks—and perhaps I should preface that by speaking first to the points that Professor White made—I did not suggest that investment in equities was unwise. I spoke to certain activities of managers of the funds in recent years, particularly the adoption of the so-called performance fad and the concentration of investments. This, I believe, is a matter of concern.

I have also been speaking to this growing institutionalization of our society which has had its effects in business and in finance generally for many years. With my usual lack of modesty, I think I can take a little bit of credit for the current study that is being conducted by the SEC to get some real hard facts beyond mere suppositions in this whole area of institutional investment.

I must add, and I also indicated quite plainly in my statement that on balance this movement to equities may be a good thing. In fact,

I think it is inevitable. And it is a movement which, by the way, is being watched with a great deal of interest abroad. In certain countries on the continent, pension funds have been used as instruments of fiscal policy by the government, by restricting their investments to either government securities or government-related securities, thereby providing ready access to capital on a continuing basis to the government.

I think that would be an unfortunate situation if it should develop here. There is already a developing momentum abroad to break those chains—and I think they are chains—in a number of countries abroad.

It is, also undoubtedly true—it must be—if the employer is asked to contribute more towards the pension fund, obviously he cannot do this solely on a philanthropic basis and, obviously, part of that cost must be passed on to the public, either directly or in some form of tax incentive or similar arrangement. It just goes against any suggestion of common sense that this would not happen. But this is the basis upon which decisions were made a long time ago, and continue to be made by every administration with which I am familiar, to encourage private pensions, recognizing that there is an inflationary as well as a counterinflationary force at work.

At the present time I believe that the drain of savings, and I do not mean that word in a pejorative sense, but merely a descriptive sense, is probably greater than the outflow back to the retirees, but I must repeat, as Dr. Murray pointed out, we may soon reach a point of balance. It is my recollection, and Dr. Murray can correct me, that as early as ten years ago it was suggested that within five years that plateau would be reached. We have not reached it yet and I hasten to suggest again, perhaps without discretion, that that plateau may be farther down the line than current estimates suggest, perhaps because many plans will be made available to a wider group of people.

Chairman GRIFFITHS. Mr. Conable?

Representative CONABLE. I do not want to belabor this but honestly I do not see how you can come to any conclusion but that the pension fund movement has generally been anti-inflationary from a number of points of view. Most important, it has tended to defer demand for goods and services because it has been a form of saving, the creation of a pile of savings that otherwise would have been spent currently. Even when we may reach a balance in current payout, we are still going to be deferring a certain part of the demand for goods and services by the development of these funds.

In the second place, it has apparently provided a major source of capital and our whole system is based on the accumulation of capital. We have accumulated capital privately rather than in the public sector the way some of the Communist countries have, and this accumulation of capital has made possible the building of the markets and the generation of the business enterprises that are going to meet consumer demands. Therefore capital accumulation is anti-inflationary in that sense.

I am wondering if the development of pension plans is likely in your view, gentlemen, to be very substantially affected by a sharply increasing wage base in social security in the years ahead. There are proposals to increase the wage base of social security now and

there is likely to be some expansion in the wage base in social security. The increase in this wage base, of course, has overlapped what was traditionally an area reserved to the private pension plans. I am wondering if you see any threat to the pension plan movement in substantial expansion of the wage base on social security?

Mr. WHITE. I think of them as reasonably direct substitutes and as a matter of fact there is an example in the 1950's which is an analogous case. Before the growth of private pension plans, the life insurance companies had been experiencing a reasonably rapid rate of growth in life insurance reserves. When private pension plans began to grow, the rate of growth of life insurance reserves diminished, as individuals found ways to substitute, in fact, to buy more retirement income through a pension plan than through life insurance companies.

Representative CONABLE. So you think there is a good deal of trade-off?

Mr. WHITE. Yes, a great deal of trade-off. And life insurance companies have acted as though that is a real trade-off, they have responded by entering the pension management business.

Representative CONABLE. Would you like to carry this a little farther, Mr. White, and suggest that if we do expand the wage base on social security substantially that we should then start investing the social security trust fund in other than government securities?

Mr. WHITE. I think regardless of whether we expand its base, if in fact the trust fund is there to generate income for the recipient of the trust, it ought to be invested in their best interests.

Representative CONABLE. Do you understand that it is now invested solely in government——

Mr. WHITE. I understand and in this regard I would like to go back to one of the things Mr. Cohen said. I do not want to argue any with Mr. Cohen any more than he wants to argue with me, but I do not think performance is a fad. I think it is a necessity and I think any trustee who tries to create an asset that is in the interests of his potential beneficiaries has to manage that so that he gets the best product as he can.

If you want to attract money into pension funds, private or public pension plans, then you have got to make it attractive to acquire that kind of asset. That means the trustees must perform. While there may be limits to the activities which in fact are justified by a real interest in performance and these limits may be exceeded by some, the interest in performance has to be essential. It should be true for the Government pension funds as well as it is for the private.

Representative CONABLE. Mr. Cohen, have you made any study of the difference in performance of pension funds and mutual funds, the one voluntary, the other comparatively involuntary, and the differing patterns of demand on these funds by the participants resulting in different types of investment and therefore different types of performance?

Mr. COHEN. Well, I have been out of the Government for a little while and I no longer have the ready access to the information that is required to answer that question. But I do have an observation or two to make. It goes back to what Professor White said.

I think that, prior to 1969, there is no question that many of the institutions which relied on the investment of discretionary savings—discretionary investment of savings, perhaps that is a better way of putting it—such as mutual funds and other voluntary institutions, some of which were devoted to what I call the performance fad here, did exceptionally well. It is also true that period was characterized by rising prices. But, I think that the experience of the past year and a half has indicated that many of those who did the best and were No. 1—and the name of the game was to be No. 1—are now No. 275 or lower. This is a fact, not figment.

The point I was trying to make, was that, even in the area where you have perhaps the widest group of sophisticated investment managers, there is a change of point of view.

To the extent that pension funds are limited in their investment to debt-type securities and then only to the so-called safest, which carries with it as a corollary the lowest rates of return, obviously they do not fare as well as funds which are largely invested in equity securities, whether speculative or less speculative.

During the past year, however, many of these pension funds and many of the funds administered by banks which were generally considered less performance-oriented, less speculative, compared favorably, if not much more favorably, in investment results with some of the so-called performance type funds.

Despite the current change in investment attitude, there is no question that the point you make is well taken; there should be a reorientation of the whole field of investment.

Representative CONABLE. Isn't it inevitable that a pension fund, assuming that it is a fairly mature one, would have to have a fairly constant rate of payout and therefore would have to have a higher liquidity generally than the voluntary association, the mutual fund?

Mr. COHEN. That is precisely the point I was trying to make.

Representative CONABLE. Therefore the pension funds have performed a little better in a time of declining equity markets?

Mr. COHEN. Exactly. The excesses that have been so well seen in the securities markets began to take hold not only in the pension funds but in the foundations and other institutions. I am a little older than my colleague immediately to my right. In 1933 and 1934 I worked for the 20th century fund when it was studying the effect of the 1929 crash and the subsequent bad times on a number of things, including institutions, which happened to be my particular job. In those days I pretended to be something of an economist. I disclaim any right to that title now. But——

Representative CONABLE. Even economists are being more modest nowadays.

Mr. COHEN. Well, modesty has never been my forte as some of you know, but I must say that, even though we were then studying the effects of the market on institutions and they were very drastic, and today we are studying the effects of the institutions on the markets, recent events have now turned the situation around slightly so that we are again looking at a problem we looked at 30 and 40 years ago.

All I was suggesting here is: One, it is inevitable that equity securities should be involved. Two, because pension funds should be

brought within the grasp of the employee who has, as I say, the dimmest notion of how closely his future is tied to the securities market, and if there is an increase in allocation of what otherwise might be discretionary income to pension funds which has the anti-inflationary effect here mentioned, to that extent his future is tied even closer to the investments in that fund.

I was merely pointing to a danger which I think is now generally accepted to exist by all investment managers.

Representative CONABLE. I have one last question, if I may.

Mr. COHEN. I wanted to add one more thing. The bill which the senior Senator from New York introduced in the last session of Congress which deals with some of the more controversial areas, but I think very important areas of funding, vesting, portability and insurance, perhaps even more acutely raises this problem of careful investment, careful allocation of funds. Thank you.

Representative CONABLE. My last question is to Mr. White again. I was very interested in his comments about restrictions imposed on bank investments—the effort we have made in the past, for instance, to try to force savings institutions into the mortgage market. You feel this is unwise because it constitutes a subsidy by usually low-income savers for the housing industry and people that should be subsidized in other ways. I wonder if from that you would conclude that there really isn't much justification for different types of savings institutions in the banking field—if you would advocate a fairly broadly powered unibank sort of an institution with savings banks merging into the commercial banks and fulfilling the same general flexible banking function with fairly broad powers of investment discretion?

Mr. WHITE. Well, I would not advocate regulation against such things taking place. Neither would I require there be a variety of institutions each of which is separate and none of one which is the same.

Representative CONABLE. You see some role for specialization still in the thrift institutions?

Mr. WHITE. I think lots of institutions will find it in their interest to specialize in attracting savings from certain groups or to specialize in investments in certain kinds of assets. So that I would not expect that there would be one homogeneous kind of institution.

Representative CONABLE. Then your interest is in simply reducing the imposed direction of investment by thrift institutions in any particular direction?

Mr. WHITE. That is correct. As an example, the current actions that are being taken by the Federal Home Loan Bank Board with respect to savings and loan associations seem to be appropriate attempts to expand the kind of liabilities they can issue.

Representative CONABLE. Thank you Madam Chairman.

Mr. COHEN. If I could just add a word. I think there was one aspect of Mr. Conable's question that I would like to speak to if I remember it correctly.

Implicit in the question I think was another issue: whether or not there should be any restriction upon the competition as between different types of institutions that can provide methods whereby pensions and profit-sharing plans may be created and developed.

I would join my colleagues here or at least Professor White—I do not know whether Dr. Murray has spoken to that point. There should be the widest competition. Restrictions on competition, whether the competition comes from banks, insurance companies, of general or special character such as those with which Dr. Murray is associated, is in the best interests of the development in the long run of the most favorable pension funds for more of our citizens.

Chairman GRIFFITHS. Senator Javits?

Senator JAVITS. Thank you very much, Madam Chairman.

I greatly appreciate—I must explain to the witnesses that I have four committees going at this particular moment.

Mr. COHEN. You are slowing down, Senator.

Senator JAVITS. One of them is on the Genocide Treaty which I think all will agree is something that demands urgent attention.

I am very grateful to the former Chairman of the SEC for his very gracious reference to my bill on pension funds. This supportive testimony can be very helpful.

Similarly, I might say to Mr. White I thank him for setting up the criteria which essentially are met by this bill. And, Madam Chairman, I think it might be appropriate if the Chair is agreeable to include both my own bill and the administration's bill which I introduced as the ranking member of the Labor Committee——

Chairman GRIFFITHS. We will be delighted to do so.

Senator JAVITS (continuing). As part of the record together with some explanatory material from the Congressional Record concerning them.

(The bills and explanatory material referred to by Senator Javits for inclusion in the record follow:)

S. 2167—INTRODUCTION OF THE PENSION AND EMPLOYEE BENEFIT ACT OF 1969 [1]

Mr. JAVITS. Mr. President, I introduce, for appropriate reference, a bill entitled "The Pension and Employee Benefit Act of 1969." This bill is a comprehensive legislative proposal to deal with the major problems and defects in our private pension plan system and would accomplish the following:

First, the bill would establish minimum vesting standards for pension plans, thereby giving assurance that no pension plan could set its eligibility standards so high as to deny pension eligibility to all but a few employees.

Second, the bill would establish minimum funding standards, thereby giving assurance that pension funds will be operated on a sound and solvent basis, enabling the fund to deliver the benefits which have been promised.

Third, the bill would establish a program of pension plan reinsurance so that plans meeting the vesting and funding standards of the bill would be insured against termination, and retirees would be insured against loss of benefits if an employer goes out of business before the plan has been fully funded.

Fourth, the bill would provide for the establishment of a special central portability fund, participation in which would be on a voluntary basis, enabling pension plans to have a central clearinghouse of pension credits for persons transferring from one employer to another.

Fifth, the bill would establish certain minimum standards of conduct, restrictions on conflicts of interest, and other ethical criteria which are to be followed in the administration of pension plans and other plans providing benefits for employees.

Sixth, the bill would establish a U.S. Pension and Employee Benefit Plan Commission to administer the requirements of this bill. The Commission would

[1] From the Congressional Record, May 14, 1969.

be given sufficient enforcement powers to insure compliance, but the bill also provides for judicial review, insuring to the maximum feasible extent against arbitrary exercise of the Commission's powers.

Seventh, the bill consolidates in the Commission most existing Federal regulatory standards relating to pension and welfare plans, thereby relieving employers, unions, insurance companies, and banks of the necessity of dealing with multiple Federal agencies—such as the Labor Department under the Disclosure Act or the Treasury Department under the pension provisions of the tax code. Under this bill, a qualification certificate from the Pension Commission will be sufficient to satisfy substantially all Federal regulatory statutes governing employee benefit plans.

And eighth, the bill establishes Federal court jurisdiction of suits involving pension plans, and provides a simplified method for enforcement and recovery of pension rights.

I. BACKGROUND

Mr. President, there are now over $100 billion in private pension plans, yet there is almost no Federal regulation of the conduct of these plans' affairs, no minimum standards governing their establishment or operation, and, far too often, no practical means by which a beneficiary can secure his rights.

Mr. President, I am committed to preserving, fostering, and improving the private pension plan system. I join those who also want to improve social security, but I have no illusions that social security will, or ought to, replace private pension plans.

For private plans serve a dual purpose of supplementing the limited benefits payable under social security while at the same time providing very substantial funds for investment, thereby fostering the growth of this Nation's economy.

Four year's ago, the President's Committee on Corporate Pension Funds issued a report in which it was recommended that every pension plan be required to "provide some reasonable measure of vesting for the protection of employees"; that minimum funding standards be established because 'inadequate funding of private pension plans under present standards places an unwarranted financial risk on employees during their retirement years"; that "the possibility of developing an institutional arrangement for transferring and accumulating private pension credits deserves serious study"; and that, although funding provides some measure of protection for retirees, it "may not protect plan participants from losing at least some of their equity in the event of a plan's termination," and, to meet the latter problem, the idea of reinsurance "is worthy of serious study."

The Cabinet Committee's report has stimulated a great deal of thought and discussion during the past 4 years. Various congressional committees have begun to look into the problem. Thus, the Fiscal Policy Subcommittee of the Joint Economic Committee, of which I am also a member, held several hearings growing out of many complaints received from all parts of the country protesting that people who had worked long years for a pension were denied benefits on various grounds which seemed unfair or that the funds set aside to provide for the benefits they had been promised proved far from sufficient. Other hearings looked into the feasibility of a pension reinsurance program and the possibility of amending the Taft-Hartley provision dealing with labor-management trust funds. And, of course, the Senate Permanent Investigations Subcommittee, of which I am also a member, held several very revealing investigations of the affairs of certain plans, and unearthed shocking misapplication of plan assets—some $4 million in one case—all without violation of any State or Federal law.

Finally, last year, the General Subcommittee on Labor of the House held hearings on S. 1024, the administration's fiduciary standards bill, and the Senate Labor Subcommittee held 1 day of hearings on that bill as well as my own comprehensive bill, S. 103, and the administration's minimum standards bill, S. 3421.

These hearings, however, constitute no more than a beginning.

II. THE BASIS FOR THIS BILL

The subject of employee benefit plans, particularly pension plans, is very complex, so much so that in the absence of a specific legislative proposal, the dialog tends to remain abstract and diffuse.

The bill I introduce today represents the distillation of years of inquiry and thought by my staff and myself on this problem. I do not, however, claim that this bill represents the only way of dealing with problems in the pension field; there are other approaches which can and should be explored. It is my hope that this bill will serve as a focal point for the pension debate and that out of subsequent discussions of it and other proposals which have and will be made, will emerge specific legislation designed to cope with the problems which exist in the pension field.

III. THE NEED FOR A COMPREHENSIVE APPROACH

I believe that all of these problems are so interrelated that they cannot be solved without a comprehensive legislative program dealing not only with malfeasance of administrators, and not only with the consequences of plant shutdowns and plant terminations, but also with the broad spectrum of questions such as adequacy of funding, reasonable minimum standards of vesting, transferability of credits under some circumstances, and, in short, the establishment of certain general minimum standards to which all private pension plans must conform.

That is by no means to say that we should create a legislative straightjacket which would destroy the flexibility and inventiveness which have been one of the foundations of the enormous growth of pension plans in recent years. But I think there ought to be some minimum standards in this field. And, in my judgment, those minimum standards will no more force all pension plans to be the same than the minimum wage law forces all employees' wages to be the same. The minimum is merely the basic level which decency and order require.

A. Funding and vesting

When we speak of adequate "funding," we mean setting aside sufficient funds to pay the benefits provided in the plan. When we speak of "vesting," on the other hand, we ordinarily mean the establishment of a participant's interest in a fund which he will retain even if he loses his job.

It is easy enough to "fund" a plan with no vesting—as there are no vested liabilities, there is no need for funds to pay those liabilities. For example, if a fund promises to pay "such benefits as the trustees may decide from time to time to pay," the plan can never be 'unfunded" because the trustees can always decide to cut benefits.

Conversely, a "vested interest" in an unfunded plan may be worth very little, because no matter how "vested" a pension right may be, it is worthless if the trust fund is depleted.

Either way—a vested interest in an unfunded plan, or a funded plan with no vested interests—an employee may learn after years of faithful service that his expected pension was a cruel hoax.

There is no easy solution, however, for industry needs vary widely; vesting after 20 years may work well in an industry with a stable workforce, while in certain high-labor-turnover trades such 20-year vesting may set the standards so high as to make pension almost unattainable for most employees. I refuse to believe, however, that the problem is insoluble.

This bill sets the standards at a point which is, in my judgment, a bare minimum: As to vesting, the bill requires that an employee after 6 years of service must receive a nonforfeitable right to at least 10 percent of his pension benefits, and an additional 10 percent for each additional year of service under the plan, so that full vesting would occur after 15 years.

This approach is generally referred to as "deferred graded vesting"; it not only assures men and women who have devoted years of their lives to working under a pension plan that they will not be deprived of benefits to which they are, in fairness, entitled, but it also eliminates the possibility of a worker losing all of his pension rights because he loses his job 1 day, or 1 month, before benefits are to vest.

In the Committee on Government Operations, where we looked into these matters, we have found plans where no one was entitled to any benefits, and some millions of dollars were left floating in the air, so strict were eligibility standards.

As to funding, again this bill is minimal, for it gives existing plans 40 years to amortize their unfunded liabilities, and 30 years for new plans. That

is a long time, but it is considered a reasonable amortization period by most pension planners.

Nevertheless, it has been suggested that this bill, without further qualifications, could have a damaging effect on pension plans in certain low-wage industries. In some of those industries, it is argued, payment of even minimal pensions depends upon marginal funding and eligibility standards so high that most employees do, in fact, forfeit their rights before retirement. That is an unhappy situation, but if it is true that the choice in those industries is between such a plan or no pension at all, then we need to find out the facts—the precise details and I call upon the pension planners and administrators, the Government agencies, and others with specific knowledge and experience in the field to come forward with what information they have so that we can be sure that whatever law we enact will help and not hinder the development, solvency, and fairness of private pension plans.

Conversely, it may also turn out, in some multiemployer plans, that, because of the added opportunity for continued employment under these plans even after involuntary separation from a particular job, vesting standards may not be need to be as high as elsewhere and can still assure eligibility of a reasonable proportion of the participants. Once again, we need the facts, the precise details of as many varied types of pension plans as we can find, to be sure that this legislation is refined and tailored to fit the needs of the private pension industry. But the only way, in my judgment, to find those facts is to focus on a particular bill, a precise legislative proposal, and see exactly how it will work.

Finally there is provision in the bill for granting a delay of 5 years in complying with the vesting and funding standards to plans which would face real hardships if compliance were required immediately. This 5-year delay could be granted to plans which would otherwise be threatened with termination because of the added cost of immediate compliance or where a reduction in wages or plan benefits might be necessary to allow the plan to comply.

B. Portability

The problem of portability is intimately related to funding and vesting. As long as plans have no minimum standards, it will be difficult indeed to devise any effective portability scheme—for how can an employee with a vested interest in an inadequately funded plan convert that interest into an "equivalent" participation in another plan which has lots of money but no vested interests. At first the employee had an enforceable interest in nothing; and now he want to exchange that for an enforceable interest in something.

On the other hand, I want to make it very clear—and the bill specifically provides—that the portability clearinghouse feature of this bill is completely voluntary. It is a convenience to those funds which already have, or will have, benefit and funding structures similar enough to permit transferability. It is my hope that this portability service will be attractive enough to induce many plans to participate, but it will be up to them.

There is, however, another feature in this bill which is, in effect, a kind of a defacto portability. The bill permits special funding standards for multiemployer plans, allowing them to fund over a longer period of time on a less stringent basis, under certain specified conditions. The theory of this less stringent funding for multiemployer plans is that, while employers come and go, many industries, as such, go on "forever," and therefore there is much less risk that a plan will be terminated before its unfunded liabilities are amortized. As a result, multiemployer plans are made comparatively more attractive by this bill, and, of course, a multiemployer plan gives to each participant a kind of "portability" of his pension credits, as long as he works for any employer under the plan.

Finally, the mere existence of minimum vesting standards creates, if not portability, at least a substitute for it. An employee with a vested pension right may not be able to take it with him when he moves to another job, but at least he can come back and get the pension when he reaches retirement age. The result may be that he will get two small pension checks instead of one larger one later on, but the total will often be the same.

Thus, voluntary portability under the bill, plus incentives for multiemployer plans, plus minimum standards for vesting, all aim in the same direction—

giving the employee the right to some protection from forfeiture when circumstances require that he change jobs.

C. Reinsurance

Reinsurance, like portability, sounds fine all by itself, but it is part and parcel of the vesting-funding package. If we are to insure employees that their pensions will be paid even if the employer's business terminates, then we must regulate the pension fund itself, at least to a limited extent. Surely we would not ask the Federal Deposit Insurance Corporation to reinsure bank deposits without some control of the bank's affairs. Yet, if we regulate the fund itself, it seems inevitable that we require some minimum standard of vesting, or else we may be insuring that the money will be there, without insuring that anyone will have a right to receive it when he retires.

This bill reinsures against one contingency: termination of the employer's business before the unfunded liabilities of the pension plan are funded. The premium is geared to the amount of such unfunded liabilities, and cannot exceed 1 percent of that amount.

This is not the maximum type of pension reinsurance which would be devised. But it meets the major problem: It would, if it had been on the books 10 years ago, have protected against the tragedy in the Studebaker shutdown in South Bend, when one employee who was 59 years old and had worked for Studebaker for 43 years, starting at the age of 16, forfeited 85 percent of his pension rights. And he was not alone, for there were 20 other Studebaker employees, each with more than 40 years of service, who were in the same boat. Studebaker's plan was a good one. It would have met the funding standards of this bill, and it could have been reinsured, and those employees could have been 100 percent protected.

I am not prepared to ask for compulsory reinsurance of pension plans without some minimum standards for all. It is easy enough to set up an actuarily unsound plan which is bound to go broke, and then make the solvent plans pay higher premiums to cover unsound ones. But I do think we can devise a scheme which will let each plan bear a minimal cost of reinsurance, each knowing that every other participant in the reinsurance program is held to the same minimum standards of solvency. That is what this bill would do.

D. Ethical standards of administration

Title IV of this bill establishes certain basic standards for the administration of all employee benefit funds—not just pension funds. Conflicts of interest, kickbacks, payroll-padding, and so forth are prohibited. This title of the bill is specifically designed to outlaw the practices disclosed several years ago in hearings before the Permanent Investigations Subcommittee.

But beyond such standards, the bill provides for jurisdiction in the Federal courts and a wide battery of remedies to insure not only that benefit plans are administered without conflicts of interest, but also in accordance with the contract or trust agreement, as well as pursuant to the fiduciary standards which we have developed over the years in our courts of equity.

E. Remedies

Title V of the bill gives the Commission the right to sue in Federal Court to require compliance with the vesting-funding-reinsurance provisions of the bill, and it gives the Federal district courts equivalent jurisdiction to entertain a suit by a plan administrator to test any action of the Commission authority to sue to enforce the ethical standards established by title IV of the bill. And it also permits private parties to sue for rights guaranteed by the bill, as well as for breach of any contract or trust guaranteeing them any rights.

The alternative remedies are important; too often a beneficiary who has wrongfully been denied his rights will not bring suit because his costs in maintaining legal action will exceed the small amount of his pension. It is in cases like these in which a pensioner—or a group of pensioners—with a meritorious case can request the Commission to bring suit in their behalf.

The district courts, in turn, are authorized to issue injunctions or other orders to compel compliance with the law, and, if necessary, to put a fund into receivership until its affairs are put in order.

The bill does not attempt to spell out all the fiduciary standards to which every trustee must adhere. It does specifically prohibit certain conflicts of interest, but, beyond that, the bill leaves the matter of trustee standards to

the courts—as has been done with great success for hundreds of years under our Anglo-American legal tradition. The law the courts will apply under this bill in such cases will vary—if the trust agreement specifies the law of a particular State, that State's law will apply unless it is contrary to the policy of Federal law; otherwise, it will be Federal common law, as developed by the Federal courts. In my judgment, that is the best way to develop fiduciary standards—and it is the way most consistent with our legal traditions.

F. Special problems of profit-sharing retirement plans

Profit-sharing plans, which I have long sought to encourage as a valuable inducement to labor-management cooperation in the interest of stability and higher productivity, present many significant differences from pension plans, even when profit-sharing involves payment of benefits on retirement. This was clearly brought out in recent hearings on private pension plans held by the Joint Economic Committee. These differences in operation necessitate differences in treatment, although in both cases the goal should be to insure fulfillment of the legitimate expectations of the participants.

The bill I am introducing today seeks to reflect these important differences. It defines profit-sharing retirement plans separately from ordinary pension plans, and reflects the fact, for example, that true-profit-sharing retirement plans are automatically fully funded because benefits are entirely dependent upon the employer's profit's.

IV. THE PENSION COMMISSION—A SINGLE AUTHORITY TO REPLACE MULTIPLE AGENCIES

The concept of a single authority to regulate the creation and operation of pension plans is one which should be beneficial to the labor organizations, employers, and participants as well as those who sell and service pension plans, such as the banks, insurance companies, and pension consultants. Presently various aspects of some pension plans are unregulated while other aspects are regulated by State agencies, by the Treasury Department, Labor Department, and the Securities and Exchange Commission, among others. The need for coordination of these efforts together with any new regulations is obvious. Accordingly, this bill would make the qualification procedures now administered by the Treasury a part of the operations of the proposed Pension Commission. It may be that the entire scope of Treasury operations affecting pension plans should be transferred to the Commission. And yet, such determinations as the manner of integrating pension benefits with social security benefits and the determination of reasonable levels of compensation obviously have an important impact on Federal revenue considerations. Similarly, the extent to which regulations of pension plan investments is now performed by the Securities and Exchange Commission warrants careful consideration as to what functions, if any, should be transferred to the proposed Commission.

The point to be made here is that a great deal of thought will be required to develop a rational and coordinated systems for the regulation of pension and other employee benefit systems without adversely affecting the traditional role of existing agencies now concerned with some aspect of these plans. But the goal is an important one, and worthy of the effort that will be required. For I am convinced that a single agency is required. It will be a very difficult task to regulate the operations of employee benefit plans sufficiently to assure the legitimate expectations of employee participants while at the same time avoiding undue or unnecessary interference with the operation of these plans. Overregulation or unnecessary regulation would be worse than none, for it would deter the installation and improvement of these much needed programs. It is a tortuous course to be steered between the problems of frustrated expectations for pension plan members growing out of no regulation and the equally damaging frustrations growing out of an irrational regulatory scheme which deters the employer from instituting a pension plan for the employees. It seems clear to me that this course could best be steered by an agency which has the general responsibility for encouraging the growth of the private pension system including the implementation of needed rules to protect pension participants.

Mr. President, as I have said, the complexities in this field are awesome. The bill I introduce today is not perfect, but it represents several years work by myself and my staff, in consultation with representatives of the business community, organized labor, and the banking and insurance industries. I hasten to add that none of those groups endorse all of the bill, though each, I suspect, has much to gain from certain features of it.

45-800—70——4

The bill I introduce today is similar in many respects to S. 1103, which I introduced in the 90th Congress. It is also similar in some respects to provisions of two separate and less comprehensive bills sponsored by the Johnson administration in the last Congress, and I would hope that the Nixon administration would carefully study all these proposals.

One of the principal differences between this bill and S. 1103 is in the vesting provisions. S. 1103 would have permitted two different types of vesting: full vesting at age 45 after 15 years or 50 percent vesting after 10 years and 5 percent per year thereafter, also at age 45.

Upon further reflection, I have become convinced that deferred graded vesting is preferable to full vesting at a given point of time since it eliminates the possibility that a worker can be forced to lose all his pension benefits just because he was laid off or quit 1 day before all his benefits were scheduled to vest. Under the present bill, no benefits would have to vest for 6 years. At the end of the 6th year of continuous service, 10 percent of benefits would have to vest, with an additional 10 percent for each year thereafter until full vesting occurs after 15 years.

Another change from S. 1103 concerns the Commission's power to issue regulations to implement the act and the establishment of a unified scheme of Federal law applicable to employee benefit plans. Under today's bill the Commission is given the power to issue regulations, in accordance with the Administrative procedure Act; such regulations may define actuarial, accounting, technical and trade terms and may prescribe limitations on actuarial assumption as to such matters as interest rates, mortality and turnover. The Commission is, moreover, required to consult with other Federal agencies which have jurisdiction over employee benefit plans with a view to insuring a unified consistent scheme of regulation of employee benefit plans. Finally, the bill gives the President power to delegate authority to enforce and administer other laws applicable to employee benefit plans from other Federal agencies to the Commission, where such delegation would help in establishing a simplified, unified and consistent scheme of regulation and administration of laws applicable to these plans.

I wish to express my admiration and gratitude to my administrative assistant, Frank Cummings, for the years of thought and experience as an outstanding labor-management lawyer he has poured into the months of work he spent in drafting this bill. For several years, he was the minority counsel to the Committee on Labor and Public Welfare. It is largely due to his brain and hard work that this entire concept has been established, structured, and presented to the Senate. He has a great right to be proud of this proposal. Also to others who have been consulted or otherwise helped, I express my gratitude and appreciation, and particularly to Eugene Mittleman, the minority counsel of the Senate Committee on Labor and Public Welfare, who has worked with me and Mr. Cummings in refining and revising this bill.

Following my sponsorship of this subject, the previous administration felt it incumbent to come in with a bill. I am hopeful that based on the bill I am introducing today, which is revised and brought up to date, this administration may adopt the concept and come forward with a measure to deal with this problem.

I do not claim that my bill is the only one to deal with this problem. There are other approaches which can and will be explored, but I think this bill can serve as a focal point, and, with other proposals which have been made and will be made, specific legislation can emerge designed to cope with the problems I have outlined as existing in this field.

Mr. President, technical aspects of this bill, as well as other changes from S. 1103, are explained in an explanatory memorandum I have prepared, and I ask unanimous consent that the full text of the bill, together with the text of that explanatory memorandum, be printed in the RECORD at the conclusion of my remarks.

Mr. President, this bill was referred to the Committee on Labor and Public Welfare when it was introduced in the 90th Congress, and I ask unanimous consent that it again be referred to that committee, with the understanding that if the bill is reported, and if it contains any provisions, as reported, amending the Internal Revenue Code, the bill shall then be re-referred to the Finance Committee for consideration of any such provision within the jurisdiction of that committee.

The VICE PRESIDENT. The bill will be received and appropriately referred, as requested by the Senator from New York; and, without objection, the bill and the memorandum will be printed in the RECORD.

The bill (S. 2167), to provide additional protection for the rights of participants in employee pension and profit-sharing-retirement plans, to establish minimum standards for pension and profit-sharing-retirement plan vesting and funding, to establish a pension plan reinsurance program, to provide for portability of pension credits, to provide for regulation of the administration of pension and other employee benefit plans, to establish a U.S. Pension and Employee Benefit Plan Commission, and for other purposes, introduced by Mr. JAVITS, was received, read twice by its title, and referred to the Committee on Labor and Public Welfare, by unanimous consent, then to the Committee on Finance, when reported, if it contains amendment of the Internal Revenue Code, and ordered to be printed in the RECORD, as follows:

"S. 2167

"*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That this Act may be cited as the 'Pension and Employee Benefit Act of 1969'.

"DEFINITIONS

"SEC. 2. As used in this Act—

"(1) The term 'Commission' means the United States Pension and Employee Benefit Plan Commission established under section 3.

"(2) The term 'employee' means an individual who performs service for a continuous period of not less than six months on one or more States for an employer, and includes an officer or director of a corporation or of an unincorporated organization and an agent acting for his principal on a substantially full-time basis.

"(3) The term 'employees' benefit plan' means any plan providing for the payment of any of the benefits specified in section 2(4).

"(4) The term 'employees' benefit fund' means any fund, whether established pursuant to a collective bargaining agreement or unilaterally by an employer or by a labor organization, which is available for the payment either from principal or income, or both, to persons who are employed in an industry affecting commerce or who are members of a labor organization representing employees in an industry affecting commerce, or to members of the families, dependents, or beneficiaries of such persons, of one or more of the following benefits: Medical or hospital care, pension on retirement or death of employees, benefits under a profit-sharing-retirement plan, compensation for injuries or illness resulting from occupational activity or insurance to provide any of the foregoing, or unemployment benefits or life insurance, disability and sickness benefits, or accident benefits, or pooled vacation, holiday, severance or similar benefits, or defraying the costs of apprenticeship training programs, or, in the case of a fund subject to the restrictions of section 302(c) of the Labor-Management Relations Act, providing any other benefit which may be permitted by subsections 302(c) (5) or 302(c) (6) of that Act: *Provided,* That any fund to which contributions are made solely to provide workmen's compensation benefits, disability benefits, or other benefits required by State or local law to be provided to employees shall not be deemed to be an employees' benefit fund. To the extent that benefits under an employees' benefit plan are provided through the medium of an insurance contract under which benefits are guaranteed by the insurance company to the extent that insurance premiums are paid, and under which neither the employer nor any labor organization retains the power to instruct the insurance carrier with respect to entitlement to receipt of benefits, disposition of assets or any other matter relating to the moneys received by the insurance carrier pursuant to the plan, such plan shall not be deemed to involve an employees' benefit fund subject to the provisions of title IV.

"(5) The term 'employer' means any person acting directly as an employer or indirectly in the interest of an employer in relation to a pension plan or employee's benefit fund, and includes a group or association of employers acting for an employer in such capacity.

"(6) The term 'person' means an individual, partnership, coroporation, mutual company, joint stock company, trust, unincorporated organization, association, or employee organization.

"(7) The term 'State' means any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, American Samoa, Guam, Wake

Island, the Canal Zone, and Outer Continental Shelf Lands defined in the Outer Continental Shelf Lands Act.

"(8) The term 'commerce' means trade, commerce, transportation, or communication, among the several States, or between any foreign country and any State and any place outside thereof.

"(9) The term 'industry affecting commerce' means any activity, business, or industry in commerce or in which a labor dispute would hinder or obstruct commerce or the free flow of commerce and includes any activity or industry 'affecting commerce' within the meaning of the Labor-Management Relations Act, 1947, as amended, or the Railway Labor Act, as amended.

"(10) The term 'life annuity' means an annuity that continues for the duration of the life of the annuitant, whether or not it thereafter continued to some other person.

"(11) The term 'deferred life annuity' means a life annuity that commences at retirement age under a pension plan, but in no event later than age seventy.

"(12) The term 'pension benefit' means the aggregate annual, monthly, or oher amounts to which an employee will become entitled upon retirement or to which any other person is entitled by virtue of such employees death.

"(13) The term 'pension plan' means a pension fund or plan, other than a profit-sharing-retirement plan, organized and administered to provide pension benefits for employes or their beneficiaries, and includes, without limiting the generality of the foregoing:

"(A) A unit benefit plan under which pension benefits are determined with reference to remuneration of an employee for each year of service, or for a selected number of years of service.

"(B) a money purchase plan under which pension benefits are determined at the retirement of an employee with reference to the accumulated amount of the aggregate contributions paid by or for the credit of the employee, and

"(C) A flat benefit plan under which the pension benefits are expressed either as a fixed amount in respect of each year of employment or as a fixed periodic amount.

"(14) The terms 'registered pension plan' and 'registered profit-sharing-retirement plan' mean, respectively, a pension plan or profit-sharing-retirement plan registered with and certified by the Commission as a plan organized and administered in accordance with title I.

"(15) The term 'reinsured pension plan' means a registered pension plan which has been reinsured under title II and which has been in operation for at least five years and, for each of such years, has met the registration requirements of the title I: *Provided*, That any addition to or amendment of a reinsured pension plan shall, If such addition or amendment involves a significant increase, as determined by the Commission, in the initial unfunded liability of such pension plan, be regarded as a new and distinct pension plan which may become a 'reinsured pension plan' only after meeting the five-year operation requirements of this paragraph and section 202(c) and the registration requirements of title I.

"(16) The term 'supplemental pension plan' includes a pension plan established for employees whose membership in another pension plan is a condition precedent to membership in the supplemental pension plan.

"(17) The term 'voluntary additional contribution' means an additional contribution by an employee to or under a pension or profit-sharing-retirement plan except a contribution the payment of which, under the terms of the plan, imposes upon the employer an obligation to make concurrent additional contribution to or under the plan.

"(18) The term 'experience deficiency' with respect to a pension plan means any actuarial 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 provisions of title I, other than as required by section 108(b) (3).

"(19) The term 'fully funded' with respect to any pension plan means that such plan at any particular time has assets actuarily determined by a person authorized under section 108(e) to be sufficient to provide for the payment of all pension and other benefits to all employees and former employees then entitled to an immediate or deferred benefit under the terms of the plan.

"(20) The term 'provisionally funded' with respect to any pension plan means that such plan at any particular time has insufficient assets to make it

fully funded, but has made provision pursuant to section 108 for special payments sufficient to liquidate all initial unfunded liabilities or experience deficiencies.

"(21) The term 'initial unfunded liability' means the amount, on the first day of January, 1968, or the effective date of a pension plan or any amendment thereto, whichever is later, by which the assets are required to be augmented to ensure that the plan is fully funded.

"(22) The term 'special payment' means a payment made to or under a pension plan for the purpose of liquidating an initial unfunded liability or experience deficiency.

"(23) The term 'fund' shall mean a trust fund, but shall also include a contractual right pursuant to an agreement with an insurance company.

"(24) The term 'funding' shall mean payment or transfer of assets into a fund, but shall also include payment to an insurance company to secure a contractual right from such company.

"(25) The term 'profit-sharing-retirement plan' means a plan established and maintained by an employer to provide for the participation in his profits by his employees in accordance with a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan upon retirement or death. Such plan may include provisions permitting the withdrawal or distribution of the funds accumulated upon contingencies other than, and in addition to, retirement and death.

"(26). The term 'interest in a profit-sharing-retirement plan' means the amount allocated to the account of a participant in a profit-sharing-retirement plan.

"(27) The term 'service for a continuous period' means service for a period of time without regard to periods of temporary suspension of employment.

"(28) The term 'administrator' means the person or persons designated by the terms of a pension plan, collective bargaining agreement, trust agreement, or other document establishing or relating to a pension plan or employees' benefit fund as having responsibility for the effective control, disposition or management of the money or other assets contributed to or received by a pension plan or employees' benefit fund; or, in the absence of such designation, the person or persons actually responsible for the control, disposition, or management of such money or other assets, irrespective of whether such control, disposition, or management is exercised directly or through an agent or trustee designated by such person or persons.

"ESTABLISHMENT OF PENSION AND EMPLOYEE BENEFIT PLAN COMMISSION

"SEC. 3. (a) There is hereby established in the executive branch of the Government an independent agency to be known as the 'United States Pension and Employee Benefit Plan Commission'. The Commission shall be composed of five members to be appointed by the President, by and with the advice and consent of the Senate. Members of the Commission shall serve for terms of six years, except that (i) of the members first appointed, two shall be appointed for a term of two years, two shall be appointed for a term of four years, and one shall be appointed for a term of six years, and (ii) members appointed to fill vacancies occurring by reason of death or resignation shall be appointed for the unexpired term of their predecessors. Not more than three members of the Commission shall be members of the same political party, and in making appointments members of different political parties shall be appointed alternately as nearly as may be practicable. No member of the Commission shall engage in any business, vocation, or employment other than that as serving as a members, nor shall any member participate, directly or indirectly (except as a beneficiary) in the management of any plan or fund subject to regulation under this Act. One of the members shall be designated by the President as Chairman of the Commission. Three members shall constitute a quorum of the Commission.

"(b) (1) Section 5314 of title 5, United States Code (which lists positions in level III of the Executive Schedule) is amended by adding at the end thereof the following:

"'(46) Chairman, United States Pension Commission.'

"(2) Section 5315 of such title (which lists positions in level IV of the Executive Schedule) is amended by adding at the end thereof the following:

"'(78) Members, United States Pension Commission.'

"(c) The Commission is authorized to appoint and fix the compensation of such officers and employees, and to incur such expenses as may be necessary to enable it to carry out its functions.

"POWERS AND DUTIES OF COMMISSION

"SEC. 4. It shall be the duty of the Commission—

"(1) To promote the establishment, extension, and improvement of pension, profit-sharing-retirement and other employee benefit plans;

"(2) To accept for registration all pension and profit-sharing-retirement plans required and qualified to be registered with the Commission under title I, and to reject any pension or profit-sharing-retirement plan that does not qualify for registration;

"(3) to cancel certificates of registration of pension and profit-sharing-retirement plans registered under such title which cease to be qualified for such registration;

"(4) to direct and administer the pension reinsurance program established by title II;

"(5) to direct and administer the pension portability program established by title III;

"(6) to enforce the provisions of title IV; and

"(7) to perform such other functions as may be necessary to administer the provisions of this Act.

"(b) The Commission or its duly authorized representatives shall have power, at any reasonable time—

"(1) to inspect the books, files, documents, and other records respecting pension and profit-sharing-retirement plans kept by an administrator, employer, insurer, trustee, or other person in relation to such plans: *Provided*, That the Commission may delegate its powers under this subsection (b) to the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation in cases involving books, files, documents, or other records held by a bank or trust company, subject to their respective supervisory power, and

"(2) to require any such administrator, employer, insurer, trustee, or other person to furnish, in a form acceptable to the Commission, such information as the Commission deems necessary for the purpose of ascertaining whether this Act and regulations of the Commission hereunder have been or are being complied with.

"(c) The Commission is authorized by regulation to prescribe minimum standards and qualifications for persons performing services required by the provisions of this Act to be performed by actuaries and, upon application of any person, to determine whether such person meets the standards and qualifications so prescribed. The Commission shall issue certificates of qualification to applicants determined by the Commission after such examination, investigation, or other procedure as it may deem necessary, to meet such standards and qualifications.

"(d) The Commission is authorized by regulation to prescribe reasonable fees for the registration of pension and profit-sharing-retirement plans and other services to be performed by it in connection with such plans under this Act, and to make and enforce such other regulations as may be necessary to enable it to carry out its functions and duties under this Act. All fees collected by the Commission shall be paid into the general fund of the Treasury.

"(e) The Commission shall transmit to the Congress annually a report of its activities under this Act during the preceding fiscal year.

"(f) In accordance with the Administrative Procedure Act, the Commission may prescribe such rules and regulations as may be necessary or appropriate to carry out the purposes of this Act. Among other things, such rules and regulations may define actuarial, accounting, technical, and trade terms; may prescribe reasonable limitations or actuarial assumptions as to interest rates, mortality, turnover rates and other matters; may prescribe the form and detail of all reports required to be made under this Act; and may provide for the keeping of books and records and the inspection of such books and records. Prior to promulgating rules or regulations, the Commission shall consult with other Federal departments or agencies which have jurisdiction over employee benefit plans with a view to avoiding unnecessary conflict, duplication or inconsistency in the rules and regulations which are applicable to such plans under other laws of the United States.

"APPROPRIATIONS

"SEC. 5. There are authorized to be appropriated such sums as may be necessary to enable the Commission to carry out its functions and duties.

"ADMINISTRATION OF WELFARE AND PENSION PLANS DISCLOSURE ACT

"SEC. 6. (a) The functions of the Secretary of Labor and the Department of Labor under the Welfare and Pension Plans Disclosure Act, as amended, are hereby transferred to and shall be administered by the Commission.

"(b) All personnel, property, records, and unexpended balances of appropriations, which the Director of the Bureau of the Budget determines are used or intended for use by the Secretary of Labor or the Department of Labor primarily in the administration of functions transferred under the provision of this section, are transferred to the Commission.

"(c) In addition to the filing requirements of the Welfare and Pension Plan Disclosure Act, it shall be a condition of compliance with section 7 of such Act that each annual report hereinafter filed under that section shall be accompanied by a certificate or certificates in the name of and on behalf of the plan, the administrator, and any employer or labor organization participating in the establishment of the plan, designating the Commission as agent for service of process on the persons and entities executing such certificate or certificates in any action arising under the Welfare and Pension Plans Disclosure Act or this Act.

"TITLE I—BENEFIT STANDARDS

"PLANS TO WHICH TITLE APPLIES

"SEC. 101. (a) Except as provided by subsection (b), this title applies to any pension plan and, to the extend hereinafter provided, to any profit-sharing-retirement plan, established by an employer engaged in commerce or in any industry or activity affecting commerce or by any employee organization or organizations representing employees engaged in commerce or in an industry or activity affecting commerce or by both.

"(b) This title shall not apply to a pension or profit-sharing-retirement plan if—

"(1) such plan is administered by the Federal Government or the government of a State or subdivision thereof, or by an agency or instrumentality thereof;

"(2) such plan is administered by an organization which is exempt from taxation under the provisions of section 501(a) of the Internal Revenue Code of 1954 and is administered as a corollary to membership in a fraternal benefit society described in section 501(c) (8) of the Internal Revenue Code of 1954 or by an organization described in section 501(c) (3) or (4) of such Code: *Provided*, That the provisions of this paragraph shall not exempt any plan administered by a fraternal benefit society or organization which represents its members for purposes of collective bargaining;

"(3) such plan is established by a self-employed individual for his own benefit or for the benefit of his survivors or established by one or more owner-employers exclusively for his or their benefit or for the benefit of his or their survivors:

"(4) such plan covers not more than twenty-five participants:

"(5) such plan is established and maintained outside the United States by an employer primarily for the benefit of employees who are not citizens of the United States; or

"(6) such plan is unfunded and is established by an employer primarily for the purpose of providing deferred compensation for a select group of management employees and is declared by the employer as not intended to meet the requirements of section 401(a) of the Internal Revenue Code.

"REGISTRATION OF PLANS

"SEC. 102. (a) Every administrator of a pension or profit-sharing-retirement plan to which this title applies shall file with the Commission an application for registration of such plan. Such application shall be in such form as shall be prescribed by regulation of the Commission, and shall be accompanied by a copy of the plan, a copy of the trust deed, insurance contract, by law, or other

document under which the plan is constituted. Thereafter, while such plan is in force, the administrator shall maintain its qualification for registration under this title.

"(b) In the case of plans established on or after January 1, 1968, the filing required by subsection (a) shall be made within six months after such plan is established. In the case of plans established prior to January 1, 1968, such filing shall be made on such date or on such later date as may be specified by the Commission.

"(c) If after examination of a pension or profit-sharing-retirement plan filed under this section, the Commission is satisfied that such plan is qualified for registration under this title the Commission shall issue a certificate of registration with respect to such plan. If the Commission is not so satisfied it shall notify the administrator.

"(d) If at any time subsequent to the issuance of a certificate under subsection (c) with respect to any plan, the Commission determines that such plan is no longer qualified for registration under this title, it shall notify the administrator.

"(e) A notification under subsection (c) or (d) shall set forth the deficiency or deficiencies in the plan or in its administration by reason of which the notification is given, and shall give the administrator, the employer of the employees covered by the plan, and the labor organization, if any, representing such employees a reasonable time within which to remove such deficiency or deficiencies. If the Commission thereafter determines that the deficiency or deficiencies have been removd it shall issue or continue in effect the certificate, as the case may be. If it determines that the deficiency or deficiencies have not been removed it shall enter an order denying or canceling the certificate of registration.

"ANNUAL REPORTS ON REGISTERED PLANS

"SEC. 103. The Commission may, by regulations promulgated pursuant to the Administrative Procedures Act, provide for the filing of single reports satisfying the reporting requirements of this Act and the Welfare and Pension Plans Disclosure Act.

"AMENDMENTS OF REGISTERED PLANS

"SEC. 104. Where a pension or profit-sharing-retirement plan filed for registration under this title is amended subsequent to such filing, the administrator shall within six months after the effective date or the date of adoption of such amendment, whichever is later, within sixty days after the effective date of such amendment file with the Commission a copy of the amendment and such additional information and reports as the Commission by regulation requires to determine the amount of any initial unfunded liability created by the amendment and the special payments required to liquidate such liability.

"QUALIFICATION OF PLAN FOR REGISTRATION

"SEC. 105. A pension or profit-sharing-retirement plan shall be deemed to be qualified for registration under section 102 if it conforms to, and is administered in accordance with, the standards and requirements set forth in section 102 and sections 106 to 110, inclusive.

"GENERAL REQUIREMENTS

"SEC. 106. (a) Every pension plan and, to the extent required by regulations issued by the Commission, every profit-sharing-retirement plan shall define the benefits provided by such plan, the method of determination and 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. Each such plan shall provide for the furnishing of a written explanation to each member of the plan of the terms and conditions of the plan and amendments thereto applicable to him, together with an explanation of the rights and duties of the employee with reference to the benefits available to him under the terms of the plan and such other information as may be required by regulations of the Commission.

"(b) The Commission shall by regulation require each plan to furnish each participant, upon termination of service with a vested right to a deferred life annuity, pension, or other vested interest, with a certificate setting for the

benefits to which he is entitled, including but not limited to the name and location of the entity responsible for payment, the amount of benefits, and the date when payment shall begin, as such regulations shall specify. A copy of each such certificate shall be filed with the Commission. In any proceeding arising under this Act, such certificate shall be deemed prima facie evidence of the facts and rights set forth in such certificate.

"(c) A pension or profit-sharing-retirement plan filed for registration under this title, and any trust forming a part of such plan, shall meet all the requirements set forth in section 401 of the Internal Revenue Code of 1954, as determined by the Commission, except to the extent such requirements are inconsistent with the provisions of subsection (a) of this section or of sections 107 to 110, inclusive.

"VESTING OF BENEFITS

"SEC. 107. (a) A pension or profit-sharing-retirement plan filed for registration under this title shall provide, under the terms of the plan in respect of service on or after the effective date of this Act, or by amendment to the terms of the plan or by the creation of a new plan on or after such date in respect of service on or after the effective date of such amendment or new plan, that—

"(1) a member of the plan who has been in the service of the employer, or has been a member of the plan, for a continuous period of six years is entitled upon termination of his employment or membership in the plan prior to attaining retirement age (i) in the case of a pension plan to a deferred life annuity commencing at his normal retirement age, and (ii) in the case of a profit-sharing-retirement plan to a nonforfeitable right to his interest in such plan, equal to 10 per centum of full pension benefits as provided by the plan in respect of such service or of such interest, respectively, and such entitlement shall increase by at least 10 per centum per year of continuous service thereafter until the completion of fifteen years of continuous service, after which such member shall be entitled upon termination of employment or membership in the plan prior to attaining retirement age to a deferred life annuity commencing at his normal retirement age equal to the full pension benefits as provided by the plan in respect of such service, or to the full amount of such interest in the profit-sharing-retirement plan, respectively;

"(2) the pension benefits provided under the terms of a pension plan, the deferred life annuity referred to in paragraph (1), and an interest in a profit-sharing-retirement plan referred to in paragraph (1) shall not be capable of assignment or alienation and and shall not confer upon any employee, personnel representative or dependent, or any other person, any right or interest in such pension benefits, deferred life annuity, or profit sharing retirement plan, capable of being assigned or otherwise alienated: *Provided*, That the Commission may by regulation provide for the final disposition of plan assets when beneficiaries cannot be located or ascertained within a reasonable time.

"(b) Anything in subsection (a) to the contrary notwithstanding, a pension or profit-sharing-retirement plan may provide for vesting upon service or membership in the plan for a lesser period than is provided in such subsection.

"(c) Anything in subsection (a) to the contrary notwithstanding, when a plan so provides, an employee may receive in discharge of his rights thereunder upon termination of employment prior to attaining normal retirement age as defined in the plan, or upon attaining such retirement age, a lump sum amount equal to the command value of the annuity prescribed by the plan, or, in the case of a profit-sharing-retirement plan, the value of his interest in such plan.

"(d) If a pension plan so provides, a person who is entitled to a deferred life annuity under subsection (a) may, before the commencement of payment of such life annuity, elect to receive, partly or wholly in lieu of the deferred life annuity described by subsection (a)—

"(1) a deferred life annuity the amount of which is reduced or increased by reason of early or deferred retirement, by provision for the payment of an optional annuity to a survivor or to the estate of the employee, or by variation of the terms of payment of such annuity to any person after the employee's death, and

"(2) a payment or series of payments by reason of a mental or physical disability as prescribed by regulations of the Commission.

"(e) For the purposes of subsections (b) (2) and (c), the commuted value of a deferred life annuity shall be computed on the basis of such interest rate and mortality tables and in such manner as may be approved by the Commission.

"FUNDING OF PLANS

"SEC. 108. (a) A pension plan filed for registration under this title shall provide for funding, in accordance with the tests for solvency prescribed by this title, that is adequate to provide for payment of all pension benefits, deferred life annuities and other benefits required to be paid under the terms of the plan. A pension plan shall be deemed to be solvent for the purposes of this title if it is fully funded or provisionally funded.

"(b) Provisions for funding 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 liability and experience deficiency. The contribution of the employer, including any contributions made by employees, shall consist of the payment currently into the plan or fund of—

"(1) all current service costs;

"(2) 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,

"(A) in the case of an initial unfunded liability existing on the effective date of this Act, in any plan established before that date, forty years from that date, and

"(B) in the case of an initial unfunded liability resulting from an amendment to a pension plan made on or after the effective date of this Act, or resulting from the establishment of a pension plan on or after the effective date of this Act, thirty years from the date of such amendment or establishment; and

"(3) where the 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: *Provided*, that the Commission may suspend the special payments requirements or extend the five year period provided in this subparagraph (3) in cases involving business necessity or substantial risk to the continuation of the employing enterprise.

Notwithstanding the provisions of this subsection, (i) the liquidation of initial unfunded liabilities or experience deficiences may be accelerated at any tme, and (ii) where an insured pension plan established before the effective date of this Act, is funded by level annual premiums to retirement age for each individual member and benefits are guaranteed by the insurance company to the extent that premiums have been paid, it shall be deemed to meet the requirements of paragraph (2)(A) of this subsection.

"(c) one year after the effective date of this Act, in the case of pension plans registered on or before that date, or within six months after the date of establishment of the plan in other cases, the Administrator shall submit a report of the person authorized by subsection (e) certifying—

"(1) the estimated cost of benefits in respect of service in the first year during which such plan is required to register and the rule for computing such cost in subsequent years up to the date of the next report;

"(2) the initial unfunded liability, if any, for benefits under the pension plan as of the date on which the plan is required to be registered; and

"(3) the special payments required to liquidate such initial unfunded liability in accordance with subsection (b).

Where an insured pension plan is funded by level annual premiums extending not beyond the retirement age for each individual member and benefits are guaranteed by the insurance company to the extent that premiums have been paid, the report required by this subsection 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 (1), (2), and (3).

"(d) The administrator in respect of a registered pension plan shall cause the plan to be reviewed by a person authorized by subsection (e) not more than three years after registration and at intervals of not more than three years thereafter and the person reviewing the plan shall prepare a report certifying—

"(1) the estimated cost of benefits in respect of service in the next succeeding years and the rule for computing such cost in subsequent years up to the date of the next report;

"(2) 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

"(3) the special payments which will liquidate any such experience deficiency over a term not exceeding five years.

If any such report discloses a surplus in a pension plan the amount of any future payments required to be made to the fund or plan may be reduced by the amount of such surplus. A report under this subsection shall be filed with the Commission by the administrator upon its receipt.

"(e) The reports and certificates referred to in subsections (c) and (d) shall be made by an actuary certified by the Commission under section 4(c): *Provided*, That the Commission may exempt any plan, in whole or in part, from the requirement that such reports and certificates be filed where the Commission finds such filings to be unnecessary.

"(f) Anything in this section 108 to the contrary notwithstanding, if evidence satisfactory to the Commission shall be filed on behalf of a pension plan in connection with an application for registration under this title demonstrating that (i) such pension plan is a multiemployer plan in which at least 25 per centum of the employees in the industry covered by the plan, either nationally or in a particular region in which a substantial number of employees in such industry is employed, participate, and (ii) no single employer employs more than 20 per centum of the employees covered by the plan, and (iii) the history and present business condition of the industry make it improbable that there will be a substantial decrease in employment in the industry within the foreseeable future—

"(I) the Commission may register such plan without regard to the funding requirements of section 108 if such plan meets the following alternative funding requirements:

"(1) annual payment into the fund of all current service costs;

"(2) annual payment into the fund of an amount equal to the interest, at such rate of interest as the Commission shall prescribe, but not more than 6 per centum per annum, on the unfunded liability of such fund at the date each such payment is made;

"(3) annual payment into the fund of an amount equal to the insurance premium for such year required to be paid on behalf of such fund by section 203 of title II of this Act; and

"(4) in computing unfunded liability under this subsection (f) the Commission may permit a multiemployer plan to compute such liability solely on the basis of information obtained from participants pursuant to a requirement of the plan under which each such participant, upon reaching the age of forty and completing ten years of continuous service, is required to file with the Administrator of the plan notification of his status under the plan.

"(II) the Commission may by regulation approve alternative requirements for payments into the fund other than those specified in subparagraph I of this subsection (f) when, in the opinion of the Commission, such standards will provide reasonable assurance of sufficient assets in the fund of the multiemployer plan to provide for payment of anticipated benefits.

"(g) Each pension plan shall, as a condition of registration under this title, apply for reinsurance and pay the reinsurance premiums provided in title II.

"(h) For the purpose of this section, a profit-sharing-retirement plan, within the meaning of section 2(26) of this Act, which meets the requirements of title I insofar as they are made specifically applicable to such a plan by section 105 shall be deemed fully funded.

"DISCONTINUANCE OF PLANS

"SEC. 109. (a) Upon complete termination, or substantial termination as determined by the Commission, of a pension plan—

"(1) All contributions by an employer, a labor organization, an employee or other person made after January 1, 1968, in respect of the deferred life annuity prescribed in section 107(a) shall be applied under the terms of the plan—

"(A) first, in the case of persons who have already retired and begun to draw benefits under the plan, or who, on the date of such

termination, had the right to retire and begin to draw such benefits immediately, to provide the life annuities to which such persons were entitled at the date of termination of their employment:

"(B) second, in the case of persons who have vested rights under the plan but have not reached retirement age and begun to draw benefits, to provide the deferred life annuities to which they were entitled at the date of such termination of the plan; and

"(C) third, in the case of any other participants in the plan, to provide deferred life annuities to which they are entitled under the plan pursuant to the requirements of section 401(a)(7) of the Internal Revenue Code of 1954, as amended; and

"(D) in any case, the Commission may approve payment of survivor benefits with priorities equal to those of the employees or former employees on whose service such benefits are based.

"(2) The employer, and the employees of the plan so provided, shall be liable to pay all amounts that would otherwise have been required to be paid to meet the tests of solvency prescribed by section 108, up to the date of such termination, to the insurer, trustee, or administrator of the plan.

"(3) No part of the assets of the plan shall revert to the employer until provision has been made for all pensions and other benefits vested or otherwise payable under section 109 according to the plan in respect of age and service up to the date of the discontinuance to members of the plan and for all benefits to pensioners and their pension beneficiaries in accordance with the terms of the plan.

"(b) Upon complete termination, or substantial termination as determined by the Commission, of a profit-sharing-retirement plan, the interests of all participants in such plan, shall fully vest.

"PAYMENTS TO SURVIVORS

"SEC. 110. (a) Where in accordance with the terms of a pension or profit-sharing-retirement plan an employee or former employee has designated a person or persons to receive a benefit payable under the plan in the event of the employer's death—

"(1) the employer's liability to provide the benefit shall be discharged upon payment to such person or persons of the amount of the benefit; and

"(2) such person or persons may upon death of the employee or former employee enforce payment of the benefit, but the employer shall be entitled to set up any defense that he could have set up against the employee or former employee. As used in this subsection, the term "employer" includes a trustee or insurer under a pension or profit-sharing-retirement plan.

"(b) An employee or former employee may from time to time alter or revoke a designation made under a pension or profit-sharing-retirement plan, but any such alteration or revocation may be made only in the manner set forth in the plan.

"AMENDMENT TO INTERNAL REVENUE CODE

"SEC. 111. (a) Section 401 of the Internal Revenue Code of 1954 (relating to qualified pension, etc. plans) is amended by redesignating subsection (j) as (k) and by inserting after subsection (i) the following new subsection:

"'(j) PENSION AND PROFIT-SHARING-RETIREMENT PLANS TO WHICH THE PENSION AND WELFARE BENEFITS ACT OF 1969 APPLIES.—For purposes of this part, any pension or profit-sharing-retirement plan to which title I of this Act applies, and any trust forming a part of such plan—

"'(1) shall be treated as meeting the requirements of this section during any period for which a certificate of registration with respect to such plan issued by the United States Pension Commission under such title is in effect or an application therefor is pending before the Commission, and

"'(2) shall be treated as not meeting the requirements of this section during any period for which such application has not been timely filed or such certificate has been denied or cancelled by such Commission.'

"(b) The amendment made by the subsection (a) shall apply with respect to periods after the effective date of this Act, except that with respect to any pension plan established before the effective date of this Act, such amendment shall not apply to any period before the date specified by the Commission under section 102(b).

"MINIMUM WAGE QUALIFICATION

"SEC. 112. Contributions by an employer to a registered pension or profit-sharing-retirement plan shall not be deemed to be part of or to affect the 'regular rate' as that term is used in section 7 of the Fair Labor Standards Act.

"DELEGATION OF OTHER REGULATORY AUTHORITY

"SEC. 113. The President, as may be necessary or appropriate to establish and maintain a uniform, consistent and simplified system of law applicable to employee benefit plans, may by Executive Order delegate to the Commission authority to administer and enforce any other provisions of the laws of the United States insofar as such provisions regulate or affect employee benefit plans.

"DELAY IN THE APPLICATION OF TITLE I

"SEC. 114. If the Commission finds that the application of this Title to any employee benefit plan would increase the costs of the parties to the plan to such an extent that there would result a substantial risk to the voluntary continuation of the plan or a substantial curtailment of pension benefit levels or the levels of employees' compensation it may grant to such plan a delay, not to exceed five years, in satisfying the requirements of this Title, under such conditions as it may prescribe as necessary or appropriate to effectuate the policies of this Act.

"TITLE II—PENSION REINSURANCE

"ESTABLISHMENT OF PROGRAM

"SEC. 201. There is hereby established a program to be known as the Federal pension reinsurance program (hereinafter referred to as the 'program'). The program shall be administered by, or under the direction and control of, the Commission.

"CONTINGENCY INSURED AGAINST UNDER PROGRAM

"SEC. 202. (a) The program shall insure (to the extent provided in subsection (b)) beneficiaries of a reinsured pension plan against loss of benefits to which they are entitled under such pension plan arising from substantial cessation of one or more of the operations carried on by the contributing employer in one or more facilities of such employer before funding of the unfunded liabilities of the fund.

"(b) The rights of the beneficiaries of a reinsured pension plan shall be insured under the program only to the extent that such rights do not exceed—

"(1) in the case of a right to a monthly retirement or disability benefit for the employee himself, the lesser of 50 per centum of the average monthly wage he received from the contributing employe in the five-year period after the registration date of the plan for which his earnings were the greatest, or $500 per month;

"(2) in the case of a right on the part of one or more dependents, or members of the family, of the employee, or in the case of a right to a lump sum survivor benefit on account of the death of an employee, an amount found by the Commission to be reasonably related to the amount determined under subparagraph (1). In the case of a periodic benefit which is paid on other than a monthly basis, the monthly equivalent of such benefit shall be regarded as the amount of the monthly benefit for purposes of clauses (1) and (2) of the preceding sentence.

"(c) If a registered pension plan has not been registered under title I for each of at least the five years preceding the time when there occurs the contingency insured against the rights of beneficiaries shall not be insured: *Provided*, That the Commission may, in its discretion, credit against the five year requirement of section 202(c) one or more years prior to the effective date of this Act for any pension plan which, during such prior years, would have satisfied the registration requirements of title I had this Act been in effect.

"PREMIUM FOR PARTICIPATION IN PROGRAM

"SEC. 203. (a) Each registered pension plan shall pay an annual premium for reinsurance under the program upon payment of such annual premium as

may be established by the Commission. Premium rates established under this section shall be uniform for all pension funds insured by the program and shall be applied to the amount of the unfunded liability to such insured pension fund. The premium rates may be changed from year to year by the Commission, when the Commission determines changes to be necessary or desirable to give effect to the purposes of this title; but in no event shall the premium rate exceed 1 per centum for each dollar of unfunded liability. Premiums under this title shall be payable as of the effective date of this Act, or for plans adopted after that date, as of the effective date of such plans.

"(b) If the Commission determines that, because of the limitation on rate of premium established under subsection (a) or for other reasons, it is not feasible to insure against loss of rights of all beneficiariès of reinsured pension plans, then the Commission shall insure the rights of beneficiaries in accordance with the following order of priorities—

"First: individuals who, at the time when there occurs the contingency insured against, are receiving benefits under the pension plan, and individuals who have attained normal retirement age or if no normal retirement age is fixed have reached the age when an unreduced old-age benefit is payable under title II of the Social Security Act, as amended, and who are eligible, upon retirement, for retirement benefits under the pension plan:

"Second: individuals who, at such time, have attained the age for early retirement, and who are entitled, upon early retirement, to early retirement benefits unde the pension plan; or, if the pension plan does not provide for early retirement, individuals who, at such time, have attained age sixty and who, under such pension plan, are eligible for benefits upon retirement;

"Third: in addition to individuals described in the above priorities, such other individuals as the Commission shall prescribe.

"(c) Participation in the program by a pension plan shall be terminated by the Commission upon failure, after such reasonable period as the Comsion shall prescribe, of such pension fund to make payment of premiums due for participation in the program.

"REVOLVING FUND

"SEC. 204. (a) In carrying out its duties under this title, the Commission shall establish a revolving fund into which all amounts paid into the program as premiums shall be deposited and from which all liabilities incurred under the program shall be paid.

"(b) The Commission is authorized to borrow from the Treasury such amounts as may be necessary, for deposit into the revolving fund, to meet the liabilities of the program. Moneys borrowed from the Treasury shall bear a rate of interest determined by the Secretary of the Treasury to be equal to the average rate on outstanding marketable obligations of the United States as of the period such moneys are borrowed. Such moneys shall be repaid by the Commission from premiums paid into the revolving fund.

"(c) Moneys in the revolving fund not required for current operations shall be invested in obligations of, or guaranteed as to principal and interest by, the United States.

"TITLE III—PENSION PORTABILITY PROGRAM

"ACCEPTANCE OF DEPOSITS

"SEC. 301. (a) It is declared to be the policy of the Congress that a system of pension portability should be established by the Federal Government to facilitate the voluntary transfer of credits between registered pension or profit-sharing-retirement plans having similar benefit features and actuarial assumptions. Nothin in this title nor in the regulations issued by the Commission hereunder shall be construed to require participation in such portability system by a plan as a condition of registration under this Act.

"(b) The Commission is authorized and directed, in accordance with regulations prescribed by it, to receive amounts which are transferred to it from a registered pension or profit-sharing-retirement plan and which are in settlement of an individual's rights under the plan when such individual is separated from employment covered by the plan before the time prescribed for payments under the plan to such individual or to his beneficiaries.

"SPECIAL FUND

"SEC. 302. Amounts received by the Commission pursuant to section 301 shall be deposited in a special fund which shall be established by it for the purposes of this title. The amounts in the fund which are not needed to meet current withdrawals shall be invested as provided under regulations prescribed by the Commission.

"INDIVIDUAL ACCOUNTS

"SEC. 303. There shall be established and maintained in accordance with regulations prescribed by the Commission, an account for each individual with respect to whom the Commission receives amounts under this title. The amount credited to each such account shall be adjusted at the times and in the manner provided by such regulations to reflect earnings of the special fund and transfers from the special fund for costs of administration.

"PAYMENTS FROM INDIVIDUAL ACCOUNTS

"SEC. 304. Amounts credited to the account of any individual under this title may, in accordance with regulations prescribed by the Commission, be paid by the Commission—

"(1) to a registered plan, if such individual becomes an employee covered by such plan and if such plan has benefit features and actuarial assumptions similar to those of the plan which such amount was originally transferred, or

"(2) to such individual or his beneficiaries, if he dies or reaches the age of sixty-five.

Payments under this section shall be made at such times, in such manner, and in such amounts in a lump sum or otherwise as may be determined under such regulations. The amount of any periodic payments shall be determined on an actuarial basis.

"COST OF ADMINISTRATION

"SEC. 305. There are authorized to be made available out of the special fund established pursuant to section 302 such amounts as the Congress may deem appropriate to pay the costs of administration of this title.

"EFFECTIVE DATE

"SEC. 306. No amount may be transferred to the Commission pursuant to section 301 of this title before the before the first day of the twelfth month following the month in which this Act is enacted.

"TECHNICAL ASSISTANCE

"SEC. 307. The Commission and the Secretary of Labor are authorized to provide technical assistance to employers, trade unions, and administrators of pension and profit-sharing-retirement plans in their efforts to provide greater retirement protection for individuals who are separated from employment covered under such plans. Such assistance may include, but is not limited to (1) the development of reciprocity arrangements between plans in the same industry or area, and (2) the development of special arrangements for portability of credits within a particular industry or area.

"TITLE IV—ADMINISTRATION OF EMPLOYEES' BENEFIT FUNDS

"SEC. 401. Every employees' benefit fund established to provide for the payment of benefits under an employees' benefit plan shall be established pusuant to a duly executed trust agreeemnt shall set forth the purpose or purposes for which such fund is established and the detailed basis on which payments are to be made into and out of such fund.

"SEC. 402. Moneys in an employees' benefit fund shall be available for expenditure only for the sole and exclusive purpose of paying to employees or their families, dependents, or beneficiaries the benefits for which it was established, and for defraying the reasonable costs of administration of such fund. None of the assets of an employees' benefit fund shall be held, deposited, or invested outside the United States unless the indicia of ownership remain within the jurisdiction of a United States district court. Any such assets remaining upon

dissolution or termination of the fund shall, after complete satisfaction of the nation, be distributed ratably to the beneficiaries thereof, or, if the trust agreement so provides to the contributors thereto; *Provided*, That in the case of a registered pension or profit-sharing-retirement plan, such distribution shall be subject to the requirements of the previous titles of this Act.

"SEC. 403. The person or persons responsible for the administration of an employees' benefit fund shall cause an independent audit to be made of the fund annually, and shall make the results thereof available for inspection by interested persons at the principal office of the fund and at such other places as may be designated in the agreement or instrument pursuant to which the fund is established.

"SEC. 404. No person who is an officer or employee of an employer or association of employers or a labor organization, which is a party to any agreement establishing or relating to an employee's benefit fund, shall receive or accept, directly or indirectly, whether through a corporation or other entity owned or controlled in any substantial degree by such person or otherwise, any payment, loan, pledge, hypothecation, assignment, or other transfer out of the assets of such fund (other than benefits to which such person is entitled as an employee), except that if such person is an officer or employee of such fund, reasonable fees or expenses of attending meetings in connection with the business thereof may be paid from the fund to any such officer or employee attending such meetings in an official capacity. Nothing herein contained shall prohibit the purchase by a profit-sharing-retirement plan or other profit-sharing plan, in the ordinary course of business, of the securities or indebtedness of any corporation or other business entity employing directly or through a subsidiary or parent entity a substantial number of the beneficiaries of such fund.

"SEC. 405. All investments and deposits of the funds of an employees' benefit fund and all loans made out of any such fund shall be made in the name of the fund or its nominee, and no officer or employee of the fund, no trustee or administrator or officer or employee thereof, no employer or officer or employee thereof, and no labor organization, or officer or employee thereof shall either directly or indirectly accept or be the beneficiary of 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 fund.

"SEC. 406. The provisions of this title shall not be applicable to a bank, trust company, or insurance company which is subject to examination and regulation by the Federal Government or a State government, nor to the employees or representatives, acting in an authorized capacity, of such a bank, trust company, or insurance company, nor to the assets owned or held by such a bank, trust company, or insurance company: *Provided*, That this section shall not exempt from the coverage of this title any person other than such a bank, trust company, insurance company, or their employees or representatives acting in an authorized capacity, issuing instructions or otherwise dealing with such a bank, trust company, or insurance company in connection with an employees' benefit fund.

"TITLE V—ENFORCEMENT

"SEC. 501. Whenever the Commission—

"(1) determines, in the case of a pension or profit-sharing-retirement plan required to be registered under title I, that no application for registration has been filed in accordance with section 102(a), or

"(2) issues an order under section 102(e) denying or canceling the certificate of registration of a pension or profit-sharing-retirement plan,

the Commission may petition any district court of the United States having jurisdiction of the parties, or the United States District Court for the District of Columbia, for an order requiring the employer or other person responsible for the administration of such plan to comply with such requirements of title I as will qualify such plan for registration under title I.

"SEC. 502. Whenever the Commission has reasonable cause to believe that an employees' benefit fund is being or has been administered in violation of the requirements of title IV, the Commission may petition any district court of the United States having jurisdiction of the parties or the United States District Court for the District of Columbia for an order (1) requiring return to such fund of assets transferred from such fund in violation of the requirements of such title, (2) requiring payment of benefits denied to any beneficiary in violation of the requirements of such title, and (3) restraining conduct in violation

of the requirements of such title by any person performing duties in connection with the administration of such fund.

"SEC. 503. Upon the filing of any petition pursuant to section 501 or 502, the district court may, in its discretion, appoint a receiver to take possession of the assets of the plan or fund which is the subject of the petition and to administer them until such time as the violations of law alleged in such petition no longer exist.

"SEC. 504. Suits by persons entitled, or who may become entitled, to benefits from employees' benefit funds or plans may be brought in any district court of the United States having jurisdiction of the parties, or in the United States District Court for the District of Columbia without respect to the amount in controversy and without regard to the citizenship of the parties (1) against any such fund or plan to recover benefits required to be paid from an employees' benefit fund or plan pursuant to the terms of the agreement pursuant to which such fund or plan is established or other constituent instrument; or (2) on behalf of and in the name of an employees' benefit fund against any person who shall have transferred or received any of the assets of such fund in violation of any such agreement or of the requirements of title IV.

SEC. 505. The provisions of the Act entitled 'An Act to amend the Judicial Code and to define and limit the jurisdiction of courts sitting in equity, and for other purposes', approved March 23, 1932 (29 U.S.C. 101–115) shall not be applicable with respect to suits brought under this title.

"SEC. 506. Suits by an administrator of a pension plan, a profit-sharing-retirement plan, or an employees' benefit fund, to review any final order of the Commission, to restrain the Commission from taking any action contrary to the provisions of this Act, or to compel action required under this Act, may be brought in the name of the plan or fund in the district court of the United States for the district where the fund has its principal office, or in the United States District Court for the District of Columbia.

"SEC. 507. In any case in which a trust agreement relating to a fund subject to this Act contains a provision stating that it shall be construed under the law of a particular State, such provision shall be controlling in any suit arising under this Act for breach of any agreement or trust relating to an employees' benefit fund, unless such State law shall be contrary to the provisions or policy of this Act.

"SEC. 508. Nothing in this Act shall be deemed to nullify any provision of any State or Federal law not in direct conflict with a provision of this Act. If any provision of this Act or the application of such provision to any person or circumstance is held invalid, the remainder of this Act and the application of such provision to other persons or circumstances shall not be affected."

The explanatory memorandum presented by Mr. JAVITS is as follows:

"EXPLANATORY NOTES CONCERNING PRINCIPAL PROVISIONS OF THE PENSION AND EMPLOYEE BENEFIT ACT

"DEFINITIONS

"The definitions, as well as title I of the bill, follow the general format, after extensive revision, of the Pension Benefits Act, 1965, of the Province of Ontario, Canada. While the language of that Act obviously required substantial re-working to fit within the special framework of United States law and the different pattern of United States pension plans, nevertheless the general outlines of the Ontario Act may be useful, as a statute *in pari materia*, in intepreting this bill. The full text of the Ontario Act, as well as its interpretative regulations and an explanatory statement by the Prime Minister of Ontario, are set forth in *Private Pension Plans, Hearing Before the Subcommittee on Fiscal Policy of the Joint Economic Committee* 89th Cong., 2d Sess. 6–21 (1966).

"The term 'Commission' (section 2(2)) refers to a new agency, the United States Pension and Employee Benefit Plan Commission, which would be established under section 3 and would be given enforcement jurisdiction over all provisions of this Act, as well as over other existing laws dealing with employee benefit plans which are now administered by other agencies.

"The terms 'employee benefit plan' and 'employee benefit fund' are used only in title IV and the enforcement provisions of title V. Title IV does not regulate employee benefit plans which do not provide for benefits through the medium of an employee benefit fund. Only one section of the Act in any way affects an

employee benefit plan without a fund, and that is section 504, which permits suits by private parties for breach of an agreement relating to an employee benefit plan.

"The 'commerce' language (section 2(9)) is intended to reach the outer limits of the Constitutional power to regulate interstate commerce, subject to the specific exemptions and exclusions set forth in the bill.

"The term 'pension plan' (section 2(13)) does not include a plan meeting the definition of a 'profit-sharing-retirement plan' (section 2(25). Profit-sharing-retirement plans are dealt with separately in the bill. To the extent that a deferred profit sharing plan does not meet the terms of the definition set forth in section 2(25), however, it could nevertheless be considered a pension plan subject to the requirements of the bill applicable to such plans. A regular profit-sharing plan, however, as distinguished from a profit-sharing-retirement plan, ordinarily would not fall within either definition and would not be covered by title I, because no retirement benefits would be provided.

"The term 'reinsured pension plan' (section 2(14)), which is used in title II, is, strictly speaking, a misnomer, as the program provided under title II is really an insurance, rather than a 'reinsurance', program, except in cases involving plans funded originally through the medium of an insurance contract. Note also that, while plans are required to pay premiums from the first day of coverage under the Act, they do not become effectively 'reinsured' until 5 years have expired. Note further that an amendment to a plan resulting in a substantial increase in unfunded liability may be deemed a new 'plan' for reinsurance purposes.

"ESTABLISHMENT OF COMMISSION

"The Commission established by section 3 would be an independent agency organized on the SEC pattern. The language of section 3(a) is similar to the language establishing the SEC. The general intent of the bill is to centralize all federal regulation relating to employee benefit plans in a single agency, thereby to the maximum feasible extent relieving plan administrators of the burden of multiple-agency regulation and avoiding the necessity of multiple applications, multiple inspections, and overlapping jurisdictions. Thus, Sections 111 and 112 would have the effect of consolidating within the Commission jurisdiction over the principal existing regulatory laws concerning pension plans—tax and minimum wage qualification. It is understood that jurisdiction over section 401 of the Internal Revenue Code has been jealously guarded by the Treasury. Nevertheless, section 111 recognizes that the Treasury may have conflicting policy cosiderations: on the one hand, it seeks to implement the policy of encouraging pension plans, which is inherent in section 401 of the Code, yet on the other hand the Treasury is legitimately concerned with maximization of revenue. The transfer of section 401's enforcement to the Commission would ensure that that section will be interpreted in a manner most sympathetic to the growth and soundness of private pension plans.

"In order to further the objective of consolidation and simplification, two provisions have been added to this bill which were not contained in S. 1103 of the 90th Congress. Sec. 113 would allow the President to delegate power from other agencies concerned with administering or enforcing other laws covering employee benefit plans to the Commission for the purpose of establishing a unified, simplified and consistent scheme of regulation of employee benefit plans. Sec. 4(f) requires the Commission, prior to adopting regulations, to consult with other federal agencies concerned with administering or enforcing other laws affecting employee benefit plans with a view to ensuring consistency among the regulations of different agencies, insofar as they affect employee benefit plans This latter provision is in recognition of the fact that it may not be possible to consolidate all regulations in this field under the Commission. Thus, the SEC will continue to have responsibility to enforce the securities laws, and the Federal Reserve and other agencies will continue to regulate banks. Section 4(b)(1) also recognizes this fact and attempts to avoid duplication by allowing the Commission to delegate its functions in certain cases to other agencies which would be inspecting banks in any event.

"Section 6(a) transfers to the Commission the administration of the Welfare and Pension Plans Disclosure Act. Ideally, that Act should be consolidated with and made a part of the provisions of this bill, and no doubt such would be the case in the long run. As an interim matter, however, Section 103 does permit the Commission to consolidate the reporting requirements of the two Acts into a single report form.

"Section 4(c) would authorize the Commission to license persons performing actuarial services and certifications under the bill. Despite the rather extended series of definitions in section 2 and rather technical statement of funding and vesting requirements in title I, a great deal will inevitably depend on the accuracy of actuarial determinations. It would be impractical to regulate actuarial assumptions such as life expectancy and rate of labor turnover by setting forth requirements in statutory form. The approach of this bill, therefore, is to regulate to some extent the persons competent to make certifications based on such assumptions and to permit the Commission to promulgate regulations concerning actuarial assumptions. This bill contains a provision, not included in S. 1103 of the 90th Congress, which would permit the Commission to promulgate such regulations. The long-term accuracy of actuarial assumptions and certifications is also subject to a check under section 108(b)(3), which requires that an actuarial error resulting in an experience deficiency would need to be corrected and funded over a much shorter period of time than any other unfunded liability.

"Section 6(c) should be read together with the enforcement provisions of title V. While title V permits institutions of legal proceedings in any of the United States District Courts, there are often problems of obtaining service of process upon all the necessary parties. Section 6(c) of my bill would permit an action to be brought against a plan or person in only one district outside his home district, and that would be the District of Columbia, as service of process could always be made upon the necessary parties merely by serving the Commission as statutory agent.

"FUNDING AND VESTING

"As indicated above, this title uses the Ontario Pension Benefits Plan Act as a general model (see comments on definitions, above). It should be noted that the enforcement provisions relating to title I do not, however, appear in this title but rather are placed in title V, along with all other enforcement provisions under the Act. Enforcement of title I is not based on the typical device of an administrative hearing followed by review in the Court of Appeals, where the Commission's findings would be final and binding. Rather, the Commission would be required in any case in which, for example, registration is denied, to bring an action in a District Court to compel compliance with the registration requirements of the Act, and the Commission would have to prove its case *de novo*. In addition, any person aggrieved by an action of the Commission, as, for example, in a case in which registration is denied, would not be required to wait for the Commission to seek enforcement but could bring an action in a District Court immediately to review the Commission's action. Thus, maximal judicial review is provided.

"The notice requirements of section 106(a) require only that each participant receive an explanation of his rights under a plan, but also that an employee leaving his job with a vested interest in a pension must receive a certificate telling him what kind of a right he has, so that, years later when he reaches retirement age, he will know precisely what he can expect. This bill also provides (S. 103 did not) that a copy of the certificate must be filed with the Commission and that the certificate will constitute prima-facie evidence of the facts stated therein in a proceeding under the Act.

"One of the major differences b
this year's bill concerns vesting. This bill requires what has come to be called 'graded deferred vesting.' The requirement is that 10% of benefits must be vested by the end of six years of service, plus 10% per year thereafter so that full vesting must be achieved by the end of 15 years. There are no minimum age requirements.

"The funding provisions of section 106 are basically 40 year funding for old plans, and 30 years funding for new plans or new amendments. Thus, a plan starting out anew with an initial unfunded liability based upon past credited service occurring prior to the effective date of the plan would be required to pay into the plan sufficient money to cover current service costs plus sufficient additional moneys to amortize the initial unfunded liability over 30 years. But in any case in which the estimate of the sums necessary to achieve such 30-year funding is in error and an 'experience deficiency' develops, the deficiency must be made up in 5 years, subject to the hardship proviso set forth in section 108(b)(3).

"In the case of multiemployer plans meeting the requirements of section 108(f), alternative funding requirements are provided, in recognition of the fact that such plans tend to be more stable and less susceptible to termination. Section 108(f) is designed to meet some of the problems of such industries as the apparel and clothing industries, where, because the plans' continuance does not depend on the contiuance of any particular employer, full funding need not be achieved as rapidly. Even so, it has been suggested that an additional alternative funding arrangement such industries may be warranted, requiring that in such plans, for example:

"(A) The projected income throughout the ensuing 10-year period, based on expected contributions as contribution rates stipulated in existing collective bargaining agreements, plus expected interest, shall be at least as great as the projected expenses of the plan, provided that such plan (i) has been in existence and has paid benefits for at least 10 years prior to the registration of the plan, and (ii) has retired at least 5 per centum of the employees covered by the plan at the time of registration and thereafter; and

"(B) The calculation of the projections under paragraph (A) above shall be based on the following numbers of employees: (1) employees who may be anticipated to receive retirement payments during the succeeding 10 years, including those already on the retirement rolls and (2) employees who within one year prior to acquiring vested rights hereunder notify the plan administrator in writing of their expectation to acquire such rights under the plan during the following year.

"The viability and soundness of such additional alternatives, along with such others as may be proposed, are certainly worthy of serious consideration.

"REINSURANCE

"This feature of the bill is based in part on a measure sponsored by Senator Hartke in the 89th Congress. The two major differences between this title and that bill are that this bill does *not* insure against loss of plan assets through bad investments, and it does undertake to insure pension plans without regulating them. Instead, this title insures against one contingency only—termination of the employing enterprise before full funding—and insurance applies only to plans meeting the vesting and funding standards of title I, and then only after 5 years compliance. The bill sponsored by Senator Hartke made reinsurance a condition of tax qualification, while this bill makes reinsurance a mandatory requirement, under section 203(a), as well as a condition of registration under section 108(g).

"PORTABILITY

"The portability program under title III is completely voluntary, and section 301(a) sets forth a specific declaration of policy prohibiting the Commission from making participation in the portability program a condition of registration under title I. The existence of a portability clearing house, however, may be a useful service to those organizations which have already begun to seeks ways of developing reciprocal credit systems. Certain labor organizations, particularly in the building trades, have pension plans in various regions of the country with similar benefit and funding features and have sought to establish reciprocity systems between such regional plans. The existence of a central pension credit clearing house may be a useful accommodation and catalyst for such reciprocity arrangements.

"ADMINISTRATION OF EMPLOYEES' BENEFITS FUNDS

"Title IV deals with many of the same problems as are dealt with in the Administration bill introduced by Senator Yarborough, S. 1024, and Mr. Perkins, H.R. 5741. There are a number of significant differences, however.

"Section 401 requires that if there is a fund, it must be established pursuant to a duly executed trust agreement, thus, in effect, producing substantially the same effect as is accomplished by the Administration's bill which clothes the administrators of such funds with the responsibilities of 'fiduciaries.'

"The basic difference here is that establishes the familiar standard of 'a man of ordinary prudence' and then turns the interpretation of that term over to the Federal courts exclusively. (Sections 14(a) and 9). The result of those provisions of the Administration bill would seem to be to wipe out

the vast body of State case law on the subject of trusts and fiduciary responsibility, except to the extent that it is incorporated into the development of federal case law on the subject. Such a development of a federal case law of trusts, however, will only occur after many years, as the cases arise one by one in the federal courts. In the meantime, there will be considerable uncertainty among trustees as to what the law really is. Such uncertainty for an extended period may well be too high a price to pay for the establishment of federal fiduciary standards.

"Titles IV and V of this bill, on the other hand, take a more moderate approach. Insofar as trust agreements contain 'choice of law' provisions designating the trust law of a particular state as applicable, such provisions are required to be honored, pursuant to section 507, provided they do not conflict with the policy of this Act (this proviso was not included in S. 1103). If no such 'choice of law' provision is included in the trust agreement, then the federal courts would apply federal law. Under this system, certainty would be preserved for those trustees who require it—typically banks and trust companies—while the development of federal law would proceed in those cases where no specific State law is spelled out.

"Along the same lines, the Administration bill again attaches no importance to the historical development of trust law, in that it provides, in section 14(k), that no 'exculpatory provision' shall relieve any fiduciary from any of his responsibilities. Of course, the law of trusts, as it has developed in the cases down through the centuries, has developed various standards for enforcing or nullifying such 'exculpatory clauses,' depending on the circumstances. For example, in many pension trusts, responsibility is divided between the trustee (often a bank or trust company) and a labor-management 'Committee,' which typically is given power to 'instruct' the trustee as to certain matters. Typically, a trust company or bank simply will not accept appointment as a trustee under these circumstances unless the trust agreement provides that the Bank shall not be held responsible for any action taken in reliance on instructions from the 'Committee' as provided in the agreement. Is this an illegal 'exculpatory clause' under the Administration bill? It seems likely. Nor can all such problems be spelled out in the statute. The answer, once again, is to leave such matters to development through the case law, and to proserve what certainly we already have by allowing existing case law to continue in existence where it is specifically made applicable under the terms of the trust agreement.

"The 'conflict of interest' provisions of this bill and the Administration bill are quite similar. As indicated above, title IV applies only to funds, not to plans without funds—i.e., those whose benefits are payable solely out of the general assets of the employer. A principal difference between the provisions of this bill and the administration bill concerns the prohibition against being on two payrolls at once. The administration bill, like this bill, prohibits fiduciaries from receiving any assets out of the fund, except as regular benefits. The administration bill attempts to accomplish this first, by stating that the moneys in the fund shall be used 'for the sole and exclusive purpose' of providing benefits and defraying 'reasonable costs of administering the plan.' (Section 14c. The Administration bill also prohibits the making of loans from the fund to any fiduciary (Section 14(f)), and prohibits a fiduciary from dealing with the fund in his own account (section 14(e)(3)). These provisions will *probably* cover most conflict of interest situations, unless a dishonest person is quite clever. The trouble is that recent hearings have shown the development of the most ingenious schemes for siphoning off pension funds, and a bill such as this ought to be drafted, with such ingenious schemes in mind.

"The administration concentrates on the possible misdeeds of the fiduciary—the trustee himself, while my bill concentrates on the representatives of the employer or the union. My bill controls the actions of the truly independent trustee only by application of the law of trusts, without attempting to spell out every detail of that law as it exists in the cases, but my bill does specifically prohibit the representatives of the employer or the union from siphoning off fund assets to their own use, and this is done in much more comprehensive language than that used in the administration bill (section 404).

"One other major difference between the two bills relates to payroll padding. Last year's Investigations Subcommittee hearings disclosed that one of the most

effective ways of depleting a fund was to permit an officer of the employer or the union to draw a salary from both the fund and the employer or union, as the case may be. The theory of my bill is that if a union officer is serving as a trustee and still drawing his salary from the union, he may not also draw a salary from the fund itself—though he may receive expense money and a reasonable fee for attending fund meetings, and the same prohibition is applied to management officers. (Section 404). The Administration bill allows such officers to be on both payrolls at once, but instead limits fiduciaries to 'reasonable compensation'. Such a provision may well get the Labor Department into the business of passing on the reasonableness of every fee paid to every trustee in the Nation, which seem to me to be neither necessary nor wise. I would rather focus on those salaries which are paid in the true conflict of interest situation, and, when it comes to the hiring of the truly independent trustee in a truly arms-length business situation, rely on the ordinary law of trusts.

"ENFORCEMENT

"Title V contains enforcement provisions covering the whole bill. These provisions should be read in connection with the notes under section 6 (service of process) and Title I (judicial review of Commission determinations with respect to funding and vesting). Basically, section 501 permits the Commission to sue to enforce title I, and section 502 permits the Commission to sue to enforce title IV. Section 503 authorizes the Court to appoint a receiver where necessary, in either case. Section 504 provides a private remedy in case of violation of title IV or in case of violation of any provision of a plan. The law applicable in any such case based upon a breach of contract or breach of trust, however, would be State law in any case in which the agreement designates the law of a State as applicable, and in all other cases, federal common law would apply, although, of course, the federal courts would be expected to draw upon the State common law as a source for the development of a federal common law in this area. Of particular importance are the provisions of sections 502 and 504 which permit suit to be brought by the Commission or a participant *either* against the fund to compel payment of benefits, *or* 'in the name of the fund' against any other person to compel return of misappropriated assets—a remedy comparable to the familiar 'stockholders derivative suit' under the law of corporations."

S. 3589—INTRODUCTION OF EMPLOYEE BENEFITS PROTECTION ACT—ADMINISTRATION BILL TO AMEND THE WELFARE AND PENSIONS PLANS DISCLOSURE ACT[1]

Mr. JAVITS. Mr. President, on behalf of the administration, I introduce, for appropriate reference, a bill to amend the Welfare and Pension Plans Disclosure Act. This bill is the subject of the Presidential message received today and printed later in the RECORD.

The bill I introduce today represents a vast improvement over existing law by greatly strengthening the disclosure requirements for employee benefit plans and establishing stringent fiduciary standards designed to protect the rights of millions of American workers who are covered by employee welfare or pension benefit plans. While, as I shall indicate later, I also favor other types of pension plan reforms, there is no question that the present bill is also vitally needed to remedy serious defects in existing law which have permitted racketeers and other unscrupulous persons to jeopardize the security of thousands of American workers.

Existing law, namely the Welfare and Pension Plans Disclosure Act, is predicated on a philosophy of disclosure: Congress assumed at the time that act was passed in 1958 that given adequate disclosure of the facts related to employee benefit plans, employees adversely affected by the acts of plan fiduciaries would be willing and able to take the necessary steps to protect their rights under State law.

Sadly, the facts which have surfaced in recent years as a result of investigation by the news media and by local, State, and Federal Government bodies, including the Senate Permanent Investigations Subcommittee of

[1] From the Congressional Record, Mar. 13, 1970.

which I am a member, have demonstrated that we were too optimistic in 1958 about the sufficiency of disclosure requirements alone to prevent chicanery by plan administrators and other "parties in interest."

Even now, the Senate Labor Subcommittee, of which I am the ranking minority member, is about to undertake an extensive investigation of abuses in the employee benefit plan area—a fact of which the Senate was informed yesterday when it acted to approve the additional funds for the subcommittee to do the thorough job that needs to be done. Coming as it does at the commencement of the subcommittee investigation, the bill I am introducing today is most timely. This bill, together with S. 2167, which I introduced earlier this session, will give our investigation the legislative basis it should have by highlighting the defects of present law and the inadequacy of the disclosure philosophy which underlies it.

Present law is inadequate for the following reasons:

First, the disclosure required is not sufficiently detailed.

Second, aggravating the lack of specificity in the required disclosure is a definition of "party in interest" which fails to include persons who are not nominally parties in interest—for example, employers, trustees, union officers—but really are under the control of such parties. Thus, transactions between employee benefit plans and wholly-owned subsidiaries of contributing employers or relatives of trustees or union officials need not be reported under present law.

Third, under present law, even if the Secretary of Labor suspects misfeasance, he is unable to do anything about it. At most he can investigate and report it, but the burden is left on the participants or beneficiaries to protect their rights under State law. All too often, participants and beneficiaries of plans, out of ignorance or fear or both, have just not been capable of bearing this burden.

Fourth, the State law which applies to employee-benefit plans is usually the common law of trusts, developed over the centuries. These trusts usually involve but a single settlor and, at most, a relatively small, well defined class of beneficiaries. In addition, there is a very serious problem arising from the fact that at common law the definition of "trustee" is quite narrow in scope, while in pension and welfare trust administration, the number of persons who handle and exercise control of the funds is much broader. Further, of course, the multistate operations of many such funds makes the application of a single State's law often unworkable, and in any event, the "conflict of laws" problems which arise in such cases are often a stumbling block to effective enforcement of State law.

Clearly, this body of traditional trust law, vast as it is, must be applied quite differently to employee benefit plans which are the product of collective bargaining and may cover thousands of employees of many different employers. It is not surprising then that a great deal of uncertainty exists today with respect to the duties, righs, obligations of, and remedies against, plan trustees and administrators; especially in connection with jointly administered plans where the trustees actually represent different parties with possibly opposing interests.

Finally, in the case of plans covering employees and beneficiaries in many States service of process, venue, and jurisdictional requirements compound even further the difficulty facing individual employees who might want to institute a suit to protect their rights under present law.

The administration bill which I am introducing today is specifically designed to remedy these defects, as well as to provide additional protections to plan participants.

Much greater specificity of disclosure would be required, particularly with respect to investments in, and transactions with, "parties in interest," which are defined much more broadly than under existing law.

An annual audit by an independent accountant would also be required.

The new definition of "party in interest" includes those, such as administrators, officers, trustees, contributing employers and unions having members covered by the plan and the officers' agents and employees of such employers or unions, now included under present law as well as persons controlling or controlled by contributing employers and relatives, partners or joint venturers with persons now included in the definition. "Relatives" is defined to include all ancestors, descendants, spouses and close in-laws. It is to be noted that in thus broadening the definition of "party in interest" this bill

goes much further than the bill submitted by the last administration in dealing with the same subject matter.

The bill also provides a Federal standard of conduct—the "prudent man" rule—for all employee benefit fund administrators and imposes an obligation on cofiduciaries with joint responsibility to prevent and redress breaches of such responsibility by each other. Fiduciaries who breach their responsibility are made personally liable to make good losses to the fund, and exculpatory provisions are rendered null and void.

The bill further specifies that fiduciaries must discharge their duties "solely in the interests of the participants and their beneficiaries" and also specifically prohibits a wide range of "conflict-of-interest" transactions between the fund and parties in interest subject to certain necessary and reasonable exceptions. In the types of conduct prohibited, the present bill is much more specific than the previous administration's bill. Of particular interest is the provision limiting future investments in contributing employer's stock to a total—when combined with previous holdings—of 10 percent of fund assets—this limitation does not apply to profit-sharing, stock bonus and similar types of funds. This 10 percent limit is to be compared with the 20 percent limit contained in the bill reported out by the House Committee on Education and Labor in the 90th Congress. Also to be noted is a provision prohibiting payment of compensation by a fund—except reasonable expenses—to persons receiving full-time pay from contributing employers or unions whose members are participants in the fund. This provision is also included in my bill S. 2167, and was not included in the previous administration's bill. Another safeguard is the prohibition for 5 years, of persons convicted of certain crimes serving in fiduciary position on employee benefit funds. This is similar to the prohibition on holding union office contained in section 504 of the LMRDA.

The present bill remedies the defect in existing law relating to enforcement by opening the Federal courts to suits by the Secretary of Labor or plan participants—if the amount in controversy exceeds $10,000. The Secretary may enforce any provision of the act, including the fiduciary standards provisions; plan participants or beneficiaries may sue to enforce their right to copies of reports and other documents required to be made available to them, to recover benefits or clarify their right to benefits under a plan, and, as representatives of a class, to redress breaches of fiduciary responsibility by plan administrators. In Federal court actions, process may be served nationwide.

In view of the problems of service of process and jurisdiction involved in maintaining individual suits against funds or their administrators I have some doubts about the desirability of conditioning access to the Federal courts by individuals on at least $10,000 being in controversy, the provisions of the bill permitting counsel fees to be awarded to successful defendants, as well as plaintiffs, and allowing the court to require plaintiffs to post bond to cover such fees.

In summary, those are the highlights of this important bill. I am convinced that is represents a long step in the right direction of providing adequate protection for the rights and expectations of participants and beneficiaries of employee benefit funds.

I would also like to discuss, briefly, some aspects of the relationship between this administration's bill and the broader approach to pension reform which I have taken in my own bill, S. 2167, the Pension Employee and Benefit Act.

The ultimate objective of Federal legislation in this field ought to be to insure that employees who are depending on benefit plans to provide them with help in times of sickness or disability or with retirement security ought to receive that to which they are reasonably and lawfully entitled. At a bare minimum this means that employee benefit funds ought to be protected from outright embezzlement as well as the more subtle, but no less insidious, types of malfeasance and breaches of trust that have occurred and to which the administration's bill is directed. S. 2167 covers this problem and in fact goes beyond the administration bill in certain respects such as requiring all plans to be the subject of a trust instrument, but clearly the administration's bill does a most thorough and complete job in this area.

We must also be concerned with the plan participant who loses his benefits because his plan is not adequately funded, and his employer goes out of business, or the participant whose employment terminates for reasons which may be entirely beyond his control, such as sickness, disability or layoff and who, thereby, is forced to forfeit all of his accrued benefits because he

didn't work quite long enough to meet what may be inordinately long vesting requirements?

Every year, some 200,000 employees are affected—we don't know how many actually lose benefits—by pension plan terminations. In addition, the forfeiture ratio under many plans as a result of long vesting requirements and high turnover rates exceeds 75 percent, which means that less than one out of four employees now covered by such pension plans will receive any benefits from them.

S. 2167, my comprehensive bill, attempts to meet these problems by providing what I consider to be reasonable minimum standards for vesting and funding. Vesting would have to commence at 10 percent after 6 years and increase 10 percent per year thereafter until full vesting is achieved after 15 years. New plans would have to be fully funded after 30 years, old ones after 40 years. My bill also provides for a reinsurance plan in the case of premature termination due to cessation of the employer's business, and a mechanism for the creation of true pension portability. It would also provide for administration by an SEC-type commission which would take over the current duties of the Labor Department and the Internal Revenue Service in this area.

It is important to note that the administration's bill I am introducing today does not ignore these problems completely, either. Thus, the new disclosure provisions require a great deal of information concerning vesting and forfeitures to be included in annual reports. Actuarial assumptions must also be set forth in detail. The administration's bill thus implicitly recognizes the importance of vesting and funding provisions to participants. A provision similar to that contained in S. 2167 requiring a statement of rights to be given to persons upon termination of their participation in a plan which will be prima facie evidence of their rights is also included.

All of these matters will, of course, be explored thoroughly by the Subcommittee on Labor in its forthcoming hearings. I note, in this connection, that the Senator from Kentucky (Mr. COOPER) in his individual views printed in the report of the Rules Committee on Senate Resolution 360, authorizing funds for the Labor Subcommittee's investigation, specifically called attention to the need for the subcommittee to consider the desirability of minimum vesting standards in the law. I assure him that the subcommittee will do so.

Mr. President, I ask unanimous consent that there be printed in the RECORD the full text of the bill, the text of the accompanying letter from the Secretary of Labor, the text of an accompanying explanatory statement, a section-by-section analysis prepared by the administration, and a print of the Welfare and Pension Plans Disclosure Act as it would be amended by this bill.

The PRESIDING OFFICER (Mr. YOUNG of Ohio). The bill will be received and appropriately referred; and, without objection, the bill and material will be printed in the RECORD.

The bill (S. 3589) to amend the Welfare and Pension Plans Disclosure Act, introduced by Mr. JAVITS, was received, read twice by its title, referred to the Committee on Labor and Public Welfare, and ordered to be printed in the RECORD, as follows:

"S. 3589

"*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That, in order to strengthen and improve the protection of participants in and beneficiaries of employee welfare and pension benefit plans under the Welfare and Pension Plans Disclosure Act of August 28, 1958, as amended (92 Stat. 997), such Act is amended as follows:

"SEC. 1. Short Title. Immediately following the Table of Contents of such Act is added the title 'Short Title', and the following paragraph:

" 'SEC. 1. This Act may be cited as the "Employees Benefits Protection Act".'

"SEC. 2(a). The title of section 2 of such Act is amended by adding the words 'Declaration of' after the word 'and'.

"(b) Subsection (a) of section 2 of such Act is amended by striking out the words 'welfare and pension', and by adding the words 'that the operational scope and economic impact of such plans is increasingly interstate;' after the word 'substantial;', adding the words 'and adequate safeguards' after the word 'information', and adding the words 'and safeguards be provided' after the word 'made'.

"(c) Section 2(b) is amended by striking out the period at its end and inserting in lieu thereof a comma followed by the words 'by establishing fiduciary standards of conduct, responsibility and obligation upon all persons who exercise any powers of control, management or disposition with respect to employee benefit funds or have authority or responsibility to do so, and by providing for appropriate remedies and ready access to the Federal courts.'

"SEC. 3. (a) Subsections 1 through 13 of section 3 of such Act are redesignated by striking out the numbers '1' through '13' and inserting in lieu thereof the letters 'a' through 'm' respectively.

"(b) Sections 3 (a) and (b) are amended by inserting the words 'or maintained' after the word 'established' in both subsections.

"(c) Sections 3 (c), (d), (f), and (g) are amended by striking out the words 'welfare or pension' where they appear in each subsection respectively.

"(d) Section 3(m) is amended to read as follows: '(m) The term 'party in interest', means any administrator, officer, trustee, custodian, counsel, or employee of any employee benefit plan, or a person providing benefit plan services to any such plan, or an employer any of whose employees are covered by such a plan or any person controlling, controlled by, or under common control with, such employer or officer or employee or agent of such employer or such person, or an employee organization having members covered by such plan, or an officer or employee or agent of such an employee organization, or a relative, partner or joint venturer of any of the above described persons.'

"(e) Section 3 is further amended by adding subsections 'n' through 'x', to read as follows:

"'(n) The term "relative" means a spouse, ancestor, descendant, brother, sister, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law.

"'(o) The term "administrator" means—

"'(1) the person specifically so designated by the terms of the plan, collective bargaining agreement, trust agreement, contract, or other instrument, under which the plan is operated; or

"'(2) in the absence of such designation (A) the employer in the case of an employee benefit plan established or maintained by a single employer, (B) the employee organization in the case of a plan established or maintained by an employee organization, or (C) the association, committee, joint board of trustees, or other similar group of representatives of the parties who established or maintain the plan, in the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations.

"'(p) The term "employee benefit plan" or "plan" means an employee welfare benefit plan or an employee pension benefit plan or a plan providing both welfare and pension benefits.

"'(q) The term "employee benefit fund" or "fund" means a fund of money or other assets maintained pursuant to or in connection with an employee benefit plan and includes employee contributions withheld but not yet paid to the plan by the employer. The term does not include: (1) any assets of an investment company subject to regulation under the Investment Company Act of 1940: (2) premiums, subscription charges, or deposits received and retained by an insurance carrier or service or other organization, except for any separate account established or maintained by an insurance carrier.

"'(r) The term "separate account" means an account established or maintained by an insurance company under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains or losses of the insurance company.

"'(s) The term "adequate consideration" when used in section 14 means either (1) at the price of security prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or (2) if the security is not traded on such a national securities exchange, at a price not less favorable to the fund than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer.

"'(t) The term "nonforfeitable pension benefit" means an immediate or deferred pension or other benefit which a participant or his beneficiary would upon proper application be entitled to receive under the provisions of the

plan if at the time in question he had terminated his employment, irrespective of any conditions subsequent which could affect receipt of such benefit.

"'(u) The term "accrued benefit" means that benefit which, irrespective of whether such benefit is nonforfeitable, is equal to: (1) in the case of a profit sharing or money purchase type pension plan, the total amount credited to the account of a participant; (2) in the case of a unit benefit type pension plan, the benefit units credited to a participant; or (3) in the case of other types of pension plans, that portion of the prospective benefit of a participant of the plan as the Secretary may by rule or regulation provide constitutes the participant's accrued benefit under the plan.

"'(v) The term "security" has the same meaning as in the Securities Act of 1933, 15 U.S.C. 77(c) et seq.

"'(w) The term "fiduciary" means any person who exercises any power of control, management or disposition with respect to any moneys or other property of an employee benefit fund, or has authority or responsibility to do so.

"'(x) The term "market value" or "value" when used in this Act means fair market value where available, and otherwise the fair value as determined in good faith by the administrator.'

"SEC. 4. (a) Subsection (a) of section 4 of such Act is amended by striking out the words 'welfare or pension', 'or employers', and 'or organizations.'

"(b) Section 4(b) is amended by striking out the words 'welfare or pension', and is further amended in paragraph (3) thereof by adding the letter designation '(A)' after the word 'administered' the second time it appears, adding a comma after the word 'society' the first time it appears, followed by the words 'order or association', adding the letter designation '(B)' after the word 'or' the first time it appears, striking out the word 'and' the second time it appears and adding in lieu thereof the word 'or', and by adding a comma after the word 'society' the second time it appears, followed by the words 'order, association'.

"(c) Paragraph (4) of section 4(b) is amended by striking out the period at its end and adding in lieu thereof a comma, followed by the words 'except that participants and beneficiaries of such plan shall be entitled to maintain an action to recover benefits or to clarify their rights to future benefits as provided in section 9(e) (1) (B).'

"SEC. 5. (a) Subsection (a) of section 5 of such Act is amended to read as follows:

"'(a) The administrator of an employee benefit plan shall cause to be published in accordance with section 8 to each participant or beneficiary covered thereunder (1) a description of the plan and (2) an annual financial report. Such description and such report shall contain the information required by sections 6 and 7 of this Act in such form and detail as the Secretary shall prescribe and shall be executed, published, and filed in accordance with the provisions of this Act and regulations of the Secretary.'

"(b) Section 5(b) is amended, and section 5(c) added, to read as follows:

"'(b) The Secretary may require the filing of special terminal reports on behalf of an employee benefit plan which is winding up its affairs, so long as moneys or other assets remain in the plan. Such reports may be required to be filed regardless of the number of participants remaining in the plan and shall be on such forms and filed in such manner as the Secretary may by regulation prescribe.

"'(c) The Secretary may by regulation provide for the exemption from all or part of the reporting and disclosure requirements of this Act of any class or type of employee benefit plans, if the Secretary finds that the application of such requirements to such plans is not required in order to effectuate the purposes of this Act.'

"SEC. 6. Section 6 of such Act is amended to read as follows:

"'A description of any employee benefit plan shall be published as required herein within ninety days after the establishment of such plan or when such plan becomes subject to this Act.

"'(b) The description of the plan shall be comprehensive and shall include the name and type of administration of the plan; the name and address of the administrator; the schedule of benefits; a description of the provisions providing for non-forfeitable pension benefits (if the the plan so provides) written in a manner calculated to be understood by the average participant, and if the plan does not provide such benefits, a statement to this effect; the source of the financing of the plan and the identity of any organization through which

benefits are provided; whether records of the plan are kept on a calendar year basis, or an a policy or other fiscal year basis, and if on the latter basis, the date of the end of such policy or fiscal year; the procedures to be followed in presenting claims for benefits under the plan and the remedies available under the plan for redress of claims which are denied in whole or in part. Amendments to the plan reflecting changes in the data and information included in the original plan, other than data and information also required to be included in annual reports under section 7, shall be included in the description on and after the effective date of such amendments. Any change in the information required by this subsection shall be reported in accordance with regulations prescribed by the Secretary.'

"SEC. 7. (a) Subsection (a) of section 7 of such Act is amended by adding the number '(1)' after the letter '(a)', and by striking out that part of the first sentence which precedes the word 'if' the first time it appears and inserting in lieu thereof the words 'An annual report shall be published with respect to any employee benefit plan if the plan provides for an employee benefit fund subject to section 14 of this Act or'.

"(b) Section 7(a) (1) is further amended by striking out the word 'investigation' and inserting in lieu thereof the words 'notice and opportunity to be heard', by striking out the words 'year (or if' and inserting in lieu thereof the words 'policy or fiscal year on which', adding a period after the word 'kept', and striking out all the words following the word 'kept.'

"(c) Section 7(a) is further amended by adding the following paragraphs:

"'(2) If some or all of the benefits under the plan are provided by an insurance carrier or service or other organization, such carrier or organization shall certify to the administrator of such plan, within one hundred and twenty days after the end of each calendar, policy, or other fiscal year, as the case may be, such reasonable information determined by the Secretary to be necessary to enable such administrator to comply with the requirements of this Act.

"'(3) The administrator of an employee benefit plan shall cause an audit to be made annually of the employee benefit fund established in connection with or pursuant to the provisions of the plan. Such audit shall be conducted in accordance with accepted standards of auditing by an independent certified or licensed public accountant, but nothing herein shall be construed to require such an audit of the books or records of any bank, insurance company, or other institution providing an insurance, investment, or related function for the plan, if such books or records are subject to periodic examination by an agency of the federal Government or the government of any State. The auditor's opinion and comments with respect to the financial information required to be furnished in the annual report by the plan administrator shall form a part of such report.'

"(d) Sections 7 (b) and (c) of such Act are amended to read as follows:

"'(b) A report under this section shall include—

"'(1) the amount contributed by each employer; the amount contributed by the employees; the amount of benefits paid or otherwise furnished; the number of employees covered; a statement of assets, liabilities, receipts, and disbursements of the plan; a detailed statement of the salaries and fees and commissions charged to the plan, to whom paid, in what amount, and for what purposes; the name and address of each fiduciary, his official position with respect to the plan, his relationship to the employer of the employees covered by the plan, or the employee organization, and any other office, position or employment he holds with any party in interest;

"'(2) A schedule of all investments of the fund showing as of the end of the fiscal year:

"'(A) The aggregate cost and aggregate value of each security, by insurer;

"'(B) The aggregate cost and aggregate value by type or category, of all other investments, and separately identifying (i) each investment the value of which exceeds $100,000 or three percent (3%) of the value of the fund and (ii) each investment in securities or properties of any person known to be a party in interest.

"'(3) a schedule showing the aggregate amount, by type of security, of all purchases, sales, redemptions and exchanges of securities made during the reporting period; a list of the issuers of such securities; and in addition a schedule showing, as to each separate transaction with or with respect to securities issued by any person known to be a party in interest, the issuer, the type and class of security, the quantity involved in the trans-

action, the gross purchase price, and in the case of a sale, redemption or exchange, the gross and net proceeds (including a description and the value of any consideration other than money) and the net gain or loss.

"'(4) a schedule of purchase, sales or exchanges during the year covered by the report of investment assets other than securities—

"'(A) by type or category of asset the aggregate amount of purchases, sales, and exchanges; the aggregate expenses incurred in connection therewith; and the aggregate net gain (or loss) on sales, and

"'(B) for each transaction involving a person known to be a party in interest and for each transaction involving over $100,000 or three percent (3%) of the fund, an indication of each asset purchased, sold or exchanged (and, in the case of fixed assets such as land, buildings, and leasehold, the location of the asset); the purchase or selling price; expenses incurred in connection with the purchase, sale or exchange; the cost of the asset and the net gain (or loss) on each sale; the identity of the seller in the case of a purchase, or the identity of the purchaser in the case of a sale, and his relationship to the plan, the employer, or any employee organization.

"'(5) a schedule of all loans made from the fund during the reporting year or outstanding at the end of the year, and a schedule of principal and interest payments received by the fund during the reporting year, aggregated in each case by type of loan, and in addition a separate schedule showing as to each loan which

"'(A) was made to a party in interest, or

"'(B) was in default, or

"'(C) was written off during the year as uncollectable, or

"'(D) exceeded $100,000 or three percent (3%) of the value of the fund,

the original principal amount of the loan, the amount of principal and interest received during the reporting year, the unpaid balance, the identity and address of the obligor, a detailed description of the loan (including date of making and maturity, interest rate, the type and value of collateral and other material terms), the amount of principal and interest overdue (if any) and as to loans written off as uncollectable an explanation thereof.

"'(6) a list of all leases with

"'(A) persons other than parties in interest who are in default, and

"'(B) any party in interest,

including information as to the type of property leased (and, in the case of fixed assets such as land, buildings, leaseholds, etc., the location of the property), the identity of the lessor or lessee from or to whom the plan is leasing, the relationship of such lessors and lessees, if any, to the plan, the employer, employee organization, or any other party in interest, the terms of the lease regarding rent, taxes, insurance, repairs, expenses and renewal options; if property is leased from persons described in (B) the amount of rental and other expenses paid during the reporting year; and if property is leased to persons described in (A) or (B), the date the leased property was purchased and its cost, date the property was leased and its approximate value at such date, the gross rental receipts during the reporting period, expenses paid for the leased property during the reporting period, the net receipts from the lease, and with respect to any such leases in default, their identity, the amounts in arrears, and a statement as to what steps have been taken to collect amounts due or otherwise remedy the default;

"'(7) a detailed list of purchases, sales, exchanges or any other transactions with any party in interest made during the year, including information as to the asset involved, the price, any expenses connected with the transaction, the cost of the asset, the proceeds, the net gain or loss, the identity of the other party to the transactions and his relationship to the plan;

"'(8) if some or all of the assets of a plan or plans are held in a common or collective trust maintained by a bank or similar institution or in a separate account maintained by an insurance carrier, the report shall include a statement of assets and liabilities and a statement of receipts and disbursements of such common or collective trust or separate account and such of the information required under section 7(b), (2), (3), (4), (5), (6), and (7), with respect to such common or collective trust or separate account as the Secretary may determine appropriate by regulation. In

such case the bank or similar institution or insurance carrier shall certify to the administrator of such plan or plans, within one hundred and twenty days after the end of each calendar, policy, or other fiscal year, as the case may be, the information determined by the Secretary to be necessary to enable the plan administrator to comply with the requirements of this Act;

"'(9) in addition to reporting the information called for by this subsection 7(b), the administrator may elect to furnish other information as to investment or reinvestment of the fund as additional disclosures to the Secretary.

"'(c) If the only assets from which claims against an employee benefit plan may be paid are the general assets of the employer or the employee organization, the report shall include (for each of the past five years) the benefits paid and the average number of employees eligible for participation.'

"(e) Section 7(d) is amended by striking out the capital 'T' in the word 'The' the first time it appears in paragraphs (1) and (2) and inserting in lieu thereof a lower case 't'.

"(f) Section 7(e) is amended to read as follows:

"'(e) Every employee pension benefit plan shall include with its annual report (to the extent applicable) the following information:

"'(1) the type and basis of funding.

"'(2) the number of participants, both retired and nonretired, covered by the plan,

"'(3) the amount of all reserves or net assets accumulated under the plan,

"'(4) the present value of all liabilities for all nonforfeitable pension benefits and the present value of all other accrued liabilities,

"'(5) the ratios of the market value of the reserves and assets described in (3) above to the liabilities described in (4) above.

"'(6) a copy of the most recent actuarial report, and

"'(A) (i) the actuarial assumptions used in computing the contributions to a trust or payments under an insurance contract, (ii) the actuarial assumptions used in determining the level of benefits, and (iii) the actuarial assumptions used in connection with the other information required to be furnished under this section 7(e), insofar as any such actuarial assumptions are not included in the most recent actuarial report.

"'(B) (i) if there is no such report, or (ii) if any of the actuarial assumptions employed in the annual report differ from those in the most recent actuarial report, or (iii) if different actuarial assumptions are used for computing contributions or payments than are used for any other purpose, a statement explaining same.

"'(7) a statement showing the number of participants who terminated service under the plan during the year, whether or not they retain any nonforfeitable rights, their length of service by category, the present value of the total accrued benefits of said participants and the present value of such benefits forfeited, and,

"'(8) such other information pertinent to disclosure under this section 7(e) as the Secretary may by regulation prescribe.'

"(g) Section 7 is further amended by striking out in their entirety subsections (f), (g) and (h).

"SEC. 8. (a) Section 8 of such Act is amended by striking out subsections (a) and (b) in their entirety and by redesignating subsection (c) as subsection (a).

"(b) The subsection redesignated as subsection (a) is further amended by striking out the words 'of plans' after the word 'descriptions', striking out the word 'the' before the word 'annual' and adding the word 'plan' before the word 'descriptions'.

"(c) Section 8 is further amended by adding subsections (b), (c), (d) and (e), to read as follows:

"'(b) The administrator of any employee benefit plan subject to this Act shall file with the Secretary a copy of the plan description and each annual report. The Secretary shall make copies of such descriptions and annual reports available for inspection in the public document room of the Department of Labor.

"'(c) Publication of the plan descriptions and annual reports required by this Act shall be made to participants and beneficiaries of the particular plan as follows:

"'(1) the administrator shall make copies of the plan description (including all amendments or modifications thereto) and the latest annual report and the bargaining agreement, trust agreement, contract, or other instrument under which the plan was established and is operated available for examination by any plan participant or beneficiary in the principal office of the administrator;

"'(2) the administrator shall furnish to any plan participant or beneficiary so requesting in writing a fair summary of the latest annual report;

"'(3) the administrator shall furnish to any plan participant or beneficiary so requesting in writing a complete copy of the plan description including all amendments or modifications thereto, or a complete copy of the latest annual report, or both. He shall in the same way furnish a complete copy of the bargaining agreement, trust agreement, contract, or other instrument under which the plan is established and operated. In accordance with regulations of the Secretary, an administrator may make a reasonable charge to cover the cost of furnishing such complete copies.

"'(d) The administrator of an employee pension benefit plan shall furnish to any plan participant or beneficiary so requesting in writing a statement indicating (1) whether or not such person has a nonforfeitable right to a pension benefit, (2) the nonforfeitable pension benefits, if any, which have accrued or the earliest date on which benefits will become nonforfeitable, (3) and the total pension benefits accrued.

"'(e) Upon the termination of service under the plan of a participant having a right to a benefit, payable at a later date, the plan administrator shall furnish to the participant or his surviving beneficiary a statement setting forth his rights and privileges under the plan. The statement shall be in such form, be furnished and filed in such manner, and shall contain such information, including but not limited to the nature and amount of benefits to which he is entitled, the name and address of the entity responsible for payment, the date when payment shall begin and the procedure for filing his claim, as the Secretary may by regulation prescribe. The statement furnished to the participant or his surviving beneficiary or a true copy shall be prima facie evidence of the facts, rights and privileges set forth therein.'

"SEC. 9. (a) Subsection (a) of section 9 of such Act is amended by adding the words 'sections 5 through 13 of' before the word 'this'.

"(b) Section 9 is further amended by striking out in their entirety subsections (b) through (i) and inserting in lieu thereof subsections (b) through (k), to read as follows:

"'(b) Any plan administrator who fails or refuses to comply with a request as provided in section 8 within thirty days (unless such failure or refusal results from matters reasonably beyond the control of the administrator) by mailing the material requested to the last known address of the requesting participant or beneficiary may in the court's discretion be personally liable to such participant or beneficiary in the amount of up to $50 a day from the date of such failure or refusal, and the court may in its discretion order such other relief as it deems proper.

"'(c) The Secretary shall have power, when he believes it necessary in order to determine whether any person has violated or is about to violate any provision of this Act, to make an investigation and in connection therewith he may require the filing of supporting schedules of the financial information required to be furnished under section 7 of this Act and may enter such places, inspect such records and accounts, and question such persons as he may deem necessary to enable him to determine the facts relative to such investigation. The Secretary may report to interested persons or officials concerning the facts required to be shown in any report required by this Act and concerning the reasons for failure or refusal to file such a report or any other matter which he deems to be appropriate as a result of such an investigation.

"'(d) For the purposes of any investigation provided for in this Act, the provisions of sections 9 and 10 (relating to the attendance of witnesses and the production of books, records, and documents) of the Federal Trade Commission Act of September 16, 1914, as amended (15 U.S.C. 49, 50) are hereby made applicable to the jurisdiction, powers, and duties of the Secretary or any officers designated by him.

"'(e) Civil actions under this Act may be brought—

"'(1) by a participant or beneficiary—

"'(A) for the relief provided for in section 9(b), or

"'(B) to recover benefits due him under the terms of his plan or to clarify his rights to future benefits under the terms of the plan;

"'(2) by the Secretary or by a participant or beneficiary (as a representative party on behalf of all participants or beneficiaries similarly situated where the requirements for maintaining a class action are met) for apppropriate relief, legal or equitable, to redress a breach of any responsibility, obligation or duty of a fiduciary, including the removal of a fiduciary who has failed to carry out his duties or who is serving in violation of section 15 of this Act; or

"'(3) by the Secretary, to enjoin any act or practice which appears to him to violate any provision of this Act.

"'(f) (1) Civil actions under this Act brought by a participant or beneficiary may be brought in any court of competent jurisdiction, State or Federal.

"'(2) Where such an action is brought in a district court of the United States, it may be brought in the district where the plan is administered, where the breach took place, or where a defendant resides or may be found, and process may be served in any other district where a defendant resides or may be found.

"'(3) Notwithstanding any other law, the Secretary shall have the right to remove an action from a State court to a district court of the United States, if the action is one seeking relief of the kind the Secretary is authorized to sue for herein. Any such removal shall be prior to the trial of the action and shall be to a district court where the Secretary could have initiated such an action.

"'(g) The district courts of the United States shall have jurisdiction without respect to the amount in controversy, to grant the relief provided for in sections 9(e) (2) and (3) in any action brought by the Secretary. In any action brought under section 9(e) by a participant or beneficiary the jurisdiction of the district court shall be subject to the requirement contained in 28 U.S.C. 1331.

"'(h) (1) In any action by a participant or beneficiary, the court in its discretion may

"'(A) allow a reasonable attorney's fee and costs of the action to any party;

"'(B) require the plaintiff to post security for payment of costs of the action and reasonable attorney's fees.

"'(2) A copy of the complaint in any action by a participant or beneficiary shall be served upon the Secretary by certified mail who shall have the right, in his discretion, to intervene in the action.

"'(i) In any civil action authorized to be brought by the Secretary by this Act, or to enjoin any act or practice, or to collect any penalty assessed by the Secretary, the Attorney General shall represent the Secretary, unless the Attorney General delegates all or part of this authorization to the Secretary.

"'(j) Except as provided in this Act, nothing contained herein shall be construed or applied to authorize the Secretary to regulate, or interfere in the management of, any employee welfare or pension benefit plan.

"'(k) In order to avoid unnecessary expense and duplication of functions among Government agencies, the Secretary may make such arrangements or agreements for cooperation or mutual assistance in the performance of his functions under this Act and the functions of any such agency as he may find to be practicable and consistent with law. The Secretary may utilize the facilities or services of any department, agency, or establishment of the United States or of any State or political subdivision of a State, including the services of any of its employees, with the lawful consent of such department, agency, or establishment: and each department, agency, or establishment of the United States is authorized and directed to cooperate with the secretary and, to the extent permited by law, to provide such information and facilities as he may request for his assistance in the performance of his functions under this Act. The Secretary shall immediately forward to the Attorney General or his representative any information coming to his attention in the course of the administration of this Act which may warrant consideration for criminal prosecution under the provisions of this Act or other Federal Law.'

"SEC. 10. Section 13 of such Act is amended by striking out the word 'welfare' after the word 'employee' the second time it appears in subsection (a),

striking out the words 'or of any employee pension benefit plan' after the word 'plan' the first time it appears in subsection (a), striking out the words 'welfare benefit plan or employee pension' after the word 'employee' the second time it appears in subsection (b) and striking out the words 'welfare benefit plan or of an employee pension' after the word 'employee' the first time it appears in subsection (d).

"SEC. 11. Such Act is further amended by renumbering sections 14 through 18 as sections 16 through 20, respectively, and by adding the following new sections:

" 'FIDUCIARY RESPONSIBILITY

" 'SEC. 14. (a) Every employee benefit fund shall be deemed to be a trust and shall be held for the exclusive purpose of (1) providing benefits to participants in the plan and their beneficiaries and (2) defraying reasonable expenses of administering the plan.

" '(b) (1) A fiduciary shall discharge his duties with respect to the fund—

" '(A) solely in the interests of the participants and their benefiicaries;

" '(B) with the care under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; and

" '(C) in accordance with the documents and instruments governing the fund insofar as is consistent with this Act.

" '(2) Except as permitted hereunder, a fiduciary shall not—

" '(A) lease or sell property of the fund to any person known to be a party in interest;

" '(B) Lease or purchase on behalf of the fund any property known to be property of any party in interest;

" '(C) deal with such fund in his own interest or for his own account;

" '(D) represent any other party with such fund, or in any way act on behalf of a party adverse to the fund or to the interests of its participants or beneficiaries;

" '(E) receive any consideration from any party dealing with such fund in connection with a transaction involving the fund;

" '(F) loan money or other assets of the fund to any person known to be a party in interest;

" '(G) furnish goods, service or facilities to any person known to be a party in interest, or

" '(H) permit the transfer of any property of the fund to, or its use by, or for the benefit of any person known to be a party in interest.

The Secretary may by rule or regulation provide for the exemption of any fiduciary or transaction from all or part of the proscriptions contained in this subsection 14(b) (2), when the Secretary finds that to do so is consistent with the purposes of this Act and in the interest of the fund and its participants and beneficiaries; Provided, however, that any such exemption shall not relieve a fiduciary from any other applicable provisions of this Act.

" '(c) Nothing in this section shall be construed to prohibit any fiduciary from:

" '(1) receiving any benefit to which he may be entitled as a participant or beneficiary in the plan under which the fund was established:

" '(2) receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the fund; *Provided* that no person so serving who already receives full-time pay from an employer or an association of employers whose employees are participants in the plan under which the fund was established, or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred and not otherwise reimbursed;

" '(3) serving in such position in addition to being an officer, employee, agent or other representative of a party in interest;

" '(4) engaging in the following transactions:

" '(A) purchasing on behalf of the fund any security which has been issued by an employer whose employees are participants in the plan under which the fund was established or a corporation controlling, controlled by, or under common control with such employer; *Provided*

that the purchase of any security is for no more than adequate consideration in money or money's worth; *Providede further,* that if an employee benefit fund is one which provides primarily for benefits of a stated amount, or an amount determined by an employee's compensation, an employee's period of service, or a combination of both, or money purchase type benefits based on fixed contributions which are not geared to the employer's profits, no investment shall be made subsequent to the enactment of this amendment by a fiduciary of such a fund in securities of such an employer or of a corporation controlling, controlled by, or under common control with such employer, if such investment, when added to such securities already held, exceeds 10 per cent of the fair market value of the assets of the fund. Notwithstanding the foregoing, such 10 per cent limitation shall not apply to profit sharing plans, nor to stock bonus, thrift and savings or other similar plans which have the requirement that some or all of the plan funds shall be invested in securities of such employer;

"'(B) purchasing on behalf of the fund any security other than one described in (A) immediately above, or selling on behalf of the fund any security which is acquired or held by the fund, to a party in interest, *Provided,* (i) that the security is listed and traded on an exchange subject to regulation by the Securities and Exchange Commission, (ii) that no brokerage commission, fee (except for customary transfer fees), or other remuneration is paid in connection with such transaction, and (iii) that adequate consideration is paid;

"'(5) making any loan to participants or beneficiaries of the plan under which the fund was established where such loans are available to all participants or beneficiaries on a non-discriminatory basis and are made in accordance with specific provisions regarding such loans set forth in the plan;

"'(6) contracting or making reasonable arrangements with a party in interest for office space and other services necessary for the operation of the plan and paying reasonable compensation therefor;

"'(7) following the direction in the trust instrument or other document governing the fund insofar as consistent with the specific prohibitions listed in subsection 14(b) (2);

"'(8) taking action pursuant to an authorization in the trust instrument or other document governing the fund, provided such action is consistent with the provisions of subsection 14(b).

"'(d) Any fiduciary who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this Act shall be personally liable to make good to such fund any losses to the fund resulting from such breach, and to restore to such fund any profits of such fiduciary which have been made through use of assets of the fund by the fiduciary.

"'(e) When two or more fiduciaries undertake jointly the performance of a duty or the exercise of a power or where two or more fiduciaries are required by any instrument governing the fund to undertake jointly the performance of a duty or the exercise of a power, but not otherwise, each of such fiduciaries shall have the duty to prevent any other such cofiduciary from committing a breach of a responsibility, obligation or duty of a fiduciary or to compel such other co-fiduciary to redress such a breach; Provided that no fiduciary shall be liable for any consequence of any act or failure to act of a co-fiduciary who is undertaking or is required to undertake jointly any duty or power if he shall object in writing to the specific action and promptly file a copy of his objection with the Secretary.

"'(f) Each employee benefit plan shall contain specific provisions for the disposition of its fund assets upon termination. In the event of termination, whether under the express terms of the plan or otherwise, such fund, or any part thereof, shall not be expended, transferred or otherwise disposed of, except for the exclusive benefit of the plan participants and their beneficiaries. Notwithstanding the foregoing, after the satisfaction of all liabilities with respect to the participants and their beneficiaries under an employee pension benefit plan in accordance with the Internal Revenue Code and regulations promulgated thereunder, any remaining fund assets may be returned to any person who has a legal or equitable interest in such assets by reason of such person or his predecessor having made financial contribution thereto.

"'(g) No fiduciary may be relieved from any responsibility, obligation or duty under this Act by agreement or otherwise. Nothing herein shall preclude

any agreement allocating specific duties or responsibilities among fiduciaries, or bar any agreement of insurance coverage or indemnification affecting fiduciaries, but no such agreement shall restrict the obligations of any fiduciary to a plan or to any participant or beneficiary.

"'(h) No action, suit, or proceeding based on a violation of this section shall be maintained unless it be commenced within three years after the filing with the Secretary of a report, statement or schedule with respect to any matter disclosed by such report, statement or schedule, or, with respect to any matter not so disclosed, within three years after the complainant otherwise has notice of the facts constituting such violation, whichever is later, provided, however, that no such action, suit or proceeding shall be commenced more than six years after the violation occurred. In the case of a willfully false or fraudulent statement or representation of a material fact or the willful concealment of, or willful failure to disclose, a material fact required by this Act to be disclosed, a proceeding in court may be brought at any time within ten years after such violation occurs.

"'(i) A fiduciary shall not be liable for a violation of this Act committed before he became a fiduciary or after he ceased to be a fiduciary.

"'PROHIBITION AGAINST CERTAIN PERSONS HOLDING OFFICE

"'SEC. 15. (a) No person who has been convicted of, or has been imprisoned as a result of his conviction of: robbery, bribery, extortion, embezzlement, grand larceny, burglary, arson, violation of narcotics laws, murder, rape, kidnapping, perjury, assault with intent to kill, assault which inflicts grievous bodily injury, any crime described in section 9(a) (1) of the Investment Company Act of 1940, 15 U.S.C. 80a–9(a) (1), or a violation of any provision of this Act, or a violation of section 302 of the Labor Management Relations Act of 1947, 61 Stat. 157, as amended, 29 U.S.C. 186, or a violation of Chapter 63 of Title 18, United States Code, or a violation of section 874, 1027, 1503, 1505, 1506, 1510, 1951, or 1954 of Title 18, United States Code, or a violation of the Labor-Management Reporting and Disclosure Act of 1959, 73 Stat. 519, as amended, 29 U.S.C. 401, or conspiracy to commit any such crimes or attempt to commit any such crimes, or a crime in which any of the foregoing crimes is an element, shall serve—

"'(1) as an administrator, officer, trustee, custodian, counsel, agent, employee (other than as an employee performing exclusively clerical or janitorial duties) or other fiduciary position of any employee welfare or pension benefit plan, or

"'(2) as a consultant to any employee benefit plan,

during or for five years after such conviction or after the end of such imprisonment, unless prior to the end of such five year period, in the case of a person so convicted or imprisoned, (A) his citizenship rights, having been revoked as a result of such conviction, have been fully restored, or (B) the Board of Parole of the United States Department of Justice determines that such person's service in any capacity referred to in clause (1) or (2) would not be contrary to the purposes of this Act. Prior to making any such determination the Board shall hold an administrative hearing and shall give notice of such proceeding by certified mail to the State, County, and Federal prosecuting officials in the jurisdiction or jurisdictions in which such person was convicted. The Board's determination in any such proceeding shall be final. No person shall knowingly permit any other person to serve in any capacity referred to in clause (1) or (2) in violation of this subsection.

"'(b) Any person who willfully violates this section shall be fined not more than $10,000 or imprisoned for not more than one year or both.

"'(c) For the purposes of this section, any person shall be deemed to have been 'convicted' and under the disability of 'conviction' from the date of the judgment of the trial court or the date of the final sustaining of such judgment on appeal, whichever is the later event, regardless of whether such conviction occurred before or after the date of enactment of this section.

"'(d) For the purposes of this section, the term 'consultant' means any person who, for compensation, advises or represents an employee benefit plan or who provides other assistance to such plan, concerning the establishment or operation of such plan.'

"SEC. 12. (a) Subsection (b) of section 16 of such Act, as renumbered by this Act, is amended by striking out the word 'such' the second time it appears and by inserting in lieu thereof the word 'the', and striking out the word

'calendar' the second time it appears and inserting in lieu thereof the word 'fiscal'.

"(b) Renumbered section 16(d) is amended by striking out the words 'rate of $50 per diem' and inserting in lieu thereof the words 'maximum per diem rate authorized in the current Department of Labor Appropriation Act for consultants and experts', adding the words 'such members are' after the word 'when' the first time it appears, and striking out the designation '73b-2' after '5 U.S.C.' and inserting in lieu thereof the designation '5703'.

"(c) Renumbered secion 16 is further amended by striking out in its entirety subsection (e).

"SEC. 13. (a) Renumbered section 17 is amended by adding a comma after the word 'Act' the first time it appears in subsection (a), followed by the designation '5 U.S.C. 551 et seq.,', and by adding at the end of subsection (a) the following sentence: 'The Secretary, or his delegate, in consultation with the Secretary of the Treasury or his delegate, shall prescribe all necessary rules and regulations for the administration and enforcement of this Act, except that all rules and regulations issued with respect to Section 14 shall be prescribed by the Secretary of Labor or his delegate with the concurrence of the Secretary of Treasury or his delegate.'

"(b) Renumbered section 17 is further amended by deleting in their entirety subsections (c) and (d).

"SEC. 14. Renumbered section 18 is amended to read as follows:

" 'SEC. 18. It is hereby declared to be the express intent of Congress that except for actions authorized by section 9(e) (1) (B) of this Act, the provisions of this Act shall supersede any and all laws of the States and of political subdivisions thereof insofar as they may now or hereafter relate to the fiduciary, reporting and disclosure responsibilities of persons acting on behalf of employee benefit plans provided that nothing herein shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking or securities or to prohibit a State from requiring that there be filed with a State agency copies of reports required by this Act to be filed with the Secretary. Nothing herein shall be construed to alter, amend, modify, invalidate, impair or supersede any law of the United States (other than the Welfare and Pension Plans Disclosure Act of 1958 as amended (92 Stat. 994) or any rule or regulation issued under any such law.'

"SEC. 15. Renumbered section 20 is amended to read as follows:

" 'SEC. 20(a) The provisions of paragraph (b)(3), (4) and (5) of section 7 relating to the aggregating of items reported shall become effective two years after enactment hereof.

" '(b) The amendments made by this Act to the reporting requirements of the Welfare Act to the reporting requirements of the Welfare and Pension Plan Disclosure Act shall become effective upon the promulgation of revised report forms by the Secretary.

" '(c) All other provisions of this Act shall become effective thirty days after enactment hereof.

" '(d) In order to provide for an orderly disposition of any investment, the retention of which would be deemed to be prohibited by this Act, and in order to protect the interest of the fund and its participants and its beneficiaries, the fiduciary may in his discretion effect the disposition of such investment within three years after the date of enactment of this Act or within such additional time as the Secretary may by rule or regulation allow, and such action shall be deemed to be in compliance with this Act.'

"SEC. 16. The Table of Contents of such Act is amended to read as follows:

" 'TABLE OF CONTENTS

"EMPLOYEE BENEFITS PROTECTION ACT

" 'Sec. 1. Short Title.
" 'Sec. 2. Findings and declaration of policy.
" 'Sec. 3. Definitions.
" 'Sec. 4. Coverage.
" 'Sec. 5. Duty of disclosure and reporting.
" 'Sec. 6. Description of the plan.
" 'Sec. 7. Annual reports.
" 'Sec. 8. Publication.
" 'Sec. 9. Enforcement.

" 'Sec. 10. Reports made public information.
" 'Sec. 11. Retention of records.
" 'Sec. 12. Reliance on administrative interpretation and forms.
" 'Sec. 13. Bonding.
" 'Sec. 14. Fiduciary responsibility.
" 'Sec. 15. Prohibition against certain persons holding office.
" 'Sec. 16. Advisory Council.
" 'Sec. 17. Administration.
" 'Sec. 18. Effect of laws.
" 'Sec. 19. Separability of provisions.
" 'Sec. 20. Effective date.'

"SEC. 17. (a) Sections 664, 1027 and 1954 of title 18, United States Code, are amended by striking out the words 'Welfare and Pension Plans Disclosure Act' wherever they appear and inserting in lieu thereof the words 'Employee Benefits Protection Act.'

"(b) Subsection (a) of section 1954 of title 18, United States Code, is further amended by striking out the words '3(3) and 5(b)(1) and (2)' and inserting in lieu thereof the words '3(c) and 3(o)'."

The material presented by Mr. JAVITS is as follows:

U.S. DEPARTMENT OF LABOR,
Washington, D.C., March 13, 1970.

Hon. SPIRO T. AGNEW,
President of the Senate,
Washington, D.C.

DEAR MR. PRESIDENT: I am transmitting herewith draft legislation entitled "Employee Benefits Protection Act", as recommended by the President in his message today. I am also forwarding an analysis of the bill's major objectives and other supporting material.

The proposal will amend the Welfare and Pension Plans Disclosure Act to impose fiduciary responsibility on persons who exercise power of control, management or disposition over employee benefit funds. Additional amendments require disclosure of further information concerning the financial operations of such funds. The proposed legislation will provide basic protection for the vast sums now being handled through welfare and pension funds.

I urge that early and favorable consideration be given to this bill.

Sincerely,

GEORGE P. SHULTZ,
Secretary of Labor.

"EXPLANATORY STATEMENT OF AMENDMENTS TO THE WELFARE AND PENSION PLANS DISCLOSURE ACT

"The fundamental purpose of the proposed amendments to the Welfare and Pension Plans Disclosure Act is the broadening and strengthening of the protection of rights and interests of participants and beneficiaries of employee welfare and pension benefit plans. This aim is accomplished in three ways. First, by the addition of two new sections: one setting forth responsibilities and proscriptions applicable to persons occupying a fiduciary relationship to employee benefit plans, including a 'prudent man' standard for evaluating the conduct of all fiduciaries; the other barring from responsible fiduciary position in such plans for a period of five years all persons convicted of certain listed criminal offenses. Second, by additions to and changes in the reporting requirements designed to disclose more significant information about plans and the transaction engaged in by those controlling plan operations and to provide specific data to participants and beneficiaries concerning the rights and the benefits they are entitled to under their plans. Third, by providing remedies through either State or Federal courts to insure that the protections provided by the Act can be effectively enforced.

"I. FIDUCIARY RESPONSIBILITY

"A fiduciary is one who occupies a position of confidence or trust. As defined by the amendments, a fiduciary is a person who exercises any power of control, management or disposition with respect to monies or other property of an employee benefit fund, or who has authority or responsibility to do so. The fiduciary responsibility section, in essence, codifies and makes applicable

to these fiduciaries certain principles developed in the evolution of the law of trusts. The section was deemed necessary for several reasons.

"First, a number of plans are structured in such a way that it is unclear whether the traditional law of trusts is applicable. Predominantly, these are plans, such as insured plans, which do not use the trust form as their mode of funding. Administrators and others exercising control functions in such plans under the present Act are subject only to minimal restrictions and the applicability of present State law to employee benefit plans is sometimes unclear. Second, even where the funding mechanism of the plan is in the form of a trust, reliance on conventional trust law often is insufficient to adequately protect the interests of plan participants and beneficiaries. This is because trust law had developed in the context of testamentary and inter vivos trusts (usually designed to pass designated property to an individual or small group of persons) with an attendant emphasis on the carrying out of the instructions of the settlor. Thus, if the settlor includes in the trust document an exculpatory clause under which the trustee is relieved from liability for certain actions which would otherwise constitute a breach of duty, or if the settlor specifies that the trustee shall be allowed to make investments which might otherwise be considered imprudent, the trust law in many States will be interpreted to allow the deviation. In the absence of a fiduciary responsibility section in the present Act, courts applying trust law to employee benefit plans have allowed the same kinds of deviations, even though the typical employee benefit plan, covering hundreds or even thousands of participants, is quite different from the testamentary trust both in purpose and in nature.

"Third, even assuming that the law of trusts is applicable, without provisions (lacking in the present Act) allowing ready access to both detailed information about the plan and to the courts, and without standards by which a participant can measure the fiduciary's conduct (also lacking in the present Act), he is not equipped to safeguard either his own rights or the plan assets. Furthermore, a fiduciary standard embodied in Federal legislation is considered desirable because it will bring a measure of uniformity in an area where decisions under the same set of facts may differ from State to State. It is expected that courts will interpret the prudent man rule and other fiduciary standards bearing in mind the special nature and purposes of employee benefit plans intended to be effectuated by the Act.

"Finally, it is evident that the operations of employee benefit plans are increasingly interstate. The uniformity of decision which the Act is designed to foster will help administrators, fiduciaries and participants to predict the legality of proposed actions without the necessity of reference to varying State laws.

"Section 14(a), when read in connection with the definition of the term "employee benefit fund", makes it clear that the fiduciary responsibility provisions apply only to those plans which have assets at risk. Thus an unfunded plan, such as one in which the only assets from which benefits are paid are the general assets of the employer, is not covered. However, if the plan does not have assets at risk, the form in which those assets are held is deemed to be a trust, whether or not a trust agreement exists, and the trust assets may be used only for the two stated purposes: providing benefits for participants and defraying reasonable administrative expenses.

"The next two subsections (14(b) and (c)) incorporate the core principles of fiduciary conduct as adopted from existing trust law, but with modifications appropriate for employee benefit plans. These salient principles place a twofold duty on every fiduciary: to act in his relationship to the plan's fund as a prudent man in a similar situation and under like conditions would act, and to act solely in the interest of the participants and beneficiaries of the plan; that is, to refrain from involving himself in situations or transactions where his personal interests might conflict with the interests of the participants and beneficiaries for whom the fund was established. Thus, section 14(b)(1) sets out the prudent man standard and the attendant affirmative duties to discharge responsibilities in conformance with instructions (as set out in the governing plan documents) and solely in the interest of the plan's participants and beneficiaries. There follows a list of proscriptions (section 14(b)(2)) which represent the most serious type of fiduciary misconduct which in one way or another has occurred in connection with some welfare or pensions plans. Some of these situations have

been found in the administration of the WPPDA. Others have been discovered by congressional investigations, newspaper reporters, audits, and miscellaneous sources. While the magnitude of these improper practices is small in relation to the total number of plans in existence, the seriousness of the improper practices disclosed indicates the need for additional precautions to insure that these specific examples do not become general conditions. The list of proscriptions is intended to provide this essential protection.

"The exemption provision which follows the listed proscriptions has been included in recognition of established business practices, particularly of certain institutions, such as commercial banks, trust companies and insurance companies which often perform fiduciary functions in connection with employee benefit plans. The Secretary will provide, by individual or class exemptions, exceptions so that the established practices of these institutions and others are not unduly disrupted, so long as they are consistent with the purposes of the Act.

"Next, there are listed transactions in which fiduciaries are expressly allowed to engage. This listing is necessary for reasons similar to those which required inclusion of the exemption provision. That is, the breadth of the proscriptions, while considered necessary for the reasons stated above, would operate in some cases to prohibit transactions which are deemed desirable to the sound, efficient functioning of employee benefit plans. It was therefore necesary to specify that certain transactions, likely to be engaged in by fiduciaries of virtually all plans, will be allowed notwithstanding the proscriptions. It is emphasized, however, that even with respect to the transactions expressly allowed, the fiduciary's conduct must be consistent with the prudent man standard unless the trust instrument specifically directs investments.

"Especially significant among the expressly allowed transactions is that which permits, in most types of plans, investment of up to ten percent of the fund assets in securities issued by the employer of employees who are participants in the plan. Since such an employer will often be an administrator of his plan, or will function as a trustee or in some other fiduciary capacity, this provision creates a limited exception to the listed proscription against self-dealing. The exception is made in recognition of the symbiotic relationship existing between the employer and the plan covering his employees. Such investments are commonly made under provisions in a trust agreement expressly allowing them. The ten percent limitation is prospective only, and does not require divestiture by funds already holding more than that percentage. Furthermore, the limitation does not apply to profit sharing plans, which, by their very nature, require greater investment in the employer's securities. Subsection 14(c) also recognizes the practice of including in trust instruments various authorizations governing the handling of the fund. Many such authorizations have been inserted by legal draftsmen because of questions in their judgment as to authority and are generally recognized as appropriate.

"The next two subsections (14(d) and (e)) are intended to codify, with respect to employee benefit fund fiduciaries, rules developed under the law of trusts. Thus a fiduciary is made personally liable for his breach of any responsibility, duty or obligation owed to the fund, and must reimburse the fund for any loss resulting from such a breach. He must also pay over to the fund any personal profit realized through use of fund assets. Where two or more fiduciaries manage a fund, each must use care to prevent a co-fiduciary from committing a breach or to compel a co-fiduciary to redress a breach. Plan business in accordance with the governing instruments of the plan, or in the absence of such provisions, majority of fiduciaries and a fiduciary who objects in writing to a specific action and files a copy of his objection with the Secretary is not liable for the consequences of such action.

"The requirement (subsection 14(f)) that every plan contain specific provisions for the disposition of fund assets upon termination is necessary to avoid confusion on the part of fiduciaries and participants and beneficiaries alike as to the proper disposition of the fund assets upon termination of the plan. It is essential at such a time that the plan administrator (who is still, notwithstanding the termination, a fiduciary subject to the Act) know how assets remaining in the plan's fund must be distributed and it is important that the distribution plan be specified so that participants and beneficiaries can assess the property of the fiduciary's actions when the plan terminates. The requirement that liabilities to participants and beneficiaries be satisfied

before claims on the fund by contributing parties will be heard is inserted to insure that the interests of participants and beneficiaries will be fully protected.

"Exculpatory and similar clauses which purport to relieve a fiduciary from any responsibility, obligation or duty when the Act are expressly prohibited and made void as against public policy. Whatever the validity such provisions might have with respect to testamentary trusts, they are inappropriate in the case of employee benefit plans. The large numbers of people and enormous amounts of money involved in such plans coupled with the public interest in their financial soundness, as expressed in the Act, require that no such exculpatory provision be permitted.

"It is noted that the basic three year statute of limitations (subsection 14(h)) for suits to enforce the fiduciary provisions or redress a fiduciary's breach may be extended up to an additional three years where the breach is not discovered earlier. In no event can a suit be maintained more than six years after the violation occurred. Where there has been a willfully false or fraudulent misstatement or concealment of a material fact, an action may be brought any time within ten years after the violation occurs.

"Finally, by subsection (i) a fiduciary is specifically made not liable for violations committed before he became or after he ceased to be a fiduciary.

"The second all new section, section 15, prohibits persons convicted of certain listed crimes from serving, for a period of five years after conviction or the end of imprisonment for such conviction, in a responsible position in connection with an employee benefit plan. The prohibition is considered necessary because of the large funds involved and the attendant great risk of a loss affecting a large number of persons. Section 15 is modeled after section 504 of the Labor-Management Reporting and Disclosure Act (LMRDA) which bars persons convicted of certain crimes from serving as union officers. The presence of the LMRDA prohibition is another reason for including a similar provision in the Protection Act. Without such a provision, persons barred from serving as union officers might take positions with employee benefit plans. The danger inherent in such a transfer is especially great where elements of organized crime are involved.

"The crimes listed have been chosen with reference to three kinds of criminal activity. These are (1) ativities which involve a wrongful taking of property, (2) activities which are related to, and often occur in connection with the efforts of organized crime elements in the labor-management and securities fields, and (3) activities of a nature so vicious that involvement in them casts grave doubt on the individuals' responsibility. Thus, in addition to the specifically named crimes the list includes crimes described in section 9(a)(1) of the Investment Company Act of 1940 (involving misconduct in the securities field), violations of section 302 of the Labor-Management Relations (Taft-Hartley) Act, certain violations of the LMRDA, violations of chapter 63 of Title 18, United States Code (mail fraud) and violation of sections 874 (kickbacks from public works employees), 1027 (false statements in documents required by the Welfare and Pension Plans Disclosure Act), 1954 (offer, acceptance or solicitation to influence operations of employee benefit plan), 1503 (jury tampering), 1505 (obstruction of government agency proceedings), 1506 (theft or alteration of court record or process; false bail), 1510 (obstruction of criminal investigations) and 1951 (interference with commerce by threats or violence), of Title 18, United States Code. The section contains its own criminal penalty, with a higher fine than that provided for other criminal violations of the Act. It is the same penalty as that specified in section 504, LMRDA.

"II. REPORTING AND DISCLOSURE

"The underlying theory of the Welfare and Pension Plans Disclosure Act to date has been that reporting of generalized information concerning plan operations to plan participants and beneficiaries and to the public in general would, by subjecting the benefit plans to the light of public scrutiny, insure that the plan would be operated according to instruction and in the best interests of the participants and beneficiaries. The Secretary's role in this scheme was minimal. Disclosure has been seen as a device to impart to participants and beneficiaries sufficient information to enable them to know whether the plan was financially sound and being administered as intended. It was expected that the knowledge thus disseminated would enable partici-

pants to police their plans. But, experience has shown that the limited data available under the present Act is insufficient even though the burden of enforcement has been partly assumed by the Secretary. The Amendments therefore are designed to increase the data required in the reports, both in scope and in detail. Experience has also demonstrated a need for a more particularized form of reporting, so that the individual participant knows exactly where he stands with respect to his plan—what benefits he is entitled to and what steps he must follow to secure his benefits. Moreover, the addition of fiduciary responsibility provisions has increased the need for both generalized and particularized data. On one hand, participants will be able to ascertain whether the plan's fiduciaries are observing the rules set out in the fiduciary responsibility section only if they have access to sufficient data about plan transactions. On the other hand, the prophylactic effect of the fiduciary responsibility section will operate efficiently only if fiduciaries are aware that the details of their dealings will be open to inspection, and that individual participants and beneficiaries will be armed with enough information to enforce their own rights as well as the obligations owed by the fiduciary to the plan in general.

"There are three significant changes designed to impart more information about the plan and its operations in general. First, the annual report must include the opinion of an independent accountant based upon the results of an annual audit. Such information will allow better assessment of the plan's financial soundness by administrators and participants alike (the exemption for the books of institutions providing investment, insurance and related functions and subject to periodic examination by a government agency will prevent duplicative audit examinations of these institutions). Second, plans except those which are unfounded must include in their reports information pertaining to leases, party in interest transactions and investment assets other than securities in addition to information about securities, investments and loans. Finally, actuarial information is now required so that participants and beneficiaries can judge the progress of the plan's funding scheme and its overall financial soundness.

"Amendments to provide particularized information to individual participants and beneficiaries are found in section 8. In addition to the obligation to make available copies of the plan description and latest annual report, the administrator will be required to furnish to a participant or beneficiary so requesting in writing a fair summary of the annual report or a statement of what benefits (including nonforfeitable benefits, if any) have accrued in his favor or both. This will enable a participant to find out where he stands with respect to the plan at any given time. The statement which must be supplied to a participant (or his survivor) having a right to a pension benefit upon his termination of service under the plan, is designed to insure that the participant or survivor will know exactly what procedures must be followed to secure his benefits.

"Further, the administrator must furnish to participants and beneficiaries upon request copies of the plan description, annual report, or bargaining agreement, trust agreement, contract or instrument under which the plan is established and operated. He may make a reasonable charge to cover the cost of such copies.

"III. ENFORCEMENT

"The changes in the enforcement provisions have made so that the rights given to participants and benficiaries elsewhere in the Act will be enforceable in an appropriate forum. The enforcement section reflects the addition of the fiduciary responsibility provisions and provides remedies of two kinds; those designed to rectify fiduciary breaches and those to insure that participants and beneficiaries, and the Secretary, will receive the information required by the reporting and disclosure provisions. Suits to redress breaches of duty by a fiduciary may be brought by a participant or beneficiary only as a representative in a class action. Certification by an accountant as a prerequisite to the Secretary's investigation is no longer necessary because the annual audit requirement allows an assumption that the plan report is accurate.

"Participants and beneficiaries may sue in any State court of competent jurisdiction.

"For actions in Federal courts, nationwide service of process is provided in order to remove a possible procedural obstacle to having all proper parties

before the court. Federal and State courts are given discretion to award attorney's fees and court costs to any party in actions brought by a participant or a beneficiary. The court also has discretion to require the plaintiff to post security for court costs and reasonable attorney's fees.

"Fiduciary breaches may be rectified through civil suits only. Criminal penalties for such breaches are inconsistent with the principles established under the common law of trusts. However, criminal penalties remain available in cases of reporting violations, and, under Title 18, United States Code, in cases of embezzlement, false statements, bribery and kickbacks in connection with employee benefit plans.

"IV. EFFECT OF OTHER LAWS

"The Act provides for a uniform source of law for evaluating the fiduciary conduct of persons acting on behalf of employee benefit plans and a singular reporting and disclosure system in lieu of burdensome multiple reports. States may require the filing with a State agency of copies of reports required under the Act. State courts as well as Federal courts are available to provide remedies under the Act. Furthermore, the Act expressly authorizes cooperative arrangements with State agencies as well as other Federal agencies and provides that State laws regulating banking, insurance and securities remain unimpaired.

"SECTION-BY-SECTION ANALYSIS OF AMENDMENTS TO THE WELFARE AND PENSION PLAN DISCLOSURE ACT

"TITLE

"The amendment changes the title of the Act from 'Welfare and Pension Plans Disclosure Act' to 'Employee Benefits Protection Act.' The underlying purpose of the Act has always been the protection of the benefit plan interests of employees and the newly added fiduciary responsibility provisions will broaden the scope of this protection, making the use of the word in the title appropriate. The descriptive title is amended to read simply 'An act to amend the Welfare and Pension Plans Disclosure Act.'

"TABLE OF CONTENTS

"The table of contents reflects the addition of two wholly new sections; section 14, entitled 'Fiduciary Responsibility' and section 15, entitled 'Prohibition Against Certain Persons Holding Office.' It also reflects the change in the title of section 2 from 'Findings of Policy' to 'Findings and Declaration of Policy.'

"SHORT TITLE—SECTION 1

"Section 1 provides that the Act may be cited as the Employee Benefits Protection Act.

"FINDINGS AND DECLARATIONS OF POLICY—SECTION 2

"Section 2, presently titled 'Findings and Policy' has been retitled 'Findings and Declaration of Policy.' Language has been added to subsection (a) in recognition of the increasing impact of employee benefit plans on interstate commerce and to stress the intent of the amendments to provide greater safeguards in the protection of participants' and beneficiaries' rights under employee benefit plans. Subsection (b) contains a new clause reflecting the broadened policies of the Act.

"DEFINITIONS—SECTION 3

"The definitions of 'employee welfare benefit plan' and 'employee pension benefit plan' have been modified to make it clear that a plan will fall within the definition not only if it is established by an employer or an employee organization, but also when it is maintained by such an entity.

"The definition of 'party in interest' has been broadened and the definition of 'administrator' has been removed from section 5 and added, in changed form, to section 3. Definitions of the following words and terms have also

been included: relative, employee benefit plan, employee benefit fund, separate account, adequate consideration, nonforfeitable pension benefit, accrued benefit, security, fiduciary and market value.

"Since the term 'employee benefit plan', which means either a plan providing pension benefits or a plan providing welfare benefits or a plan providing both, has been added to the definition section, the term 'employee welfare or pension benefit plan', and the term 'employee welfare benefit plan or employee pension benefit plan' have been deleted from the Act wherever feasible and the term 'employee benefit plan' has been substituted. These changes are not referred to elsewhere in this analysis.

"COVERAGE—SECTION 4

"Subsection (a) no longer contains the words 'or employers' and 'or organizations.' There is no change in substance, since the singular is read to include the plural. 1 U.S.C. § 1.

"Paragraph (3) of subsection (b) now contains subparagraph headings (A) and (B) and the words 'order or association' have been added to subparagraph (A) and to the proviso. The word 'or' has been substituted for the word 'and' in subparagraph (B) for the sake of clarity. The changes conform the language more closely to the Internal Revenue Code to which the language refers.

"Paragraph (4) of subsection (b) specifies that participants or beneficiaries of plans covering less than 26 participants may bring actions to recover benefits or to protect a contingent interest in benefits, even though the plan is not otherwise covered by the Act.

"DUTY OF DISCLOSURE AND REPORTING—SECTION 5

"The second sentence of subsection (a) has been changed slightly to achieve greater clarity.

"The definition of the term 'administrator' has been changed and added, as noted above, to section 3. Subsection (b) authorizes the Secretary to require special terminal reports. Subsection (c) contains a simplified and more flexible version of an exemption power than the 'variation' power currently in subsection (a).

"DESCRIPTION OF THE PLAN—SECTION 6

"Subsection (a) has been updated. Subsection (b) has been modified to require that the plan description include an easily understood explanation of any plan provision dealing with nonforfeitable pension benefits or a statement, if applicable, that the plan does not provide such benefits. The current requirement that all plan description changes be filed within 60 days has been modified to allow flexibility in accordance with the Secretary's regulations. Subsection (b) has also been modified to eliminate the requirement that the bargaining agreement, trust agreement, contract or other instrument under which the plan was established or is operated be included in the plan description; such full documents are made available for inspection by a participant or his representative, or he may obtain copies of such documents upon request and payment of reasonable charges pursuant to section 8(c).

"ANNUAL REPORTS—SECTION 7

"Section 7 has been rearranged and broadened. Paragraph (1) of subsection (a) sets forth the basic reporting requirements for all plans. Notice and opportunity to be heard rather than an investigation, is now the prerequisite to the Secretary's requiring a report from a covered plan with less than 100 participants. Paragraph (2) requires the carriers, in the case of an insured plan, to certify necessary information to the plan administrator within 120 days afer the end of the plan year, and is identical to section 7(g) of the present Act. Paragraph (3) requires each plan to be audited annually by an independent accountant and the auditor's report with respect to financial information required to be filed under section 7 must accompany the plan's annual report. An exception is included for the books of banks and insurance companies, if subject to periodic examination by Federal or State agencies.

"Subsection (b) sets forth the kinds of information and transactions which must be reported by all plans, save those which are unfunded. Paragraph (1) covers general information, and requires identification of all

fiduciaries. Paragraph (2) calls for data concerning all plan investments and paragraph (3) requires information with respect to transactions in securities.

"Paragraph (4) deals with transactions involving property other than securities. Loans are covered in paragraph (5) and leases in paragraph (6). Paragraph (7) calls for a list of all party in interest transactions. Paragraph (8) contains special instructions where plan assets are held in a common or collective trust or in a separate account by an insurance carrier and allows the Secretary to prescribe rules for reporting in such situations. Paragraph (9) permits the administrator to furnish additional investment information if he desires to do so.

"Subsection (c) deals with unfunded plans—plans in which the benefits are paid out of the general assets of the employer or the employee organization.

"Subsection (d) sets forth the reporting requirements for insured plans and is identical to section 7(d)(1) and (2) of the present Act.

"Subsection (e) elicits actuarial information, to the extent applicable from all plans.

"PUBLICATION—SECTION 8

"Subsections (a) and (b) provide for the preparation of forms for plan descriptions and annual reports by the Secretary and for inspection of completed descriptions and reports in the public document room of the Department of Labor.

"Subsection (c) restates the current requirements of disclosure to participants; copies of the plan description and most recent annual report and the bargaining agreement, trust agreement, contract, or instrument under which the plan is established or maintained must be made available for examination by participants and beneficiaries at the administrator's principal office and a summary of the annual report must be furnished to any participant or beneficiary so requesting in writing. Copies of the plan description or annual report or agreement or instrument under which the plan is established must be furnished on request but a reasonable charge may be made to cover the cost.

"Subsection (d) provides that upon written request, the administrator must furnish to a participant or beneficiary a statement of information concerning nonforfeitable pension benefits accrued, and total accrued pension benefits.

"Subsection (e) provides that upon termination of service, each participant or his surviving beneficiary is entitled to receive a statement of his rights and privileges under the plan. The Secretary is authorized to prescribe the manner in which the statement must be furnished, its form, and its content beyond the mandatory content requirements stated in the subsection. Such statement is prima facie evidence of the facts, rights and privileges set forth therein.

"ENFORCEMENT—SECTION 9

"Subsection (a) restates the current criminal penalty for willful violations of sections 5 through 13 of the Act.

"Subsection (b) provides for liability, in the courts discretion, of up to $50 a day in the even of an administrator's failure or refusal to comply with the written request of a participant or beneficiary for a plan description, annual report, statement of accrued benefits (section 8(d)) or the bargaining agreement, trust agreement or contract under which the plan was established and is operated.

"Subsection (c) gives the Secretary the authority to investigate when he believes it necessary to determine whether any person has violated or is about to violate the Act. Subsection (d) incorporates the subpoena provisions of the Federal Trade Commission Act and makes them applicable in an investigation by the Secretary.

"Subsection (e) deals with civil actions. Suits may be brought by participants and beneficiaries individually for (1) the relief provided for in subsection (b), (2) to recover benefits due or clarify his rights to future benefits and (3) as representatives of a class to redress a breach of fiduciary duty. The Secretary may sue to enjoin any act which violates the Act and to redress a fiduciary breach.

"Subsection (f) allows participants and beneficiaries to bring any action authorized in subsection (e) in any court of competent jurisdiction, State or Federal. Authorization for broad service of process is provided for suits in Federal district courts by participants and beneficiaries to recover benefits

due or clarify his rights to future benefits and by participants and beneficiaries or the Secretary to redress a fiduciary breach. The Secretary is allowed to bring any other action authorized in subsection (e) in the proper Federal district court.

"Subsection (g) vests Federal district courts with jurisdiction in any action brought by the Secretary to grant any of the relief provided for in subsection (e) without respect to the amount in controversy or the ciizenship of the parties. Actions brought by participants or beneficiaries must meet the jurisdictional amount requirement applicable to the Federal district courts.

"Subsection (h) gives the court discretion to allow reasonable attorney's fees and costs to any party and also gives the court discretion to require the posting of security by the plaintiff for those fees and costs. A copy of the complaint must be sent to the Secretary.

"Subsection (i) prohibits the Secretary from interfering with the management of, or otherwise regulating any plan, except as authorized in the Act.

"Subsection (j) authorizes the Secretary to make arrangements with other government agencies, State or Federal, for cooperation in performing his functions under the Act. Provision is made for the transmission of evidence from the Secretary to the Attorney General in cases of criminal violations of the Act.

"REPORTS MADE PUBLIC INFORMATION—SECTION 10

"Remains identical in substance and form to present Act.

"RETENTION OF RECORDS—SECTION 11

"Remains identical in substance and form to present Act.

"RELIANCE ON ADMINISTRATIVE INTERPRETATIONS AND FORMS—SECTION 12

"Remains identical in substance and form to present Act.

"BONDING—SECTION 13

"Remins identical in substance to present Act.

"FIDUCIARY RESPONSIBILITY—SECTION 14

"This section is entirely new. Subsection (a) states that all employee benefit funds shall be deemed trust funds which may be used only to provide benefits and defray reasonable administrative costs.

"Subsection (b) sets forth a non-inclusive list of fiduciary responsibilities and proscriptions. The listed responsibilities relate to the fiduciary's duties. They must be discharged solely in the interest of the participants and beneficiaries, as a prudent man under like circumstances would do and in accordance with the documents governing the plan insofar as they are consistent with the Act. The listed proscriptions provide that a fiduciary may not lease or knowingly sell fund property to a party in interest, lease or knowingly purchase property on behalf of the fund from a party in interest, deal with the fund on his own account, represent another party dealing with the fund or act on behalf of a party adverse to the fund or the interests of the participants or beneficiaries, receive consideration from a party dealing with the fund in connection with a transaction involving the fund, loan fund assets to any party in interest, furnish goods, services or facilities to any party in interest, or permit transfer of property of the fund to a party in interest, or permit its use for his benefit. The Secretary is authorized to exempt from any or all of the listed proscriptions, individually or by class, such fiduciaries or transactions as he finds to be sufficiently regulated by State or Federal authorities to effectuate the purposes of section 14.

"Subsection (c) lists transactions in which fiduciaries may not be barred from engaging: receiving benefits as a participant or beneficiary of the plan, receiving reasonable compensation or reimbursement for services performed with respect to his duties in connection with the fund, serving as a fiduciary in addition to being a party in interest, purchasing on behalf of the fund securities issued by the employer of employees who are plan participants up to a 10% limit, purchasing or selling securities on behalf of the fund to a party in interest under certain conditions, lending to participants or beneficiaries on a non-discriminatory basis, making arrangements for office space with a party in

interest, or following directions in a trust instrument insofar as they are consistent with the prohibitions listed in section 14(b)(2). Subsection (c) also provides that a fiduciary is not barred from taking action pursuant to an authorization in the trust instrument if such action is consisent with subsection 14(c).

"Subsection (d) provides that a fiduciary shall be personally liable to make good to the fund for any loss due to his breach of any responsibility imposed by the Act and must pay over to the fund any profit he makes through use of fund assets.

"Subsection (e) sets out the rules for fiduciaries acting jointly. Under subsection (f), each plan is required to make provision for disposition of fund assets upon termination of the plan. All liabilities and obligations must be satisfied with respect to participants and beneficiaries before any party who has contributed to a pension plan can partake.

"Subsection (g) makes exculpatory provisions void as against public policy insofar as such provisions purport to relieve from obligations under the Act and subsection (h) contains a statute of limitations for suits to redress fiduciary breaches. Subsection (i) provides that a fiduciary shall only be liable for violations committed while he is a fiduciary.

"PROHIBITION AGAINST CERTAIN PERSONS OFFICE—SECTION 15

"This new section, which bars persons convicted of certain crimes from holding administrative or fiduciary positions in connection with employee benefit plans is modeled after a similar provision in the Labor-Management Reporting and Disclosure (Landrum-Griffin) Act of 1959.

"Subsection (a) lists the crime conviction of which shall constitute a bar. Included within the bar are conspiracies or attempts to commit the crimes, as well as crimes in which any of the listed crimes is an element. Persons so convicted are barred for a period of five years from the date of conviction or the end of a period of imprisonment for such a conviction from serving in any fiduciary position, including but not limited to an administrator, officer, trustee, custodian, counsel, agent or employee of an employee benefit plan or a consultant to such a plan. Persons performing exclusively janitorial or clerical duties are exempted, as are persons whose citizenship rights have been fully restored and persons whose service in connection with the plan has been determined by the Parole Board of the Department of Justice not to be contrary to the purposes of the Act.

"Subsection (b) states the criminal penalty for violation of the section. Subsection (c) clarifies the meaning of 'convicted' for purposes of determining the beginning of the five year period and subsection (d) defines the word 'consultant.'

"ADVISORY COUNCIL—SECTION 16

"This section is virtually identical to the corresponding section, section 14, in the present Act. Subsection (b) of the amendment provides that the Secretary's report to Congress of his activities under the Act shall be based on the past fiscal, rather than calendar, year. Subsection (d) changes the rate of compensation of Advisory Council members from $50 per diem, to the maximum per diem rate for consultants authorized by the Department of Labor Appropriations Act. Subsection (e) has been rendered obsolete by changes in Title 18, United States Code and has therefore been deleted.

"ADMINISTRATION—SECTION 17

"Subsection (a) now includes that citation of the United States Code for the Administrative Procedure Act and provides that the Secretary or his delegate in consultation with the Secretary of the Treasury or his delegate shall have the authority to prescribe rules and regulations necessary for the administration and enforcement. All rules and regulations issued under section 14 are to be prescribed by the Secretary in concurrence with the Secretary of the Treasury.

"Subsections (c) and (d) are no longer applicable and have been deleted.

"EFFECT OF OTHER LAWS—SECTION 18

"Section 18 designates the Act as the exclusive form of regulation for employee benefit plans within the areas covered, but provides that State

laws which otherwise regulate insurance, banking or securities shall remain operative. It provides further that States may require the filing with State agencies of reports required by the Act to be filed wih the Secretary.

"SEPARABILITY OF PROVISIONS—SECTION 19

"Remains identical in substance and form to the corresponding section, section 17, of the present Act.

"EFFECTIVE DATE—SECTION 20

"Subsection (a) provides that the provision of paragraph (b)(3) of section 7 shall become effective two years after enactment. Subsection (b) provides that amendments to the reporting requirement of the WPPDA shall be effective upon promulgation of revised reporting forms by the Secretary. Subsection (c) makes all other provisions effective 30 days after enactment.

"Subsection (d) permits a fiduciary to take up to a year after enactment to dispose of prohibited investments. A longer period may be allowed by the Secretary by rule or regulation.

"AMENDMENTS TO TITLE 18, UNITED STATES CODE

"The language of sections 664, 1027, and 1954 of Title 18, United States Code, which set forth penalties for criminal offenses involving embezzlement, false statements, and bribery and kickbacks in connection with employee benefit plans, has been changed where necessary to conform to the amendments made by the Act. No substantive changes have been made in these sections."

Senator JAVITS. Also, Mr. White, I want to be sure that I understand your concept of subsidy that you refer to in your statement and which Mr. Mittelman who has been sitting in for me has heard. As I understand it, you speak of subsidy in terms of the poor family or very moderate-income family as essentially some rental subsidy where a subsidy of loans, as you put them here, for example, you speak of income subsidies for housing, subsidies for loans would be an underwriting of part of the interest? Is that what you have in mind?

Mr. WHITE. Yes, either by giving the subsidy to individuals with which to complete their interest payments, or by giving it to institutions. As I take it there is a bill about to go before the Congress which lets a savings and loan institution originate a mortgage at 7 percent and sell it to the Home Loan Bank. The Home Loan Bank is then subsidized by an amount necessary to cover the difference between its borrowing cost and 7 percent.

Senator JAVITS. Yes. Would the panelists have any opinion on this question? I think that we are now thinking very much along these lines. We have already done it with respect to the student loan program. There it is a subsidy to the individual.

Mr. WHITE. Yes.

Senator JAVITS. And the question is whether in terms of the credit markets it would be more or less desirable to have the subsidy go to the individual mortgagor or whether it would be desirable to let it be reflected in the rate charged the mortgagor by letting the subsidy go directly to the savings institution or the mortgagee who might, for example, decide to allocate the benefits of this subsidy differently to different borrowers, whereas if you made it to the individual, that would make it mandatory that each individual be treated as the legislation treated him.

Mr. MURRAY. I think, Senator, you have mentioned the chief advantage in having any form of subsidy made to the lender, that is to say, that you then permit that flexibility in allocation which has some desirable features in that it may be conducive to innovation in lending practices, lending arrangements, and new types of lending indeed. I think we have seen in recent years great benefits from innovation in the forms and types and varieties of lending activities, and considering what we are looking forward to, hopefully at least in terms of the size and range of housing demand, it would seem desirable to have that kind of flexibility available through the lending institutions.

Senator JAVITS. Of course, the difficulty—go ahead.

Mr. WHITE. In that case the lender decides who gets the subsidies rather than the Congress in terms of whom it gives the income to.

Senator JAVITS. Right. Is that a disadvantage for the lender to decide?

Mr. WHITE. I think it is not so clear that in fact the interests of the Congress will be served. If the problem of providing housing to individuals of certain income is the example we are going to take for a moment, then it may be that the more direct way to get it at the Congress interest is to give the income to those individuals or the right to subsidy to these individuals the Congress wishes to receive it, rather than to institutions and hope the institutions allocate it in the best of the interests of Congress. I must admit there are many more administrative problems associated with giving it to individuals, but it seems to me it is more likely to get at its major objectives than if the subsidy is given to the lender.

Mr. MURRAY. Perhaps it would depend very much on the institution. A savings institution like a mutual savings bank or savings and loan association has a strong incentive to lend to individuals because they are their prospective savers and the saver of small means is highly valued as a prospective saver, whereas if the lender were a state pension fund or whatever, with no direct relationship with the individual as a potential saver, it would not necessarily work as well.

Senator JAVITS. Mr. Cohen?

Mr. COHEN. I have no expertise in this area, but I cannot resist taking part of the time. First of all, as a matter of principle, I would agree that it does provide an incentive to the private sector, if some discretion is vested in the lender, to devise new and ingenious methods of financing which by its very nature is difficult of achievement by the Congress. Nevertheless, I think there is a potential distortion that may result when lenders alone make the decisions. It has been suggested that certain types of lenders are restricted by their own instruments. or the State law, as to the persons to whom they can make loans. Thus certain savings institutions may lend only to members, that is, savers, and does provide a potential for discriminatory treatment whether or not so intended.

Now, of course, I think the Congress with its usual genius will develop a scheme whereby we will have the best of both possible worlds. I think this can happen, if a certain area of discretion is vested in the private sector with some supervision by a Federal

authority to eliminate some of these distortions and to assure an evenhanded treatment in different parts of the country and as among different types of institutions and individuals.

Senator JAVITS. Of course, we are doing it both ways now.

Mr. COHEN. In the Housing Acts, for example, sure.

Senator JAVITS. Yes. For very low-income families at a rate as low as 1 percent which is subsidized by the Government. This recent bill that you referred to, Mr. White, just went through the Senate, tackles it the other way. That is, it gives the lender an opportunity to sell his mortgage either net without points or if he has deducted points, he sells on a different basis to the FNMA. That in effect gives him the factor of discretion as to what mortgage he will give and to whom and at what rate. But I think it still is vastly different from giving a subsidy rather than a repurchase right to the individual lender, depending upon how much in mortgage money he is putting out and to what class of the population.

Well, I certainly appreciate what you gentlemen have conveyed.

Do you think that—Mr. Cohen especially—do you think that these very bearish market conditions will have resulted in a fundamental change in the investment policy of pension funds, in that they will not wish to invest in equity securities?

Mr. COHEN. No. I think that there will be a continued desire to invest in equity securities. In 1969, for example, was a year of bear market proportions, and I am referring particularly to the last quarter of 1969. Nevertheless, investment in equity securities was undiminished by privately administered pension funds.

The fact of the matter is, I suppose, that as these funds grow, they do not have any other place to go. That is one point, but it is certainly a nonscientific point.

I do think that there is now a reexamination of investment policies by all investment managers, whether they manage pension funds—and today many pension funds are managed by the very same people who manage mutual funds—or other types of investment vehicles. All of them are reexamining the principles which seemed to be so widely accepted in 1968 and were receiving growing acceptance, not only in the typical mutual funds area or even in the discretionary account brokerage area where investments management is really the name of the game rather than selling securities. These people are reviewing the situation and past techniques and practices. It is inevitable that managers of the pension funds will do the same thing. Indeed, the imposition of a fiduciary standard would bring home to all managers the need to reexamine that situation very carefully.

Senator JAVITS. But you do not see any permanent impact upon the investment decision of pension funds by virtue of this——

Mr. COHEN. You mean as to allocation to equity securities?

Senator JAVITS. Right.

Mr. COHEN. No. I think this will continue and I believe it must and should.

Senator JAVITS. Thank you, Madam Chairman.

Chairman GRIFFITHS. I would like to ask what should the attitude with respect to the management of companies be for the funds?

45-800—70——7

Should they, for example, vote the stock or just sell when they disapprove of management policies?

Mr. COHEN. With all due deference, Madam Chairman, Mr. Murray is associated with two large institutions who are involved in this area and I defer to him for once.

Chairman GRIFFITHS. Fine.

Mr. MURRAY. Thank you. I just finished turning in my questionnaires for the College Retirement Equities Fund to the SEC Study of Institutional Investors and this, of course, has the effect of sharpening one's thinking.

We do not subscribe, in CREF, the original variable annuity fund which now has a billion and a quarter of assets, we do not subscribe to the notion that if you cannot agree with management on every single proposal that you ought somehow just to go out and sell the stock. We take our voting rights seriously. We always vote our proxies one way or another. When we vote contrary to management's recommendation, which we do with a fair degree of frequency, I always sit down and write them a letter explaining why.

One thing impressed me as I was reviewing our experiences in order to answer the questionnaire. I was struck by the fact that corporate managements treat the institutional investor politely even to the point of being deferential because obviously they like to have us as a shareholder, and then they go right ahead and do exactly as they please.

Chairman GRIFFITHS. They just like your money.

Mr. MURRAY. They like to have you as a shareholder. But based upon our experience, and we voted and argued with management on matters repeatedly, I would say that in the past five years, I really cannot find a single solitary instance where corporate management ever changed what they had made up their minds to do. They know that as long as they have the proxy machinery at their disposal, all they have to do is to enclose a postage-paid return envelope and shareholders will vote as management recommends. They really do not care in any serious way whether we disagree verbally, in writing, or in the voting of our proxies. I think institutions have been criticized as silent partners in not assuming their responsibilities of ownership, and this criticism is well justified in my opinion, but I may say that on the record, attempting to exercise one's responsibility is an exercise for the most part in futility.

Chairman GRIFFITHS. How can we adequately assess the fund manager's performance when they are so reluctant to tell even their real owners what is going on?

Mr. MURRAY. I think we must insist on detailed reporting so that the basic data are available. Given the data, it is possible nowadays, with our new techniques for measurement and with the use of the computer, to measure return and risk characteristics of a pension fund portfolio with considerable accuracy, but one must have the detailed financial information in order to make that calculation.

Chairman GRIFFITHS. May I ask, would you suggest that banks be forced to disclose this information also?

Mr. MURRAY. They are, of course, usually these days forced to disclose to the company but they are not forced to disclose it to the participants. I must say I can see no reason whatever for their not

disclosing information in detail. We have done it in CREF since it was organized and it has never in any way hampered the effectiveness of the management of the fund.

It is commonly said, you know, that if we tell too much, it will prevent us from making good investments. People will know too much about what we are doing. I submit that this is not supported by the facts, that complete detailed disclosure in no way hampers the investment manager, and if it is given to those with a legitimate, clear interest in the fund, those who are participating in it, they will then have the basis for intelligent judgment as to how they are being treated and what the real experience of the pension fund is.

Chairman GRIFFITHS. Would you limit the amount of money that a pension fund could invest in its own stock?

Mr. MURRAY. I would.

Chairman GRIFFITHS. Its own company?

Mr. MURRAY. I think that it is undesirable when the individual is dependent on the future of that enterprise for employment continuity and future contributions to his retirement benefits. He should not also be relying for his asset, for the support of his pension plan, on the same enterprise. I do not say this about profit-sharing plans which perform a different function but for a pension program it seems to me undesirable that any significant fraction of the fund be invested in the employers' securities.

My own inclination would be to reduce it from even the proposed 10 percent to something like 5 percent, and a great many pension funds managers make it a rule that no more be invested in the company's own securities than would be invested in any representative corporation in which the trustee would be investing.

Chairman GRIFFITHS. Wouldn't a vesting feature really shapen up management of pension funds or require that they be sharpened? Aren't they—there really is no way now—we do not check the performance and you do not really have to. Most of these funds, if they just do not have money, they do not pay the people. That is all there is to that. The only ones I can see right now that are going to be enabled to pay where there is a vested feature are going to be those in municipalities.

We have a municipality right outside Detroit now that is not paying and I would think there is some problem with this because the municipality did not put in its money when it should have and now the tax base will not support it.

Mr. MURRAY. This is unfortunately true in some of our state and local government systems, although even there they still have the taxing power which a private corporation does not have. I am not defending their failure to provide the funds because this is bad practice in charging the future generations of taxpayers for the services being rendered at the present time.

I think that in this whole area of disclosure, meaningful reports to the participants which would include an independent auditor's certification and a consulting actuary's valuation of the fund and appraisal of the progress being made in its funding, would provide the people with a real live interest in the funds a basis on which they would know whether it was being responsibly and adequately

funded. They would then have a basis to know whether they ought to bring some kind of an action to protect their position.

One of our problems is that everybody likes to make generous retirement income promises. This is a happy thing to do. Everybody smiles and feels very happy.

The painful part, of course, is paying for them, and it always seemed to me very unfair to hold out promises to people without the real assurance that they can and will be fulfilled under careful, responsible, systematic management.

Chairman GRIFFITHS. One of the things that caused me to be interested in these hearings was that in previous hearings we found that one large company had $500 million in a fund on which they had never paid in any one year as much as half the interest and the fund had been in effect for more than 30 years.

Now, the thing that fascinated me was that it seemed to me that the fund has taken on a life of its own and I was really interested in finding out what are people doing with these funds? What really is the effect of it? And then some elderly gentleman came into my office and showed me the papers and I checked it through the Labor Department and he was absolutely right. He was a member of a very small union in which some 3 years before an accountant had told them, the Labor Department, this fund is completely funded. There are no conceivable circumstances under which it could not pay every single demand that will ever be made upon it, and at the end of 3 years they had collected another million and a half dollars.

The fund went on. Nobody shut it off. There were only 152 people who ever could collect and you now had more than $4 million collected for them. And they were only getting $50 a month.

So I though it was quite fascinating. I mean what are these people doing with this money? And what is the effect on the general public? And what effect does this have upon my husband's and my investments?

It seems to me that these are the questions that ought to be answered.

I have talked too long.

Mr. Widnall?

Representative WIDNALL. I will pass.

Representative CONABLE. I would like to yield to Senator Javits, who is under pressure of time.

Senator JAVITS. I just have a question or two.

I was going to ask Mr. Murray a followup question to that of Mrs. Griffiths'. What about leading a fight on a management? Aside from just giving them your proxy or withholding it. What about organizing a consortium of stockholders and bondholders and leading a fight on the management and throwing them out? Why should you have to sell your stock if they run the company badly?

Mr. MURRAY. I really do not think you should have to. I think this could well be a great sacrifice of the resources of the fund. But I think you will appreciate, Senator, the difficult position in which an institutional portfolio manager finds himself. If I go and ask a dozen other fund managers, somebody is surely going to call me a concentration of economic power and accuse me of using the economic power of the fund to carry out forced changes.

Now, despite that accusation, if the chips were down and this was the only way that you could go about protecting the investment, then I think we as trustees of other people's money must undertake that responsibility and answer to whatever charges are made. In the absence of that kind of a clear cut and shall we say salvage kind of situation, I think it is apparent that institutions are not eager to be subjected to that kind of criticism which is widely tossed about without any real justification or consideration of the facts.

Senator JAVITS. Well, now, in the interests of corporate democracy, wouldn't it be desirable to give you a piece of machinery by which you could repair to your beneficiaries—and they are your constituency. And as Mrs. Griffiths saids, why should the fund have a life of its own? Why aren't your constituents entitled to decide what the stockholders have a right to decide? What are you going to do with our investment?

Mr. MURRAY. We exercise our discretion, as I say, without great effectiveness. I really think that Mr. Cohen and his predecessors did a very fine job of reforming the proxy mechanism. I am afraid that the structure that they have built up to protect the abuse of that system also makes it rather difficult to do anything without mounting that mammoth undertaking of filing information and clearing it with the SEC.

I can see Manny Cohen getting ready to respond. Let me just finish, Manny.

The question is should it be possible for a responsible institutional investor to make his attitude and feeling widely known short of going through that total time-consuming and expensive process now provided under the statutes?

I yield perforce to the former chairman.

Senator JAVITS. Mr. Cohen, if you would allow me because my time may be up before you finish your answer——

Mr. COHEN. He knows me well.

Senator JAVITS. I would just like to say this. I consider the issue of corporate democracy to be one of the most critical in our whole society and I think it contributes tremendously to crisis and I think it is one of the ways of resolving the crisis which exists in our country, so I would like to tell you all that this is a subject I think we ought to pursue very diligently in the Congress as it is one of the most neglected of all of the opportunities which we have in this country.

Representative CONABLE. Senator, may I add something there. It seems to me, Mr. Murray, that if you are called a concentration of economic power it is probably because you are one. With economic power, of course, goes responsibility. I would not worry about being called things like that. I realize that you may not have the structure necessary to lead proxy fights, but certainly I would agree with the Senator, that corporate democracy becomes increasingly a serious issue just as union democracy is a serious issue, simply because of the size of the units we are dealing with and the diffusion of power which has resulted. That needs attention.

Mr. COHEN. Senator, in my prepared statement I adverted to this particular problem. For the record I might also refer to the publi-

cation of a report by Robert Tilove in 1959 which goes into some of these issues in great detail.

Now, a great deal has happened since 1959. The march of institutionalization seems to accelerate each year.

The "pass through" possibility of passing through the voting power I think has a great deal of appeal. I am afraid, however, that there is another side of the coin. As Congressman Conable pointed out, with this concentration of power goes responsibility, a responsibility which presumably could be diluted if there is a requirement that they pass through the voting power to uninformed and unsophisticated pension holders?

Senator JAVITS. Mr. Chairman, I did not have on my mind passing through. I just meant like giving them the opportunity if they wish to repair to their constituents.

Mr. COHEN. They do have it today I think in many cases. I should also note that the statement Dr. Murray made about the policies of his company really represents a more enlightened view of the situation than that held by managers of other institutions. But, I think the trend is going that way because institutionalization of investments, institutionalization of markets generally is proceeding at great pace and cannot be stopped. It is inevitable. Our whole society is being institutionalized. As a consequence, the focus of attention really should be to require, as this legislation does, the imposition of a clearly stated and understood fiduciary responsibility on the managers and leave to them the worry and the trouble of determining what is in the best interests of the beneficiaries of these trust funds.

This is the traditional American way and, generally speaking, it works fairly well.

Senator JAVITS. I would only add if I still have time, Madam Chairman, that it works well with a sanction but the voter can always through you out and that should apply to the manager, too, at periodic intervals. That is republican form, I strongly agree with it, republican with a small "r," but I think that is a very essential precaution, that you are in for such a time, one, two, three, whatever it is to be, but at a given time your constituents have a right to be heard, too.

Now, I realize that many of these funds have these provisions just like many mutual insurance companies have these provisions on the part of the policyholders, but one of the difficulties with our society is that whether it is because of conditions that hedge them in or practicalities, this just never happens and hence the sanction is not meaningful because it is never applied.

Mr. COHEN. Senator, I just want to add one note. In recent years, particularly in the era of the takeover bids, which is still alive although struggling some, it has been suggested that institutions have participated in a number of these activities. I have no doubt that it will continue, largely because of the more enlightened approach and the acceptance of responsibility as expressed by Dr. Murray.

I think there is another aspect of this that perhaps is not as clear. The mere fact that institutional investors are on the scene is a source of great delight to and sometimes concern to management. Oh, they

love to have the institutional investors come in and buy their stock because it raises market prices, options are worth a lot more, and emoluments of office are worth a great deal, and that is a very happy time. But if the institutions begin to sell and knock the stock into a cocked hat, why then all you gentlemen up here receive all kinds of complaints. I know because some of them used to be bucked to me. This is part of the game. While I tried to make it sound funny, it is a very serious business because it does reflect an indirect influence which these institutions do exert upon the managers of American industry and that, too, I think is most helpful. And if that is tied with a fiduciary responsibility. I think we are pointed in the right direction.

Senator JAVITS. Thank you very much.

Chairman GRIFFITHS. Mr. Conable, do you have another question?

Representative CONABLE. I would like to ask Mr. Cohen something about mutual funds. I know that is a special interest of his.

I have suggested that the further development of pension plans may be somewhat inhibited by government action extending the wage base for social security. I wonder if our failure to enforce tough antitrust laws and prevent the further conglomeration of business interests could ultimately be a substantial impediment to the development of the mutual funds industry? It seems to me we are getting many, many corporations now that are virtually mutual funds themselves.

Mr. COHEN. I am glad you said it, sir.

Representative CONABLE. These conglomerates are providing a degree of diversity which was essentially the purpose for mutual funds in the first place. Such corporations are held together primarily by financing, with the expert management coming from the corporate president instead of the mutual fund administrator. I am wondering if you see down the road here some falling off of this mutual fund development. Really a great deal of our mutual funds now are investing in what are in effect mutual funds and not really giving the degree of skill that is needed to justify the fees they receive, for instance.

Mr. COHEN. Mr. Conable, the remarks you make I think are very pertinent and very acute but I do not see these developments as impeding the growth of the mutual fund. As long as the rewards for the management of the funds and the rewards for selling interests in the funds continue at the substantially higher level than that available in the sale of securities generally, I think that this growing institutionalization of investment through those media will continue. And I think this can be seen by the fact that despite a bear market in 1969, the growth of assets by virtue of sales of interest in funds continued with very slight abatement.

I do not see any problem. Nor do I see that any increase in benefits or requirements for contributions to pension funds will slow the growth of mutual funds materially. Obviously, we are in an area where there is a certain competition, sometimes witting, sometimes unwitting, between different investment media which serve a similar general purposes.

We have CREE, to which Dr. Murray has referred, which is a voluntary organization but makes available to university professors a great many of the benefits which would be provided by legislation of the kind that Senator Javits is espousing and which the Presidential Committee suggested some years ago. This is one of the benefits to which I think Dr. Murray alluded when he said the private sector should remain in the picture in a very substantial way. I do not see any really materially important effect upon the mutual funds industry.

I do think that there are other financial intermediaries, that have traditionally provided similar services to wealthier citizens, now prepared to provide those services to less affluent citizens. But they are engaged in a kind of a life and death struggle with people in the mutual funds industry. There is an obvious effect there, whether or not competition which the banks could provide should be allowed to flower in this area, an area in which now only the insurance companies, increasingly every day, and mutual funds live.

Representative CONABLE. In short, you would expect, then, continuing growth in this type of institutional intermediary?

Mr. COHEN. Yes, sir.

Representative CONABLE. And you do not feel that there are self-limiting factors at work in the marketplace today that are likely to reduce the need for congressional interest in the impact of such institutions on our whole economy?

Mr. COHEN. I see the growing institutionalization continuing and perhaps accelerating but I also see the need for continuing oversight by the Congress as to the effects of these institutions on the markets, on the beneficiaries, and on the economy as a whole.

Representative CONABLE. And would that be the conclusion of your colleagues as well? That this——

Mr. WHITE. Yes.

Representative CONABLE. Their type of development will continue to expand?

Mr. MURRAY. Yes, indeed.

Representative CONABLE. Thank you.

Chairman GRIFFITHS. Mr. Widnall, did you have anything you would like to ask?

Representative WIDNALL. I do not have any in particular about that. But in my own observation of the American scene, it seems to me the growing impersonalization of everything and computerization of everything can lead to our self-destruction in the end in the securities field. I had an experience with something that happened to my mother-in-law a number of months ago. She had a stock that had been paying very well over a period of years. The earnings increased to the point where they were at their high, but the company was taken over by another company and they discontinued the dividends on her stock despite the fact that it was being earned and being earned to a greater extent than ever before. But in the conglomerate picture these uses——

Mr. COHEN. I am familiar with some things like that.

Representative WIDNALL (continuing). For that money in other directions are, I would say, speculative and manipulative, more for the benefit of a few people within the group than for those that were investing as a whole.

Could you comment on that?

Mr. COHEN. Yes, I will be glad to, Mr. Widnall. I have spoken to this subject over a number of years. I recognize the point you make and there is no doubt that the pace at which conglomeration took place in recent years, frequently by the use of the take-over bid—which, incidentally, we borrowed in its present form from our British cousins who have been dealing with this problem for almost a decade—has brought with it a number of abuses and that these abuses need attention. They have already received some attention through amendment of the Internal Revenue Code. The subject matter is the subject of hearings by other subcommittees of Congress. They are also the subject of continuing concern to other agencies of government concerned with this development. And yet, having said that, I am also concerned that what is a very imaginative use of—in many cases—resources by capable managers, even though there are others who do not quite fit that category, may be defeated if we outlaw these merger efforts. It would be pretty much like throwing the baby out with the bath water. The abuses are almost similar or, at least, have some resemblance to previous events in our economic history and they are already on the books, very successful legislative efforts to deal with abuses. The Public Holding Company Act of 1935 and, indeed, the Investment Company Act of 1940, were both designed to deal with abuses arising out of gross institutionalization of our society.

Now, in the last decade, particularly in the last five or six years, before the bear market brought its own dampers, this had been running almost wild in the view of many. There is no question about that. Nor is there any question about the suggestion that Congressman Conable made that many of them begin to look like investment companies. I am sure that the relevant regulatory agencies and departments of the government have been worrying about this problem for some little while. In short, I agree with your concern. There are problems. The problems can be dealt with, but it does not require that we put a halt to this very imaginative private enterprise development.

Representative WIDNALL. That is all.

Chairman GRIFFITHS. I would like to thank each of you for appearing here this morning. It is very kind of you and you have added greatly to our knowledge. Thank you very much.

This hearing is adjourned until tomorrow morning in this room at which time we will hear Mr. Arthur Levitt, Mr. Roy A. Schotland, Professor James H. Schulz, and Professor Walter Werner.

(Whereupon, at 12:20 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Tuesday, April 28, 1970.)

INVESTMENT POLICIES OF PENSION FUNDS

TUESDAY, APRIL 28, 1970

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10:05 a.m., in room S-407, the Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling, economist for the minority.

Chairman GRIFFITHS. Today we have four eminent authorities in the analysis of problems and issues in the institutional investment area.

Prof. James Schulz, from the University of New Hampshire has done considerable research in the economic circumstances of the aged. His doctoral thesis involved a projection of these circumstances for 1980. Today he will address his remarks to these important and related subjects.

Prof. Roy Schotland, Associate Dean of the Georgetown Law School and formerly Chief Counsel of the SEC's institutional investor study, and before that, was law professor at the Universities of Pennsylvania and Virginia. He was also editor of the monumental special study of the securities markets, completed several years ago.

Professor Werner is professor of law at both the Columbia Law and Columbia Business Schools. He also has been a long-term student of the institutional investor and the securities markets and was the first Director of the Office of Policy Research at the SEC, an office which was the direct outgrowth of a recommendation study by the "special study" of the SEC.

Dean Schotland and Professor Werner will direct their attention to such questions as the advisability of use of pension funds for social purposes and the impact of the funds on financial markets and related subjects.

Arthur Levitt is comptroller for the State of New York, an elected official who has held this position longer than anyone before him. As sole trustee for one of the largest State pension systems he has had more than his share of headaches evolving sensible investment policies to achieve adequate incomes for current and prospective public pensioners.

Gentlemen, we look forward to hearing from you, and I want to express our appreciation for your presence here today.

Mr. Schulz, you may proceed. Since time is short, I hope that each of you will try to keep your oral testimony to 15 minutes or so. Your full statements will be made part of the record.

STATEMENT OF JAMES H. SCHULZ, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF NEW HAMPSHIRE

Mr. Schulz. Thank you.

May I just add to the introduction that at the present time I am also visiting professor of economics at the Florence Heller Graduate School for Advanced Studies in Social Welfare, Brandeis University:

Chairman Griffiths. Thank you.

Mr. Schulz. It is most heartening to see this subcommittee continue its investigations into the developing role of private pensions. It is my opinion that the growth and development of private pension plans merit the continued attention of the Congress during a period when this relatively new institution is undergoing such rapid change.

This subcommittee, as I understand it, is primarily interested in the fiscal and monetary significance of growing private pension funds and fund management. While my research has not been focused on these specific questions, as such, I have been concerned with a related question which has an important bearing on what the aggregate fiscal and monetary impact of private pensions will be. This is the question of how older persons in this country can insure that they have sufficient economic resources in retirement to maintain an adequate standard of living.

Due to inability or neglect, a great many people have failed to prepare, through individual or group action, for an ever-growing number of retirement years. This has resulted in the plight of today's poverty-stricken retired aged population. Enough reliable statistical information has now been accumulated to substantiate clearly the existence of a relatively low economic status for all but a very small minority of the current retired aged in the United States.

It is becoming increasingly apparent that families young and old and, in some sense, our society as a whole must come to grips with two major socioeconomic questions regarding retirement:

1. What is an "adequate" retirement income?
2. What should be the respective roles of individuals, private industry, and governments in planning and providing income for retirement?

It is the latter question which most relates to the aggregate impact of private pensions. We are developing a reliance in this country on two major but contrasting types of pension institutions: private and public. One distinguishing characteristic of the public pension systems is that they operate with little or no funding; whereas, private pension systems are usually heavily funded. Thus, the aggregate impact of private pensions ultimately depends on the three-way choice made in our society in deciding what will be the respective

roles of individuals through personal saving, private industry through private pensions, and government through public pensions in planning and providing for retirement living.

As this subcommittee considers the problems arising out of the impact of private pensions on the economy and its monetary markets, therefore, it may be useful to review briefly how well private pensions are doing in providing retirement income and what the prospects are, in this regard, for the near future.

I think that the role to be assumed in our society by private pensions—as opposed to personal savings and social security benefits—is still basically unresolved. In a recent study prepared for the Senate Special Committee on Aging, I identified a number of conflicts of purpose which have developed as pension plan coverage has spread throughout private industry. One of these conflicts occurs between employees of large and small companies.

The costs of providing pension coverage in small companies with few employees is comparatively high. This results from the inability of small companies to realize the economies of scale associated with the establishment and administration of plans covering a large number of persons. Workers in small firms which cannot or do not provide pension coverage must rely in retirement on Social Security benefits, supplemented by any savings they may have. But with both private and public pension systems operating which provide retirement benefits to the same workers in a large number of cases, it is unrealistic to assume that the pension levels of either public or private pensions are not influenced by the benefit levels of the other. Thus, raising benefit levels for workers covered by private pensions probably results in less political pressure and less apparent "need" for increases in social security retirement benefits. But workers not covered by private pensions are inevitably the losers in any slowdown in the rate of social security increases.

The ability to expand private pension coverage thus becomes a crucial issue in deciding what will be the respective roles of social security and private pensions in the economy. Coverage under private retirement plans is continuing to expand with about a million workers added to plan rolls each year. However, the work force has been growing by approximately the same number of persons so that little, if any, progress is being made in reducing the number of persons without pension coverage.

For example, the Social Security Administration estimated that by the end of 1967 there were 27.6 million employed workers covered by private pensions and deferred profit-sharing plans—a gain of some 1.2 million over 1966. This growth was a little more than the 3.9 percent rise from 1965 to 1966 and was greater than the usual year-to-year gain in the period since 1960, when absolute increases were between 700,000 and 900,000.

In contrast, the Social Security Administration has just released figures which show only a 2.2 percent rise in coverage for 1968—an increase of only 600,000 workers. This absolute increase in workers covered is one-half the net gain in coverage for the preceding year, 1967. As a result of this slow growth the proportion of the private

wage and salary work force covered by private plans did not change. In fact, the proportion covered was about 45 percent 7 years ago and had reached only 47 percent by the end of 1968.

The lack of pension coverage remains, of course, concentrated among small employee groups. If the private sector is unwilling or unable to devise ways of covering the large numbers of persons in the labor force currently without private pension coverage, greater reliance will have to be placed upon the social security system.

For those workers, however, covered by private pensions, the question arises as to what the level of private pension benefits is and what it will be in the future. If we were forced to select one body of information which is important above all others in evaluating the impact or role which private pensions will play in providing income security in retirement, it would no doubt be information on private pension benefit levels. Hence, as I recently stated in my report to the Senate Special Committee on Aging, it is an astounding fact to find that today we do not know what the level of private pension benefits is and how they are changing over time.

In 1965, a BLS study of private pension plan benefits appeared, but because of extremely unrealistic assumptions, the findings are of little usefulness. More recently, BLS study was made of 100 negotiated pension plans and trends were examined between two periods: 1961–1964 and 1964–1968. Once again it would be pure folly to generalize about what are the trends in private pension benefits from this unrepresentative sample of plans—which in many cases are plans of the pension leaders.

Aside from these BLS studies of very limited usefulness, there are almost no other studies which look at private plans as a whole to judge the levels of future benefits being credited to employees currently covered by such plans. An exception, however, is a group of projections by me of private pension benefits in 1980. These projections were part of a larger study which sought to investigate what the future economic circumstances of the retired aged population would be in light of past and current private and public pension developments.

In order to investigate the future economic circumstances of the retired aged population, a simulation model was constructed to incorporate and represent the essential features of the major private and public pension systems existing in the United States. In addition, the model was designed to take into account relationships among important demographic and work force variables influencing the pension position and savings behavior of individuals in the economy.

Various methodological techniques are used by researchers for simulating or representing reality. The technique used in conjunction with the model cited above was stochastic simulation—stochastic in the sense that the model allows for the element of chance in addition to asserting special relationships among the variables. Given certain specified inputs, probabilities of occurrence for various events can be specified. Utilizing the services of a high-speed electronic computer, the model can then be used to investigate the problem under consideration; that is, to project pension income and asset distributions for a future aged population.

I will not go into the details of how the simulation was done except to say that the basic data used for the simulation projections

were from a large national sample of persons in the U.S. population who were between the ages of 45 and 60 in 1960. These persons were aged, in effect, 20 years using the simulation process. At the end of 20 years, these people will be age 65 or older and represent the aged population in 1980. As the people in the sample were aged they faced the possibilities of death, labor force entry and exit, job change, changes in pension coverage and vesting, unemployment, and retirement. Thus, the simulation process is an attempt to move a real and represenative group of people through time, exposing them to various possible occurrences for example, job loss—occurrences which will influence the amount of public and private pensions these people will ultimately receive in retirement. During the simulation, work income and pension coverage histories were kept for each individual. Pension benefits were then calculated for each individual. Then, having calculated private and public pension benefits, a "census" was taken of the retired population at the end of the simulation period, and distributions were derived of pension income for couples and unrelated persons.

Allow me, Madam Chairman, to depart briefly from my prepared statement to make a number of additional comments about these private pension projections. Some persons in the private pension field have challenged my projections as being too pessimistic; that is, too low in view of recent changes which have occurred in various pension plans.

On this point I would like to make my position very clear. First, the common practice in proving that substantial improvements are occurring in private pension benefit levels is to refer to a number of plans where recent changes have occurred. Often these plans are what are characterized as "pension leaders." But we must be careful in generalizing about private pension levels as a whole from small and perhaps biased samples.

We currently lack studies which look at a broad spectrum of plans and by using realistic assumptions try to analyze what private pension level trends have developed in recent years.

Second, looking at current benefit formulas ignores the fact that many plans do not make retroactive adjustments for prior years of service under old formulas. While most negotiated plans with service only formulas probably do adjust retroactively, this is not as common among nonnegotiated plans.

Therefore, if a dramatic change is occurring in the level of private pension benefits, changes greater than assumed in my projections, then I hope that this will be proven by thorough economic investigation rather than by the impressions of actuaries, informative as they may be.

The fact that I consider my projections useful in formulating pension policy does not mean that I can guarantee their accuracy. Rather, it testifies, I think, to the lack of economic research and analysis in this area. I would only hope that those who consider my projections as unduly optimistic and I have been the recipient of both types of criticism will join in a common goal of urging and promoting continued investigation on this most vital question.

At the present time, in this regard, I am cooperating with the Office of Research and Statistics, Social Security Administration,

in updating and refining the simulation model used to make the projections which I am presenting today.

Now, turning to these projections, it is commonly believed that the current large number of workers covered by private pensions and the high incidence of some kind of vesting protection will cause a significant improvement in private pension benefits for future retirees. The results of the simulation projecting caution against this assumption—at least for the near future.

Certainly there will be more workers receiving private pensions in the future, and the pension benefits received will undoubtedly be higher. The key question, however, is how significant will the improvement be and how long will it take? The fact that over 28 million workers are covered by private pension plans or deferred profit-sharing plans and that roughly two-thirds of these workers are covered by plans with some form of vesting tells us little about ultimate benefits. Even the more liberal of current industry plans usually require 10 years of service for any vesting of benefits. Most plans also require that a minimum age requirement be met, and many require more than 10 years of service most commonly 15. Relatively slow improvement seems to have occurred since Prof. Merton Bernstein concluded:

The indications are that, despite the fact that vesting provisions are common in plans, only the very long-term employees are protected by vesting as presently practiced. The millions of others who change jobs are not.

Regarding the level of future private pension benefits, table 1 shows the result of the simulation projection of private pension income for the retired population in 1980. Two alternative income distributions for couples and unmarried individuals are shown. The first projection assumes that private pension benefit levels increase 3 percent each and every year after 1964. The second projection assumes a 5 percent increase. The projections show that present levels of private pension benefits will be of little help to the next generation of retirees. Over one-third of private pension recipients are projected to receive less than $1,000 a year in private benefits. Even if a significant upward trend in benefit levels is assumed, one-half to two-thirds of the private pension recipients in 1980 will be getting less than $2,000 private pension income.

TABLE 1.—PROJECTED PRIVATE PENSION INCOME DISTRIBUTION FOR RETIRED COUPLES AND UNMARRIED INDIVIDUALS, 1980

Private pension income	Couples [1]		Unmarried Individuals [1]	
	3-percent trend	5-percent trend	3-percent trend	5-percent trend
Total percent	100	100	100	100
Under $1,000	35	22	49	33
$1,000 to $1,999	39	36	34	34
$2,000 to $2,999	17	22	11	18
$3,000 to $3,999	6	11	3	7
$4,000 to $4,999	2	5	1	3
$5,000 and over	(2)	4	(2)	3

[1] Recipients only. Trend refers to annual increase in level of benefits. Same recipient rate assumed for each run.
[2] Less than 0.5 percent.

Source: Adapted from James H. Schulz, "The Economic Status of the Retired Aged in 1980; Similation Projections," Social Security Administration, Research rept. No. 24 (Washington, D.C., Government Printing Office, 1968), table 20, p. 69.

In terms of providing adequate income in retirement, such projections, together with projections of social security benefits, indicate that we still have a long way to go in providing adequate retirement income for many older Americans. The future inadequacy of pension income for the retired can be illustrated, for example, by two charts which I have brought with me today. These charts are based upon the simulation projections which I discussed briefly before and were prepared for use by the Senate Committee on Aging.

Chart 1 shows the percentage distribution of total pension income projected for couples and single individuals in 1980. Given the existing institutional pension structure and certain minimum assumptions with regard to changes in these institutional arrangements in the next decade, a majority of the retired aged in 1980 will have pension income below any reasonable level of adequacy. Total pension income will be below $3,000 for about half the couples, and below $2,000 for more than half the single individuals.

CHART 1

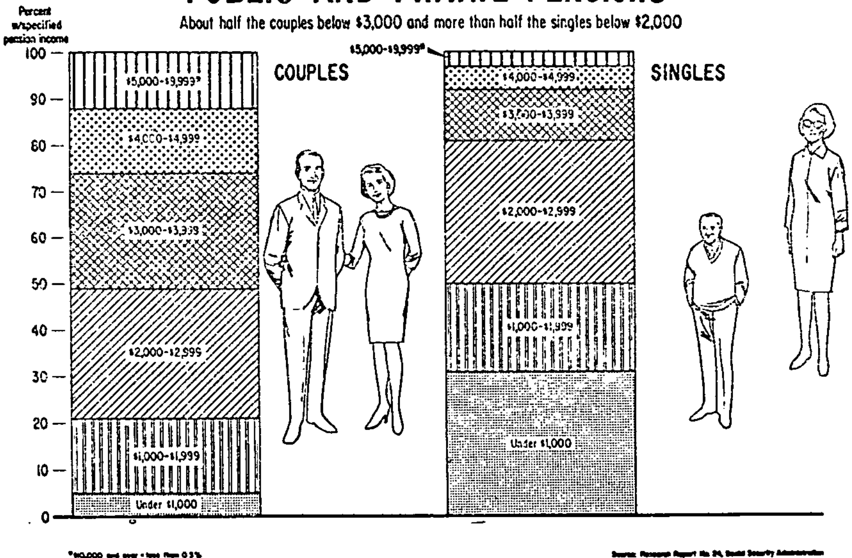

Chart 2 shows the results of comparing total pension benefits at the time of a worker's retirement with his average earnings during the 5 years prior to retirement. For workers retiring between 1960 and 1980, simulation projections indicate that approximately three-fourths of the males and one-half of the unmarried females will have a ratio of pension income to prior average earnings of less than 0.50, that is, less than 50 percent. In fact, nearly one-quarter of the married males have a projected ratio of less than 0.20.

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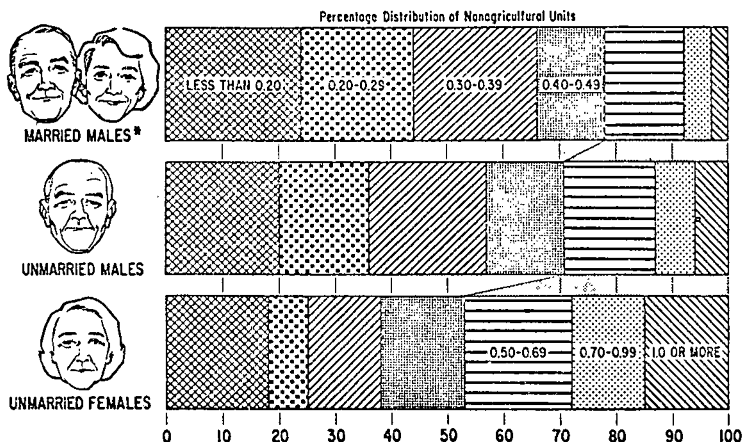
CHART 2

FOR MOST RETIREES, PENSION INCOME WILL BE LESS THAN HALF OF PAST EARNINGS

Projected Ratio at Retirement of Public and Private Pensions to Preretirement Earnings



Of perhaps greatest interest to this subcommittee is the implication from these projections that private pension plans would have to liberalize at a much faster rate if they are to fill in the gap between projected retirement pension income and anticipated retirement spending needs. This implies that pension funds would have to grow at rates greater than their current pace.

I have not dealt with the general economic impact of the current growth of private pension plans in my statement today. However, I have tried to show that any efforts to significantly improve the economic situation of older people by providing them with more adequate incomes through private pension plans are likely to significantly affect the aggregate impact private pension funds will have on the economy in the future.

There is no question in my mind that the current development and growth of private pensions is one of the major institutional changes occurring within our economic system. Once again, therefore, I would like to compliment this subcommittee for its pioneering work in this area and urge it to continue examining, as the facts become known, the economic significance of this growing sector of our economy.

Thank you for giving me this opportunity to appear before the subcommittee.

Chairman GRIFFITHS. Thank you, Mr. Schulz.

Mr. Schotland?

STATEMENT OF ROY A. SCHOTLAND, ASSOCIATE DEAN, GEORGETOWN UNIVERSITY LAW CENTER

Mr. SCHOTLAND. Thank you, Madam Chairman. Pursuant to request, I wish to note at the outset that although I served until

last month as Chief Counsel of the Securities and Exchange Commission's Institutional Investor Study, the views I express today are entirely my own, have not been discussed with and cleared by the Commission or the study nor do they derive from nor, so far as I know, reflect the thinking at the Commission or the study. I will, especially in light of the bulk of my statement, try to reduce it as much as I can.

Chairman GRIFFITHS. Thank you very much.

Mr. SCHOTLAND. First, no new words or data are needed about the catastrophic insufficiency of funds available for such socially useful activities as housing, or for State and local government projects like schools and hospitals, or for inner city business enterprise. The severity of the problem, and our relative unresponsiveness to it, call less for further lawyerlike or economic analysis than for political leadership.

It is equally well known, and being valuably documented and analyzed by these hearings, that the funds held for pension plans are enormous and growing at a staggering rate. Private pension funds' aggregate assets were $126.2 billion as of the the end of 1969 according to last week's SEC release. I might point out that that is a $26 billion increase over the press release announcing these hearings. I do not think that indicates the rate of growth, though.

The growth rate of State and local pension funds has become even more rapid; their assets totalled $52 billion by the end of 1969.

With such vast funds available, identifiable, and enjoying the benefits of tax exemption, it is unsurprising that the call should arise to tap those funds for activities starved for new investment. And it is right to look to the pension funds for help: the only question is how to get that help. Bills have been introduced that would require private pension funds to invest prescribed proportions of their assets in housing investments.

Some noncompulsory steps have already been taken to draw pension plan moneys into such projects. We need more devices like the new mortgage-backed bonds of the GNMA to induce pension funds to invest in such projects and below I suggest legislative steps to be taken. But any legal requirement that pension funds buy certain kinds of investments will be bad for pensioners—today's and tomorrow's. It will undermine confidence in pensions and thus add to inflation. Moreover, the idea that pension funds must meet today's needs for investment in order to justify or "earn" their tax exemption, is new, strange, and hopefully will not recur.

Pension funds are tax exempt because, by their very existence, they are "socially useful projects." First, they provide for decent, dignified retirement—not only for today's old people, but for all of us when we become old.

Second, pension fund are perhaps the best machinery we have for increasing personal savings. Most people cannot save for themselves as well as they can by way of pension funds, because current needs and temptations tend to win out over the needs of future decades.

However, if one focuses upon particular investment areas, espe-

cially housing and State and local government projects, it is undeniable that pension funds do little and lately have been doing less.

Pension fund investment in housing is episodic at best. But most dramatic has been the pension fund's noninvestment in, or net liquidation of, State and local government bonds. Private pension funds, being tax exempt, are not even listed among the sources of funds for such securities in the last decade. State and local pension funds, although also tax exempt of course, for noneconomic reasons were large holders of State and local bonds but have been net sellers since 1960, cutting their holdings almost in half. Clearly, then, pension funds have not met the public sector needs for the society's basic infrastructure. The pattern of pension fund investment is clearly to avoid such fund-starved projects as low-cost housing and local government financing, for the very reason that has kept others away from those projects: Those projects offer poor economic returns, badly below inflation-adjusted returns elsewhere. It is the obligation and the reason for being of the pension funds to earn good returns so as to help meet obligations to pensioners.

Pension funds simply must make high-yield investments: a 1-percent difference in yield earned on pension fund assets means roughly a 20 to 25 percent difference in ability to pay benefits, or in the employer's cost of paying the benefits. If pension funds are forced to make some low-yield investments, the funds' ability to pay benefits will be strikingly reduced. Even if the benefits are not immediately affected, because they are fixed by contract, and as is most frequently the case, the employer, not merely the fund, is ultimately liable for the benefits, the employer will be much less willing to agree to further increases in pension benefits. He will know that he will be unable to make his contributions to the pension fund work productively enough to cover the costs of benefits. And benefits must be raised frequently unless inflation is stopped permanently, or else we will all be like the retired clergymen who, in the 1960's, were getting total pension benefits of $600 per annum, because their pension depended on salaries of earlier decades.

Professor Schulz' testimony this morning makes clear how current and important is the dimension of the problem.

In the last 18 years, I believe United States Steel has agreed 11 times to increase pension benefits. If pension funds cannot be run to meet pension benefit costs, unions will find it easier to bargain for increases in current compensation, whose costs can be met by adjustments more within management's control. We will see a rise in current income, reduction in deferred income, and obviously, a new inflationary force will have been added.

Secondly, a legal requirement that pension funds make any particular kind of investments will undermine confidence in pension plans. Workers will be less willing to accept deferred compensation, as fear will spread that by the time they become eligible to enjoy their pensions, the Government will have taken steps which reduce the value of the pension. Providing for retirement, and increasing personal savings, are sufficient social contributions in themselves, as well as immensely important economic contributions to the endless

battle against inflation. Undermining those contributions for short-run help with today's pressing problems is shortsighted. Surely we should not sell other people's inheritance for a mess of pottage, especially when they do not even get the pottage.

Thirdly, such a legal requirement, by compelling purchase of what are sure to be lower yield investments and thus lowering the funds' overall yield and raising the cost of pension benefits, will make it much harder to increase portability, vesting, funding, and the other improvements which everyone involved with pensions has been striving for over the years.

A further difficulty with any legal requirement lies in defining what will qualify as "socially useful projects." For example, the need for aid to low-income housing is far too great to allow such a requirement to be satisfied by aid to high-income housing. Yet, one bill which requires pension funds to shift a quarter of their assets into housing investment over the next 25 years, would allow that requirement to be satisfied 100 percent by investment in highest-income housing. The bill permits the requirement to be satisfied either by holding certificates of deposit or other obligations of savings and loans, without any ceiling on the cost of the housing involved, or by directly holding any residential property again without cost ceiling. We must never subsidize housing for the rich at the ultimate expense of pensioners.

Moreover, implementing any legal requirement which, like one bill introduced, does not assure pension funds adequate time to adjust their portfolios, would unnecessarily upset the securities markets and lower the prices at which the pension fund would be selling.

Last, any such requirement goes against the decades-long, decisive trend away from legal inhibitions on the kind of investments fiduciaries may make. In ordinary trust law, we have seen the almost universal abandonment of the "legal list" in favor of the "prudent man" rule. In life insurance, the tight statutory net covering investments has been consistently changed in favor of fewer restrictions and higher ceilings on the amounts that may be invested in common stocks.

Rather than inventing new procrustean beds, we should make the investments in question attractive to pension funds. For example, the Federal National Mortgage Association's debentures and the Government National Mortgage Association's mortgage-backed bonds, are an imaginative combination of Government guarantees, an attractive yield, and freedom from the need to deal with borrowers. However, even the energetic people presently involved in these programs have not been able, thus far, to attract much new investment. Hopefully, the HUD conference with pension fund and other money managers this week, will result in a significant infusion of new funds.

In addition to HUD's work on new devices, Treasury officials have been "jawboning' pension funds and others to invest more in housing, but there are several problems here. First, the Treasury has not heeded its own preachings: so far as I have been able to learn after substantial efforts, the Treasury will not reveal the public

benefits, if any, served by Federal bank deposits totaling roughly $6 billion. Contrast this with the admirable service to social purposes by use of public bank deposits under a plan originated by Illinois Treasurer Adlai Stevenson, which plan is now being studied by other States. Further, I believe the Treasury has taken no steps to use the unemployment trust fund—which has about $13 billion assets belonging to the States but is managed by the Treasury with a wretched yield of less than 4.5 percent. I am happy to hear from Mr. Levitt that New York is doing much better than that. The Treasury should improve its own performance as trustee, if it expects other fiduciaries to change theirs.

Second, I am told it is understood that the new investments won by "jawboning" are not committed to low or moderate-income housing, or any other "socially useful project." I am told that as much as 90 percent of the newly pledged money may well go into high-income housing. Thus, the Administration's activity seems publicity-oriented and a bail-out for the guilding industry rather than a basic commitment like that made by the Life Insurance Association members with their $2 billion urban program.

We have good new devices to attract new money into housing, but we have done nothing about the catastrophe in state and local government financing. In spite of sharply higher needs because of population growth, rising expectations, and cost inflation, State and local bonds increased only about 33 percent in 1966–69 compared with 1962–65, from $24.4 billion to $32.3 billion. In shocking contrast, the net increase in corporate bonds was about 120 percent, from $25.2 billion in 1962–65, to $55.3 in 1966–69, in addition to all the other expanding sources of corporate financing. The comparative starvation of the public sector is expected to be still worse in 1970: net new State and local bonds will total $9.5 billion, compared to almost $17 billion net new corporate bonds.

It would be nonsense to suggest that there should be parity in the amount of net new debt of corporations and of State and local governments. It is even more dangerous nonsense to continue leaving States' and localities' new financing to the ravages of inflation fueled by the incomparably greater bargaining power of corporations.

What is needed, even more than steps to draw pension fund moneys into the mortgage markets, are steps to make State and local bonds attractive to pension funds.

The Urban Institute has proposed that the Federal Government subsidize municipal bond interest when held by State and local retirement funds:

These subsidies should be largely self-supporting since the taxable security incomes given up by these non-taxpaying investors will be held by taxpaying investors.

The cost of such a subsidy scheme would be for $4 billion in State and local securities with five per cent coupons, $80 million dollars with a 40 percent coupon subsidy.

This compares to the $7.5 billion that the Federal Government dispenses in grants. Communities and States would continue to issue bonds in the present manner. Underwriting would continue to be in the hands of private investment bankers in the same manner as today. The Federal Government or any agency

of it would have no interest in control of the amount, timing, nature or otherwise of State and local borrowing. The market mechanism would remain the same in all mechanical details. The subsidy pays for itself by, first, keeping taxpaying investors from holding exempt securities and, second, keeping non-taxpaying investors from holding taxable securities.

The Urban Institute proposal is excellent, and may be simpler and more efficient than, for example, giving the pension beneficiaries a tax credit for the exempt investments or the exempt income earned by their fund, or giving corporate contributors to pension funds an extra deduction to reflect the exempt income the fund earns. Steps must be taken to remove the quirk of our tax laws which is depriving State and local financing of access to pension fund monies. The effort to support the Urban Institute proposal should not be limited to opening up State and local pension funds only, on the sloganized rationalization "State monies for State needs", but must open up private pension funds too, and the subsidy should include a Federal guarantee, just as has been done for the mortgage market.

I recommend two further legislative steps to make pension funds more likely to buy "socially useful investments," even if their yield is low. First, we should free pension fund managers of their fear of legal liability if they invest for "social yield" rather than pursuing maximum return consistent with safety of principle. Pension funds should be statutorily enabled to invest up to, say, 10 percent of their assets in projects—safeguarded to avoid party-in-interest problems—with "social yield" such as low-cost housing. Absent such enabling legislation, banks, insurance companies and other money managers will understandably say, "But my obligation is to make the portfolio grow and produce." Of course, even with such legislation the parties involved would be free to preclude any investment for "social yield", or to limit the amount so invested to a figure below the statute. The contribution of the statute will be to increase the likelihood that at least some assets, of almost every pension fund, will come to socially useful projects whatever their profitability. However, in addition to such an enabling statute, competition among money managers may make existing pension fund portfolio managers fearful of losing the client unless they perform outstandingly. Voluntary efforts must be undertaken to change attitudes toward pension fund management so that, just as corporations make charitable contributions and otherwise aid the public welfare without any direct return in profit, pension funds will do so, too. The change in thinking is likely to occur faster if the ultimate management of pension funds, and thus the ultimate selection of investment strategy and of portfolio managers, were democratized to include more worker participation.

One final comment on the notion that pension funds should be required to buy particular investments. It is no answer to the impact of Vietnam on our economy to exact tribute from pension funds to cover expenditures which our Nation's leaders have assigned too low a priority.

The second question, in calling these hearings, Chairman Griffiths stressed that pension funds have participated in the increasing trend to rapid turnover of common stock investments, and asked: "Are such trends in the public interest?"

I trust I do no violence to the chairman's question if I paraphrase it as, "What does the spread of the 'performance orientation' mean

to pension funds and to the public interest generally"? I equate the higher activity rates to the "performance orientation" because, to date, they tend to be the shorthand statistical measure of that orientation. The rise in the activity rate indicates a change in investment practices which, in many ways, is a great improvement over the somnolence of earlier days, but which has brought new problems that need correction. The need for correction by no means indicates that the performance orientation is wrong, or that our system is sick.

Why should we be concerned about a rise in activity rates, or a spread and heightening of the performance orientation? We may dismiss fears that pension funds are "churning" their portfolios to generate commissions: episodes of that can occur, but a pension fund does not have the incentive to churn which mutual funds or banks have. At least for present purposes, we also may dismiss fears that pension funds are already being jeopardized by investments in "high-flying" securities. The greater danger to beneficiaries has been obsolete management, relying unduly on fixed-income securities. However, the spread of the performance orientation to pension funds is all too likely to bring with it some of the excesses of that orientation, and corrective steps should not wait until after harm has been suffered.

Maybe in light of where the market ended up yesterday, one need not speak about "after the harm has been suffered."

The key problems created by the rising performance orientation cannot be considered in the context of pension funds alone. These problems involve all substantial-sized institutional investors—that is, all portfolios of, say, $10 million or more invested primarily in the securities markets, managed by bank trust departments, insurance companies, mutual funds or investment advisers, or independent managers of a pension fund, et cetera. If I am right about what are the key problems, the impact of these problems includes at least an unnecessary destabilization of the stock market—we are seeing a good deal of this lately—and a profound pressure on managements of operating companies to change in a direction of very questionable social worth.

First, we should consider the role of the money managers. Forty years ago, Berle and Means and others taught that there was a great difference between who managed a corporation and who owned it, that there might be a substantial divergence of interest and viewpoint between managers and owners, and that the managers almost always had complete control of the situation. That was the first phase of the managerial revolution. Now we are in the second phase, in which stock-holders no longer manage even their own stockholdings. Stockholdings are being "institutionalized." In 1957, institutions held 23 percent of all outstanding stock, and now they hold between 35 and 40 percent. This means that a market previously characterized by a vastly heterogeneous set of buyers and sellers with a wide spectrum of differences, has come to be dominated by professionals. There are real differences among the professionals, too, but the range of difference is much narrower.

In a sense, we would be better off if the money managers were still more homogeneous than they are, because although most of

them are practicing the investment business, some have given that up for the money game. They are responsible for our stock markets becoming the scene of the largest form of organized gambling in America. The money gamers, managing enormous amounts in total, are responsible for the excesses of the performance orientation. Oversimplified as it may seem, the key characteristic of the money game is just what the rise in the activity suggests: too much trading. The extremely high particular portfolio rates that lie behind the averages largely reflect the short-term basis on which stocks are selected for portfolios managed by the money gamers. Stocks are bought not only on fundamentals, but on rumors, tips, fads and fancies about the company or industry or what a Government official will say in an after-lunch speech. Stocks are bought in the expectation that some ephemeral event will produce a rise of a few points, a jiggle on the chart, so that a quick though small profit can be plucked out and the proceeds plunged into the next hot item for its moment in the sun. Because there is such readiness to leap in, there must be equal readiness to leap out when the ephemeral information proves wrong or ineffective, or when its effect is exhausted. And because the money gamers are relatively quite homogeneous in approach, background, and sources of information, very frequently they move in packs.

"The only thing faster than institutions stampeding together out of the same stocks is the Egyptian Army in retreat", said the head of the institutional department at the New York City firm of Scheinman, Hochstin & Trotta. Sharp, swift price swings would be at least arguably acceptable if they reflected fundamental events changing the worth of the company. But who will assert that it was fundamental changes, and not gamblers crowding the exits, which caused last week's plunge from 150 to 70, in 2 days, in Ross Perot's Electronic Data Systems? Or the same week's drop in Raychem from 156 to 110? Or in Telex from 122 to 88? These wild fluctuations indicate distorted prices, pushed high when gamblers managing great amounts of other people's money ignore fundamentals and buy in the hope they can leap out before the chain letter comes to its end. The money gamers figure that the portfolios they run are so large that they can push the price so high, and they are so close to the situation that they will be almost certain to come out with a good profit at least before the stock falls far.

The twist to the money game is that it falls out even on those who never agreed to play. If one stock in an industry group is pulled into the game, others in that group tend to be moved by it. The stock market pro tanto loses its role as a pricing mechanism. Small investors tend to lose confidence in the market and tend either to withdraw their money from the market or, in final irony, to commit their money to the money managers.

The money gamers play as they do because of the intense competition among money managers for new money to manage, and the way in which money managers are compensated for succeeding in that competition. The competition that causes the most acute problems started with the mutual funds. New mutual shares are sold best by showing high performance: if a fund can sharply raise the value of its portfolio in any single period, it well draw in vast new

amounts of money and then the managers will be able to draw out vastly increased compensation, since they pass along to their shareholders little, if any, of whatever economies of scale there might be. Even if the fund's subsequent performance is mediocre, almost all the money drawn in by the "hot" period will stay, partly because once a mutual fund shareholder has paid the sales load, he is reluctant to pull out. Also, it is human nature not to want to admit a mistake and to prefer to wait for verification that one chose wisely after all. Thus, all a mutual fund manager needed was "hot" performance for a relatively short period: even if his subsequent performance was so bad that his beneficiaries went elsewhere and his compensation dried up, the money earned before that happens is more than enough to induce him to make his portfolio "swing", since even if it does swing down after it swings up, by that time he can swing out.

Thus, the entire emphasis, indeed the sole focus of the game players moves to the short run. It is more important that the next earnings reports on the stocks owned show at least a continued rate of growth, than that the companies embark on new research which may produce earnings 2 years later, or stop polluting their own area although it may mean slightly less net profit.

Even if we are tempted to ignore a stock market which is becoming less an evaluator of corporate worth and more a branch of Las Vegas, the frightening truth is that such a market has serious, distorting impacts on our economy.

We can never expect money managers to have as long-range an orientation as operating managements. Some say that planning in the auto industry, about which I am sure the chairman knows vastly more than I, is about 6 years ahead, and international oil companies go a few decades ahead. Money managers are not tied, like operating managements, to particular assets or lines of enterprise: they can always sell out in a moment or at most in a few days. That liquidity for savings is one of the great contributions of our securities markets. However, the time has come to consider putting a premium on buying stocks on fundamentals, correspondingly inhibiting buying stocks for quick-turn profits from "jiggles."

First, we need study to make sure that what I have described above is sufficiently accurate and not limited to so few episodes that it simply is no problem. We need to inquire whether money gaming is occurring in various forms (I have described one of the simplest), with sufficient frequency to warrant official steps.

Second, assuming that we find need for official steps, we should consider imposing a tax to induce purchase for a reasonable holding period, and to inhibit speculative trading with vast sums of other people's money. We must stop thinking of securities, at least those held by institutional portfolios of over, say, $10 million, as ordinary capital assets to be treated for tax purposes the same as real estate, and so forth.

I submit that such institutional portfolios with an activity rate above a level to be determined after careful study, ought to pay a graduate tax on capital gains, depending on the length of the holding period. If a fund with an activity rate above the set level buys and sells within 1 month, there is at least a good case for taxing away

all its profits. Losses would be set off against longer term profits. If the turn-around is within 3 months, the tax would be 60 percent; within 6 months, 50 percent; et cetera. This will induce buying on fundamentals, serious research, and all the other things which make up the market that we should have.

Mere disclosure of trading would surely help, but will not solve the problem.

Some would call such a tax confiscatory. Others would call it a turnover tax, or an antichurning tax. I call it an antigambling tax.

We can never freeze investors in particular investments. Nor should we treat an institutional portfolio with low or reasonable turnover the same as "swinging" portfolios, for anyone may make mistakes, anyone can have a misfortune, buying a stock just before a negative event and quick sales in such cases should not be inhibited or penalized. But the time has 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.

The arguments against any such antigambling tax will come first from the securities industry, but it ill behooves the perpetrators of the greatest mismanagement American business has ever seen, to complain that their income may be reduced in the effort to improve the utility of the very stock markets they live on. The main line of argument will be that liquidity will be damaged. This is always the argument when some vestige of the stock exchanges' private club practices are questioned, or when the industry's various legal umbrellas against free competition are challenged. Floor traders, those gamblers in the very heart of the exchanges, were said to be needed to assure liquidity, but studies showed that they traded only in "hot" stocks when no liquidity was needed, and where liquidity was missing, so were they.

In any event, the fear for liquidity is needless, because some form of antigambling tax to correct excesses of the short-term orientation is only one of the two steps that must be considered to make our stock markets serve the people rather than the money managers. The relative homogeneity of the money managers, and their impacts on market stability and corporate action, are such serious problems because of the size and concentration of institutional portfolios. In 1940, the entire mutual fund industry managed assets of $450 million: today, each of 30 companies alone manages more than that, and the industry manages just under $50 billion. Those facts are well known, indeed, often advertised by the industry. What is never advertised is the degree of concentration among mutual funds: SEC Chairman Hamer H. Budge, wrote Congressman John E. Moss recently:

> Ten mutual fund management companies control about 52 percent of the net assets of the industry and that 15 of them control about 65 percent.

Mutual funds are modest compared to bank trust departments. By the end of 1968, total assets of $283 billion were managed by insured commercial bank trust departments. This represents growth of $30 billion per year for at least the preceding 2 years. Of the

$283 billion, $188 billion is in stocks and that is over 20 percent of the outstanding stock in the United States; and close to another $39 billion is in corporate bonds. This growth is being fueled in substantial part by private pension funds: almost three-quarters, or $84.3 billion of 1968's $115.3 billion in private pension assets, were bank managed.

Not even the size and growth of bank trust departments are as remarkable as the concentration of control of that $283 billion. Five banks, all in New York City, managed $67.4 billion, or almost 25 percent. If we add the next five banks, we have 10 banks managing $102.1 billion, or over one-third of all trust department assets in the $3,317 banks.

As for the insurance companies, suffice it to note a question posed in advertising material for an Institutional Investor Magazine Conference to be held next month considering, among other matters, the future of the securities industry: "In 1980, will everyone be working in Hartford"?

When the SEC originally introduced the bill which became the Investment Company Act of 1940, section 14 limited the size of investment companies to $150 million, and prohibited any person from managing more than $150 million in investment company assets. The industry response was that such behemoths would never come into being. We should remember that argument when we are told that we need have no fear of the entire economy's being dominated by unlimited-sized institutional investors, and by concentration in a few supergiants.

No size limitation was put into the Investment Company Act. Instead, Congress directed the SEC to study the matter, as it has done several times since.

Hopefully, the SEC's pending Institutional Investor Study will speak to this issue, for the study is the Commission's first opportunity to look at investment companies in the full context of all institutional investors. All evidence from prior studies suggests that there are no such economies of scale attendant to managing mammoth portfolios, as to justify their impacts on the markets and on the corporations in which they hold massive blocks of stock. The time has come to tell the people what economic or other necessities require us to continue allowing investment companies to grow to monstrous size. The time has come to tell why the law should not accelerate the widespread, growing practice in investment companies, bank trust departments, pension funds, and insurance companies, of splitting up portfolios for management in smaller portions.

Hopefully, the report from the President's new Commission on Financial Institutions will tell us why bank trust departments should not be limited in size, and split off completely from bank commercial departments.

Are trust departments subsidizing commercial departments, to the detriment of competing lenders as well as of the banks' own trust beneficiaries? Of even if there is subsidization, is it beneficent because it enables the bank to lend more money? Are commercial departments helping trust departments in ways which injure other investors or money managers competing with the banks? Or are commercial banks' trust departments so situated that they are inher-

ently ineffective? A fascinating fact in the Comptroller's brand new study of bank trust performance is that nondeposit trust companies performed remarkably better than commercial bank trust departments. The study's sample of trust company common trust funds is very small, and this is the first year in which that category was separated out, so further work is needed.

If money managers are to be limited in the amount they can manage, we will have more competition for savings, and thus more savings and less inflation. To assure such competition and to preserve incentives for successful money management, we should consider less rather than more regulation of sales and management compensation.

With money managers limited in the amounts they can manage, the stocks of medium-sized and smaller corporations will become appropriate investments as they are not today, as Manuel Cohen suggested yesterday.

These facts mean, for example, that one of our five major bank trust departments has about 50 percent of its assets in just 50 stocks. Improving the market for smaller corporations may even aid deconcentration in industry generally.

Unless elephantiasis and concentration are stopped in institutional investing, it is hard to see how anything can ever be done about concentration in this Nation, and such essentially beneficent machinery as our pension funds will ultimately prove to be taking control of the economy away from the people, in return, at best, for a placid retirement.

Thank you very much.

Chairman GRIFFITHS. Thank you very much. I am for the antigambling tax right now.

(The prepared statement of Mr. Schotland follows:)

PREPARED STATEMENT OF ROY A. SCHOTLAND

My name is Roy Schotland; I am Professor and Associate Dean at Georgetown University Law Center, here in Washington. Pursuant to request, I wish to make explicit that although I served until last month as Chief Counsel of the Securities and Exchange Commission's Institutional Investor Study, the views I express today are entirely my own, and have not been discussed with or cleared by the Commission and the Study, nor do they derive from or, so far as I know, reflect the thinking at the Commission and the Study.

I have been asked to consider two questions: First, should pension funds be required to invest any particular proportion of their assets in "socially useful projects." Second, how is the public interest affected by the fact that pension funds have joined the increasing trend to rapid turnover of common stock investments—that is, that the "performance orientation" has spread to the pension funds.

I

No new words or data are needed about the catastrophic insufficiency of funds available for such socially useful activities as housing, or for state and local government projects like schools and hospitals, or for inner-city business enterprise. The severity of the problem, and our relative unresponsiveness to it, call less for further lawyerlike or economic analysis than for political leaders.

It is equally well-known, and being valuably documented and analyzed by these hearings, that the funds held for pension plans are enormous and growing at a staggering rate. Private pension funds' aggregate assets were $126.2 billion as of the end of 1969 (according to the most recent data, last week's SEC Statistical Series Release No. 2437, Table 2.). The $11 billion dollar increase in 1969 was, percentagewise, lower than in any other year in the decade.

However, growth has been so rapid that only three years ago, so able an authority as Roger Murray underestimated by two-fifths the increase that would occur by 1970: He predicted an increase of $31.5 billion from end 1965 to end 1970, but the increase will be over $50 billion. (Murray, Economic Aspects of Pensions (1968), pp. 30, 92.) The growth rate of state and local pension funds has become even more rapid; their assets totalled $52 billion by the end of 1969 (same source).

With such vast funds available, identifiable, and enjoying the benefits of tax exemption, it is unsurprising that the call should arise to tap those funds for activities starved for new investment. And it is right to look to the pension funds for help: the only question is how to get that help. Bills have been introduced that would require private pension funds to invest prescribed proportions of their assets in housing investments. One of these bills, H.R. 15660, would force private pension funds to shift a quarter of their assets into housing investment within the next 25 years. Another, H.R. 15402, would delegate to the Secretary of Housing and Urban Development the authority to "determine which private pension funds shall be required to make such investments [in low- and moderate-income housing] and the amount of the investment to be required by each." Secretary Romney has said, "If we don't get a transfer of funds on a voluntary basis, you're going to do it on some other basis. (Hearings before House Committee on Banking and Currency, February, 1970.) (Note that under the previous Administration, which according to some was less committed to free enterprise, the Department of Housing and Urban Development said this:

"Little purpose would be served if legislation were enacted to require financial institutions, subject to Federal Government supervision, to allocate a certain percentage of their loans and investments to borrowers located in ghetto areas. Such a requirement would tend to have a stultifying effect on the total volume of loans and investments made by these supervised financial institutions. In order to meet such a quota requirement, financial institutions would tend to hold back on loans and investments made in other areas so that the percentage quota could be met. As a result, the total volume of loans and investments could be appreciably smaller than might otherwise occur if there were no percentage requirements.

"In the final analysis, what is needed is not a shift of loans and investments from other areas into ghetto areas, but rather a general expansion in the total volume of loans and investments. Such a general expansion is best accomplished by monetary and fiscal policies that induce a more plentiful supply of credits at more moderate interest rates."

Testimony of Deputy Under Secretary William B. Ross, Hearings on Financial Institutions and the Urban Crisis, Senate Banking and Currency Subcommittee on Financial Institutions, 90th Cong. 2d Sess. (1968), pp. 73, 81-82.

Some non-compulsory steps have already been taken to draw pension plan monies into housing, notably the new mortgage-backed bonds offered by the Government National Mortgage Association. We need more such devices to induce pension funds to invest in such projects, and below I suggest legislative steps that should be taken. But any legal requirement that pension funds buy certain kinds of investments will be bad for pensioners—today's and tomorrow's. It will undermine confidence in pensions and thus add to inflation. And it will likely help some vested interests rather than only socially useful projects. Moreover, the idea that pension funds must meet today's needs for investment in order to justify or "earn" their tax exemption, is new, strange, and hopefully will not recur.

Pension funds are tax exempt because, by their very existence, they *are* "socially useful projects." First, they provide for decent, dignified retirement—not only for today's old people, but for all of us when we become old. We need not spend time considering the suffering and public welfare problems we would face if we lacked this great protection. Second, pension funds are perhaps the best machinery we have for increasing personal savings. Most individuals cannot save for themselves as well as they can via pension funds, because current needs and temptations tend to win out over the needs of future decades. (Some studies suggest that people with pension coverage save on their own even more than people without, possibly because retirement security seems within reach rather than hopeless.) Pension funds not only increase personal savings, but also increase the likelihood that the savings will be invested by sophisticated management. Beyond the personal tragedy in small investors' propensity to

buy boiler-room schemes and underwater real estate, such schemes are not as economically productive as the sound corporations and projects to which professional investors usually limit themselves, especially when acting as fiduciaries.

It would not be mere word-play to ask whether our pension plans, which invest almost all their funds in government securities or the securities of corporations which tend to be the major businesses of America, are not already investing in "socially useful projects." Whatever one's problems with American Telephone & Telegraph, it is a useful enterprise. However, if one focuses upon particular investment areas, especially housing and state and local government projects, it is undeniable that pension funds do little and lately have been doing less. Since 1966, net increase in ownership of 1–4 family mortgages by private non-insured pension funds and state and local funds, combined, has been zero; and the private non-insured funds have had only $100 million net increase in other mortgages, while the state and local funds' net increase was lower than in the preceding two years. (Salomon Brothers & Hutzler, Supply and Demand for Credit in 1970, Table II A.) Remember that since 1966, private non-insured funds' total assets grew by $23 billion, and state and local funds' total assets grew by $17 billion.

Most dramatic has been the pension funds' non-investment in, or net liquidation of, state and local government bonds. Private pension funds, being tax exempt, are not even listed among the sources of funds for such securities in the last decade. (See, e.g., Bankers Trust Company, The Investment Outlook for 1969, Table 12.) State and local pension funds, although also tax exempt of course, for non-economic reasons were large holders of state and local bonds, but have been net sellers of such securities since 1960 (same source, for 1969 and for 1970), cutting their holdings almost in half (I.B.A., p. 6). Clearly, then, pension funds have not met the public sector needs for the basic infrastructure upon which the private sector and all citizens rely—for such essentials as schools, hospitals, other public facilities, and low-income housing. It is true that particular funds, especially those which unions manage or participate in managing, have made notable investments in housing, but these are as exceptional as they are commendable. And, it must be noted, many funds (including union funds) invest not in the mortgages of desperately needed low-income housing, but in those of high-yield luxury apartment houses, office buildings, and other commercial projects, often with "equity kickers." The short of it is that pension fund investment in housing, particularly low-cost housing, is episodic at best. The pattern of pension fund investment is clearly to avoid such fund-starved projects as low-cost housing and local government financing, for the very reason that has kept others away from those projects: they offer poor economic returns, badly below inflation-adjusted returns elsewhere. It is the obligation and the raison d'etre of the pension funds to earn good returns so as to help meet obligations to pensioners. It is not the pension funds' obligation—legal, economic or moral—to try to correct the impact of inflation, especially as any such effort would ultimately be financed at the expense of pensioners.

Pension funds simply must make high-yield investments: a one percent difference in yield earned on pension fund assets means roughly a 20-25% difference in ability to pay benefits, or in the employer's cost of paying them. (Bernstein, The Future of Private Pensions (1964), p. 41; see also The Financial Post, Apr. 25, 1970. "Pension Advisers Gain Battle for 'Performance'," p. 5, col. 3.) If pension funds are forced to make some low-yield investments, the funds' ability to pay benefits will be strikingly reduced. Even if the benefits are not immediately affected, because they are fixed by contract, and as is most frequently the case, the employer, not merely the fund, is ultimately liable for the benefits, the employer will be much less willing to agree to further increases in pension benefits. He will know that he will be unable to make his contributions to the pension fund work productively enough to cover the costs of benefits. And benefits must be raised frequently unless inflation is stopped permanently, or else we will all be like the retired clergymen who, in the 1960's, were getting total pension benefits of $600 per annum, because their pension depended on salaries of earlier decades. (Bernstein, p. 171.) In the last 18 years, I believe U.S. Steel has agreed eleven times to increase pension benefits. Arthur J. Goldberg has said, "The union and management come to the bargaining table with some appraisal of how much money there is in the 'kitty' for an increase. The appraisals are, naturally, different. But it is the

total cost of improvements which provide the framework within which the union and management bargain." (Quoted in Harbrecht, Pension Funds and Economic Power (1959), p. 39.) If pension funds can't be run to meet pension benefit costs, unions will find it easier to bargain for increases in current compensation, whose costs can be met by adjustments more within management's control. We will see a rise in current income, reduction in deferred income, and obviously, a new inflationary force will have been added.

Secondly, a legal requirement that pension funds make any particular kind of investments will undermine confidence in pension plans. Workers will be less willing to accept deferred compensation, as fear will spread that by the time they become eligible to enjoy their pensions, the government will have taken steps which reduce the value of the pension. We know how hard it is to get younger members of the work force to see the value of pensions, and this will make the bargaining situation harder. We need assurance that down the years pensions will likely be increased so as to avoid devaluation by inflation, and the fund will still be productive when we come to need it. Providing for retirement, and increasing personal savings, are sufficient social contributions in themselves, as well as immensely important economic contributions to the endless battle against inflation. Undermining those contributions for short-run help with today's pressing problems is short-sighted. We should not sell other people's inheritance for a mess of pottage, especially when they don't even get the pottage.

Thirdly, such a legal requirement, by compelling purchase of what are sure to be lower-yield investments and thus lowering the funds' over-all yield and raising the cost of pension benefits, will make it much harder to increase portability, vesting, funding, and the other improvements which everyone involved with pensions has been striving for over the years. The obstacle blocking such improvements is cost.

A further difficulty with any legal requirement lies in defining what will qualify as "socially useful projects." For example, the need for aid to low-income housing is far too great to allow such a requirement to be satisfied by aid to high-income housing. We need to help those who cannot help themselves, not merely to get the construction industry out of trouble. Yet, H.R. 15660, which requires pension funds to shift a quarter of their assets into housing investment over the next 25 years, would allow that requirement to be satisfied 100% by investment in *highest*-income housing. The bill permits the requirement to be satisfied either by holding certificates of deposit or other obligations of savings and loan associations, without any ceiling on the cost of the housing involved, or by directly holding any residential property. We must never subsidize housing for the rich at the ultimate expense of pensioners. Too many people stand to gain by a broadly-defined requirement, and such bills are too technical in nature to win public support for those legislators who would fight to keep the requirement limited to serving the purposes of all the people, not merely those well-represented in the lobbies.

Moreover, implementing any legal requirement which, like H.R. 15402, does not assure pension funds adequate time to adjust their portfolios, would unnecessarily upset the securities markets and lower the prices at which the pension fund would be selling. Once the impact of the legal requirement has been absorbed, prices would adjust upward, but all affected by the size of their pension fund's assets would have suffered a permanent loss. A further problem of implementation is the high likelihood of litigation before the requirement could be carried out: obviously, any fund in which employees have vested rights will claim that those rights are being unconstitutionally impaired.

Last, any such requirement goes against the decades-long, decisive trend away from legal inhibitions on the kind of investments fiduciaries may make. In ordinary trust law, we have seen the almost universal abandonment of the "legal list" in favor of the "prudent man" rule. In life insurance, the tight statutory net covering investments has been consistently changed in favor of fewer restrictions and higher ceilings on the amounts that may be invested in common stocks. Indeed, the greatest change in life insurance company investments, the near-universal allowance of separate accounts (which usually have no governmental restrictions on their investments), has occurred precisely because life companies were at a competitive disadvantage in the struggle with banks for management of pension funds. In state and local retirement systems, we see another movement toward removing procrustean requirements on the form of investments. Even in the completely unregulated sphere of university

endowments, the great event has been the Ford Foundation-sponsored 1969 studies by William Cary and the Barker Committee, calling for investment management free of traditional restrictions.

The reason for this unbroken trend against legally-imposed restrictions on the form of investments is that, economically, they just haven't worked: they have consistently operated to the disadvantage of the very beneficiaries they were designed to protect. Worse yet, as the Department of Housing and Urban Development said less than two years ago, in addition to hurting pensioners, legal requirements on pension funds' form of investment might very well fail to channel greater net investment into the target projects.

Instead of inventing new procrustean beds, we should make the investments in question attractive to pension funds. For example, the Federal National Mortgage Association's debentures, and the Government National Mortgage Association's mortgage-backed bonds, are an imaginative combination of government guarantees, an attractive yield, and freedom from the need to deal with borrowers. However, even the energetic people presently involved in these programs have not been able, thus far, to attract much new investment. Hopefully, the HUD conference with pension fund and other money managers this week, will result in a significant infusion of new funds.

In addition to HUD's work on new devices, Treasury officials have been "jawboning" pension funds and others to invest more in housing, but there are several problems here. First, the Treasury has not heeded its own preachings: so far as I have been able to learn after substantial efforts, the Treasury will not reveal the public benefits, if any, served by Federal bank deposits totalling roughly $6 billion. Contrast this with the admirable service to social purposes by use of public bank deposits under Illinois Treasurer Stevenson, now being studied by other states. (Hearings on Financial Institutions and the Urban Crisis, Senate Banking and Currency Subcommittee on Financial Institutions, 90th Cong. 2d Sess. (1968) pp. 209-232.) Further, I believe the Treasury has taken no steps to use the Unemployment Trust Fund—which has about $13 billion assets belonging to the States but is managed by the Treasury with a wretched yield of less than 4.5%. The Treasury should improve its own performance as trustee, if it expects other fiduciaries to change theirs. Second, I am told it is understood that the new investments won by "jawboning" are not committed to low- or moderate-income housing, or any other "socially useful project." Thus the Administration's activity seems publicity-oriented, rather than a basic commitment like that made by the Life Insurance Association members with their $2 billion urban program.

We have good new devices to attract new money into housing, but we have done nothing about the catastrophe in state and local government financing. In spite of sharply higher needs because of population growth, rising expectations, and cost inflation, state and local bonds increased only about 33% in 1966-9 compared with 1962-5, from $24.4 billion to $32.3 billion (Bankers Trust Co., Investment Outlook For 1970, Table 12). In shocking contrast, the net increase in corporate bonds was about 120%, from $25.2 billion in 1962-5, to $55.3 in 1966-9 (same source, Table 10). Note that during 1962-5, both corporations and state and local governments increased their debt by almost exactly the same amount, but in addition to the sharply higher subsequent rise in corporate debt, non-financial corporations alone increased their new internal financing from $198 billion in 1962-5 to $249.7 billion in 1966-9, and all corporations increased their net new stock issues from $1.9 billion in 1962-5 to $6.9 billion in 1966-9 (same source, Tables 26 and 11). The comparative starvation of the public sector is expected to be still worse in 1970: net new state and local bonds will total $9.5 billion, compared to $16.8 billion net new corporate bonds—plus $5.1 billion net new corporate stock and, for nonfinancial corporations alone, new internal financing of $59.3 billion, or $65.5 billion according to another source (Salomon Brothers and Hutzler, Supply & Demand for Credit in 1970, Table III B).

It would be nonsense to suggest that there should be parity in the amount of net new debt of corporations and of state and local governments. It is even more dangerous nonsense to continue leaving states' and localities' new financing to the ravages of inflation fueled by the incomparably greater bargaining power of corporations. Corporations, aided by subsidy via the tax deduction for whatever interest they pay, can offer bonds at virtually any price the market demands, and in addition can offer equity and "equity kickers." States and localities have no subsidy except the tax exemption on the interest they pay.

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The shrinking market for their bonds has forced them to pay interest rates which, combined with the tax exemption, result in disproportionately high returns for high-bracket taxpayers at the expense of greater cost for local taxpayers, and so state and local government projects become increasingly harder to authorize.

What is needed, even more than steps to draw pension fund monies into the mortgage markets, are steps to make state and local bonds attractive to pension funds. It is mere accident that the market for such bonds excludes pension funds; the coincidence of the double tax exemption makes tax-exempt interest rates uneconomical for tax-exempt funds. The fact that state and local retirement funds used to be substantial holders of such bonds was the result of political rather than economic decisions. Moreover, for at least the last decade, even those retirement funds have been selling rather than buying municipal bonds, lowering their total holding by almost one-half.

The Urban Institute has proposed that the Federal Government subsidize municipal bond interest when held by state and local retirement funds.

"These subsidies should be largely self-supporting since the taxable security incomes given up by these nontaxpaying investors will be held by taxpaying investors. That is, the diminished supply of tax-exempts to taxpaying investors will channel their holdings into taxable investments and the tax revenues from these would approximate the subsidy required to induce the State and local pension funds to hold tax-exempts.

"Altogether, the State and local funds could supply from $4 to $8 billion a year to the municipal bond new issue market. Moreover, these inflows would be largest in times of stringent monetary conditions when municipal yields soar above their traditional relationship to those on taxable instruments. The cost of such a subsidy scheme would be, for $4 billion in State and local securities with 5 percent coupons, $80 million dollars with a 40 percent coupon subsidy. This compares to the $7.5 billion that the Federal government dispenses in grants to State and local facilities alone.

"Some specific notes on the proposals:

"1. The UI proposals do no violence to the principle of tax-exemption. They rather expand the supply of funds in such a way as (1) to increase the efficiency of tax-exemption *qua*-subsidy to State and local borrowers and (2) to reduce the extent of tax shelter available to high income-tax bracket investors.

"2. Communities and states would continue to issue bonds in the same manner. Underwriting would still be in the hands of private investment bankers. The Federal government or any agency of it would have no interest in a control over the amount or timing or nature of any state and local borrowing. The market mechanism would remain the same in all mechanical details.

"3. But a new investor group, that of the State and Local Pension Funds, would now be purchasing State and local bond issues. For example, if the subsidy rate were 40 percent, pension funds would acquire municipals on the basis of a 40 percent markup on coupon yields to be covered by a Federal government subsidy. Thus, if municipal bonds were selling at 6 percent, a pension fund buying this bond would receive a post-subsidy yield of 8.40 percent. Today, that would be above the yield available on the highest grade corporate issue.

"4. The pension fund would receive the subsidy routinely on the presentation of a copy of the coupon to the Treasury. Although there might need to be some provisions to protect the Treasury against intra-governmental transactions and to insure "arms length" transactions, there would be no restriction as to the nature or maturity or purpose of the municipal bond. The buying decision is left strictly up to the pension fund.

"5. State and local pension funds are growing at a rate of about 10 percent or $4 billion a year. Their total assets are $45 billion, the majority of which are invested in corporate bonds. Given that the average investment life of their fixed income securities (93 percent of the total) is 10 years, they have a rollover of $4 billion as well as net new funds of $4 billion to invest each year. If roughly one half (or $4 billion) of this were to be invested in State and local securities, it would be sufficient to absorb about 40 percent of the $10 billion annual net increase in State and local securities. A 40 percent expansion in net available funds would not only allow for more borrowing but would lower the cost of the borrowing done. And the market would be greatly stabilized.

"6. How does the subsidy pay for itself? The subsidy pays for itself by (1) keeping tax-paying investors from holding tax-exempt securities, and (2) keeping non-taxpaying investors from holding taxable securities. Of course, this

rearrangement is not brought about by fiat or purposeful exclusion, but is an outcome of removing the barrier which tax-exemption forms to the investment flow of certain non-taxpaying institutions—in this case, the State and local pension funds—into the tax-exempt market.

"While the final outcome is a complicated thing, the essential idea can be expressed as follows: Given a fixed supply of tax-exempt bonds and investor resources, the pension funds would absorb part of the supply of tax-exempt bonds. High taxable income investors, that now demand a high discount to hold municipals, would acquire taxable investments instead. (A simple way of looking at it is that they would purchase the corporate bonds that otherwise would have been held by the pension funds.) Taxable investors would pay taxes where now taxes are avoided—both by their holding of tax-exempts and by the pension funds holding potentially taxable securities. These taxes would probably cover most if not all of the subsidy since the average marginal rate on tax-exempt investors is approximately 40 percent.

"There are other costs and savings to consider. Federal government borrowing costs might go up somewhat, but it is primarily a short-term market and State and local pension funds make only a small contribution in support. On the other hand—and this is very important—the broadened municipal market would be able to absorb a greater volume of financing and at a lower cost. This type of support would cheapen the borrowing of governments, especially in times of tightness when the taxable to non-taxable yield ratio drops off precipitously.

"The dimensions of this potential source of demand for municipal issues are shown in Table 1. In June, 1968, the latest date for which these data are available, total asset holdings of SLRF's were $44.5 billion. Of this total, $38.0 billion (85 percent) was composed of U.S. Government securities, corporate bonds, and mortgages. Although corporate stock holdings are growing both absolutely and relatively, fixed interest market securities are clearly the major assets of these funds.

"The rate of growth of the SLRF's has been substantial. Their portfolios have doubled since 1961 and have increased almost sevenfold since 1952. In recent years, the increment to their asset holdings have amounted to about $4.5 billion per year and have been increasing. Thus, the SLRF's seem ideally suited as a potential source of investment in public facility financing.

"Moreover, these funds historically have held state and local securities, and through the late 1950's municipals consisted of over 25 percent of their total asset holdings. Since then, a combination of more flexible investment regulations and the desire of SLRF managers for higher yields has led to the declining position of municipals in SLRF portfolios. By June 1968, only 5.3 percent of total asset holdings consisted of state and local securities.

"Table 2 demonstrates the extent to which an increase in earnings has paralleled the decline in state and local security holdings of the SLRF's. Since 1959 when the proportion of municipal security holdings fell below 25 percent of the total portfolio, the increment in portfolio earnings as a percentage of the increment in portfolio size has almost always been above 4.5 percent.

"There is an obvious lack of economic incentive for the SLRF's to invest in municipal issues. The remainder of this memorandum is devoted to the presentation of a subsidy device which would provide this incentive.

"A subsidy mechanism ideally should possess the following characteristics:

"(1) It should provide a clear incentive for SLRF's to invest in municipal securities as opposed to their present asset holdings.

"(2) It should be simple to administer and free from federal regulation and control.

"(3) It should be relatively inexpensive in terms of cost to the U.S. Treasury.

"The subsidy plan which we are proposing satisfies these criteria." (Testimony of Hon. Louie Welch, Mayor, City of Houston, Texas, Hearings on Tax Reform Act of 1969, Senate Finance Committee, 91st Cong. 1st Sess. (1969), part 4, pp. 3083, 3091–3, 3098.)

The Urban Institute proposal is excellent, and may be simpler and more efficient than, for example, giving the pension beneficiaries a tax credit for the exempt investments or the exempt income earned by their fund, or giving corporate contributors to pension funds an extra deduction to reflect the exempt income the fund earns. Steps must be taken to remove the quirk of our tax laws which is depriving state and local financing of access to pension fund monies. The effort to support the Urban Institute proposal should not be limited to opening up state and local pension funds only, on the sloganized

rationalization "State monies for state needs," but must open up private pension funds too, adding their $126 billion to the $52 billion of state and local funds as the potential market for municipal securities. Furthermore, the subsidy should be at least 50%, so that the federal taxpayer subsidizes state and local financing at least as much as he now subsidizes corporate financing. And the subsidy should include a federal guarantee, just as has been done for the mortgage market.

Other investment needs, such as inner-city business enterprise and rural cooperatives, must also be dealt with by discrete methods to make them attractive for purchase by pension funds. I recommend two further legislative steps to make pension funds more likely to buy "socially useful investments," even if their yield is lower than available commercial investments. First, we should free pension fund managers of their fear of legal liability if they invest for "social yield" rather than pursuing maximum return consistent with safety of principle. By analogy to the "basket clause" statutes which enable life insurance companies to invest free of their usual restrictions, pension funds should be statutorily enabled to invest up to, say, 10% of their assets in projects (safeguarded to avoid party-in-interest problems) with "social yield" such as low-cost housing. Absent such enabling legislation, banks, insurance companies and other money managers will understandably say "But my obligation is to make the portfolio grow and produce." Of course, even with such legislation the parties involved would be free to preclude any investment for "social yield," or to limit the amount so invested below the statutory figure. The contribution of such a statute will be to increase the likelihood that at least some assets, of almost every pension fund, will come to socially useful projects whatever their profitability. However, in addition to such an enabling statute, competition among money managers may make existing pension fund portfolio managers fearful of losing the client unless they perform outstandingly. Voluntary efforts must be undertaken to change attitudes toward pension fund management so that, just as corporations make charitable contributions and otherwise aid the public welfare without any direct return in profit, pension funds will do so too. The change in thinking is likely to occur faster if the ultimate management of pension funds, and thus the ultimate selection of investment strategy and of portfolio managers, were democratized to include more worker participation. In many industries, corporate management has vehemently resisted any effort to take away its complete control of the pension fund to which it contributes for the benefit of the workers. Unions have too many other matters to bargain over to give much negotiating emphasis to breaking management's monopoly. The law should step in where collective bargaining tends not to work and where democracy and economic welfare would gain from securing jointly-managed pension funds, whatever the industry.

One final comment on the notion that pension funds should be required to buy particular investments. During any war, budget constraints result in starvation for the civilian portion of the public sector. We get helicopters instead of hospitals. If the war continues at any significant budget cost, we need a war excess profits tax. It is no answer to exact tribute from pension funds in order to cover expenditures which our nation's leaders have assigned too low a priority.

II

In calling these hearings, Chairman Griffiths stressed that pension funds have participated in the increasing trend to rapid turnover of common stock investments, and asked "Are such trends in the public interest?" The Chairman referred to the recent SEC data showing that pension funds doubled their activity rate since 1965 from 11.3 percent to 22.3 last year. However, mutual funds' activity rate went from 21.2 percent in 1965 to 49.8 percent in 1969, life companies from 13.6 percent to 28.1 percent, and property and liability companies from 8.2 percent to 26.1 percent. The year of the great leap forward was 1965, when mutual funds' activity rate rose from 21.2 to 33.5 percent: before that the rate had been only inching up, and after that other institutional investors followed the mutual funds, although they are still behind (or is it ahead?).

I trust I do no violence to the Chairman's question if I paraphrase it as "what does the spread of the "performance orientation" mean to pension funds and to the public interest generally?" I equate the higher activity rates to the "performance orientation" because, to date, they tend to be the short-hand statistical measure of that *orientation*. A portfolio's *performance* is its total

return, whether by dividends or other forms of distribution, or by capital gains. Such a brief description leaves open the critical questions of (a) over what time period, and (b) to what extent should performance be adjusted to reflect the degree of riskiness of the investments. The *performance orientation* is characterized by a willingness to assume relatively high risk—compared with traditional investment practices of fiduciaries—and to move freely and quickly from one investment to another, ceaselessly trying to reach an ideal in which one never holds an investment except when its price is rising. (At equal risk of caricature, one might describe the non-performance orientation as the view that dividends and other distributions are worth more than the equivalent number of dollars in capital gains, that if a security was worth buying there is a very strong presumption that it is worth holding indefinitely, and that the only risk in fixed-income securities is the remote one of the debtor's insolvency.) Suffice it to say that the rise in the activity rate indicates a change in investment practices which, in many ways, is a great improvement over the somnolence of earlier days, but which has brought new problems that need correction. The need for correction of excesses by no means indicates that the performance orientation is wrong, or that our investment system is sick.

Why should we be concerned about a rise in activity rates, or a spread and heightening of the performance orientation? We may quickly dismiss fears that pension funds are "churning" their portfolios to generate brokerage commissions: episodes of that can occur, but a pension fund needs only execution, research and minor services from broker-dealers and so does not have the incentive to churn which mutual funds or banks have. (As for remedying churning where it does exist, meaningful disclosure to beneficiaries so that the possibility of private suits will serve as an inhibition, and changes in the structure of compensation in the securities industry are needed steps getting attention from others.) At least for present purposes, we also may dismiss fears that pension funds are already being jeopardized by investments in "high-flying" securities. The greater danger to beneficiaries has been obsolete management, relying unduly on fixed-income securities often carried on the books only at cost lest admitting the market value would draw attention to how poor the investment management has been. Of course, we have had some scandals in pension fund management, like the UMW funds in demand deposits, but those have involved conflicts of interest of one sort or another, not the performance orientation. However, the spread of the performance orientation to pension funds is all too likely to bring with it some of the excesses of that orientation, and corrective steps should not wait until after harm has been suffered. As for suggestions that the performance orientation, or at least "instant performance" are already things of the past, this form of potentially excessive speculation is just as likely to be a recurring phenomenon as all other forms of excessive speculation. A most recent example is the "hot issue" market of the early 1960's, about which no corrective steps were taken and so the phenomenon returned in the late 1960's.

The key problems created by the rising performance orientation cannot be considered in the context of pension funds alone. These problems involve all substantial-sized institutional investors—that is, all portfolios of, say, $10 million or more invested primarily in the securities markets, managed by bank trust departments, insurance companies, mutual funds or investment advisers, or independent managers of a pension fund, private foundation or educational endowment. If I am right about what are the key problems, their impact includes at least an unnecessary destabilization of the stock market (we are seeing a good deal of this lately, and I don't mean merely the fall in prices), and a profound pressure on managements of operating companies to change in a direction of very questionable social worth.

First it is necessary to consider the role of the money managers. Forty years ago, Berle and Means and others taught that there was a great difference between who managed a corporation and who owned it, that there might be a substantial divergence of interest and viewpoint between managers and owners, and that the managers almost always had complete control of the situation. That was the first phase of the managerial revolution. Now we are in the second phase, in which stockholders no longer manage even their own stockholdings. Stockholdings are being "institutionalized"—the reduction of direct stock investment by individuals and the rise in indirect investment through mutual funds, bank trust departments, investment advisers, variable annuities, and pension funds. In 1957, institutions held 23 percent of all outstanding stock,

and now they hold between 35 and 40 percent. This is partly the result of a switch from other forms of investment into equities, but mainly it results from individuals' putting more money into stocks, and hiring professionals to manage the money to a steadily increasing extent. This means that a market previously characterized by a vastly heterogeneous set of buyers and sellers, with a wide spectrum of differences in investment abilities, approaches and needs, has come to be dominated by professionals. Of course there are real differences among the professionals too, but the range of difference is much narrower, and the differences in investment needs tend to be lost when individual savings are pooled in, e.g., a mutual fund.

In a sense, we would be better off if the money managers were still more homogeneous than they are, because although most of them are practicing the investment business, some have given that up for the money game. This latter group, managing enormous amounts in total, are responsible for the excesses of the performance orientation. Over-simplified as it may seem, the key characteristic of the money game is just what the rise in the activity rates suggest: too much trading. This is not to say that a portfolio traded at 20 percent or 30, or even perhaps 50 or 100 percent, is necessarily being traded excessively—that judgment could be made only in light of all facts relevant to that portfolio, its beneficial owners, etc. But the extremely high particular portfolio rates that lie behind the averages, largely reflect the short-term basis on which stocks are selected for portfolios managed by the money gamers. Stocks are bought not only on fundamentals indicating what the corporation is worth, but on rumors, tips, fads and fancies about the company or industry or what a government official will say in an after-lunch speech. These stocks are bought in the expectation that some ephemeral event will produce a rise of a few points, a jiggle on the chart so that a quick though small profit can be plucked out and the proceeds plunged into the next hot item for its moment in the spotlight. Because there is such readiness to leap in, there must be equal readiness to leap out when the ephemeral information proves wrong or ineffective, or when its effect is exhausted. And because the money-gamers are relatively quite homogeneous in approach, background, and sources of information, very frequently they move in packs. This means that prices swing sharply and swiftly: "The only thing faster than institutions stampeding together out of the same stocks is the Egyptian army in retreat," said Meyer Berman, head of the institutional department at New York City's Scheinman, Hochstein and Trotta (Forbes, "The Herd Instinct," March 1, 1970, p. 85). Sharp, swift price swings would be at least arguably acceptable if they reflected fundamental events changing the worth of the company in question, for example, an announcement of unexpectedly poor earnings. But who will assert that it was fundamental changes, and not gamblers crowding the exits, which caused last week's plunge from 150 to 70, in two days, in Ross Perot's Electronic Data Systems? Or the same week's drop in Raychem from 156 to 110? Or the innumerable other examples of what happens when the money game turns bearish? These wild fluctuations indicate distorted prices, pushed high when gamblers managing great amounts of other people's money ignore fundamentals and buy in the hope they can leap out before the chain letter comes to its end. It is not as simple as the old "greater fool" theory: rather, the money game players figure that the portfolios they run are so large that they can push the price so high, and they are so close to the situation that they will be almost certain to come out with a good profit at least before the stock falls far.

The terrible twist to the money game is that it falls out even on those who never agreed to play. If one stock in an industry group is pulled into the game, others in that group tend to be moved by it. The corporation whose shares at the subject of the game (and perhaps others in the industry group) can, while the share prices are inflated, acquire corporations which may be sounder but which have not caught the fancy of the bestowers of magically high price-earnings ratios. If a corporation's stock is plunged down by the money game, that corporation's borrowing, acquiring (or resisting acquisition) and ability to compensate its employees, are all hurt. The stock market *pro tanto* loses its role as a pricing mechanism to help allocate resources and help determine who shall manage the resources. Small investors generally lose confidence in the market and tend either to withdraw their money from the market or, in final irony, to commit their money to the money managers. As for the small investors who happened to be in the stock during the game, one can only philosophize that

though they may have learned a lesson, a new herd of sheep will be available tomorrow for another fleecing.

The money-gamers play as they do because of the intense competition among money managers for new money to manage, and the way in which money managers are compensated for succeeding in that competition. At bottom, the competition that causes the most acute problems started with the mutual funds. New mutual fund shares are sold best by showing high performance: if a fund can sharply raise the value of its portfolio in any single period, it will draw in vast amounts of money and then the managers will be able to draw out vastly increased compensation, since they pass along to their shareholders little if any of whatever economies of scale there might be. Even if the fund's subsequent performance is mediocre, almost all the money drawn in by the "hot" period will stay, partly because once a mutual fund shareholder has paid the sales load, he is reluctant to pull out. Also, it is human nature not to want to admit a mistake and to prefer to wait for verification that one chose wisely after all. Thus, all a mutual fund manager needed was "hot" performance for a relatively short period: even if his subsequent performance was so bad that his beneficiaries went elsewhere and his compensation dried up, the money earned before that happens is more than enough to induce him to make his portfolio "swing," since even if it does swing down after it swings up, by that time he can swing out on a nice thick cushion of capital.

Thus the entire emphasis, indeed the sole focus of the game-players moves to the short run. It is more important that the next earnings reports on the stocks owned show at least a continued rate of growth, than that the companies embark on new reseach which may produce earnings two years later, or stop polluting their own area although it may mean slightly less net profit. The President of the American Stock Exchange, Ralph Saul, said this in an address to the Women's National Democratic Club in January:

> "It may be that the basic alteration in corporate enterprise and in the securities markets during the 1960's has been a change from industrial capitalism to financial capitalism. From concentration on producing goods and services to an increasing concern with earnings-per-share, price-earnings ratios, and financial results almost independent of the process of production and consumption of industrial products and services.
>
> "This change affects all of us—stockholders, corporations, securities people, institutions, regulators. In its current issue, *Fortune* magazine reports on a survey of the demands of decision-making on the corporate chief executive, the changing attitudes of investors and the increasing importance of the stock market in corporate decisions. The article states that, "In the old days (shareholders) were satisfied to look at the scoreboard that reported how the corporation was doing on return on investment, growth of sales, and dividends. Now, however, they score a chief executive's performance mainly on the performance of the stock in the market . . . A strong drive for improving earnings per share is the new life, and it's a hard one. The chief executive often finds that to get earnings per share increasing fast enough to impress shareholders, he has to grow faster than he can grow by expanding sales in his present markets. So he turns to acquisitions. Multiply this by hundreds and thousands of corporations and you have the present climate of business; everyone is trying to acquire everyone else. And that's not all. The shareholders want their payoffs both now and in the future, and they will not forgive risky gambles that fail. If the chief executive makes a mistake . . ., the shareholders won't wait. They sell. The stock goes down. Invaders loom, or a more successful rival may politely offer a merger or acquisition to improve *his* earnings per share.' "

Even if we are tempted to ignore a stock market which is becoming less an evaluator of corporate worth and more a branch of Las Vegas, the frightening truth is that such a market has serious, distorting impacts on our economy.

We can never expect money managers to have as long-range an orientation as operating managements. Some say that planning in the auto industry is about 6 years ahead, and international oil companies go a few decades ahead. Money managers are not tied, like operating managements, to particular assets or lines of enterprise: they can always sell out in a moment or at most in a few days. That liquidity for savings is one of the great contributions of our securities markets. However, the time has come to consider putting a premium on buying stocks on fundamentals, correspondingly inhibiting buying stocks for quick-turn profits from "'jiggles" based on rumor and minor passing events.

First, we need study to make sure that what I have described above is sufficiently accurate and not limited to so few episodes that it simply is no problem. We do not need to establish that money-gaming occurs all the time, or in all stocks, or is done by all money managers or all mutual funds. Of course none of those is true. We do need to inquire whether money-gaming is occurring, in various forms (I have described one of the simplest), with sufficient frequency to warrant official steps to stop allowing the money-gamers to rampage through our securities markets gambling with great sums of other people's money. Second, assuming that we find official steps are needed, we should consider imposing a tax to induce purchase for a reasonable holding period, and to inhibit speculative trading with great sums of other people's money. We must stop thinking of securities, at least those held by institutional portfolios of over, say, $10 million, as ordinary capital assets to be treated for tax purposes the same as real estate, businesses, etc. There are unique needs and problems to setting holding periods for securities in such institutional portfolios, and our thinking cannot be limited to considerations of how to raise revenues appropriately, as if the tax code were a tool to be used for only one task.

For example, I submit that such institutional portfolios with an activity rate above a level to be determined after careful study, ought to pay a graduated tax on capital gains, depending on the length of the holding period. If a mutual fund with an activity rate above the level for mutual funds buys and sells within one month, there is a good case for taxing away all its profit. Losses would be set off against longer-term profits. If the turn-around is within three months, the tax would 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. Mere disclosure of trading would surely help, but will not solve the problem.

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 can never freeze investors in 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 negative event, and in such cases quick sales should not be inhibited or penalized. But the time has 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.

The arguments against any such anti-gambling tax will come first from the securities industry, but it ill behooves the perpetrators of the greatest mismanagement American business has ever seen, to complain that their income may be reduced in the effort to improve the utility of the very stock markets they live on. The main line of argument will be that liquidity will be damaged. This is always the argument when some vestige of the stock exchanges' private club practices are questioned, or when the industry's various legal umbrellas against free competition are challenged. Floor traders, those gamblers in the very heart of the exchanges, were said to be needed to assure liquidity, but studies showed that they traded only in "hot" stocks when no liquidity was needed, and where liquidity was missing, so were they. (SEC, Special Study of Securities Markets, Part 2, pp. 203–242 (1963).) It is time we considered whether money-gamers are any different from the floor traders who were stopped by law five years ago—except that the money-gamers have vastly greater impact and therefore are much more dangerous.

In any event, the fear for liquidity is needless, because some form of anti-gambling tax to correct excesses of the short-term orientation is only one of the two steps that must be considered to make our stock markets serve the people rather than the money managers. The relative homogeneity of the money managers, and their impacts on market stability and corporate action, are such serious problems because of the size and concentration of institutional portfolios. In 1940, the entire mutual fund industry managed assets of $450 million: today, each of 30 companies itself manages more than $450 million, and the industry manages just under $50 billion (after the first drop in net assets in 30 years). Those facts are well known, indeed, often advertised by the industry. What is never advertised is the degree of concentration among mutual funds: SEC Chairman Hamer H. Budge wrote Congressman John E. Moss recently that "ten mutual fund management companies control about 52 percent of the net

assets of the industry and that 15 of them control about 65 percent, or nearly two-thirds." (Hearings on Mutual Fund Amendments, House Interstate and Foreign Commerce Subcommittee on Commerce and Finance, 91st Cong. 1st Sess. (1969), pp. 451–2.)

Mutual funds are modest compared to bank trust departments. By the end of 1968, total assets of $283 billion were managed by 3,317 insured commercial bank trust departments; at least another $5 billion was managed by nondeposit trust companies and non-insured banks. This sum represents growth of $30 billion per year for at least the preceding two years. Of the $283 billion, $188 billion is in stocks—over 20 percent of the outstanding stock in America—and close to another $39 billion is in corporate bonds. (Office of the Comptroller of the Currency, Bank Trusts: Investments and Performance (study by E. W. Hanczaryk, Senior Economist), 1970, pp. 2, 3, 6.) This growth is being fueled in substantial part by private pension funds: almost three-quarters, or $84.3 billion of 1968's $115.3 billion in private pension assets, were bank-managed.

Not even the size and growth of bank trust departments are as remarkable as the concentration of control of that $283 billion. Five banks, all in New York City, managed $67.4 billion, or almost 25 percent. Those five banks' trust assets grew a cool $6.6 billion in 1968 alone. If we add the next 5 banks, we have 10 banks managing $102.1 billion, or over one-third of all trust department assets in the 3,317 banks. And that does not include corporate trust and corporate agency accounts or custodial accounts, let alone the assets and power which most people never think beyond, the entire commercial department side. (The American Banker, Survey, June 25, 1969, p. 8.)

As far as the insurance companies, suffice it to note a question posed in advertising material for an Institutional Investor Magazine conference to be held next month considering, among other matters, the future of the securities industry: "In 1980, will everyone be working in Hartford?"

When the SEC originally introduced the bill which became the Investment Company Act of 1940, section 14 limited the size of investment companies to $150 million, and prohibited any person from managing more than $150 million in investment company assets. The industry response was that such behemoths would never come into being. We should remember that argument when we are told that we need have no fear of the entire economy's being dominated by unlimited-size institutional investors, and by concentration in a few supergiants.

No size limitation was put into the Investment Company Act. Instead, Congress directed the SEC "at such times as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation of the effects of size on the investment policy . . . and on securities markets, on concentration of control of wealth and industry, and on companies . . ." Section 14(b), Investment Company Act of 1940.

Hopefully the SEC's pending Institutional Investor Study will speak to this issue, for the Study is the Commission's first opportunity to look at investment companies in the full context of all institutional investors. All evidence from prior studies suggests that there are no such economies of scale attendant to managing mammoth portfolios, as to justify their impacts on the markets and on the corporations in which they hold massive blocks of stock. The time has come to tell the people what economic or other necessities require us to continue allowing investment companies to grow to monstrous size—and the challenge should not be limited to investment companies only. The time has come to tell us why the law should not accelerate the wide-spread, growing practice in investment companies, bank trust departments, pension funds, and insurance companies, of splitting up portfolios for management in smaller portions.

Hopefully the report from the President's new Commission on Financial Institutions will tell us why bank trust departments should not be limited in size, and split off completely from bank commercial departments.

Are trust departments subsidizing commercial departments, to the detriment of competing lenders as well as of the banks' own trust beneficiaries? Or even if there is subsidization, is it beneficient because it enables the bank to lend more money? Are commercial departments helping trust departments in ways which injure other investors or money managers competing with the banks? Or are commercial banks' trust departments so situated that they are inherently ineffective? A fascinating fact in the Comptroller's brand-new study of bank trust performance is that nondeposit trust companies performed remark-

ably better than commercial bank trust departments in managing equity common trust funds (Hanczaryk Study, *supra* pp. 46–47, at Table 22). The study's sample of trust company common trust funds is very small, and this is the first year in which that category was separated out, so further work is needed. The matter warrants the closest attention, for if it holds up after more study, it will have important ramifications.

If money managers are to be limited in the amount they can manage, we will have more competition for savings, and thus more savings and less inflation. To assure such competition and to preserve incentives for successful money management, we should consider less rather than more regulation of sales and management compensation.

With money managers limited in the amounts they can manage, the stocks of medium-sized and smaller corporations will become appropriate investments. Today's mammoth portfolios can get no help from even a fabulous price rise in a small position, and a large position in smaller corporations cannot be assumed without threatening to dominate the corporation, or exposing the portfolio to undue risk. Also, it is too hard for a huge institution to follow many small corporations. In short, these facts mean, for example, that one of our five major bank trust departments has about 50 percent of its assets in just 50 stocks. Improving the market for smaller corporations may even aid deconcentration in industry generally.

Unless elephantiasis and concentration are stopped in institutional investing, it is hard to see how anything can ever be done about concentration in this nation, and such essentially beneficent machinery as our pension funds will ultimately prove to be taking control of the economy away from the people, in return, at best, for a placid retirement.

Chairman GRIFFITHS. Mr. Werner?

STATEMENT OF WALTER WERNER, PROFESSOR, COLUMBIA UNIVERSITY LAW SCHOOL AND GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

Mr. WERNER. Thank you, Madam Chairman. My remarks will touch on some of the same points as my good friend and learned colleague, Professor Schotland, but I must confess that they will be in the form of a rather mild April shower after his very far-ranging and dynamic coverage.

Let me say that my testimony is going to stress the need for measures aimed at achieving greater understanding of the investment policies of private pension funds, not only on their beneficiaries but on both the securities markets and the economy generally. I propose, first, to discuss the basis for some of the important public policy questions posed by pension fund investment practice; second, to identify some of those questions; and, finally, to recommend measures essentially in my view, to provide a response to them.

I

For purposes of my remarks today, the significant aspects of pension fund administration, as I see them, are the following:

First, that these funds must be considered in both their private and public dimensions. Any single fund is a "bundle of assets to be employed as productively as possible on a long-range basis for the sole purpose of meeting pension commitments."[1] But in the aggregate these funds are vast pools of assets with potential for effecting other

[1] Old Age Income Assurance, pt. V, Financial Aspects of Pension Plans (Joint Economic Committee Print, December 1967), at p. 82.

broader goals. Now growing at a rate of $6 to $7 billion annually, the assets of these funds are approaching or passing the $100 billion mark and are said to be on their way to a level of between $200 and $400 billion in 1980. The power to direct investment of this gigantic slice of the Nation's savings is the power to help shape the direction of national economic growth. It is a large portion of the power to determine the kind of Nation that we are and are to become.

Second, that this power is now exercised by a comparatively small number of corporate managements, union leaders, and a still smaller number of professional money managers—commercial banks and trust companies, and insurance companies—to whom has been delegated the authority to make specific investment decisions.

Third, that this small group of administrator-trustees enjoys broad discretion in exercising that investment authority—even though they are subject to a variety of constraints.

Fourth, that these pension fund investment decision-makers have been subjected to increasing pressure to maximize net investment yield. For the trusteed plan, higher yield brings reduction in corporate contributions; for the Insured plan, reduction—over the long span—in premiums; and possibly for the beneficiaries of both, higher pensions.

Fifth, that this pressure has been responsible for a shift in investment policy in the direction of what is described as aggressive investment in common stocks, to use a less colorful characterization than that of Professor Schotland. Taking advantage of relaxation of legal restraints on equity investment, the funds have sharply increased the portion of their assets invested in equities. The change has been accompanied by an acceleration in the rate of stock portfolio turnover.

Finally, that this trend of the pension funds toward aggressive investment in equities is a single strand in a major development in the marketplace, one affecting not private pension funds alone but all financial institutions, investors, and the public generally. It is emergence of the concept that professional money management must be measured by proof of ability to outperform other money managers on a short-term basis. I stress the time factor, for this is important. Preoccupation with day-to-day results subordinates informed judgments concerning the future prospects of a company to judgments concerning the behavior of other market participants in trading the stock of that company. Psychology and game theory replace fundamental investment analysis as the sinews of investment policy.

We are now beginning to feel the consequences of this transformation of values and investment behavior. Some effects seem clear. It appears, for example, that the trading of financial institutions—now said to constitute more than half the trading volume of the New York Stock Exchange—does not help stabilize the markets but rather serves to create increasingly delicate, nervous markets characterized by sharp fluctuations in price. Witness the loss in a single day last week of one-third of the "value" of a listed company that the market had appraised as a billion dollar company. Whatever the immediate precipitating causes for this Yo-Yo-like drop, surely one factor contributing to this kind of erratic volatility is the new cult of instant performance embraced by institutional intermediaries.

The pattern is not unfamiliar. For the individual fund, high yield seems to be an eminently reasonable investment goal. There is a difference, again as Professor Schotland pointed out, of 19 percent, I think, between the accumulations of a dollar invested at 4 percent per annum and one invested at 5 percent. No reasonable fund administrator or money manager is, therefore, likely to be happy with a 4 percent yield when other funds are earning 5 percent. But what starts as a reasonable incentive for the individual money manager can become, and seems to be well on its way to becoming an obsession when it fuels competitive drives that restructure the investment attitudes and behavior which determine stock prices. Yet, this is precisely what seems to be happening in the markets today as the time horizon for evaluating investment performance is narrowed from years to days.

It may well be that the manner in which pension funds accumulate and disburse their assets tends to insulate them from the shockwaves generated by trading activity beamed at instant performance. But this condition is hardly a reason for encouraging or even permitting a type of investment behavior that may endanger other financial institutions and public investors generally, who are not similarly favored. Furthermore, it is clear that the quest for high yield is attended, as always, by commensurate risks. The price of failure can be a fund's liability to meet its pension commitments—a loss presumably to be borne not by administrators or money managers but by beneficiaries who share the losses and not the gains.

II

These observations point in my mind to a number of questions. Some concern the effect on the funds themselves of current fund investment policies aimed at maximizing short-term market performance. First of all, of course, what is the precise nature and extent of these policies? Who actually benefits from gains realized by a "good" performance—employee beneficiaries or the corporate employers? Or who suffers because of "poor" performance? What are the potential dangers of the performance derby to the funds and their beneficiaries?

Other questions concern the effects of those investment policies on the stock markets. Those markets are more a mystery today than ever before. Learned commentators continue to employ such terms as the "liquidity" of the "continuous auction market" and speak of the markets' functions in the formation of capital and allocation of resources or as a pricing mechanism as though these terms expressed proven concepts. But the fact is that we have no acceptable theory of market performance and function. We cannot satisfactorily explain either the simpler markets of an earlier day or current markets that have been transformed by the institutionalization of trading and changes in trading patterns as well as by the new electronic technology.

Let me cite a single basic illustration. Whatever the connection may have been prior to emergence of the cult of instant performance between the market price of a company's stock and the value of the underlying enterprise, it seems clear that one effect of the new cult

has been to attenuate the relationship, or perhaps destroy it, over long periods of time. But surely this relationship is not a matter to be left for surmise and conjecture. It is the crux of understanding the function of the stock markets in the economy. We must know the answers to questions like this before we can evaluate the effects of pension fund investment policy upon those markets and the economy.

Cognate questions of greatest import concern the goals of fund investment policy. Should that policy be measured only from the perspective that its sole purpose is to meet pension commitments? Granted that this is the primary goal, is it the only one? Should maximization of return be the sole determinant of a fund's investment policy?

An affirmative answer would appear to imply either a disregard for the broad economic and social effects of aggregate investment fund policy or confidence that investment by individual pension funds for maximum short-term gain will operate through the invisible hand of the marketplace to channel fund assets to desired uses. I find it hard to accept either view. At the very least, it would appear essential to examine the extent to which fund investment policy can be coordinated with other measures required to achieve full employment and growth under stable conditions as well as to meet our mammoth needs for new housing, for control of the environment, and similar social goals.

For we are increasingly recognizing the importance of marshalling the Nation's resources as necessary to improve, or even to maintain, the quality of life. A significant portion of those resources consists of the assets of private pension funds. Moreover, those assets owe their existence largely to a taxing policy that encourages creation and growth of such funds. We surely require no more basis than this as the impetus for exploring the feasibility of new investment arrangements and new investment instruments that will both assure the funds' capacity to meet and increase pension commitments and also direct the funds' assets into areas of greatest national need.

I am aware of the efforts to secure voluntary participation in the housing market by fund administrators and trustees and of the agreement announced last week for a new program of this type. And I know that the insured plans have long invested a considerable portion of their assets in real estate development of various kinds. These efforts underscore the potential for public policy of fund investment policy. But in the face of the pressures for stock market performance maximization, in my view, reliance on such voluntarism seems founded more on hope than on reality.

III

The singling out of the issues discussed so briefly above is not intended to imply that pension fund investment policies do not present other problems of an equally fundamental nature. I have merely stressed the areas of deepest interest to me.

All these questions point up the need, as a prerequisite to determination of responsible public policy, to understand not only the policies of pension funds but such other matters as the competition of all financial intermediaries for savings, the impact of their in-

vestment policies on the stock markets and capital markets, and the function of those markets in the economy and their role in attaining economic and social goals. In other words, this is a call for understanding the capital markets on a truly integrated and comprehensive basis.

It would be naive to lose sight of the pragmatic considerations that compel dividing this broad subject matter into segments and then acting on individual segments even while an overall study is going forward. My stress on continuing long-range comprehensive study is not intended to suggest that such study is a substitute for attacking immediate specific problems. Rather, my point is that we need both kinds of study but we get only the one. And that the price of this approach is a series of immediate responses to immediate needs that fail to take into account their effect on conditions other than the ones that called the particular responses into being.

Let me illustrate by reference to a current problem of the securities markets; the commission rate structure of the stock exchanges. It is recognized today that these commission rates exert an influence that extends far beyond the reasonableness of the fees that investors pay or that exchange members receive for their services. The rates and rate policy of the exchange also determine the kind of exchanges we are to have—for example, whether institutions such as pension funds should be members or customers of the exchanges. They also help determine whether institutions such as pension funds trade on a principal exchange, on a regional exchange, or over the counter—a decision that concerns the comparative merits of a central marketplace and a number of competitive marketplaces. These commission rates and commission rate policy also help determine the access of securities professionals, and through them their customers, to the exchange markets. And so on. Resolution of these questions directly affects private pension funds and all other investors. Yet, it is clear that this resolution, as it is being slowly and painfully worked out, is being related far more closely to the interests of various groups of broker-dealers than to those of pension funds and other institutional intermediaries. The result is, of course, a natural byproduct of the fragmentation of regulation in the capital markets.

Problems such as these are not met by piling study upon study of the individual problem or crisis. We have seen too much of that already. By the time that a particular study group is organized and has completed its project, the needs that gave rise to it are likely to have changed. That is why I look forward to the report of the SEC group studying the institutional investor with a keen anticipation that is tempered by appreciation of the limitations within which any such crash program necessarily operate. The same observation applies to any study of the capital markets that attempts to deliver a meaningful report within a brief period of time.

Why, then, in face of this skepticism concerning ad hoc piecemeal studies, propose to establish a group that will conduct continuing, long-range study of the capital markets? No study, short or long-range, is going to supply definitive answers to problems like those of either pension fund investment policies or stock exchange commission rates. But the kind of continuing study resources I am proposing should at least provide concerned governmental agencies with

the informed understanding necessary to replace easy untested generalizations. It would permit action, for example, with respect to the investment policies of pension funds that coordinated those policies with those of other participants in the markets and that were founded on understanding of the functions of those markets.

Perhaps most important of all, such a continuing study would permit reexamination of the entire pattern of regulation in the capital markets and evaluation of its adequacy to meet the new burdens constantly being imposed upon it by a complex society. Again drawing on the securities markets as an illustration, there is growing need for such review of securities legislation adopted to meet the specific challenges of the early 1930's and that appear to have been outmoded by the rush of events in recent years. Hopefully, an in-depth understanding of the operation of the securities markets as an integral part of the capital markets would point the way to change without the goad of crisis.

Thank you very much, Madam Chairman, for the opportunity to present these views.

Chairman GRIFFITHS. Thank you, Mr. Werner.

Mr. Levitt?

STATEMENT OF ARTHUR LEVITT, COMPTROLLER, STATE OF NEW YORK

Mr. LEVITT. Madam Chairman, I welcome this opportunity to take part in your inquiry into the investment policies of our various pension funds across the Nation. The announcement of your hearings stressed that you were primarily concerned about private funds, but I assume your interest also extends to the $50 billion now held by our State and local pension systems. Surely they must be included in any study of the impact of pension funds upon our economy and upon the security of our citizens. The fact is that one employed civilian out of seven today is on some government payroll. Seven million of these public employees are members of some 2,000 State and local pension systems now in operation throughout the Nation. Here rests the future security of a good share of our population.

As comptroller of the State of New York I am the trustee of the largest of these systems, although California claims that honor in some respects. But I am not sure that size is an honor in itself, indeed, size may reflect an enormous expansion which brings in its wake a host of administrative and structural problems. One, of course, is the question of investment policy—the search for maximum yield, or for maximum growth, consistent with prudence and safety.

It is impossible for me to dicuss our investment policy in detail without first relating the problem to the other major questions affecting our public pension systems. I have been concerned for many years with the benefit structure, and with the increasing cost to the taxpayers. It became increasingly apparent that a major study of these fields should be undertaken, and I proposed just such a study to a national foundation last January. While these areas of concern do not directly involve investments, each has an impact on invest-

ment requirements. I would, therefore, like to read into your record a portion of my letter to the foundation:

State and local pension systems constitute an important sector of our economy, with far-reaching effects on public finance, on public employment and on the security of our retired work force. An objective review of these systems would be a sound venture, in my opinion, and one that is long overdue.

I suggest that the first area of such a study might well be the benefit structure of these systems, as influenced by competition with private industry, by the effects of inflation, and by the growing practice of collective bargaining. Here policy questions immediately arise. What are adequate retirement benefits, at what age, and what adjustments should be made for cost-of-living changes in the economy? What are the trends in private industry, as compared with Government, in providing more liberal benefits, including death, disability and vesting benefits? What effect do these benefits have, or should they have, on attracting and holding a competent work force? What relationship should there be between the benefit structure and social security? What are the trends in offering options and what is the pattern of exercising options? What are the effects of taxation on benefits? To what extent does a public employee receive more or less favorable tax treatment?

The obvious related area of study is fiscal. The expanding benefit structure of the typical public pension system means a growing and heavy burden of taxation to meet its cost. To what extent should the cost be funded? Should investment powers be liberalized to offset inflation as much as possible? What percentage of payroll is a reasonable assessment against the employer? To what extent, if any, should employees contribute? Are actuarial assumptions in need of review? Is collective bargaining unduly increasing pension costs? As to all of these questions, are there valid distinctions between Government and private industry?

There are, of course, many other questions in an economy so influenced by inflation and by social unrest. Surely a reasoned inquiry into what the public employee may rightfully seek, and what the taxpayer may reasonably assume with respect to the cost, needs to be undertaken.

That is the end of my letter to the foundation. I have had a most encouraging reply from the foundation and so I hope that these questions will indeed be explored, if not fully answered. Meanwhile another agency, the Tax Foundation, has published a report of its statistical analysis of State and local pension systems, including a discussion of the various questions raised by the findings. The statistics are based primarily on data from the Bureau of the Census and are necessarily from 2 to 3 years out of date. These systems are growing so fast that this is a serious impediment to any study. For example, the report lists the total assets as $44 billion in 1968, but since the assets are growing at the rate of 10 percent a year, the present total must be well over $50 billion. The assets of the New York system of which I am the trustee, are listed as $2.6 billion in the report, but we have added at least another billion since the figures were compiled.

This brings me to a particular discussion of the New York State employees' retirement system. There are separate systems for teachers and for New York City, but otherwise the State system includes most other public employees in New York State—460,000 of them. We already have 60,000 persons on our retired list. The cost to the taxpayers is more than a million dollars a day, including Saturdays, Sundays, and holidays. But each day we also take in about a half million dollars in investment income, or else the tax bill would be truly enormous. All in all, total income for the last fiscal year was $640 million, including contributions from members.

The system has been noncontributory for State employees for

several years, although they may make voluntary contributions toward an additional annuity. Many municipal employers have also elected this basis for their own employees. The benefits are liberal—more so each year, in fact, under the influence of collective bargaining between the employing municipality and the representative of the employees. For example, at age 55 a State employee with 20 years of service can retire at 40 percent of final average salary, which may be based on any three consecutive years of service. And the retired employee, at age 62 or later, will be eligible not only for a cost-of-living increase but for social security benefits. There are many other substantial benefits, such as early vesting, valuable death and disability benefits, and liberal rules for obtaining credit for wartime military service.

These benefits are soundly financed, for the most part on a funded basis. Cost implications have been substantial, particularly since new benefits have often been enacted on a retroactive basis—for example, a change in the service fraction. Accordingly, during the last 10 years, the State's contribution rate has increased from 6 percent of payroll to 15 percent, not including the cost of social security. Meanwhile, salaries have been increasing under the impact of nationwide inflation. All of these factors have led to very careful attention to our investment policies.

Ten years ago, three-fourths of our funds were invested in Government bonds and the remaining one-fourth in FHA-insured mortgages. The yield was about 3½ percent. Today we are achieving a yield of more than 5 percent on a total portfolio of about $3.6 billion. Much of this improvement has been made possible by changes in the law, which we sponsored to liberalize our investment policies. The distribution of our portfolio, compared to the other State and local pension funds, may be of particular interest.

Thirty-three percent of our investments are in corporate bonds, or similar obligations. This is almost three times the percentage reported by the Tax Foundation for other funds, as of the year 1967.

Twenty-seven percent of our investments are in mortgages, including conventional, FHA, and loans for State office buildings. This is more than double the percentage reported by the Tax Foundation for other funds. The fact is the report listed only 15 State pension funds as investing in mortgages at all.

Twenty-two percent of our investments are in Federal securities, or securities of Federal agencies, not including Treasury bills. This is 5 percent more than reported by the Tax Foundation for other funds.

Twelve percent of our investments are in common stock. This is double the percentage reported for other State and local funds.

We have reduced our investment on tax-exempt State and local securities to a little over 1 percent. This is the most significant change in the last 10 years. The nationwide average reported for other funds is 6 percent.

Our remaining investments—about 5 percent of our funds—are scattered among Canadian obligations, international bank securities, and short-term obligations.

I am very proud of the dedicated career staff of civil service employees who help me manage these vast investments. In addition,

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I have appointed two advisory committees of outstanding experts in the field of finance, drawn from insurance companies, banking institutions, and consulting firms. These men serve without compensation of any kind and I am indebted to their sense of public duty. At my request, the legislature this year gave statutory recognition to these committees, a step I consider vital to proper management now and in the future.

You will note that I have a dual role—as chief fiscal officer of the State, and also as sole trustee of the employees' retirement system. It is my responsibility to achieve the highest possible yield consistent with safety. I must administer the system in such a way that there are no hidden costs in the form of inadequate funding arrangements for promised benefits, and I must assure the public that all tax dollars put into the system will be used to maximum advantage.

The concept of safety held by pension fund managers has, in recent years, been expanded and refined. Safety must now include the maintenance of the purchasing power of the invested dollars. A portfolio consisting predominantly of fixed dollar investments is no longer able to do this. Since all benefits—those currently being paid, those previously accrued for future payment, and those projected to be accrued in the future—rise under inflationary conditions, the need for the invested asset to retain their real value becomes crucial: If this need is not met, the taxpayer must make up the difference. This difference, even for a small decline in real value, can be of tremendous importance since it applies to the entire assets of the system, which will be many times as great as any 1 year's contributions.

Safety also requires the flexibility to change readily within and among types of investment as changing investment conditions require. The days when one could prudently invest in a good security and hold it indefinitely appear to be gone. An investment manager who is obliged to produce creditable results in today's markets must be constantly in touch with changing conditions.

The traditional investments of pension funds—bonds and mortgages—have not been able to keep up in performance with alternate investments in equities during prolonged periods of inflation. Since investment income is vital to the financing of a pension plan, much thought must be given to methods of maximizing this source of income.

The plan liberalizations which we have witnessed in recent years have led to spiralling costs. These have been all the more acute because of retroactivity—they apply also to pension accruals of past years, which had previously been considered to have been paid for by past contributions. On top of this, inflation alone has been boosting pension costs—even for an unliberalized benefit formula. The already overburdened taxpayer would obviously prefer to see at least part of these cost increases met by improved investment performance rather than by means of yet another tax increase.

Meanwhile, the trend toward collective bargaining has complicated the problem for us. In New York State we have 2,300 public employers participating in the State system, 2,300. Since benefits are in component parts, negotiations can often end in a variety of

special plans which can become an administrator's nightmare. And the confusion can extend to actuaries and investment managers. How can we plan ahead logically, when there may be little logic in the permutations and combinations of negotiated plans? Ideally, retirement benefits would not be subject to annual negotiation, but I know this is not realistic. They are attractive to negotiators because the bill for a new pension benefit is ordinarily not payable until some future year.

This is another trend in the operation of these funds, stressed in a letter I received from the Chairman. I refer to what is called "the institutionalization of savings." Whatever may be the national problem caused by that trend—the increasing flow of savings into annuity accumulation funds—the significance in New York State is lessened by the fact that 90 percent of our members—90 percent of them—are on a noncontributory basis.

To be sure, the existence of a pension right in itself may be a deterrent to other forms of savings, a fact which is obvious when a pension check may be delayed for one reason or another. Another indication may be that we have over $90 million in loans outstanding to members who do have annuity savings.

But of the total assets of our system, now about $4 billion, less than 19 percent is represented by the annuity savings account. Total receipts last year were about $75 million, out of a total of 460,000 members. Obviously, our system is not being used as a savings bank.

There is another factor which is now receiving nationwide attention. I refer to what has already been discussed here most eloquently and thoroughly, the pressure on pension systems to use a portion of their funds to improve social and economic conditions. At the moment, particular emphasis is being placed on mortgage loans for homeowners. There are, indeed, strong arguments in favor of such a program. Certainly, I would gladly assist in that effort, if authorized by law, but I could not as a trustee impair the yield the members of my system expect me to earn on their funds. And more than the funds of the members are at stake. To the extent the system earns a lesser yield on investments the taxpayers must ultimately suffer. In essence, then, to accept a mortgage investment at below market is to give to a homeowner what a taxpayer must eventually pay. Perhaps the solution is to subsidize a public pension system for the difference in yield. I see no other way to accomplish the desired result, at least on a large scale.

The problems I have discussed this morning are problems for fiscal officers everywhere. But they are also problems for the members of our pension funds, who worry about their security and about the effects of inflation. The fact is that inflation has had an interesting effect on retirement applications. Many members retire as early as possible, so as to begin a second career, or to start a business, in the hope of keeping pace with the economy. That is very risky. Others postpone retirement as long as possible, so as to increase their final average salary, or to take advantage of new benefits.

Every year I receive letters from members all over the State, wanting to know what to expect. And, of course, I cannot tell them, lest I mislead them. This brings the effect of inflation home to all

of us—no man can plan with certainty, when today's dollar may be tomorrow's half dollar.

And when we go beyond our personal interests—our salaries, our retirement income, our family finances—we realize that we are dealing with a national problem of the first magnitude. We have a direct concern with this economic disease which eats away at our national health—a duty to hold spending to a prudent limit, to dissuade others from incurring enormous public debt, and to plan for the future with a sensible order of priorities, if we are to stop this insidious upward spiral in public finances.

I commend this honorable committee for attacking one key aspect of this problem—the use of investment powers. Through prudent management, through farsighted investment programs, we can serve not only our public employees but we can give some measure of relief to the burdened taxpayers of this Nation. I shall be glad to cooperate in any further study you may wish to make, and I again thank you for your invitation to attend this most important hearing.

Chairman GRIFFITHS. Thank you very much, Mr. Levitt. I would like to congratulate you on asking the foundation to investigate public pensions. I daresay that there will not be a single person retired from the State of New York who is going to be in the position of those people identified there. They will be getting a very substantial income, is that not true?

Mr. LEVITT. Yes, that is true, Madam Chairman, depending on salary and length of service.

Chairman GRIFFITHS. My personal opinion is since all of us are public employees that the day is going to come when the next revolution is going to be those who are going to oppose the payment for a favored group of public employees of such tremendous pensions that are so much greater than anything they will ever get themselves and that is true whether we are Congressmen or comptrollers or Presidents or whatever. I feel that this is one of the great burdens that is being borne by American society. In fact, one small suburban area outside of Detroit has failed for the last 2 months to pay their pensions to the retired employees.

Frankly, I can foresee a possibility where you would have to sell the town.

Mr. LEVITT. I agree with that completely, Madam Chairman. I am always mindful of the burden that our system of pensions imposes upon our taxpayers unless we bear in mind the cost of all of these benefits that we are pressed to grant and which are continuously being awarded.

Chairman GRIFFITHS. It is a very great burden. May I ask why did you get out of the municipal bond market?

Mr. LEVITT. Well, there was no point to investing money in tax exempts and get the advantage of tax exemption at yields less than we can get in other types of securities.

Chairman GRIFFITHS. I noticed last year that Cincinnati had some bonds for sale paying 8 percent. They were also tax free.

Mr. LEVITT. Were those bonds out of their portfolio?

Chairman GRIFFITHS. Yes. It was a bond issued by the city of Cincinnati that paid 8 percent. I would assume that for anybody that is a pretty good investment. I noticed that they were not available to the general public.

Mr. LEVITT. You see, Madam Chairman, in the case of our New York system we have undertaken a plan whereby when the consumer price index increases by 3 percentage points or more, we increase the retirement allowance. This we do on a year-to-year basis but this, as you can readily recognize, imposes a great and substantial burden upon our retirement system. We need to be able to earn this in order to save the taxpayers from the intolerable burden that this would otherwise impose. So, in considering our program of investments, I must be mindful of the obligation to earn this extra money and I must seek investments which will grow with the economy.

Hence, we have embarked upon a program of common stock acquisition. We buy selected common stock regularly on a dollar averaging basis in the expectation that through the years as the economy grows, that the income of our retirement system will grow with the common stock portfolio.

Chairman GRIFFITHS. In the last few weeks have you bought or sold?

Mr. LEVITT. We buy every month a stated amount of common stock, in good weather, in bad, pursuing the general plan of dollar averaging in the expectation that over the long term this will redound to the advantage of our system. This has been the experience in our economy.

Chairman GRIFFITHS. In your judgment, have pension fund managers had any appreciable effect upon the action of the stock market in recent weeks?

Mr. LEVITT. Well, I am not an expert in the stock market, Madam Chairman, but in view of the sheer volume involved in the purchase of common stock by pension fund managers, I would expect that they would have an appreciable effect.

Chairman GRIFFITHS. I would like you, Mr. Schulz, to expand a little on some of the problems arising as you attempt to project the future of pension funds in the face of the possibility of continuing inflation in the future. Are assets and liabilities affected equally? Can any sensible projections be made unless you take these considerations into account?

Mr. SCHULZ. Well, in projecting the benefits—(which was what I was concerned with and not with the pension funds themselves)—the way I handled the problem of inflation, which could occur and has occurred in the past, is to make assumption with regard to the average rate at which private and public pension benefits would increase each year.

Now, a portion of that increase can be attributed to real growth occurring within the system, but also a portion of that presumably would be attributed to take account of monetary growth, monetary increases occurring within the system. So, that in the case of social security benefits, for example, the history has been very clear. The Congress has attempted to keep pace with the cost of living by increasing benefits paid to the elderly people. Thus, when I assumed an average increase of 4 percent in social security benefits each and every year, part of that 4 percent was assumed to be due to changes in the price level that would occur in the future, up through 1980.

Chairman GRIFFITHS. I would like to ask each of you what in your opinion, would be the effect of simply junking the entire pension

system and using social security, increasing the social security level? Now, I know that politically it would probably be almost impossible to do, but what would be the effect generally upon savings, upon inflation, upon the market generally if these funds were just withdrawn, they were put now into the Federal Government and you used it in social security funds only?

Mr. LEVITT. Well, we have in the State of New York now more than $4 billion of this money which has been contributed in part by the employees and in larger part by government, State government and local government, and the employees rightfully consider it all theirs.

Chairman GRIFFITHS. All their own. All right, suppose——

Mr. LEVITT. In most instances, Madam Chairman, the employee regards this as his sole asset. This is his life's savings.

Chairman GRIFFITHS. Supposing that we leave it with a grandfather clause, anybody who has paid in, but from now on there will be no tax exemption, from now on there will be only social security. Would you think it would have some merit to it?

Mr. LEVITT. I am trying to understand the points of view you are seeking to express. It seems to me that our present retirement plan provides for the people, the employees of our State and local governments, an incentive to save and a measure of security that has been valuable in attracting people to the public service and in maintaining them in peace and in comfort, relative peace and comfort, in their retirement years. Unhappily the inflation has changed this and has brought about a widespread malaise on the part of our retired people where they now see in the United States a phenomenon which presumably was not indigenous to America. They do not understand this and they have been writing in literally by the hundreds asking for help, inquiring as to what was happening.

The steady depreciation in the purchasing power of the dollar was playing havoc with these people who retired some years ago upon what was then relatively adequate retirement allowances. It was for that reason that I sponsored in the State of New York the supplemental pension benefit measured by the increase in the Consumer Price Index. This is a very costly benefit and I have been trying as the head of the pension system to earn the money necessary to pay it. For that reason we have been investing on a larger scale in carefully selected common stocks in the expectation that these investments will in and of themselves provide the increments to move with the economy and save the taxpayers from the burdens that increasing inflation would impose upon them.

This is not an easy task, Madam Chairman, and I have some grave fears about the future unless we are in a position to control the inflation. The inflation poses a real threat to our retired people and to the governments who try to solve the problem of retirement.

Chairman GRIFFITHS. It is going to be even worse if we have inflation and depression.

Mr. Werner, would you care to comment?

Mr. WERNER. Yes, I would like to try. It is a king-sized question.

I would, I think, answer it off the cuff in this way, that I subscribe to the principle that is implicit in your question, the prin-

ciple of national planning for the aged and for a national pension program. It seems to me that anything that we can do in the direction of establishing a system of national goals and priorities and then working towards them in a meaningful way is healthy. So, I like that part of what I think is implicit in your question.

I am not sure about the other half, though, and that is whether the way to achieve this goal is through a governmentally operated system. With all due deference to those of us here in the room who are in government, I have some very real questions concerning the capability of government in an area of this kind and I wonder whether the better way of achieving this goal might not be to have government set up the guideposts for the operation of private systems, public systems, Keogh plans, whatever they might be, the various types of systems that have already evolved and systems that would evolve in the future. All would operate within the benchmarks laid down by the National Government. To me this might make a better route to the national goal of responsibility for the aged that I think your question implies.

Chairman GRIFFITHS. Well, the unfairness of some people getting a really reasonable pension which is being paid by all of the people, whether it is somebody who is working in an auto plant, somebody who is working for government, or some other person, and yet those who are paying for those pensions not getting anything themselves, being really quite bad off. So that when I started, what I really am interested in is what is happening to this money. What is being done with these funds?

Every fund that we examined in the original hearings was a very large fund, not any part of which was being paid out annually, and as I pointed out, I felt as of yesterday the funds take on lives of their own. It would be very difficult to touch those funds. When a fund is not even paying out half the interest on the investment in any 1 year over a period of 30 years, then in my opinion, you either have to change the meaning of funding or you have to do something else to control it. The money is just being built up for the sake of having the money there and it is all tax-free money.

Mr. WERNER. I cannot, of course, disagree with you. Each fund looks at its own problems in its own way.

It seems to me if I were a fund administrator I would do precisely that and I think that Mr. Levitt has done an admirable job in describing today the problems of his fund.

Chairman GRIFFITHS. His problems are terrible and unique because he is the one that is paying out the pension, that is struggling with the whole thing, but also having to recommend tax increase, do you not?

Mr. LEVITT. No. Our fund is——

Chairman GRIFFITHS. You have to recommend the tax increases to the Governor, I presume?

Mr. LEVITT. No.

Chairman GRIFFITHS. You do not?

Mr. LEVITT. I am glad to say that is not my job.

Chairman GRIFFITHS. Good.

Mr. LEVITT. But I am by statute the trustee of the retirement system. We are an actuarially funded system. We have on hand sufficient money to pay all of its commitments if the system were to close today.

Chairman GRIFFITHS. That is great.

Mr. LEVITT. And we pay out what we earn. We do not accumulate unnecessarily. I am rather proud of the administration of the system. It is administered under my direction by a career staff of employees and I consider it to be one of the finest examples of a public pension system anywhere in the world.

Chairman GRIFFITHS. I am sure it is. I haven't any question.

Mr. Schotland, you seem to be wanting to say something.

Mr. SCHOTLAND. I am troubled, Madam Chairman, at the idea that perhaps the funds are accumulating money for the sake of accumulating money. I think indeed if anything, the problem is probably the opposite, as I think Professor Schulz has showed, there is going to be too little, and I think as Comptroller Levitt has demonstrated so ably from his own unique vantage point, the problem is acute in figuring out what to do when collective bargaining keeps upping the ante and we are going to get more and more of that.

At your pleasure I would like to say something about those Cincinnati bonds.

Chairman GRIFFITHS. Certainly.

Mr. SCHOTLAND. They are a beautiful investment for anybody in a high tax bracket.

Chairman GRIFFITHS. Oh, of course, definitely. They are wonderful. It is about 30 percent before taxes.

Mr. SCHOTLAND. Well, if you are a corporation paying roughly in a 50-percent-tax bracket, you invest in this and get a 16-percent yield. Not all our corporations these days are getting 16 percent. If you are in the 33-percent tax-bracket, and you do not have to be exactly wealthy to be at that point, you would be getting $12, 12-percent yield.

I think that is one of the most shocking examples of the problem. The taxpayers of Cincinnati should not consider this a good investment, to put it mildly, and this is going to make it harder and harder to authorize public projects, because we are giving money away to high bracket taxpayers out of the pocket of the lower bracket local taxpayers.

Chairman GRIFFITHS. Mr. Schotland, I did everything I could to close that loophole as that tax reform bill went through. I tried to stop that but I was not very successful.

Mr. SCHOTLAND. Perhaps we can do something with the Urban Institute proposal.

Chairman GRIFFITHS. Mr. Schulz, did you have something you wanted to say?

Mr. SCHULZ. Yes. I wanted to approach your question from a different perspective, Madam Chairman. I share with you your concern about certain inequities which the present private pension system imposes upon many people in the United States, but I think it

would be very unwise public policy to react to these inequities by suggesting the wholesale abolition of private pensions. Let me give an example of one important contribution which I think private pensions can make.

Representatives of the UAW union recently appeared before the Special Senate Committee on Aging and were asked about their programs which encourage early retirement of workers and whether this was in general a very good policy—given that average life expectancy would mean that early retiring workers have about two decades of retirement at benefits which two decades hence might seem very low compared to what they appeared to be at the time of retirement. A very interesting and thoughtful answer came back. They said that within the UAW the foundry workers have a special life expectancy, much lower that the average life expectancy. Therefore, they felt it was important that these workers be allowed to retire at an earlier age with substantial pensions.

Now, it would be very difficult to devise, I think, a public pension system for the whole country which could take accounts of the special problems of small groups such as the foundry workers. I think here is where the private pension system can perform quite admirably, taking care of these very special circumstances. So, I would say that private pensions do have their function, and we should not abolish them entirely.

Chairman GRIFFITHS. Of course, the trouble with the private pension system is that only the big and the powerful can get the pension. Each of you has pointed out the smaller industries do not have these pensions. One of the saddest things, I think, and I heard it remarked on twice, is the Keogh bill. I think somebody said yesterday the Treasury opposed the Keogh bill. True, they did, but so did 23 other members of the committee oppose it. They just did not believe in the Keogh bill in spite of the fact that millions of professional people had absolutely no opportunity to set up a pension for themselves at all.

Why should they be denied a tax-free saving? It was absolutely nonsense. The Keogh bill is not adequate now for a professional. He is not being permitted to replace anything like the part of his income that a person in government gets, and yet he would have to earn it all himself.

So, in fact, the professionals were not organized. They did not do anything. And the places where the big pensions are being given are in the highly organized industries where they have power but if you are in a small concern where there is no employee power, then you do not get the pension.

Mr. SCHOTLAND. Madam Chairman, may I suggest that perhaps rather than diminishing the protections which people in more organized industry are fortunate enough to have as a result of their own fight for collective-bargaining representation, we might integrate in some way the social security system with pension benefits so that, for example, those without any private pension coverage would get more social security coverage.

Chairman GRIFFITHS. That would be a good idea but you have to be terribly careful even on this. A. T. & T. integrated itself for years. It has only been recently that every time you lifted the social security, A. T. & T. did not reduce their pensions. I am not for that type of integration. I do not think that really would work properly.

I would like to express my deep appreciation to each one of you for being here today and I would like to ask that if the other members of the subcommittee would like to send you some questions, if you would answer, would you please answer them then for them?

Thank you very much.

This subcommittee will adjourn until 10 o'clock in the morning at this place.

(Whereupon, at 12:05 p.m., the hearing was recessed, to reconvene at 10 a.m., Wednesday, April 29, 1970.)

INVESTMENT POLICIES OF PENSION FUNDS

WEDNESDAY, APRIL 29, 1970

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10 a.m., in room S-407, the Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling, economist for the minority.

Chairman GRIFFITHS. Today we look at some special but broad aspects of the impact of the growth of pension funds on financial markets and the changing structure of control of the Nation's resources.

Professor Dietz of the University of Oregon has been a longtime student of pension fund problems, particularly in the area of goals and objectives and measurement of the proficiency with which pension funds are managed. His remarks today are addressed to these subjects.

Professor Harbrecht, of New York University in Canada, has written extensively about pension funds; his book, "Pension Funds and Economic Power," is one of the most authoritative texts in the field, dealing with the changing economic power structure as institutions grow in size and ownership of corporate stock.

Professor Lerner, of the Graduate School of Management at Northwestern University, has researched extensively the workings of financial markets. He will direct his comments to the question of the liquidity of stock markets as the size of transactions increase significantly with institutions becoming a major factor in the stock market.

Gentlemen, we appreciate your desire and interest to help us obtain a fuller understanding of these very important subjects.

You may proceed, Mr. Dietz.

Mr. DIETZ. Thank you.

STATEMENT OF PETER O. DIETZ, PROFESSOR OF FINANCE, GRADUATE SCHOOL OF MANAGEMENT AND BUSINESS ADMINISTRATION, UNIVERSITY OF OREGON

Mr. DIETZ. Thank you, Madam Chairman.

My name is Peter O. Dietz, and I am associate professor of finance, Graduate School of Management and Business Administration, University of Oregon.

Pension and Investment Policy

My own interests in the pension field are primarily twofold: (1) development of investment goals and objectives, and (2) measurement of investment performance. I would like to develop this topic along three broad questions. First, based on an analysis of investment goals and objectives, what are appropriate investments for pension funds? Second, how should investment performance be measured and how good has performance been? Finally, based on goals and an analysis of past performance, what is the future direction that pension fund investment should take?

I. Investment Goals and Objectives [1]

Sound pension fund investment administration requires the establishment of investment goals just as much as any other aspect of business enterprise. These goals become the plan of action under which the investment manager works, the basis for effective communication between trustor and trustee, and the basis for comparison with actual performance.

Pension fund managers need to be concerned with earning an adequate return on pension fund assets, since high return reduces the cost of a dollar's worth of pension payments. They also are concerned with the ability of the funded assets to meet pension liabilities. In addition to such goals as high rate of return and protection against loss of principal, there may be other major or subsidiary goals such as liquidity, current income, stable income, stability of market value, et cetera, depending upon particular circumstances. Proper establishment of such goals has an influence on investment policy. For example, a goal of current income would lead to adoption of investment policies emphasizing high-yield bonds without regard to call protection and to high-yielding common stocks without regard to future growth of dividends. But a policy calling for stable income might lead to adoption of investment policies seeking call protection even at the sacrifice of yield and to common stock investments in stable growth industries such as consumer products and public utilities. Again, a goal calling for high return might lead to an investment policy of lower grade bonds and aggressive common stock investments, whereas a goal placing emphasis on risk reduction might lead to higher grade bonds and conservative stock investments.

Some writers have implied that the investment goals of all pension funds should be similar.[2] However, discussion with corporate pension fund administrators, pension fund consultants, and invest-

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[1] For a further discussion of this topic, see: Dietz, Peter O., "Pension Funds: Measuring Investment Performance" (the Free Press, New York: 1966), ch. III; Sieff, John A., "Construction of a Retirement Fund Portfolio," Financial Analysts Journal, July–August 1965; and Dietz, Peter O. "Investment Practices of Trusteed Pension Plans," Financial Executive, June 1969.

[2] For example, See Howell, Paul L., "Common Stocks and Pension Fund Investing," Harvard Business Review, XXXVI (November 1958).

ment counselors, indicates that most pension fund experts believe there are factors peculiar to individual corporations which lead to particular goals for individual portfolios.

Investment decisions, then, should be made to meet the specific needs of a particular fund. These needs can be stated in terms of the fund's need for high investment return, its liquidity needs, and its ability to accept risk. The major factors which affect a fund's requirement for high investment return as opposed to liquidity needs and ability to withstand risk are (*a*) the reliability of cash inflow, (*b*) the predictability of cash outflow, (*c*) the company's ability to earn returns on its own assets, and (*d*) the liability structure of the pension plan. To make these points clear, I would like to discuss each of these factors briefly.

(*a*) *Reliability of cash inflow*

Pension fund benefits can be paid out of either the corpus of the fund or out of new monies received by the trustee from company and employee contributions, and from investment income. In those cases where the trustee is, for example, 99.9 percent sure that contributions and income will exceed benefits payments in each of the next 20 years there is, to all intents and purposes, no need to worry about safety of principal and liquidity of the fund's assets in the short run. However, in the situation where there is a probability of say, 50 percent that benefits will exceed contributions and income in three out of the next 20 years, a more conservative investment policy is indicated.

Cash inflow to the fund depends primarily on a corporation's earnings, internal cash generation, and work force characteristics. Thus, for example, earnings are more stable in noncyclical than in cyclical industries; growth companies have sufficient earnings to make contributions, but may have pressing cash needs. In addition to the above factors which influence the ability of a corporation to make regular payments to the fund, cognizance should be taken of a company's position within its industry. A strong, successful company can plan its competitive position to meet cash needs; a weaker company may not be so fortunate. Therefore, the trustees of General Motors pension funds would have more assurance of receiving sufficient payment from G.M., than the trustees of the American Motors fund.

Work force characteristics also have an important bearing on cash inflow. A company characterized by a young growing work force can expect to make growing contributions each year. Payout from the fund will be small by comparison, and it may be many years before payout becomes influential. An opposite situation exists in a company that has a mature work force where contributions and benefit payments are largely offsetting, and more particularly by a company where the size of the work force is declining. In the latter case, inflow is apt to be less than outflow. Funds characterized by the first attributes can afford to stand investment risks which are not tolerable under the last two conditions.

(*b*) *Predictability of cash outflow*

As indicated above, a major factor to be considered in determining liquidity needs is not only the size of the excess of cash inflow

over outflow, but also the predictability of excess inflow. The factors affecting the predictability of outflow are primarily plan characteristics and the influence of the "escalator effect"; that is, the need to increase future benefits due to inflation.

Certain types of plans have features which influence the liquidity needs of the fund. For example, in a noncontributory plan there is little possibility of cash outflow because of an employee's withdrawal from the plan. On the other hand, where plans are contributory, often employees may withdraw the amount of their own contributions upon separation from the plan. In some funds cash contributed by employees is invested differently from employer funds. This is often the case in profit-sharing plans where employee contributions can be withdrawn. This is one of the reasons that city and State administered retirement funds have higher outflow to inflow and higher outflow ratios than the average industrial plan. Another plan feature which should be considered is the death benefit feature. It is clear that liquidity needs are greater for plans making lump sum death payments than for those in which there are no death benefits. Any plan which has features allowing lump sum withdrawal, needs more liquidity than similar plans where lump sum withdrawal is prohibited.

The dangers of sudden increases in benefit payments may be particularly high for a company with older employees in a cyclical industry. In such a case, mass retirement may be forced on workers during a prolonged recession. If this causes pressure on the cash reserves of the fund, sale of securities may be necessary to meet benefit demands at a most inopportune time from an investment viewpoint.

On the other hand, the absence of liquidity pressure has been instrumental in setting investment policy for the college retirement equity fund. The president of this fund in discussing investment policy stated:

> Educators place part of their retirement savings in CREF regularly over a span of many years. Accumulations cannot be surrendered for cash. Therefore, CREF's need for cash is limited to annuities being paid and is predictable and stable. There can be no sudden rush of cash withdrawals or any other reason to force the sale of securities during periods of market weakness.
>
> All of these factors permit CREF to tie its investment policy to the long-range growth of the country rather than to short-range market positions and swings.[3]

The "escalator effect" tends to increase benefit payments over time. It will influence investment policy to the degree that trustees attempt to hedge against it in their investment policies. How greatly investment is influenced by the "escalator effect" will depend, of course, on a trustee's evaluation of trends in the cost of living, on potential union pressures for re-evaluation, and on the type of plan.

For example, level contribution plans can only be reevaluated and benefits increased if the plan is changed. This, however, is not the case in plans where benefits are based on career average or final pay.

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[3] Teachers Insurance and Annuity Assoication College Retirement Equities Fund, "CREF—The First Ten Year's Experience, A Report to Participants" (New York: TIAA & CREF, 1962), p. 3.

In such cases, pensions depend upon an employee's earnings and are not based on the amount of contributions.

The most severe impact of the "escalator effect" occurs under plans in which benefits are based on a final earnings formula. If pensions are based on a formula that is a specified percentage, say 1 percent, for each year of service multiplied by the average earnings over the last 5 years before retirement it is almost impossible to estimate pensions for a young employee. His pension, paid for his work for perhaps 40 years, depends upon his earnings between ages 60 and 65. While actuaries can predict an average employee's salary advancement, it is almost impossible to predict general salary levels 40 years hence. A fund manager may be justified in choosing an investment objective so that return on the fund will grow at a rate sufficient to match salary level increases.

(c) Company's ability to earn returns on its own assets

At each level of investment risk an investment manager will attempt to earn a maximum return for his portfolio. Thus, a discussion of the factors affecting the need for return may seem pedantic: theoretically every portfolio manager seeks maximum return at each risk level. However, once the liquidity constraint has been determined by an analysis of a fund's inflow and outflow requirements, each company should determine the importance of earning a high return on its pension fund investment, and the risk it is willing to accept.

Contributions paid into a pension fund, as opposed to other employment costs, are important to both the corporation and the employee. Earnings on these assets are an offset to pension costs. When assets are segregated for pension fund use; that is, funded, there is clearly an opportunity cost; the cost of foregoing the return available on alternative capital investment opportunities. When there is no difference between the return available on pension fund assets, and assets employed in the regular business of the company, there is no more capital cost to providing pensions than there is to investing in other corporate assets. The cost becomes substantial as the pension fund return and the rate of return on other corporate assets widens. The drive for high return on pension fund assets, all other factors being equal, will be greater for a firm having a high ability to earn on its own assets than for a company having a low rate of return.

(d) Liability structure of the pension plan

A fourth major influence on the investment policy of a pension plan is its liability structure. Consider, for example, exhibit I. If the present value of accrued benefits for retired employees is a large proportion of total liabilities, such as in plan B, a rather conservative investment policy may be desired. On the other hand, in plan A only a small portion of total liabilities are current; very little liquidity is required and in general a more aggressive investment policy may be undertaken because benefit payments will not come due for many years.

In terms of investment policy, reference to exhibit I is also helpful. We might analyze appropriate investments for each of the various categories of liabilities. For example, appropriate investments for

category (1) current portion—payable within 2 years—would undoubtedly be primarily liquid assets such as money market instruments, U.S. Government issues, and high-grade marketable corporate bonds. Categories (2) and (3) include liabilities for currently retired employees due after 2 years and liabilities for employees expected to retire in the next 5 years. Appropriate investments for these categories might logically be fixed-income securities such as money market instruments, U.S. Government issues, corporate bonds—both marketable and privately placed—sale and leasebacks, mortgages, and oil production payments. These we might consider a secondary reserve. The liabilities of categories (4) and (5) are very long run in nature. Investments made for the purpose of eventually fulfilling these liabilities should be more aggressive and can be quite flexible. Appropriate investments would include high return securities such as convertible bonds, convertible preferred stocks, corporate bonds and warrants, low-grade corporate bonds, common stocks and real estate equities. Since these liabilities will not come due for many years, the investment manager can afford to take greater risks in order to obtain high returns.

II. INVESTMENT PERFORMANCE

The first step in measuring the performance of any type of investment is clearly to find out how much was earned on the assets employed. In the measurement of pension trust investment performance, analysis begins with the problem of determining the rate of return on the pension fund assets.

The concept of rate of return is familiar to everyone. But the application of this concept to pension fund investment portfolios is subject to several serious problems of interpretation. Do we mean return on book value or market value? Do we intend return to include ordinary income or capital gains and losses, or should it include unrealized appreciation or depreciation as well?

EXHIBIT I

[In percent]

Liabilities of pension plan	Plan A	Plan B
Present value accrued benefits—retired employees:		
(1) Current portion—Payable within 2 years	5	15
(2) Long-term portion—Payable beyond 2 years	10	20
Present value accrued benefits:		
(3) Active and terminated vested employees retiring within 5 years	5	20
Current liabilities	20	45
Present value accrued vested benefits:		
(4) Other active and terminated employees	25	40
Present value accrued, nonvested benefits:		
(5) Active employees	55	15
Total liabilities	100	100

Although actuarial computations for pension funds usually include only ordinary income and realized gains and losses in the calculation of income, this concept is inappropriate for the measurement of investment performance. The economic value of the fund

includes market values. Furthermore, using only ordinary income and realized gains and losses can cause distortion in the rate of return and, perhaps more importantly, can provide management with inaccurate data on which to base its investment decisions. Rates of return based on ordinary income only which exclude market appreciation tends to bias investment policy in terms of fixed-income securities and high-dividend paying equities, while recognizing only realized gains and losses to the exclusion of unrealized gains and losses is artificial. A trustee could use wash sale techniques just for the purpose of artificially increasing return.

An example of the need for a total return measure is shown by the following illustration. Assume two identical portfolios have 100 shares of XYZ selling at $100 a share with a dividend of $3 per year. Also assume both portfolios purchased the stock for $75 a share. What are the alternative rates of return computations if portfolio A sells the stock while portfolio B keeps it?

[In percent]

	A	B
Rate of return:[1]		
1. Ordinary income	4	4
2. Ordinary income plus capital gains	36	4
3. Ordinary income plus capital gains and appreciation	36	36

[1] Based on book value.

Clearly either ordinary income or total return should be used. However, it can quickly be seen that return based on ordinary income alone should be rejected. If portfolio A were to reinvest XYZ, it would raise its book value to $100 a share. In the next year, portfolio A would show a 3-percent return, while portfolio B's return would still be 4 percent, even though each portfolio would have the same economic value.

This same example illustrates the inaccuracies inherent in using book value to measure return. Portfolio A, in taking gains, has increased book value even though both funds have the same economic value. Furthermore, book value depends on the timing of investments—book value will be high or low, depending on when the investment was made. The exclusive use of market values is in keeping with the suggestions of other authorities in the field.[4]

Thus, the basic formula for determining the return on pension fund assets is as follows:[5]

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[4] See, for example: "Measuring the Investment Performance of Pension Funds, "Bank Administration Institute (Park Ridge, Ill.), 1968; Dietz, Peter O., "Pension Funds: Measuring Investment Performance," the Free Press 1966; and Sieff, John A., "Using Past Investment Results as a Guide to Future Policy," Investment Practices, Performance, and Management of Profit Sharing Trusts, Profit Sharing Research Foundation (Evanston, Ill., 1969.

[5] In actuality, it is difficult to calculate return as indicated above due to the limitations of accounting data. However, approximately the same results are obtained by using

$$R = \frac{M_2 - M_1 - C}{M_1 + \frac{1}{2} C}$$

where (R) equals rate of return, (M_1) beginning market value, (M_2) ending market value and (C) equals contributions net of benefit payments.

Return equals ordinary dividend and interest income plus realized capital gains and losses plus unrealized gains and losses divided by average market value.

It might be of interest to the subcommittee to see the actual rates of return earned by a sample of pension funds. I have prepared three tables which show summary results of annual rates of return for 30 corporate pension funds for the years 1956–65.[6] Each table shows the highest and lowest performing funds as well as the quartiles and medians. The accompanying calculations of ranges and interquartile ranges show the dispersion of results.

Table 1 shows the results for the total investment portfolio, including all common and fixed-income securities. For the 10-year period 1956–65, the highest return was 10.0 percent, while the lowest was 2.8 percent. As might be expected, there was a wide range of results because total portfolio rates of return depend not only on individual security selection but also on the percentages of assets invested in equities versus fixed-income securities. That is, these results reflect both different investment objectives of the sample funds and different investment abilities. The range in total performance was as high as 22.4 in 1958 and as low as 6.1 in 1957. Although the ranges were quite high for individual years, they narrow rather drastically when several years are averaged together. Thus, the range for the 17 funds where data was available for the full 10-year study period was only 7.2. The interquartile range for 1956–65 was only 1.9 percent indicative of virtually similar performance for 50 percent of the funds tested. The highest fund with earnings of 10 percent was primarily invested in equities, while the fund with the 2.8-percent return was primarily invested in fixed-income securities.

Tables 2 and 3 show results for the equity and fixed-income portions of the portfolios separately. Therefore, the results shown are based solely on the selection of securities within each of these categories.

Table 2 shows that annual returns on the common stock portion of these pension fund portfolios ranged from 8.5 to 14.1 percent in 1956-60; 10.7 to 15.4 percent in 1961-65; and 10.4 to 13.4 percent for the entire 1956-65 period. The range of investment returns varied from 18.1 in 1961 to 9.3 in 1963. Again, there was far wider dispersion of results for yearly periods than for the 5- and 10-year averages. The range for 1956-65 was 3.0 and the inter-quartile range was only 1.1.

Table 3 shows the annual returns on the fixed-income portions of these same pension funds. For the 1956-60 period returns earned varied from 1.2 to 3.2 percent; for 1961-65 from 1.4 to 5.5 percent and for the entire 10-year period from 2.3 to 4.3 percent. As might be expected, the range of results for the fixed-income segment of the 30 portfolios studied is much narrower than the range for either the total portfolio or the common stock segments.

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[6] This datum was prepared while undertaking a research project for the Financial Executive Institute. The full report is available in the June, 1969, issue of the Financial Executive.

TABLE 1.—TOTAL PORTFOLIO: RANGES OF ANNUAL RATES OF RETURN

	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1956–60	1961–65	1956–65
High	6.2	4.5	24.8	9.6	9.0	27.9	5.5	18.6	14.1	16.5	10.0	13.6	10.0
1st quartile	1.4	2.8	19.3	5.7	7.5	15.1	1.2	12.5	10.8	10.2	5.5	9.0	7.3
Median	–.5	1.7	12.5	4.5	5.5	13.3	–3.1	11.2	10.0	8.2	4.9	8.1	6.3
3d quartile	–1.3	–.5	9.2	2.1	2.9	10.9	–5.2	7.8	9.0	5.8	4.2	7.2	5.4
Low	–2.8	–1.6	2.0	.1	–1.4	8.4	–12.7	6.6	7.9	3.8	3.3	5.8	2.8
Range	9.0	6.1	22.4	9.5	10.4	19.5	18.2	12.0	6.2	12.3	6.7	7.8	7.2
Interquartile range	2.7	3.3	10.1	3.6	4.6	4.2	6.4	4.7	1.8	4.4	1.3	1.8	1.9

TABLE 2.—STOCK PORTFOLIO: RANGES OF ANNUAL RATES OF RETURN

	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1956–60	1961–65	1956–65
High	17.5	0.0	47.7	17.4	9.7	35.0	–2.0	25.0	19.3	17.7	14.1	15.4	13.4
1st quartile	11.0	–5.2	44.9	13.3	6.6	28.0	–9.6	20.5	16.8	15.2	13.2	13.1	13.2
Median	8.5	–7.4	43.3	12.5	2.3	24.8	–10.9	19.5	15.7	12.3	12.3	12.5	12.3
3d quartile	7.6	–11.6	41.4	9.7	–1.6	23.1	–14.1	16.2	13.3	8.9	10.6	11.3	12.1
Low	5.3	–15.1	33.5	7.0	–2.9	16.9	–16.2	13.7	10.0	5.8	8.5	10.7	10.3
Range	12.2	15.1	14.2	10.4	12 6	18.1	14.2	11.3	9.3	11.9	5.6	4.7	3.0
Interquartile range	3.4	6.4	3.5	3.6	8.2	4.9	4.5	4.3	3.5	6.3	2.6	1.8	1.1

TABLE 3.—FIXED-INCOME PORTFOLIO: ANNUAL RATES OF RETURN

	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1956–60	1961–65	1956–65
High	–0.1	8.2	5.4	0.0	10.3	8.1	8.3	6.7	7.4	4.6	3.2	5.5	4.3
1st quartile	–4.0	7.3	2.4	–0.1	8.9	5.5	6.8	4.3	5.4	3.4	2.1	4.9	3.7
Median	–4.3	6.2	1.0	–1.6	8.5	4.8	6.4	3.2	4.7	2.3	1.8	4.4	3.1
3d quartile	–5.0	5.6	0.0	–2.2	7.7	4.6	5.0	2.9	4.2	1.6	1.4	4.0	2.7
Low	–8.0	3.9	–3.0	–4.2	6.6	–0.3	1.0	1.1	2.9	–0.3	1.2	1.4	2.3
Range	7.9	4.3	8.4	4.2	3.6	8.4	7.3	5.6	4.5	4.9	2.0	4.1	2.0
Interquartile range	1.0	1.7	2.4	2.1	2.2	0.9	1.8	1.4	1.2	1.8	0.7	0.9	1.0

Upon study of these tables, the conclusion is inescapable. Common stock returns were three to four times greater than the returns on fixed-income securities. Such a difference, if maintained over a period of years, would provide far greater pension benefits per dollar of cost. While it is true that this study period was one that was very favorable to common stock investments, these results are not out of line with longrun stock investment returns. The Fisher Lorie study found that all common stocks listed on the New York Stock Exchange earned 9.01 percent compounded annually between 1926 and 1960. The rate earned between 1950 and 1960 was 14.84 percent.[7]

III. FUTURE DEVELOPMENTS IN PENSION FUND INVESTMENTS

The results of sound management of pension fund assets are impressive. High earnings on pension fund assets enable corporations to increase pensions, lower pension costs or, as it most likely, do both. There will be a continual drive to earn good returns within the limits specified by liquidity needs and the amount of risk any specific fund can afford to take.

I might add at this point that increased returns will probably tend to lower product costs, a rather important point in this age of inflation.

We have seen that common stock investments have been between three and four times as productive as investments in fixed-income securities during the 1956–65 period. Managers of pension funds have responded to these opportunities. Common stock assets of private noninsured pension funds rose from 42.5 percent in 1959 to 62.5 percent in 1968. This percentage will probably continue to rise as funds that are still heavily committed to fixed-income investments shift to common stocks. For example, such a shift in direction is evident in the policies of the Bell System funds.

However, many pension funds have probably reached a maximum in the percentage of common stocks they wish to hold. Today, for the first time in many years, expected fixed-income returns may be as good or even better than returns in equity markets. Much depends on the ability of this country to come to grips with the issue of inflation. In an inflationary economy, the rewards for long-term commitments to fixed-income securities are meager indeed for most pension funds.

I would recommend to this subcommittee that the most important attribute of good pension fund investment is the ability of fund managers to be flexible in their investment policies. I strongly support the conclusions of the January 1965 report of the President's Committee on Corporate Pension Funds that, "in view of the wide legitimate differences regarding the most advantageous balance of retirement funds investments, the Committee does not believe it would be desirable on the basis of evidence to date to require con-

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[7] Lawrence Fisher and James H. Lorie, "Rates of Return in Investments in Common Stocks," Pamphlet: The Center For Research in Security Prices, Graduate School of Business, University of Chicago, 1963.

formity to a prescribed rule with respect to the proportion of stocks to other investments."[8] This is as true in 1970 as it was in 1965.

In this regard, two current examples of the type of flexibility and diversity of investment programs for different purposes may be of interest to the subcommittee. The first example is taken from the 1969 annual report of the Teachers Insurance and Annuity Association. This is a fixed-income-dollar purchase fund where fixed-income securities are appropriate.[9]

The fund held by TIAA to support your benefit payments are invested primarily in long-term mortgages, bonds, and other debt obligations. A major investment objective of TIAA is to place these loans where they are needed and where they can achieve for policyholders the highest possible investment return. One way in which TIAA implements this policy is by searching out opportunities for early and significant investment participation in changes occurring in the economy and in the living patterns of the American people. TIAA loans are helping to finance new and growing industries, land reclamation and development of natural resources, and the building of new and redeveloped cities. Vast needs for new and better forms of transportation and communication, for example, result in above-average yields on loans to these industries; and TIAA is investing in cable television and radio broadcasting, in the leasing of planes and airline equipment, and in the development of new types of shipping vessels. And your TIAA retirement savings now make you part owner as well as creditor of some of the corporations in which TIAA invests—through loans that include equity participation in addition to excellent rates of interest.

Participating in the insurance industry's Urban Investment Program, TIAA has concentrated on new construction, rehabilitation, and refinancing of housing and has kept well ahead of other companies in achieving its goals under the Program. Nearly $16,000,000 of your retirement funds has been invested in improved housing in the inner core of such cities as New York, Detroit, Cleveland, and Newark.

I might add that 52 percent of the TIAA portfolio is now invested in mortgages.

The second example is from the public employees retirement system of the State of Oregon. As you know, State retirement systems have historically had notoriously poor investment performance. This was often due to very restrictive investment legislation. Some funds have even invested in tax-exempt State and municipal securities. As a result, retirement benefits for State employees have been unnecessarily low.

I should like to add at this juncture that if I were a participant in a State system holding municipals that I would like to sue for malfeasance. I recognize the need to finance State and local governments, but we are now witnessing the fruits of prior well-meaning but poor legislation; that is, the tax exemption of municipal bond interest. Neither pension fund nor life insurance companies, two of the largest supplies of funds to the capital markets, find these investments attractive.

Immediate repeal of the tax exemption is necessary if local governments are to compete successfully for funds. We should in no way compound prior errors by insisting that pension funds make poor investments.

In Oregon, pressure from State employees and enlightened investment managers finally secured enabling legislation for common stock

[8] "Public Policy and Private Pension Programs." President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, U.S. Government Printing Office. January 1965, p. XV.

[9] TIAA-CREF 1969 annual report, p. 13.

investments. After court tests approval for equity investments was granted in 1969. The State of Oregon fund is now invested $329 million in fixed-income obligations and $20 million in common stocks. The common stock investment has been divided among three private investment counselors to insure good performance. An added feature of the Oregon plan is that as of January 1, 1970, employees may elect to invest up to 50 percent of their own contributions in the common stock fund on a variable annuity basis. In just 3 months, the variable annuity fund has assets of $3 million. I hope other states will follow such enlightened action.

In these remarks I have limited myself to only one aspect of the pension field—investments. The public-private retirement system we have developed in the U.S. works well from an investment standpoint. The great majority of plans are financed by employer and employee contributions which are invested by one or more third-party fiduciaries. This third party is variously an insurance company, bank trustee, or investment counselor. Thus a dual system has been created. This arrangement has as its major advantage the fact that the fiduciary's first responsibility is preserving the corpus of the fund. That is, the fiduciary represents the beneficiary in assuring the financing integrity of the fund. On the other hand, the fund sponsor, which selects the trustee, has the right to measure investment performance. The dual system thus provides the necessary balance between the sponsor's desire to lower costs of the plan by increasing return on asset and the need to preserve the assets in the fund. The record shows that where defaults on pension promises have occurred it is due to either inadequate funding or malfeasance, not poor investment management. Such a system of dual control puts a premium on high rates of return which can be used either to reduce contributions or to increase benefits or both, without incurring excessive risks. The pressure on fiduciaries to earn adequate rates of return along with nonrestrictive investment policies will assure the efficient investment of the economy's pension savings.

That completes my statement, Madam Chairman.

I will be glad to cooperate in any further study along these lines you may wish to make. And I thank you for inviting me to appear before you.

Thank you very much.

Chairman GRIFFITHS. We are delighted to have you, Mr. Dietz.

Mr. Harbrecht is our next witness.

We shall be glad to hear from you at this time, Mr. Harbrecht.

STATEMENT OF PAUL P. HARBRECHT, PROFESSOR OF LAW, YORK UNIVERSITY, TORONTO, CANADA

Mr. HARBRECHT. Thank you very much.

I should like to submit the prepared statement I have supplied to the subcommittee for the record and go over it briefly, if I may.

Chairman GRIFFITHS. Very well.

Mr. HARBRECHT. I also beg your indulgence in talking about a subject which may not be in the direct line of interest in this point in the subcommittee's survey of the pension fund problem.

I think on the whole I agree quite thoroughly with Professor Dietz that pension funds have been very well invested. I have, however, been impressed by the fact over the years that on occasions like these hearings representatives of large companies, large unions, large financial institutions and well-staffed consulting firms are very much in evidence and very vocal. And they have a good case to present.

It makes a headline if someone says that pension funds are being mismanaged. But the people who come to the fore in the defense of pension fund investments are the large banks, and not a few attorneys who service these banks. The people who belong to smaller, less well-managed investment funds or pension funds are not heard from. Still, it is very common that pension fund trustees who have discretion over pension fund investments in smaller plans are not well qualified for the task they have in hand.

I think that since in the large funds the great bulk of pension monies is in the hands of expert investment counsel, there is little difficulty with the major portion of pension fund monies. However, there is a very large number of small plans that are not so expertly invested. The kind of information that you can get about this would come from bank examining officials, say, in New York State, and other bank examining agencies that go to smaller banks in small communities. To be a pension fund trustee is often a very honorific position in a union or in a company, and can be very lucrative where there is a good stipend for attending the annual or semi-annual meeting of the trustees.

It is required by Federal law that officials who actually handle pension fund monies should be bonded. There is not, therefore, the problem with regard to outright dishonesty or embezzlement that did exist before Federal legislation was passed. But there is no protection in this law and very little protection in state law for sheer incompetence in investment management. It is all too possible under these circumstances to get incompetent trustees.

Now, I have argued that this kind of problem would not be so prevalent if it were not so dubious that a pension fund is in fact a true trust, and that people who have the care of pension funds should be treated as common law trustees.

The employee in the case of a common law trust would have a legal right to an accounting. And he would also be able to enforce the so-called prudent-man rule in managing the funds of a pension plan. That rule, very simply stated, is that as a trustee of funds one must conduct that task in such a way as if he were handling his own funds in the manner of a prudent man.

It is one of those mythical standards of the law, but it is very common in the whole law of trusts. Now, the suggestion I would like to make to this subcommittee is that a Federal statute—if we incorporate a provision like this in pension legislation—should provide that any person who has discretionary power over pension fund money should incur all the obligations of a common law trustee. This is not such an outrageous suggestion if we consider the Federal Trust Indenture Act of 1939, which was aimed at the frequent use of trust indentures providing for the money managers to be isolated from any kind of objection that could be raised by security holders

and exempting them from even the minimum obligations of trustees. This law requires that a trustee be free from any conflict of interest, imposes high standards of conduct, provides for reports of notices from the trustee to security holders, prohibits impairment of the security holder's rights to sue individually, and this would be an important feature of pension legislation, I would think, gives security holders the right to sue individually.

The Act further requires the maintenance of a list of security holders which may be used by the security holders themselves to communicate with one another regarding their rights. Very often the most serious bar to bringing any kind of action against a pension fund trustee is that the prospective pensioner simply has not got the finances to mount a legal action.

Such a statute, I think, has much to recommend it, particularly in the light of the kind of exculpatory clauses which are much in use in the standard type of pension trust.

These clauses are used in the pension plan itself to protect the employer from certain claims that may be made by the employees against him. And they are also used in the trust indentures to insulate the banker trustee or trust company from claims by employees or pensioners.

These would be claims for bad management rather than claims resulting from the simple ministerial job of deciding who should get a pension and when.

I consider that such a statute is necessary because the States seem very reluctant to act in this area, and because the courts are unlikely to take the initiative in declaring that these arrangements are in fact true trusts. The defense of employers against the claim that they are true trustees is that the obligation to pay a pension is a contractual matter between employer and employee. Whether the employer chooses to pay his obligation out of the company treasury, or current income, or out of some kind of fund that he has established does not concern the employee. I think this is a logical argument in law, but I think it is also unrealistic.

In the first place, one of the great incentives to establish a pension plan is that the contributions to and earnings of such a plan are tax free. It is a requirement of the tax law that funds so treated shall not be returned to the employer. The object of this public largesse is surely the worker and not the employer.

If these funds are to be free from the burden of taxation, and if the employer is to have the advantage of earning money to pay pensions by tax-free capital investment, he should not quarrel with the further regulation that the sequestered capital be invested prudently.

Now, there are two ways in which this objective could be reached. One way would be to expand the existing power of the Secretary of Labor to oversee pension investment. And I perceive in bureaucratic circles a desire to lay it all out with prescribed powers for the overseeing authority.

Now the Secretary may command a certain amount of reporting. He could be further directed to require of pension fund investors that they purchase securities from a preferred list, or an elaborate set of statutory prohibitions or mandates could be enacted attempting in effect to codify this prudent-man rule for use in Federal courts.

But I submit that such a detailed list of directives would be needlessly restrictive of trustees, and would also be impossible to police without expanding the staff of the Labor Department beyond all reason. The sheer volume of reporting in the Labor Department now is so extensive that it makes it very difficult to do the followup job, which is to enforce the law.

Furthermore, the burden of reporting all transactions made on behalf of pension funds would be too great for a large pension fund trustee such as the Chase Bank or Bankers Trust Co.

But the second possibility, which I would recommend, would be to declare by statute that these trustees are bound by the prudent-man rule as interpreted by the courts of the State where any challenged transaction took place. And this would not be a difficult process.

In a suit between a beneficiary and a trustee which might come into the Federal court by reason of diversity of citizenship the Federal court would have to apply State law anyway as the law now exists. The right to sue the trustee in a Federal court should be extended to all members of pension plans. The Secretary of Labor should also be given the right to bring suit on behalf of plan members in those situations where they cannot or will not act for themselves.

Pertinent to this obligation the authority of the Secretary should be expanded to investigate with subpena powers wherever he has reasonable ground to suspect that a Federal statute is being violated. He has the power to investigate now where he has reasonable cause. That phrase, I think, might be watered down a bit so that he has greater freedom to investigate and make spot checks when he needs to do so.

Such a statute, I think, would have the effect of putting the managers of pension fund assets into the same position as the Federal Trust Indenture Act of 1939 put the sellers of securities.

I do not see why pension fund managers should be in a superior or more exempt position. Their general performance is marked by high probity. But there are failures. Banks and trust companies are already operating under similar strictures in their management of private trust funds, endowment funds, and so forth. The statute I propose would not only spell out the standard which they now purport to apply to themselves, but would have the effect of extending these restrictions to noninstitutional trustees, the smaller and more informal plans that I refer to.

Now, at the opposite extreme of the range of considerations that one might take in considering pension fund is this question of economic power that large investment control brings to the trustees of pensions funds. I think that the kind of legislation I recommend would have a beneficial effect in giving some control over trustees, while still leaving the wide degree of flexibility that is necessary in prudent employment of pension fund assets. And I agree on this subject with Professor Dietz.

But I think this fiduciary standard that I have been speaking of should be extended to include employers who can manage their own funds, and who after all administer about 90 percent of the pension funds. It is not clear in Labor Department reporting whether that

refers to actual investment of the fund—undoubtedly it is not that extensive—or simply the parceling out of funds once the employees have retired.

But with a rule such as I proposed I think the principal advantages of our capital allocation system would be preserved, and the funds would be free to flow where they are most needed in the economy, with the possible exception that they are not going to go down to the people who are poor. They are people who are not incorporated in this system.

Incidentally, I feel that one of the major problems of pension funds is that they are not extensive enough. They do not cover much more than about a third of the labor force. This is an excellent institution, one very much needed in our economy, but not prevalent enough.

But the legislation that I am recommending would produce a somewhat less desirable effect. There is no doubt now that the dominant institutions in our economy are the financial institutions and that power to grow, to innovate within the economy depends very much on the power to direct the application of capital.

Various studies have shown the striking rise of the financial intermediaries as participants in economic activities since World War II.

Now, to require that all pension fund administrators with discretionary powers be subject to the fiduciary responsibilities of common law trustees would drive those pension fund administrators not already there into the expert arms of the banks and trust companies. So it would increase the power of the financial intermediaries.

Such a move, I think, would hasten the development of a situation which is already very well formed. Capital funds in our economy are really more like income, and they are more accurately conceived in terms of flows and claims than as possessions or wealth of any static kind. The old concept of wealth that we used to have is passing, and possession, ownership and all that these terms imply are outmoded concepts.

I note in the quotation from the TIAA report that the teachers are called owners in part of some of the institutions in which the fund invests. But it is a very, very weak and watered-down kind of ownership, if indeed it can be called that at all.

I would maintain that we are all sharers in a system of wealth generation and distribution, and that to buy a share of stock in a corporation now is to purchase a claim on the system, not to acquire proprietary rights. The financial institutions which control pension, mutual fund and insurance investment advanced this procedure rapidly to a point where the true power holders on the economic side of our life are not those who hold title to wealth, but those who by their ability to control the flows of funds can control what kind of economic activity shall be encouraged or discouraged.

Now already financing of business is so systematized that expansion and growth is severely limited for the small entrepreneur. The evolution of the pension fund is not a bad case in point. The demands for efficiency and expertise in fund management are such that the large financial institutions have a great advantage over the small and amateur investors. Funds flow into their hands at an increasing rate, and efficiency dictates that they dispose of them in

the largest blocks possible. This means that it is less and less efficient to service the loan to a small business, and that the larger enterprises will have access to funds at preferred rates.

These tendencies, as I see them, tend to reinforce one another. For this reason the activities of the financial intermediaries are increasingly affected with the public interest.

Now, I do not say this is wholly bad. I believe that the financial intermediaries are deeply conscious of the quasi-public role that they play. But it is still possible for them to think that what is good for the financial community, is also good for the country.

With these considerations in mind, though, I would not recommend the imposition of new restrictions upon the activities of the financial intermediaries as an answer to the buildup of power in their hands.

Here I would like to observe that it is probably premature to think of that before we have the evidence of the current study of institutional investing underway at the Securities and Exchange Commission. I understand that the subcommittee will be having at least one witness who is capable of reporting on the progress of that study.

We need much more information than we have now about these activities before we begin to regulate them in any specific way.

But as a broad objective of public policy I would recommend greater public disclosure of the activities of the financial institutions. Such a study as is going on now in the Securities and Exchange Commission ought to be an ongoing thing. It would not, for example, be unduly burdensome for the trustee of a pension fund to publish annually or semiannually a current list of portfolio holdings so that persons with an interest in their activities could follow them.

To go further at this time and report all fund transactions would be needlessly burdensome.

This kind of disclosure, I would argue, would be valuable for all financial intermediaries of a certain size. But here we are only speaking of pension funds. The need for new government supervision of institutional investment of savings has not been demonstrated, I think, but the need for greater information in a readily available form is beyond question because these institutions have such a profound impact on our public welfare.

I would suggest also that the problems extend more broadly than pension funds. Even a cursory study of pension investment shows that neither its wisdom nor its economic effect can be gauged without considering a whole host of other factors which bear upon the economic future of a prospective pensioner. Some of those factors were referred to by Professor Dietz earlier in his paper.

As prime movers in the creation of the future we all are going to share, the financial intermediaries, all of them, deserve a high degree of responsible scrutiny. The very least that can be demanded of them by the government is a full disclosure of their activities. Such disclosure need only be of a retrospective nature, and if it is, it could not be harmful to any serious investment target they might legitimately seek.

I would like to conclude my remarks with an observation on pension security that I made when I first began to study this subject

some dozen years ago, that pension expectations are no better than the health of the ongoing economic system.

If we face a serious and prolonged depression, these commitments and expectations are doomed, I think, to serious and widespread disappointment.

These expectations are more nearly tied to financial market fluctuations than life insurance, for example, but because of their diversification in assets and participants—people are born into them and die out of them—they are probably a good deal safer than personal savings.

Roger Murray has really said the same thing at the conclusion of the National Bureau of Economic Research study. He said:

> We can expect that it will become common knowledge that the validity of the pension promises ultimately rest on the capacity of our economy to grow in productivity and to achieve higher standards of living for citizens of all ages.

Which really means that we cannot consider the subject of pensions piece-meal, we have to consider it—and I do not think I am enlightening the committee particularly on this—in relation to all the other financial currents that go to make up our economy.

Thank you, Madam Chairman.

(The prepared statement of Mr. Harbrecht follows:)

PREPARED STATEMENT OF PAUL P. HARBRECHT

I should like to address myself to what I take to be the present major concern of this Subcommittee, as expressed by Chairman Griffiths, and that is, how well have pension fund managers invested the funds which they control? In my opinion, the short answer to this question has to be that they have not done too badly, given the overall objectives of pension fund investment. These are not Go-Go funds, nor are they intended to be as devoid of risk as life insurance policies.

The aggregate figures supplied annually by the Securities and Exchange Commission seem to justify a claim of success. When speaking of the performance of pension funds it is dangerous to generalize, however. At the outset we must distinguish between the large single or multi-employer plans or Taft-Hartley funds and the small union or employer managed funds. It would not be safe to conclude that all is well with the pension funds merely because it can be demonstrated that the vast bulk of the monies covering the majority of employees is well invested. It is, indeed, but there are hundreds of thousands of employees in smaller plans whose trustees are unable or unwilling to hire Wall Street investment talent or its local equivalent.

On occasions like these hearings the representatives of large companies, large unions, large financial institutions and expertly staffed consulting firms are quite vocal. They have a good case to present, but they do not speak for the employee in the small plan in which neither the employer nor the employee representative is very sophisticated about financial affairs. Such plans can and often do invest in local businesses, highly speculative securities, or at the other extreme, in such a conservative manner as to lose much of the advantages of the pooled capital which is really the savings of a group of employees.

Often the position of a pension fund trustee is assumed by a union official who has no other qualification for the task than that he is popular with his fellow workers. Often the employer, while he is good at managing a business is very naive when it comes to investments. It is not his line of work.

To be a pension fund trustee is often considered honorific and it can be lucrative when there is a fat stipend for attending the annual or semi-annual meetings of the trustees. Certain officials who actually handle pension monies may have to be bonded, so there is some protection against outright dishonesty but there is no protection against sheer incompetence and since there is no sanction, it is all too possible to get incompetent trustees.

This kind of problem could not be so prevalent if it were clear that a pension fund, and here I am talking only about the so-called self-insured funds,

is in fact a true trust. Very few courts have declared that these plans are genuine trusts so that a beneficiary, the employee in this case, may have a legal right to an accounting and so that the fund trustees are bound by the "prudent man" rule in managing the funds of a pension plan.

The suggestion I would like to make to this Subcommittee is that a federal statute be enacted declaring that any person who has discretionary power over pension fund monies shall incur all the obligations of a common law trustee. An excellent model for what I have in mind is the Federal Trust Indenture Act of 1939 (15 U.S.C. ss. 77 aaa 1952). This act was aimed at the frequent use of trust indentures which failed to provide security holders with essential protection and absolved trustees from minimum obligations. It requires that a trustee be free from any conflict of interest; imposes high standards of conduct; provides for reports and notices from the trustee to security holders; prohibits impairment of the security holders rights to sue individually; and requires the maintenance of a list of security holders which may be used by the security holders themselves to communicate with one another regarding their rights.

Such a statute has much to recommend it, particularly in the light of the kinds of exculpatory clauses much in use in the standard type of pension trust documents. These clauses are used in the pension plan itself to protect the employer from certain claims that may be made by the employee against him and are also used in the trust indentures to insulate the banker trustee from claims by employees or pensioners.

Such a statute is necessary because most of the states seem reluctant to act in this area and because the courts are unlikely to take the initiative in declaring that these arrangements are in fact true trusts. The defense of the employers against such a claim is that the obligation to pay a pension is a contractual matter between employer and employee. Whether the employer chooses to pay this obligation out of the company treasury, they argue, or out of some fund he has established does not concern the employee.

There is a good deal of logic in this argument, but it is unrealistic. In the first place, one of the great incentives to establish a pension plan is that the contributions to and earnings of such a plan are tax free. It is a requirement of the tax law that funds so treated shall no return to the employer. The object of this public largesse is surely the worker and not the employer. If these funds are to be free from the burden of taxation, and if the employer is to have the advantage of earning money to pay pensions by tax free capital investment, he should not quarrel with a further regulation that the sequestered capital be invested prudently.

There are two ways at least, in which the objective of prudent investment might be furthered by legislation. One would be to expand the existing power of the Secretary of Labor to oversee pension investment. He may now command a certain amount of reporting. He could be further directed to require of pension fund investors that they purchase securities from a preferred list. An elaborate set of statutory prohibitions and mandates could be enacted attempting, in effect to codify the "prudent man" rule for federal purposes.

I submit, however, that such a detailed list of directives would needlessly restrict trustees and would also be impossible to police without expanding the staff of the Labor Department beyond all reason. Furthermore, the burden of reporting all transactions made on behalf of pension funds would be too great for large pension fund trustees, such as the Chase Manhattan Bank or the Bankers Trust Company.

The second possibility, which I would recommend, would be to declare by statute that these trustees are bound by the "prudent man" rule as interpreted by the courts of the state where any challenged transaction took place. The right to sue the trustees in a federal court should be extended to all members of pension plans and the Secretary of Labor should also be given the right to bring suit on behalf of plan members in situations where they cannot or will not act. Pertinent to this obligation, he should be given authority to investigate, with subpoena powers, whenever he has reasonable grounds to suspect that a federal statute is being violated.

Such a statute would have the effect of putting the managers of pension fund assets into the same position as the Federal Trust Indenture Act of 1939 put the sellers of securities. Banks and trust companies are already operating under similar strictures in their management of private trust funds, endowment funds, etc. The statute I propose would only spell out the standards they now

purport to apply to themselves, but it would have the added effect of extending the same restrictions to non-institutional trustees.

THE RISE OF ECONOMIC POWER

The kind of legislation I have recommended would, I think, have a very beneficial effect in that it would provide for the maximum degree of flexibility consistent with prudence in the deployment of savings. A fiduciary standard would come into effect which would bind portfolio managers and tend to force employers, who, after all, administer about 90% of all pension and profit sharing plans, to avoid self-serving investment policies. At the same time one of the principal advantages of our capital allocation system would be preserved; that is, funds would be free to flow where they are most needed within the economy.

A somewhat less desirable effect would also be produced. There is little doubt that the dominant institutions in our economy are now the financial institutions. Power to grow, to innovate, within the economic sphere depends very much upon the power to direct the application of capital. Various studies have shown the striking rise of the financial intermediaries as participants in economic activity. To require that all pension fund administrators with discretionary powers be subject to the fiduciary responsibilities of common law trustees will be to drive those pension fund administrators not already there into the expert arms of the banks and trust companies.

Such a move will hasten the development of a situation which already exists, that capital funds in our economy are much like income and are more accurately conceived of in terms of flows and claims than as possessions or wealth of a static kind. Possession, ownership and all that these terms imply are now outmoded concepts. We are all sharers in a system of wealth generation and distribution. To buy a share of stock in a corporation is to purchase a claim on the system, not to acquire proprietary rights. The financial institutions who control pension, mutual fund and insurance investment advance this process more rapidly to a point where the true power holders on the economic side of our life are not those who hold title to wealth, but those who by their ability to control the flows of funds can determine what kind of economic activity shall be encouraged or discouraged.

Already financing of business is so systematized that expansion and growth is severely limited for the small entrepreneur. The evolution of the pension funds is not a bad case in point. The demands for efficiency and expertise in fund management are such that the large financial institutions have a great advantage over the amateur investor. Funds flow into their hands at an increasing rate and efficiency dictates that they dispose of them in the largest blocks possible. This means that it is less and less efficient to service the loan to the small business, and that larger enterprises will have access to funds at preferred rates.

For this reason the activities of the financial intermediaries are increasingly affected with a public interest. I do not hold this to be wholly bad. I believe that the financial intermediaries are deeply conscious of the quasi-public role they play, but it is still possible for them to think that what is good for the financial community is good for the country.

With these considerations in mind, I would not recommend the imposition of new restrictions upon the activities of the financial intermediaries as an answer to the build-up of power in their hands. (At the moment, anyway, recommendations of that nature would be premature. The current study of institutional investing underway at the Securities and Exchange Commission ought to shed some much-needed light on the problem.)

As a broad objective of public policy, however, I would recommend greater public disclosure of the activities of the financial institutions. It would not, for example, be unduly burdensome for the trustee of a pension fund to publish annually or semi-annually a current list of portfolio holdings so that persons with an interest in their activities could follow them. To go farther at this time and report all fund transactions would be needlessly burdensome. This kind of disclosure would be valuable for all financial intermediaries of a certain size, but here we are only speaking of pension funds.

The need for new government supervision of institutional investment of savings has not been demonstrated, as yet, but the need for greater information in readily available form is beyond question. I would suggest also that the

problem extends much more broadly than merely to pension funds. Even a cursory study of pension investment shows that neither its wisdom nor its economic effect can be gauged without considering a whole host of other factors which bear upon the economic future of a prospective pensioner. As prime movers in the creation of that future the financial intermediaries, all of them, deserve a high degree of responsible scrutiny. The very least that can be demanded of them by government is a full disclosure of their activities. Such disclosure need only be retrospective and if it is, it could not harm in any notable way the kind of market advantage they can legitimately seek.

I should like to conclude with an observation on the subject of pension security that struck me profoundly some dozen years ago; that pension expectations are no better than the health of the ongoing economic system. They are more nearly tied to financial market fluctuations than life insurance, but because of their diversification in assets and participants are probably a good deal safer than personal savings. Roger Murray has put the same thought this way:

"We can also expect that it will become common knowledge that the validity of pension promises ultimately rests on the capacity of our economy to grow in productivity and to achieve higher standards of living for citizens of all ages." [1]

Chairman GRIFFITHS. Thank you very much, Mr. Harbrecht.

I think it is very fortunate that Mr. Lerner is going to testify now.

Mr. Lerner, you may proceed, sir.

STATEMENT OF EUGENE M. LERNER, PROFESSOR OF FINANCE, GRADUATE SCHOOL OF MANAGEMENT, NORTHWESTERN UNIVERSITY

Mr. LERNER. Thank you, Madam Chairman.

Chairman GRIFFITHS. If you would like to skip the first five pages, we will get to the point where you take on Mr. Harbrecht, at the bottom of the fifth page under the heading "The Quality of the Securities Market."

Mr. LERNER. Very well, Madam Chairman.

My name is Eugene M. Lerner, and I am a professor of finance at the Graduate School of Management at Northwestern University.

Following your suggestion, Madam Chairman, I would like to skip the opening statement and I would like to submit my prepared statement for the record along with the exhibits.

Chairman GRIFFITHS. Yes, they will be printed in the record.

(The prepared statement of Mr. Lerner together with attachments follow:)

PREPARED STATEMENT OF EUGENE M. LERNER

My name is Eugene M. Lerner. I am a professor of Finance at the Graduate School of Management, Northwestern University.

My remarks today are directed at the liquidity of the market for the securities that pension funds buy and sell. By liquidity. I mean the ability of buyers to purchase the quantities of securities that they desire and the ability of sellers to dispose of the quantity of securities that they desire without influencing the price adversely, that is, without driving it up against themselves when they buy and without driving it down against themselves when they sell.

The securities of most American corporations are bought and sold in a market that is organized in a slightly different way than the market for many other products that you and I frequently buy. First, the negotiation over the

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[1] Roger F. Murray, Economic Aspects of Pensions: A Summary Report, National Bureau of Economic Research, New York, 1968.

price at which the purchase or sale of a market order will take place is not carried on by the customers who are the ultimate buyers or sellers. Rather, purchase or sale orders are placed through brokers, who, in turn, execute them and charge a commission fee for their services.

Second, if the customer's buy or sell order is relatively small, say for 100 or 200 shares, the brokers will often fill the order by trading with a person who is a dealer in the stock, rather than with another broker representing a customer that wants to sell or buy the security. A dealer is a person who is prepared to buy securities and hold them in inventory or to sell securities to a buyer from his inventory. Moreover, if a dealer does not have the stock that a customer wants to buy in inventory, he will typically sell the security to the broker, and cover his short position by making a purchase at a later date.

In security markets such as the New York Stock Exchange, the American Stock Exchange, the Midwest Stock Exchange, and so forth, the dealers that stand ready to buy and sell are called specialists. These organized exchanges have allocated all of the securities that are listed with them for trading among these specialists.

In addition to buying and selling securities for his own account, the specialist on the floor of an exchange also performs another function: at times he may act as a broker. Suppose that the price of a security is $50 a share and a customer wants to sell 100 shares when the price reaches $53. If the customer gives such an order to sell at $53 to his broker, the broker in turn will give the order to the specialist to fill. At some later time when the price of the security reaches $53, the specialist will fill the order giving it protected preferences and notify the broker that his customer sold his stock.

Not all securities, however, are traded on organized exchanges. Government bonds, as well as the common stocks of most smaller companies, banks and insurance companies are traded in the "over-the-counter" market. This is a market made up of a large number of firms who keep contact with one another through the telephone rather than speak directly to each other as they do to complete a trade on the floor of an exchange. Any brokerage firm operating in this maket can, if it elects, become a dealer in any security it wishes; that is, it can buy any security and carry it in its inventory for resale at a later time.

In recent years, a so-called "third market" has also developed. This market consists of firms that are not members of the NYSE, but are dealers in securities that are listed on the exchange. Weedon and Co. for example is a large brokerage dealer that operates in the third market. This firm maintains an inventory in approximately 250 securities and is therefore a competitor to the specialist on the floor of the exchange in these 250 issues.

A dealer in securities makes money by buying securities at one price and selling them at a higher price. The difference between the price that the dealer will pay for a security, the bid, and the price at which he will sell, the ask, is called the spread.

Any dealer in securities such as a specialist or a firm like Weedon exposes itself to a great deal of risk. Weedon recently indicated in its prospectus that during the first quarter of 1969, the range of its weekly inventories was as follows: tax-exempt bonds, $30,400,000 to $51,500,000; common stocks and convertible bonds, $27,900,000 to $39,900,000; corporate and government agency bonds, $300,000 to $3,000,000; and tax-exempt notes, $850,000 to $40,000,000. Since the company finances its inventories with demand notes from commercial banks and, since its inventories average four to five times the company's capital, an unexpected change in the market price of the securities it holds could cause a decline in the value of its inventory so as to affect substantially or even eliminate the value of its stockholder's equity.

One way that a dealer can reduce his exposure to risk is by simply not carrying a large inventory or highly volatile securities. A specialist on the New York Stock Exchange for example, need only buy 100 shares of the stock that is offered for sale at a specified price; and an over-the-counter firm can "walk away" from a customer that wants to sell a large block of stock to him. Of course, if the dealer turns down "sell" offers too often, brokers will not continue to offer him their business.

A second way that a dealer can reduce his exposure to risk is to slowly change the price or the spread of the securities in which he makes a market. For example, suppose a buyer wants to purchase a substantial number of shares and the dealer does not have them in inventory. The dealer may then offer to sell the shares to the buyer at a price that is higher than the last

trade. When other holders of the stock become aware of this high price, they may offer their shares for sale and the dealer can cover his short position by buying the securities that are offered.

The smaller the spread between the bid and "ask" price and the more willing the dealer is to take either a long or short position in the security, the better the quality of the market or the more liquid the security. The ability of the dealer to make a good market by exposing himself to the risk of price fluctuations in his inventory ultimately depends upon the amount of capital that he is prepared to commit to that issue.

To summarize, the dealer function in the securities market arises because both a buyer and seller only infrequently arrive on the scene at the same time for the same number of shares of the same issue at the same price. When this happens, the two brokers can, of course, negotiate the trade between them. However, since a dealer is always willing to take a position in the security and carry it in his inventory for later resale, both buyers and sellers can effect trades at the moment they desire by trading with him.

So long as a firm performs only a brokerage function, its need for capital is limited to the normal demands of the business; when a firm becomes a dealer, however, its need for capital increases sharply, for the firm must now inventory large holdings of securities and expose itself to the probability of losses that can arise from sharp price changes.

A dealer can limit his risk exposure by widening the spread between bid and ask prices, or by simply turning down some trading opportunities. When this happens, however, the liquidity of the securities in which the dealer makes a market is substantially reduced.

The Quality of the Securities Market

The structure of the security market was detailed above because it provides an insight into some of the factors that influence the price of a company's shares.

The organized exchanges have been structured to meet the trading demands of a large number of relatively small investors. It performs this task well. The trading unit is 100 shares, a reasonable size for most individual investors. Moreover, a specialist on the New York Stock Exchange is required to have enough capital to be able to carry in inventory 1,200 shares of each security in which he makes a market. This is probably an adequate amount of capital to provide liquidity so long as the individual transaction is small and a large number of buy and sell orders cross the floor of the exchange during a day.

Over the past decade, however, a marked change has taken place in the distribution of holdings of securities. Trust departments of banks, mutual funds, pension and profit-sharing plans, insurance companies and other institutional holders of securities have increased in absolute size and relative importance.

These institutions have placed new demands upon the securities market. One of their distinguishing features is that they tend to buy and sell large blocks of stock rather than 100 or 200 shares, simply because their holdings are so extensive. Another is that they do not require, by and large, the same type of services that a typical brokerage firm supplies its small investors. They typically do not require one-paragraph reports on new developments in specific corporations, for they are capable of performing their own analysis of companies. Similarly, they do not need analyses of market trends, economic indicators, or world events for they tend to have their own economic and research staffs. The service these institutional holders demand is the ability to buy and sell large blocks of stock quickly and without affecting the price of the security adversely: that is, without driving it up against themselves as they buy, and without driving it down against themselves as they sell. In short, these institutions want a liquid market.

Institutions therefore generally prefer to do business with those brokerage firms from whom they can buy or sell the securities in which they have an interest quickly and efficiently. This may require that the brokers themselves become dealers and buy or sell directly the securities in which the institution has an interest. At a minimum, it requires the brokerage firm to have the ability to find quickly other large buyers and sellers of the same securities so that a trade can be accomplished. Behind these preferences is the assumption that the specialist on the floor of the exchange, to whom any broker could

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take the trade, may be unable to handle the business because of his inadequate capital or his unwillingness to expose himself to the risk of a price fluctuation.

It was to meet this demand for increased liquidity that the third market developed, for dealers like Weedon do take substantial positions in securities. Moreover, to meet these institutional demands, major member firms of the New York Stock Exchange like Solomon Bros. and Hutzler, Bear, Stearns and Co., and others have become position houses or dealers rather than remaining exclusively brokers to small investors.

With specialists, third market firms, and a growing number of position houses, how liquid is the market for the securities that an institution might purchase? The answer to this question must be tentative for in spite of its obvious importance, little empirical work has been done in this area. To provide a partial answer to the question, however, the transactions of a relatively small investment fund were studied in detail over the nine month period from September, 1968 to June, 1969. During this period, the fund made 46 purchases and 29 sales. A sample list of the securities it dealt with is presented in Table 1. All of these companies are well known and most are listed on the New York Stock Exchange.

TABLE 1.—*Companies that the Fund Purchased or Sold During the Period September 1968–June 1969*

Goodyear Tire & Rubber Co.	Motorola, Inc.
Smith Kline & French Laboratories	American Cyanamid Co.
Litton Industries, Inc.	Aluminum Co. of America
National Lead Co.	Bethlehem Steel Corp.
Zenith Radio Corp.	Mortgage Guarantee Insurance Corp.
Weyerhaeuser Co.	J. C. Penny
Westinghouse Electric Corp.	Scott Foresman
Reynolds Metals Co.	Becton Dickinson & Co.
Hewlett-Packard Co.	Honeywell, Inc.
Armstrong Cork Co.	Parker-Hannefin Corp.
R. R. Donnelley & Sons	Trane Co.
Dun & Bradstreet, Inc.	Ford Motor Co.
Eastman Kodak Co.	General Electric Co.
International Business Machines	G. D. Searle & Co.
Monsanto Co.	Western Publishing Co.
Pfizer (Chas.) & Co., Inc.	Max Factor & Co.
Scott Paper Co.	U.S. Steel Corp.
American Metal Climax	O. M. Scott & Sons, CIA
Caterpiller Tractor Co.	American Telephone & Telegraph
Sunbeam Corp.	Merck & Co.
U.S. Gypsum Co.	Sterling Drug, Inc.

The 46 orders that were placed range in size from 600 shares to 6,800 shares. The data in Table 2 show that the order size of both purchases and sales clustered between 1,500 shares and 4,500 shares. These are not large blocks, which are usually defined as orders of 10,000 shares or more. They are rather, the medium-sized orders that a typical institution tends to purchase.

TABLE 2.—A DISTRIBUTION OF ORDER SIZES PLACED BY THE FUND

	Number of buy orders	Number of sell orders
Size:		
Less than 1,500 shares	2	1
1,600 to 2,500 shares	12	7
2,600 to 3,500 shares	11	7
3,600 to 4,500 shares	13	8
4,600 to 5,500 shares	3	3
5,600 to 6,500 shares	2	2
6,600 to 7,500 shares	3	1
Total	46	29

One measure of the quality of a market is the number of transactions that are required to fill an order. The data in Table 3 indicate that 10 of the 46 purchase orders were handled in a single trade; 13 required two trades and one order required 10 separate transactions to fill the order. Some of these transactions took place over several days, though most were completed within a single day. Since less than a third of the purchase orders were filled in a

single trade, these figures suggest that it was relatively difficult for this fund to accumulate even a modest size position in the securities it wanted to buy.

The data in Table 3 also show that it was a little easier for the fund to sell securities, for over half or 16, or the 29 sell orders that they placed were consummated in a single transaction. One sell order, however, required nine separate transactions because the entire position in the security could be liquidated. Unfortunately, these data are too fragmentary to be more than suggestive about possible differences in the market between buying and selling securities.

TABLE 3.—NUMBER OF ORDERS FILLED AT VARYING TRANSACTION LEVELS

	Number of buy orders	Number of sell orders
Number of transactions required to fill order:		
1	10	16
2	13	4
3	10	5
4	8	1
5	3	1
6	1	0
7	0	1
8	0	0
9	0	1
10	1	0
Total	46	29

When more than one transaction took place to fill an order, different prices could be paid for the security. The data in Table 4 show the range of prices that resulted from filling a single order. Thirteen purchase orders were filled in two separate transactions. The first row of the Table indicates that eight times both transactions took place at the same price; twice one-eighth of a point separated the two trades; once 1¼ points separated the two transactions. The bottom line of Table 4 provides a summary of the price differences between transactions of the same order. Sixteen of the 36 buy orders that involved more than one transaction were filled at the same price or at one-eighth of a point difference between the highest and lowest price; only two of the 12 sell orders, however, were filled at the same price or at one-eighth differential. A point spread of more between the lowest and highest transaction price characterized seven of the 36 buy orders and two of the 13 sell orders. These fragmentary data suggest that not only were several transactions required to fill most of the orders that the fund placed, but the transactions themselves took place at widely varying prices.

Each decision to buy or to sell that this fund made was reached at the close of a business day, and the order to buy or sell was placed the following morning. The price at which the security closed on the day the decision to buy or to sell was noted, and an estimate was prepared of what the cost of the transaction would be if it would be consummated at the closing price. Thus, if 4,000 shares of a stock selling at $50 was to be purchased, the estimated cost would be $200,000. This figure ignores commissions, which in this example would be $440 for the first 1,000 shares and $840 for the next 3,000 shares (if the trade is completed on the same day) or a little less than one per cent of the value of the trade.

TABLE 4.—PRICE SPREAD IN MULTIPLE TRANSACTION ORDERS

BUY ORDERS

Number of transactions	Number of orders	Price spread between highest and lowest transaction										
		0	⅛	¼	⅜	½	⅝	¾	⅞	1	1⅛	1¼
2	13	8	2	1						1		1
3	10	3		4		1		1		1		
4	8	1	1			1	1		2	1		1
5	3			2								1
6	1	1										
7	0											
8	0											
9	0											
10	1											1
Total	36	13	3	7		2	1	1	2	3		4

SELL ORDERS

Number of transactions	Number of orders	Price spread between highest and lowest transaction												
		0	⅛	¼	⅜	½	⅝	¾	⅞	1	1⅛	1¼	1½	3½
2	4		2		1	1								
3	5			2		1		1						1
4	1								1					
5	1			1										
6	1					1								
7														
8														
9	1												1	
Total	13		2	3	1	3		1	1				1	1

The data in Table 5 illustrate still another dimension of the quality of the market, for it shows the actual payments as a percentage of the expected payments during the months in which the transactions occurred. Note that the average buy order cost 1.46 per cent more than the planned amount, and that the average sell order realized only 98.44 per cent of the expected return. In short, on the buy side the company paid about one-half of one per cent more than it expected to pay if commissions alone were charged and it could purchase the stock at the closing price of a day ago. On the sell side, it realized about one-half of one per cent less than it expected if commissions alone were charged.

The one-half of one per cent variation in payments and returns are, of course, attributable to a price change. There is no reason to believe that securities can be purchased on one day at the closing price of the previous day. But the fact that the fund's buy orders tended to take place at higher prices and that its sell orders took place at lower prices than expected is consistent with the view that the market was so thin that even this modest size fund had the capacity to alter the price of the stocks in which it traded.

TABLE 5.—PERCENTAGE DIFFERENCE BETWEEN REALIZED EXPECTED OUTLAYS BY MONTHS DURING WHICH TRANSACTIONS OCCURRED

	Buy orders (percent)	Sell orders (percent)
September 1968	101.41	
November 1968	100.71	99.35
December 1968	100.39	97.75
February 1969	101.52	97.82
March 1969	102.55	96.29
April 1969	97.81	99.51
May 1969	101.02	98.48
June 1969	106.32	99.86
Average	1.46	98.44

Ten buy orders and 16 sell orders were filled in one transaction. Once again, the price at which the trades took place was compared to the closing price one day earlier. The data in Table 6 on the buy side are inconclusive; on the sell side, 10 of the 16 trades took place at lower prices than the previous close.

It can be argued, of course, that these results occurred because the buy orders were placed for relatively attractive securities and the sell orders for securities that many analysts came to recognize as being too high-priced. A more constructive approach to these data, however, is to recognize that they may have important implications for both the securities' business and for corporate financial managers. They suggest (and further work would have to be done to make more definitive statements) that it is difficult to buy and sell even a modest size block of stocks and that in the process of accumulating or disposing of the shares the seller may have an impact upon the price at which the stock trades. Moreover, since more and more shares are being accumulated by institutions because of the savings' habits of the country, the problem associated with block trading and the lack of liquidity in the securities market is likely to increase rather than diminish in the years to come.

TABLE 6.—THE DIFFERENCE BETWEEN REAL'ZED AND EXPECTED PRICES FOR ORDERS WITH A SINGLE TRANSACTION

	Buy orders	Sell orders
Over −1¼	0	3
−⅞ through −1⅛	1	2
−4/8 through −6/8	1	1
−⅛ through −⅜	2	4
0	1	1
+⅛ through +⅜	1	3
+4/8 through +6/8	2	0
+⅞ through +1⅛	0	1
Over +1¼	2	1
Total	10	16

The question of how dealers can make better markets is a major concern of the securities industry. Probably a prerequisite for a better market is for dealers to have more capital. But the availability of capital ultimately turns on the expected rate of profit throughout the industry as a whole. The profit rate in turn depends upon such questions as the prices charged for services, the volume and nature of services to offer to customers and the efficiency of both the stock exchanges and the brokerage firms themselves.

Perhaps the most important factor impacting profits in all aspects of the securities business today, however, is the fail problem. A fail arises when a customer, such as a pension fund, purchases a stock and fails to receive the certificates they purchased in the required five day period.

Fails are costly for a number of reasons. First, they require the multiple handling of transactions. Since the brokerage business is heavily labor intensive, handling a fail is much more costly than processing trades that are cleared efficiently. Secondly, interest expenses of the brokerage firms rise because if a firm is to make a good delivery, it must borrow the securities it owes from another source and pay the lender interest. Third, a fail increases the risk exposure of the firm for the broker that fails to receive the security due him can "buy in" the stock. "Buy ins" always cost the selling broker the difference between the buy in price and the original transaction price. Fourth, the SEC scales down the value of a broker's assets if a fail lasts beyond a specified period. This scale down can impair the broker's usable capital. Finally, as the volume of fails rise, the number of errors, misclassified dividends, and even thefts can rise.

Fails can arise for many different reasons. A broker can place an incorrect order; the selling broker may not promptly receive certificates from his customer; the transfer agent may be slow; the certificates that are delivered may not be accepted because they were not transferred correctly or the dividends that were due were not properly transferred, and so forth. This enumeration of specific sources of fails, however, misses the point that there is a total system problem here for if one part of the entire process of purchasing and delivering securities does not perform up to expectation, the repercussions are felt on banks, brokerage firms and the customers as well. If a basic improvement is to be made in this area—and in my opinion it must be if capital is to be attracted to the industry—the redesign of basic parts of the system must take place.

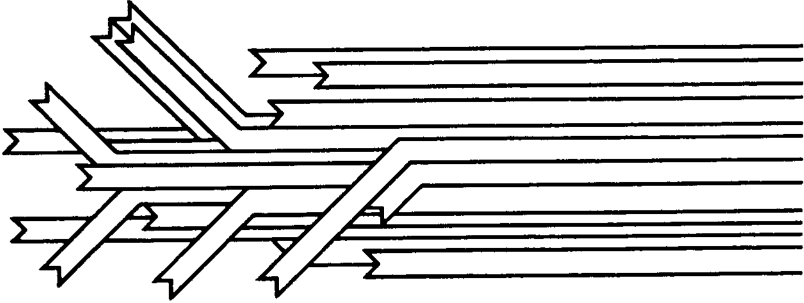
The proposal to redesign is not a radical plan. Leaders in the industry have long urged it and the Midwest Stock Exchange has developed a fully operational system—called continuous net settlement—which, if it were adopted and used by all of the exchanges would substantially eliminate the fail problem.

I am attaching an exhibit to my testimony of a statement prepared by the Midwest Stock Exchange of how the system they designed would function.

To summarize my remarks, a liquid market for securities is required pension funds and profit sharing plans; one prerequisite for a liquid market is that the amount of capital that the brokerage industry has be increased. For capital to be raised, however, the profits of the industry must increase and for profits to rise, the fail problem or the production process of transferring a stock must be eliminated. Perhaps the best way of achieving this end, a way that is practical and that I believe enjoys the support of a large portion of the brokerage industry, is the adoption of the continuous net settlement system.

CONTINUOUS NET SETTLEMENT

A NEW CONCEPT IN CLEARING FROM THE MIDWEST STOCK EXCHANGE CLEARING CORPORATION



continuous net settlement for the high volume trading of the seventies

A few years ago, it became obvious to us that with trading volume on the increase (up 317% in the past ten years on the MSE), a bold new approach to the clearing function was needed.

After 15 months of research and development, we have designed a new concept in clearing which offers major economies and far greater speed to our member firms, as well as virtual elimination of "fails." We call this new concept "Continuous Net Settlement" (CNS)

The advantages are many

CNS is simply the offsetting (or netting) of sales and purchases by each broker in each stock. Under our old manually operated system, clearing was effected on a trade-for-trade basis. That is, there was a corresponding delivery and receipt of securities for every trade.

Under CNS

Sales and purchases in a given issue are continuously offset against each other and against the broker's opening position. Only the balance (net difference) need be settled by physical delivery of stock certificates.

Continuous Net Settlement will improve your operating efficiency and save you money because:

- *Carrying costs are reduced* by cutting security movement and in-transit time.
- *Saves time and money and gives customers better service* by offsetting transactions in your own office.
- *Certificates available to satisfy your customer's needs faster* since there is less stock tied up in transit, and CNS provides stock for automatic borrowing.
- *Fails drastically reduced.* In most cases, a buyer will be able to obtain stock from Clearing on settlement day—whether or not the seller has delivered stock to Clearing.
- *For your protection,* stock positions will be marked to the market daily.
- *Provides potential for major long-range savings in personnel costs* because future increases in clearing volume will not require proportionate backoffice expansion. CNS is an automated, computerized operation.
- *Increases Clearing's capability to handle greater volume* of work under better control . . . at lower unit costs . . . thus assuring all service requirements for all members . . . all the time.

How Continuous Net Settlement works

There are basically two kinds of positions in CNS. One is a "free" position, in which the broker has taken ownership of the stock and has paid for it. The second is a "value" position, in which the broker owes, or is owed, stock.

Here are examples of each position:

Free Positions

Long Free:

The broker is in a "long free" position when he does not take delivery of stock for which he has paid—or he has delivered stock to Clearing in anticipation of a subsequent sale of that stock.

Transfer:

A transfer by Clearing of fully-paid-for securities as instructed by the broker.

Loan Free:

To make the most effective use of stock, Clearing will encourage brokers who have stock available to deposit it with the system for loan purposes. Until the stock is loaned to other brokers it will be retained in a "free" position in MSECC's "box."

Value Positions

Long Value:

Whenever a broker's purchases (plus or minus his opening position) exceed his sales, he is in a long value position. MSECC owes him stock and he owes MSECC money to pay for the stock.

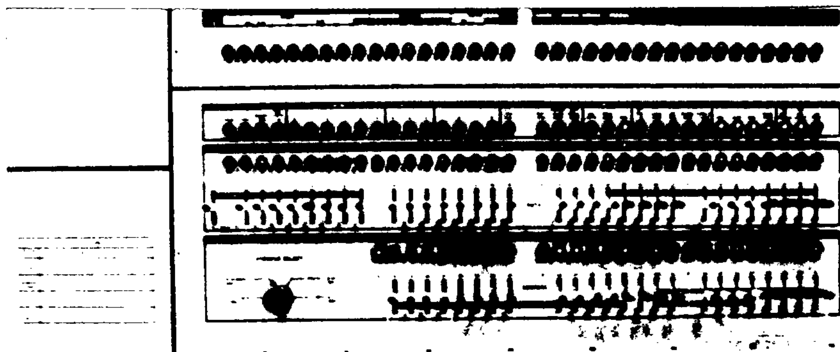
Short Value:

When a broker's sales (plus or minus his opening position) exceed his purchases, he is in a short value position. He owes stock to MSECC for which he will be paid when he delivers.

Loan Value:

When stock deposited for loan purposes is needed by the CNS system, the stock will move from "loan free" to "loan value" automatically. The broker will at that time be paid at the current market price.

In CNS, it is important to keep in mind that sales and purchases in a given issue are continuously offset against each other and against the broker's opening position. Only the balance (the net difference) need be settled by the physical delivery of stock certificates.



Although the basic CNS concept is simple enough, in actuality the system is rather complex. To help put the CNS system to work for you, we have a specialized team of experts to teach your people how the system operates.

How CNS Works . . . typical examples

The best way to give you a quick look at CNS and how it works is to follow the trading activities of an MSE member firm through typical transactions. In this way you'll have a clear picture of what CNS can do for you—and how it does it.

Let's see what happens when Able, Baker & Charles, a new MSE member firm, begins its first trading day. On this day, the firm purchases 100 shares of General Motors. Five days later (on Settlement Day One), it received a net position report from Clearing showing the following:

Firm: Able, Baker & Charles
Stock: General Motors Corporation common

Settlement Day One

Opening Position

Long Value:	0	Long Free:	0
Short Value:	0	Transfer:	0

Closing Position

Long Value:	100	Long Free:	0
Short Value:	0	Transfer:	0

On its second trading day on the MSE, Able, Baker & Charles purchased 300 shares and sold 100 shares of GM. This trade increased AB&C's long position by 200 shares:

Settlement Day Two

Opening Position

Long Value:	100	Long Free:	0
Short Value:	0	Transfer:	0

Closing Position

Long Value:	300	Long Free:	0
Short Value:	0	Transfer:	0

On day three, Able, Baker & Charles paid Clearing for the 300 shares it had in long value, asked that 100 shares be transferred to its firm name, and left the remaining 200 shares on deposit. Here is how the third settlement day shapes up:

Settlement Day Three

Opening Position

Long Value:	300	Long Free:	0
Short Value:	0	Transfer:	0

Closing Position

Long Value:	0	Long Free:	200
Short Value:	0	Transfer:	100

On trading day four, Able, Baker & Charles sold 400 shares of General Motors. These are its positions with Clearing five days later on Settlement Day Four:

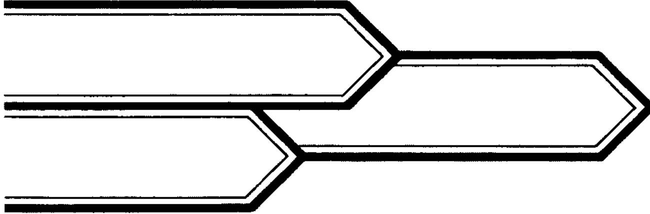
Settlement Day Four

Opening Position

Long Value:	0	Long Free:	200
Short Value:	0	Transfer:	100

Closing Position

Long Value:	0	Long Free:	0
Short Value:	200	Transfer:	100



On settlement day five, Able, Baker & Charles received the 100 shares which had been transferred into firm name, and delivered 200 shares of General Motors in settlement of its short position:

Settlement Day Five

Opening Position

Long Value:	0	Long Free:	0
Short Value:	200	Transfer:	100

Closing Position

Long Value:	0	Long Free:	0
Short Value:	0	Transfer:	0

In its five days of trading, Able, Baker & Charles had two "buys" for a total of 400 shares, and two "sells" for a total of 500 shares. Yet in settlement of those four transactions during 5 days, it had only one receipt and one delivery. More significantly, Able need not have made the one delivery if it anticipated future purchases which would offset its sell (short) position in whole or in part.

Why CNS is virtually "fail-free"

For any number of reasons, your customer may not deliver stock to you in time to avoid a fail.

For example, let us say a customer, from a cruise ship enroute to the Bahamas, orders you to sell 100 shares of General Motors. He is out of the country and his certificates are in his safety deposit box in a Chicago bank, making it literally impossible for him to deliver them to you for at least a few weeks. Under the old Clearing system, you would then have a fail.

With CNS, Clearing would normally have enough General Motors stock in the system to send 100 shares to the buyer on the fifth day. At the end of the business day on which the order was placed, you would have a "short position" in General Motors stock, as far as Clearing is concerned.

When your customer returns from the Bahamas 10 days later, he delivers the 100 shares of General Motors to you. You in turn deliver it to Clearing and receive payment for it on that same day. Clearing's computers will now credit your account and debit Clearing's.

The buying broker is protected

The broker on the buy side is likewise protected against a fail. Naturally on settlement day, the buying broker wants the 100 shares of General Motors for his customer. Under the old Clearing system, the selling broker would have failed to make delivery because his customer did not deliver the

shares to him. Under the CNS system, the buying broker simply tells Clearing to transfer 100 shares of General Motors to its customer. This delivery is made and the buying broker is charged for it. Thus, the buying broker can depend on delivery by settlement day. There are many reasons why it is important for the buying broker to know that he'll receive delivery, one of the most important of which is customer satisfaction. A member participating in a "fail-resistant" system such as CNS is unaffected by any of the dozens of situations that cause fails because CNS will be able to deliver on time.

We anticipate that Clearing will normally have stock available to fill all members' needs. Requests for delivery will be honored according to time received and the member's position in the stock. Free and long positions will have precedence over short positions.

How Continuous Net Settlement gives you price protection

CNS is based on a continuous "netting" process. As a result, price identification (i.e. contract price) of individual transactions is lost in the merging process which takes place on settlement day.

In order to price transactions and value positions, CNS, like all "netting" systems, employs a "common" price. CNS, "marks-to-the-market" all positions on a daily basis in order to assure greatest possible price protection to member firms.

As a member firm, you will receive a statement each day which shows the breakdown of charges and credits. This daily statement makes it easy for you to reconcile your figures with those of Clearing. In addition, you will receive an Activity Report and a Daily Net Position Report which will show all movement of stock and money, and their resulting net position, respectively.

Breaking the back office bottleneck

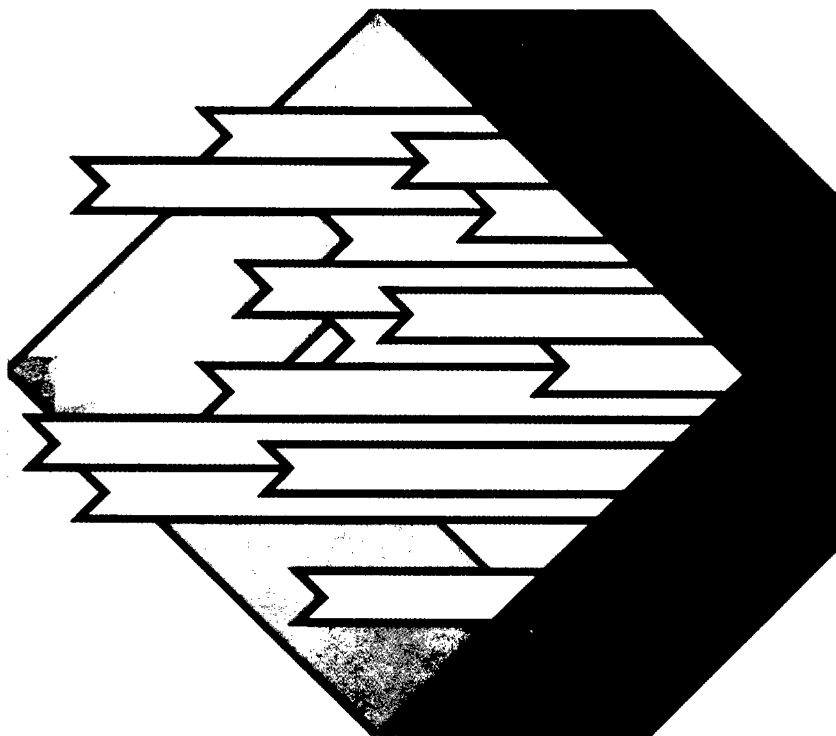
With few fails and little or no movement of actual stock, you will find that CNS will:

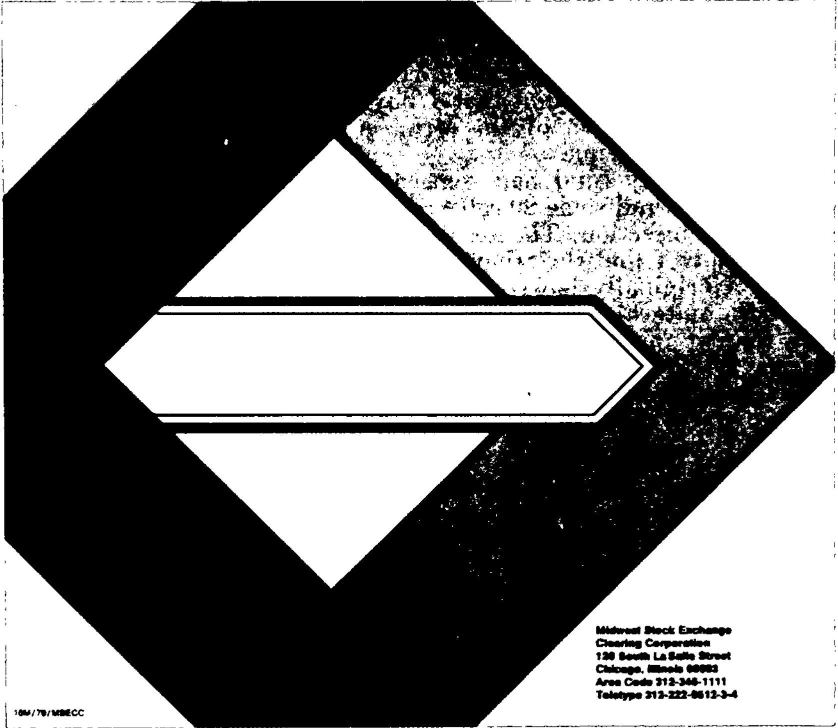
- Permit substantial volume increase with same staff
- Reduce fails to a negligible factor
- Improve cash flow
- Improve customer service via faster and more certain transfers and stock deliveries

CNS . . . a major advance

In summary, CNS represents a major advance in Clearing systems and processes. It is not only capable of handling MSE transactions, CNS is also capable of handling the clearing of listed and OTC securities on a national basis.

CNS, integrated with a central certificate depository system, can bring the securities industry closer to the point where all movement of securities can cease.




Midwest Stock Exchange
Clearing Corporation
120 South La Salle Street
Chicago, Illinois
Area Code 312

Mr. LERNER. In the first five pages I talked about the structure of the market and the role of the dealer, and so on. I say there that the structure of the securities market was detailed because it provides an insight in some of the factors that influence security prices.

I think that the most important point that I make—and let me talk extemporaneously instead of reading the statement—is that there are very high transaction costs associated with buying and selling securities. I studied one small fund. This small fund bought shares in blocks of roughly 4,000 shares at a time. That is substantially larger than the sums that I buy in, but it is not a large block by ordinary definition of the term. A block is usually defined at 10,000 shares at a time.

This particular fund had some 46 buy orders during a specific period of time and some 29 sell orders. I monitored that fund transaction by transaction. The results were shocking to me. But upon further study I find that they were shocking for the wrong reason.

When I originally looked at the transaction costs I thought that they were quite high. In general this fund paid about 1½ percent more than it might have expected to pay for the purchase of securities. By that I mean, if the price of a stock was $50 a share on Monday and the fund began to buy on Tuesday, even the small purchase of 4,000 shares was enough to drive the price of the stock up by 1½ percent.

Similarly, when it sold it drove the price down against itself by roughly the same amount.

I thought that was pretty bad performance until I spent sometime talking to other fund managers. I then found out that they wanted to hire this particular trader because he did such a good job. Their experience is 2½, or 3 percent, both ways.

Now, the entailment of this fact is this: Peter Dietz reported that on the average over a 10-year period funds earned about a 10-percent rate of return. What I am suggesting is that the very act of buying and selling added another 5 percent, 2½ on the buy side, and 2½ on the sell side. Fifty percent of the performance of these funds is therefore given away because of the lack of liquidity that exists in the market.

I think that the lack of liquidity is brought about by inadequate capital. By this I mean, I think that the dealers that buy and sell securities, the brokerage firms that take positions in stocks, the third market firms, and the specialists themselves, essentially have not got enough equity to take the kind of risks that a highly liquid market requires. And I go on to say——

Chairman GRIFFITHS. And you point out that these funds demand a highly liquid market, as I recall?

Mr. LERNER. I think they demand a very highly liquid market. I think that the market as it now exists is perfectly adequate for me and for other academics who buy in hundred share blocks.

Chairman GRIFFITHS. And Congressmen?

Mr. LERNER. And Congressmen. I do not think they are adequate for someone who buys in thousand share units or 10,000 share units. I think the reason for the inadequate capital in the entire industry is the fact that profits are not very high in this business. I think if profits were higher, if they had a higher rate of return, capital

would flow in. So the question of liquidity I think logically turns on the problem of why the rate of return is not high enough to attract more capital. And here the answer, I think, is that the industry, the entire securities industry, which includes brokerage, banks, the exchanges, and so on, have a very bad production function. And by that I mean that they do not do a good job at simply transferring the paper back and forth that we buy and sell. The realization of this became quite popular a year or so ago when the problem of what is called "the fail" appears in all the newspapers. This is the failure to deliver securities in good time. The problem is still severe. The problem of the fail is associated with the production function, with buying and selling the securities. Until a better system of transferring securities is designed—and that will require some legislation—until a better system is designed I do not think we are going to make much progress in getting a better market.

The reason that profits are not high centers on revenues and costs. On the revenue side brokers may be able to raise commissions a little bit and bring in some more funds. But I do not think that will solve the problem. If they do charge all of us a little bit more for a transaction, that will raise their revenue. But their costs are not well controlled. And the costs will not be controlled until a different production function is designed.

Now, there is some work going on. There are various industry committees. But I think that more work could be done, that it has got to be done, and that several proposals have been put forth which move in that direction. One that I find particularly attractive is the system proposed by the Midwest Stock Exchange which is called continuous net settlement.

But more than an improvement in the transfer function is required. You are going to have to have enabling legislation with respect to bank trust departments, and with respect to commingling of securities. You are going to have to have legislation that does not require the specific transfer of specific securities. Today if you buy and sell General Motors from an account you must transfer a particular security. You have got to make some amendments, I think, so that any hundred shares of General Motors is valid to account for the sale or purchase of General Motors.

My remarks, Madam Chairman, are essentially directed to a problem of liquidity. I think the problem is severe and intense. I think that until we have more adequate capital in the brokerage community, in the securities community, we will not have adequate liquidity. And I think that we will not have adequate liquidity until the entire production function of the securities industry is improved.

Chairman GRIFFITHS. It seemed to me that what you were saying in the prepared statement was that the market which was set up originally to handle small purchases such as you and I would make, handled them quite adequately?

Mr. LERNER. Yes.

Chairman GRIFFITHS. But now when you have these big institutional investors and when you have the pension funds coming in as investors, that the market just is not set up to handle that type of thing.

Mr. LERNER. I think that is right.

Chairman GRIFFITHS. So that when Mr. Harbrecht suggests that we drive all the small funds into the hands of the banks, you have really added to the problem that you already see as existing—it may be for better or worse, but still it increases the problem.

Mr. LERNER. Yes, I think that that is a fair inference from my remarks. I think the market is such that it is easier, to buy and sell, and you get a better market at a hundred shares than you do for the thousand-share transaction. Once you are into the larger fund, as Professor Harbrecht mentioned, you are going to be limited to essentially purchasing larger companies, so that you can buy 5 to 10,000 shares at a time. And that makes some sense. By the time you have done your investment analysis, which is a costly activity, you want to be able to invest a substantial block of funds in the company you evaluated. And so you will be forced to move into companies whose securities provide a little more liquidity. And even in these securities we find that the funds do not have the kind of liquidity that they would like.

Chairman GRIFFITHS. Now, I am less than willing to have Chase Manhattan handle everything.

Mr. LERNER. I am too. Some of it ought to stay in Chicago.

Chairman GRIFFITHS. Or Detroit. At any rate, I wonder, supposing they are giving the advice, and they have advised several funds to sell within the same day, the same 3 days or 5 days, than they are in fact driving down the price for other investors, are they not?

Mr. LERNER. I think that is true. And for themselves.

Chairman GRIFFITHS. But are these questions ever asked?

Mr. LERNER. Oh, they are asked all the time.

Chairman GRIFFITHS. But who sits in a position to do anything about it?

Mr. LERNER. I think you do, Madam Chairman.

Chairman GRIFFITHS. I know. But there is no law now that handles it at all.

Mr. LERNER. No. All that is now done—let me go back a second. I think the institutions that do the trading are very conscious of this impact. The banks in the Chicago area that I know a little bit about have all hired people whose exclusive job it is to make sure they get good executions and try their best. And so I think that the funds themselves, the managers—the trustees that I know are really quite responsible, and they try very, very hard to do it. After all, they have to report back to the fund itself and to the owners of the fund. And if they can do a better job, they can advertise and grow and advance, and their fees will improve. If they do a bad job they will lose the customer. But the fact remains that it is a severe market.

Chairman GRIFFITHS. But as the trust department sells and drives down the price, the commercial department of a bank can buy, right?

Mr. LERNER. I am not sure I follow that.

Chairman GRIFFITHS. Investing their own funds.

Mr. LERNER. I am sure the answer to that is no. Your statement implies some sort of self-dealing where one deliberately brought it down so another one would gain an advantage. And I know of none of this deliberate kind of self-dealing. I think that that is not as

much at stake as just the severe consequences of the fact that their actions did indeed drive it down even without——

Chairman GRIFFITHS. Without any possibility?

Mr. LERNER. Without any self-dealing.

The problem goes on the other side too, namely, when a portfolio manager is convinced that he ought to sell General Motors or he ought to sell Chrysler or he ought to sell the telephone company, because in his judgment the future prospects are not as god as in another investment, there is a desire to sell quickly.

The reason for this is that they feel they reach the result as a result of research, they think that they have some information a little bit ahead of the next fellow, and therefore they would like to sell or buy a little bit early relative to the rest of the streets. So they have a strong desire to move large blocks quickly to take advantage of the information that they develop through their own research efforts. Were they restricted in their ability to move I think that they may not be doing the best job they can for their customers. On the other hand, I think the fact is that their very action itself moves the price of the securities.

Chairman GRIFFITHS. Why should not the trust departments of banks be made to supply more information on their activities?

I notice that you rather objected, did you not, Mr. Harbrecht, to their reporting more?

Mr. HARBRECHT. No, not at all. I think that would be to misinterpret the impression I wanted to convey. What I would like to see is a great deal more information. I would stop short of demanding a report of every transaction. I think an indication of what the trust department or the bank portfolio was in aggregate, either annually or semiannually, would be sufficient so that people like my colleagues here could set down and see what they have been doing, and if they move out of one type of security into another, you can track this over a period of a few years; I would want very full disclosure, but not to the point where I added to this cost of making transactions that we have been discussing.

Chairman GRIFFITHS. There has been a suggestion in the last few days of hearings that the trust departments are being used by commercial bankers to promote the commercial end of their business at the expense of pension funds and other trust accounts. Now, Mr. Lerner has already spoken on this, but would either of you care to say anything? Would you think that this is possible?

Mr. HARBRECHT. I would observe that it certainly is possible. The banks of course would be horrified at the suggestion.

I also think it is unlikely. I have not got the kind of information either positively or negatively to make a firm statement on the subject. But this is the kind of thing that I would expect to emerge more effectively from the Securities and Exchange study that is being carried on now.

The possibility of market manipulation in a situation like this is very great. But I think just because it is so great these financial institutions must be very conscious that people like the Justice Department, the Comptroller of the Currency, and indeed this committee, and others, are keeping a sharp eye on their activities.

45-800—70——13

With regard to the attitude of these trustees I did have occasion to speak to the vice president—whom I do not want to name, because it is hard enough to get vice presidents of banks to speak to you anyway—of one of the large investment banks in New York, and he observed, taking great issue with the book I wrote on the subject, that they had no real market power. He pointed out that they had in all their pension funds approximately a tenth of 1 percent of IBM stocks, and he did not think that was a very great amount. It seemed very obvious to me at the time, and it still does, that by selective selling or buying of that security they could easily affect the price. I doubt very much if they do it intentionally. But I would very much like to have more specific information to determine whether or not that is in fact going on.

But I think, more importantly, the question that Professor Lerner has raised is whether or not the natural operation of these funds is not producing a kind of market control that is really unsought but definitely exercised by these financial institutions.

Chairman GRIFFITHS. I think he has made some very interesting points.

Mr. LERNER. Madam Chairman, I am a little bit reluctant to ask the banks to report transaction by transaction. As things now stand, the trust departments of most banks are notoriously unprofitable. The pure mechanics of the operation are such that every transaction that a bank handles, every buy and sell order, costs the bank in terms of their own internal pricing anywhere from 15 to 30 dollars. Roughly 18 tickets are prepared on every buy order, and approximately 20 tickets are prepared on every sell order. One ticket goes to the securities cage, one ticket goes to the vault, one ticket goes to the customer, and so on and so forth. Their fees, however, are limited to a percentage of the assets. And on the whole the trust departments are not particularly profitable activities. I believe that adding to reporting duties will add more to the cost and have an adverse effect on the total service they perform. This will either raise prices or eliminate some of the research or squeeze some place in the system. I think that reporting transaction by transaction is an incredibly burdensome task, that it could come, but only with some other improvements, such as banks commingle securities so that you do not have to keep every single account separated, so that they do not have to take physical possession of the securities but use a computer to keep a record of their transactions.

Let me give one statistic that I like. It is not totally apropos, but it is of interest. The banking system of the United States clears about 75 million checks a day. And they make very few mistakes in terms of your account and mine. The New York Stock Exchange sells 11 million shares a day. With 100 share transactions as a unit, that is 110,000 pieces of paper. And they cannot make delivery.

When you contrast 75 million checks a day that is done very efficiently by banks and 110,000 pieces of paper which is done inefficiently by the brokerage community you get something of the order of magnitude of the bad production function which exists with respect to securities.

Chairman GRIFFITHS. Mr. Dietz?

Mr. DIETZ. I would like to comment on a few of the issues which were raised in terms of the present issue that we are talking about, that is, reporting.

I believe that the State of New York does require pension funds to report their assets positions on an annual basis. And that has not been too onerous for the bank trustees. I would think that that is the least that we could have. And it seems to me that we could also perhaps require at least a summary statement of transactions in which, for any reporting period, we would find out what was bought and what was sold on a lump basis rather than on every transaction.

I have analyzed pension funds, and when you go through all of the pieces of paper for each transaction, you would have to build a new building here in Washington just to keep the paper.

On the issue of market price and concentration, I think one thing that we should not forget is that the market is a horse race to some extent. And while your Chase Manhattan example may be selling and causing the price to go down, it is entirely possible that the Continental Bank in Illinois will be buying.

Chairman GRIFFITHS. That is why it is desirable that the business be divided up.

Mr. DIETZ. That is correct, I agree. My observation from studying pension funds and from talking to bankers is that quite often some are buying a security, while others are selling it either lightening up on a position or decreasing their portfolio. Security analysis is not a very exact science, as those of us who are in the business of teaching it well know. And some people are doing the right thing, and others are wrong; and some are doing the right thing for the wrong purpose, and so on. It is very hard for me to believe that except in unusual cases where something really goes sour with a company—and this does happen—that you have a tremendous amount of dumping, for example, of securities, or on the other hand, everyone buying at the same time.

In those unusual cases where there is a drastic change in a company's future outlook a change in the price of a stock is going to occur, perhaps more rapidly with institutions in the market, but I think it would have occurred in any case, when the situation becomes well known to the public.

Chairman GRIFFITHS. But it occurs so quickly now.

Mr. DIETZ. It does occur more rapidly, there is no question about that.

Chairman GRIFFITHS. And it is so frightening. In the last few years—I know you were not invited here to discuss the stock market—what has been in your opinion the effect of pension funds on the stock market, and maybe the stock market on pension funds?

Mr. LERNER. If I might volunteer an answer, I think that a large part of the decline is a function of large holders trying to dispose of their holdings in a period when there is not very much liquidity. And I think that your observation about having the funds managed by multiple trustees is an eminently wise suggestion. Many of the larger funds themselves have come to this conclusion for a different reason. They have come to the conclusion in order to try to have a little competition among the various managers; in order to have a standard of comparison, so that they can see who is doing the

better job. But I would suspect that if large pension funds were required to have multiple trustees for their funds, it would result both in smaller blocks being traded at any moment of time, and it would satisfy your requirement of preventing the wholesale dumping of substantial issues simultaneously.

Chairman GRIFFITHS. We had testimony yesterday that institutional investors have a herd mentality.

Mr. LERNER. Yes, like lemmings.

Chairman GRIFFITHS. They are all running for the exits.

Mr. LERNER. Right.

Chairman GRIFFITHS. Today and 1929 differ, as has been suggested, because in 1929 the little person took it, while today it is the business investor that is really getting hit, and the little man sitting on the side, except those people who are represented in either mutual funds or in these pension funds. They do not know they are being hurt, but they are being hurt, and badly.

Mr. LERNER. Yes. Roger Murray of TIAA controls more of my savings than I do, since he manages my university savings, he has a larger sum than I do.

Chairman GRIFFITHS. Did you have something you wanted to say, Mr. Dietz?

Mr. DIETZ. Not at this point.

Chairman GRIFFITHS. I do not think I would go for the idea of giving the individual pensioner a possibility of suing the trustees. I think that you could have a less drastic remedy. Because I think that you could have a less drastic remedy. Because I think that you would either drive them into the hands of the banks, or you would have to prepare for this. And it would be at a great cost to the fund itself.

If you have reviewed in any measure recent tort judgments in this country, they are absolutely astounding. You can sue almost anybody for anything and get a really remarkable return. Judgments that would be worth more than your total earnings in your entire lifetime can be acquired for minor things. And I would say that there would be deep sympathy on the part of a jury for a person who perhaps did not get all of his pension.

Now, I would like to ask you, Mr. Dietz, did you ever review the A.T. & T. pension fund? I noticed you mentioned the Bell system.

Mr. DIETZ. I have worked with them to some extent, I never studied their entire portfolio.

Chairman GRIFFITHS. Do you have any idea of what money is invested in to a large extent?

Mr. DIETZ. To a large extent—we have reviewed the history of the fund, and we know it started off primarily with some of their own paper, and then it went into government bills, and as recently as 1960, I believe, it was invested about 80 percent in fixed income securities and 20 percent in equity, something of that nature. This is a well known fact. Starting around the early 1960's, the Bell system did move to the concept of dividing their portfolio among different bank trustees, as Professor Lerner suggests, primarily to foster some type of better performance on the part of their trustees.

In addition to the hope for better performance, there was the concept in the Bell system of wanting to get the money out of New

York; that is, they felt that this was a large financial center, and that they should have some of the money handled by banks in their own local area where they were doing business. Today I cannot make any general statement, except that I think most of their trustees are prepared to accept a further increase in common stock investments. We have a $4 billion, I suspect—maybe it is up to $4½ billion by now—portfolio, if you take all the portfolios and lump them together, which was as recently as 5 or 6 years ago 80 percent in fixed income securities. I suspect they will eventually move up to 40 or 50 percent in equities just like everyone else.

Chairman GRIFFITHS. One of the reasons I was interested in these hearings was, several years ago when we were holding hearings that fund appeared before us, and it was pointed out that they had then something like a half billion dollars on which they never even paid—and it has been accumulating over a period of years—they had never paid out one-half the interest in any 1 year.

Mr. DIETZ. I think that is probably true. You have a growing company in terms of the communications industry. The result is that as you plan for payments in 30 or 40 years from now during the early stages of any one of these funds the interest and dividends would accrue rather than be paid out.

Now, this is, of course, taken into account in the actuarial assumption which determines the amount of current costs which should be charged to this year's revenues.

Chairman GRIFFITHS. One of the things that amazed me was that at the end of 30 years you ought to have a better idea on how much money you needed. It seems to me like that thing was over-funded. And I have looked at a few of these other pension funds.

The thing that I am sure is impressing many people is that money is not there. The thing that is impressing me is that in many instances there is so much money on which nothing is being paid.

Mr. DIETZ. This is a very difficult issue——

Chairman GRIFFITHS. What I want to know is, why are we permitting all these tax-free funds to be accumulated?

Mr. DIETZ. In my testimony I suggested the problem of inflation. To give you some idea of the magnitude, I believe it is estimated that by 1990, if I remember my figures correctly, average salary levels in this country will be about $25,000, just simply based on inflation. I have played this game with myself figuring out what would happen if inflation were 3 percent a year, and my salary would just go up tremendously.

Now, if you want to have someone retire at the age of 65, at, let us say, 50 percent of what they are earning at that time, the amounts of money needed at that point would be simply staggering. In part this is what we see, that companies are prepared to fund on the basis of trying to make some estimates as to what those costs will be. And therefore we have these huge aggregations of capital.

Chairman GRIFFITHS. But it seems to me that they should look to what has already occurred and what is occurring. And the truth is that only one in nine of these people are ever going to draw a pension, isn't that right? That is just about the statistics, one in five?

Mr. DIETZ. But this is taken into account in the actuarial computation, that is, they assume the turnover. I would like to see us,

of course, strengthen the vesting provisions rather substantially. But if we do, and we continue to use the current actuarial assumptions which are being used——

Chairman GRIFFITHS. Then it will require a great deal more money.

Mr. DIETZ. Yes, funding. This is again where I would like to see some study made on what would happen if we went to a scheme in which the actuaries were able to take into account on some consistent basis the market improvements in the fund.

If we look at the market improvement it is possible that there are some funds in the country that are overfunded. I am saying it is possible. I am not sure that is so. But if you are using actuarial assumptions in which you are only loking at book values, and not including the appreciation which has occurred over the years, and particularly on some of the older funds, then it is very possible that we could have some overfunding.

Mr. HARBRECHT. Madam Chairman, there is at least a theoretical check on overfunding through the operation of the Internal Revenue Service which is supposed to keep a very sharp eye on whether or not the funding is excessive.

Chairman GRIFFITHS. They do not, they do not even look at these things but about once every 10 years.

Mr. HARBRECHT. I think it would be worth while knowing why, and whether or not another system could be substituted, or some other agency could perform this function. I suspect it is simply because the IRS is too overburdened to carry out this function. I do know of at least one case where the fund was found to be overfunded and had to return some millions of dollars to the IRS in both tax and penalties. The problem for a fund can be severe.

But I think one of the things, as Professor Dietz said, that we face in this is that we simply do not have enough information about projections from an actuarial point of view. One of the things that surely needs doing in this country is to establish more firmly the science of actuarial computation. There are not enough really first-rate actuaries around to supply pension funds with the data they need. It is amazing to me how far we get with investing all of this money and not knowing some of the very essential predispositions or assumptions that we have to work on.

Chairman GRIFFITHS. I would agree. But I think also that what we need to know is what is the effect of permitting all of these tax-free funds to be assembled in large amounts, what is the effect of it upon the market, and what is the effect of it upon American life? And that is outside the question, has anybody ever paid. Because I have come to the conclusion that few are paid, few people ever get any money from it. I am interested in knowing, why are we building up these tax-free funds. We would not need tax increases if so much tax-free money was not withdrawn from the stream of taxation. I am convinced, though, that it would be better to let the managers invest at the most profitable rate.

Yesterday afternoon in the Ways and Means Committee I asked what that portfolio makes. It makes about 4.5 as the years go along, and it is getting a higher return on bond; it is something like 7 percent now, and it is doing better. But I suggested that we free it com-

pletely and let the bankers invest in whatever they choose. And it was quite a while before they recovered.

Mr. DIETZ. Yes.

I would just like to make one comment on that. I suspect that if they took account of the market value of their portfolio in their return measurement, they probably would have earned less than it appears because of the long-term Government bonds in the portfolio. They are selling at substantial discounts today and could not be sold at book value.

Perhaps in a more serious light, though, I would like to take the opposite point of view that you are taking in terms of aggregations of capital. Pension fund assets are a substantial aid to our capital markets. If we look at the President's report to Congress, the 1970 Economic Report—and I did not bring my copy—there is an interesting table on page 79 of that report which indicates that the gross national product and needs will be roughly in balance for the next 5 or 6 years. Strangely enough, it assumes a decrease in governmental expenditures, which as a citizen I find rather difficult to accept. In any case, it does not show any great excesses.

Now, this is when you take into account the investments which the CEA feels will be needed in the homebuilding market, commercial real estate, as well as business investments. That capital has got to come from some place. And pension funds have been supplying a large amount of this capital. The fact is that we are capital short in this country. We used to talk about having too much capital. It seems to me that with interest rates running at 9 and 10 percent as they are today, this is certainly one indication that there is a capital shortage, not an excess of capital.

Chairman GRIFFITHS. Would you be for requiring pension funds to go into socially useful projects?

Mr. DIETZ. No, I could not really accept this as a requirement, because of my concern that they earn the highest rates of return available. If as a nation we are concerned about socially desirable projects, they should be subsidized explicitly so they can compete for capital funds. Why should our potential retirees be asked to carry the burden? I think that where socially needed projects are prepared to pay the going rates in the market, then pension funds will naturally put their money there.

This was indicated, for example, in the annual report from TIAA. They are moving into rehabilitation of housing in the inner city, which I would consider to be socially desirable. But they find that they can get good rates of return if it is properly done.

I would go one step further if I might. I know that you have for a long time been concerned, Madam Chairman, with the problem of pensions for the small business; that is, employees not working for large companies, the fact that only a third of the labor force, or 40 percent, whatever it is right now, is genuinely covered. Perhaps we should take a good close look at the suggestions which Roger Murray made before this subcommittee on Monday.

Another avenue here might be to allow people in small businesses to voluntarily put more into their social security accounts, or have some such mechanism. I say voluntarily, because I do believe in the dual system where we have a first line of defense such as social se-

curity and then those of us who are in private industry, education, and so on, can voluntarily be employed by employers who are willing to provide pension benefits, and in some case we make contributions ourselves. I think it would be much more equitable if we allow the contributions made by individuals to also be tax-deferred.

Chairman GRIFFITHS. Absolutely.

Mr. DIETZ. As opposed to only the portion that the employer makes. For example, in the State of Oregon—and I did not realize it when I moved out there—I now find that since I am making contributions on my own, I am paying tax dollars on that. If the State were making those contributions they would be tax deferred. I think we could perhaps improve the vesting benefits—these things are all expensive—if we went back to the system that we started with some time ago, where employees made contributions into the funds themselves rather than it only coming from employers. These improvements are costly. And this would be one way around it. As the present tax law stands, it is always better for the contributions to be made by the employer rather than by the employee.

Chairman GRIFFITHS. Of course.

We have a proposal that the excessive trading in stocks by pension funds, mutual funds and other institutional investors be stopped with the aid of a tax on the quick turnover of stock portfolios. Would any of you care to comment on this—having a turnover tax?

Do you think it would slow it down?

Mr. LERNER. I suppose it depends on who pays the tax. I have a prejudice Madam Chairman, in favor of the full discretion of the banker. I think that they have a fiduciary responsibility to do as well as they can for the pensioner and for the people whose money they manage.

I have done some studies of security selection. And I think that there is some evidence that if the earnings of a company rise you might expect the price of a stock to appreciate, and that tends to last for somewhere between 6 months to a year—that is, the people who bought Du Pont 20 years ago did very well from 1940 through the beginning of 1960, but if they continue to hold it they have not done very well at all.

So I think that there is some desire for turnover according to the judgment of the fellow who manages the fund. I see precious little reason to buy on Monday and sell on Tuesday. But I know of no responsible manager that does that.

Chairman GRIFFITHS. Mr. Harbrecht?

Mr. HARBRECHT. I would concur with that, Madam Chairman. At least I would be very slow to impose such a tax without a great deal more information that in fact this is occurring without need. There may be—after all, we have great respect for the money managers, but they are human, and they can make mistakes. They do have to recover sometimes from the position they have taken which proves to be a mistake.

I think that the system will work best if they are allowed the largest latitude. As you know, my proposal is to combine latitude with public information about what they are doing. I think that there are also built-in incentives not to do that as much as they might if they were merely acting as brokers. After all they are

scrutinized for performance and it is costly, as Professor Lerner has said, to make transactions. So churning and this kind of unwanted market activity, is, I think, much against their interest on balance. These people are in the market and in the business of investing and buying and selling securities for the long pull. They really want to attract their customers to trust them and maintain their accounts for them. Excessive turnovers will be scrutinized by corporate managers with a very jaundiced eye.

So I think there are some built-in safeguards.

Again, I would like to see some very hard and extensive information that this is in fact occurring before I would put a tax——

Chairman GRIFFITHS. This is one of the toughest things about it, that there is so little knowledge about exactly what investors for one institution are doing.

You have expressed yourself on the trust departments and commercial departments of banks. Professor Dietz makes a major point for the need for information on the market value of portfolios. To what extent do we have any current information on this subject? And do you have any recommendations for improving the flow of information?

Mr. DIETZ. We have market information to the extent that the banks supply it to corporations. When I first got interested in the problem of measuring pension fund investment performance in 1960, those reports were supplied to corporations at best on a quarterly basis, and quite often only annually. Today the prevailing practice is minimally four times a year, and quite often monthly, with the exception, perhaps, of the extensive bond portfolios. In an extensive bond portfolio, A. T. & T. for example, you might find perhaps as many as 850 or 900 different bonds. The costs of putting market prices on these kinds of securities is extremely expensive. Today with the advent of the computer it is possible to get very rapid up-to-date prices on common stocks. You just have to punch it into the machine, and it can crank it out for almost any portfolio. It is in the area of the fixed income of investments that we have very poor information, particularly on the private placements.

Chairman GRIFFITHS. Mr. Lerner?

Mr. LERNER. There is in the trade a substantial knowledge of what the rate of return is on various portfolios. One brokerage firm, for example, H. E. Becker by name, in Chicago, has a service where you submit your pension fund to the firm, and they will calculate the rate of return, and give you back how you did relative to all the other firms that so submitted their data to them. They charge a fee of sorts, for this, and ask for some brokerage commission. But they produce a very handsome volume indicating how well you did relative to roughly comparable funds.

They break down what a comparable fund is in half a dozen ways, by size, and how much jurisdiction you have, and whether it is balanced or not balanced, and so on and so forth.

So I think that if a fund manager were curious on how well—or if a pension fund were curious on how well the manager was doing, there are ways of finding this information right now. I do not think it is done by the government any place. And I know of no comparative performance prepared by the SEC or by any committee.

Mr. DIETZ. We should be getting a better handle on this in the future. The Bank Administration Institute just completed a rather expensive and extensive study on performance measurement. And as a result of that they have prepared a program which is now on magnetic tape which is made available to banks around the country. They will be able to calculate performance measures as a result of this program. This is the first time that it is going to be readily available to all banks on the same basis.

Chairman GRIFFITHS. Yesterday I commented on the inequality of these pension plans, and the fact that for those who are drawing from a government source, those pensions are really very good in comparison to other pensions. What suggestions do you have for making pensions really more equal in treatment? You have commented on the self-employed. What other suggestions do you have?

I raise the question, Why not just throw out the whole thing and increase social security?

Mr. DIETZ. If I may, I think the first question is, What do we mean by unequal? To some extent there is always a trade-off, I suppose, between what you earn today and what you expect to get from retirement benefits, so that some people may be taking lower salaries today in favor of future retirement benefits.

Chairman GRIFFITHS. Of course, this was true of government employees largely. But this is not true of UAW workers, steelworkers, and so on. The ones that have the power, the power to get the pension, have the power to get the wage.

Mr. DIETZ. Let me suggest, if I may, an analysis this way, of scrapping the entire system, as you suggest. I personally would place a high value on freedom to choose various levels and combinations of benefits under private plans.

Second, as I indicated before, I think pension fund savings add to total savings and thus enlarge the fund of capital necessary for both economic and social advancement.

And as we have indicated, if we can decentralize to the largest extent possible investment decisions, this, I think, will lead to more effective use of capital than if it is centralized.

Now, if we look at social security, this has always been meant to be a first line of defense, to provide a minimum retirement benefit. If a desirable retirement benefit is a goal of 50 percent of preretirement income, would this be the fair sort of thing that you were referring to? If you base this on a transfer tax, which is basically what social security is, I think we would find that the transfer from current consumption—that is, from wage earners to nonwage earners—would be stupendously expensive, if we just simply went in that direction of having everyone entitled through social security to 50 percent of what they had previously been earning.

So I do not see that that really is a viable solution. What we need to do, I think, is to improve private plans, by insisting on better vesting provisions, if they are going to be tax deferred. If we insist on that, then the problem of turnover would be substantially less, and more people will get the pensions which they expect when they join a company's plan.

The other additional need is a plan for small businesses and their employees.

As I suggested before, Roger Murray made one suggestion, that this be done through savings banks and thrift institutions. We need some sort of enabling legislation to allow an employee to direct his employer to put a certain amount of money, if nothing else, into passbook savings account, on the same basis as people employed in larger corporations.

And as I indicated before, it may be worth suggesting, for those people who have only social security, that they be allowed to voluntarily add something to their social security accounts on a tax-deferred basis, perhaps a matching situation with the employer, where if the employee wished to have such a plan he could require the employer to go into it.

I recognize that some people will not voluntarily do this. This might be one of the great objections, whereas if I work for a company which has a pension fund, obviously I am locked into it if I want to be in their employ.

It seems to me that as long as we have social security, which is required, then at least the basic needs are met. But this would afford an opportunity for those people—and it is primarily those engaged in corporations with 25 or 30 or less employees that do not have pension plans, because they are so tremendously expensive—to get better retirement benefits.

I might indicate that some industry trade associations are working on developing industrywide plans which they can provide for small companies with 20 or 25 employees.

I personally have been trying to get some of my friends in the investment banking community to develop such a plan and sell it. But they indicate that the costs of selling such a plan would just be stupendous.

I think, though, that the problem can be solved if we look at it—if we were to have a study and decide the best way to go about doing it.

Chairman GRIFFITHS. I am not sure that I go on the freedom of choice, because I think what the choice is, you have a choice of directing my taxes to be greater. That is what I really think your choice is.

Mr. HARBRECHT. May I address myself to that argument, Madam Chairman?

Chairman GRIFFITHS. Surely.

Mr. HARBRECHT. The proposal you make of simply turning the whole thing into a very much larger social security system is something that I have thought about from the beginning of my study of it, of the pension system. And I think it has a good deal to recommend it from the point of view of efficiency, portability. Vesting it would solve all of these problems we are trying to cope with individually at one blow. But I think in proposing that you are proposing something that goes very profoundly to the roots of how our economic system works. For example, you feel concerned that the small pension trustee will be driven into the Chase Manhattan Bank. I think the Chase Manhattan Bank would feel concerned that you are driving everybody into the hands of Washington.

Chairman GRIFFITHS. No doubt.

Mr. HARBRECHT. There is sometimes a difference of view as to who ought to be running a show.

It is very common in Europe to have statewide controlled pension arrangements.

But the thing that would concern me about a proposal like this is that the discretionary use of these blocks of capital is very important to the development of our economy. Since going to Canada about a year ago and continuing my interest in financial markets, corporations, and so forth, I have had occasion to see how the Canadian economic system works. And I am most impressed by the fact that there are about seven banks in Canada that control just about all the investment capital that is available to Canadian business.

Chairman GRIFFITHS. There are only seven banks in Canada, aren't there?

Mr. HARBRECHT. That is right. There are trust companies and there are some small investment firms. But I find in looking at this that you have a control by banks, and not a little bit by the government too, through its ability to control the banks, control of sources of investment capital. I conclude from studies of medium-sized corporations and smaller businesses that this has a very strongly inhibiting effect on the development of the Canadian economy. One of the real strengths of American economy is widespread and competitive sources of capital.

Chairman GRIFFITHS. I think you are quite right. I looked that Canadian situation over too, we live right close, and it is amazing. They have control, apparently.

Mr. HARBRECHT. Even to the point where banks will insist on taking shares of stock and even controlling interest in businesses. Their grip on the industry in Canada is somewhat astounding.

And I think to withdraw such large blocks of capital as you would be in taking on a different kind of management—that is, government management—would have an inhibiting effect on our economic development.

Chairman GRIFFITHS. I do not think it would be a good idea in a lot of ways. In the first place, you would have to raise the tax tremendously—and I am sure they would be very interested in doing it—and you would never get a very satisfactory setup. But the thing I think is very unfair is that there are people who are going to retire on reasonably decent pensions. And that is being paid for by everybody else. It is being paid for through the years because some people did not put their fair share into the tax structure. It is being paid for by those who are paying Government pensions, by those who are working now and paying taxes. It just seemed to me it would be fairer if everybody was going to be taken care of. But we need a better way to do it.

Congressman Patman recently published some data suggesting that the Standard Oil of Indiana fund had a turnover rate with total assets of 95.9 percent in 1968. General Mills' plan had a turnover rate of 130.6. How can such figures be explained?

Mr. LERNER. That turnover rate, Madam Chairman, is essentially once a year. That means that you held—the average life of a security in the portfolio is 1 year. I find that not astounding. As a matter of fact, when I look at a university where we have a turnover of 6 or 10 percent, that means the average security stays in the

portfolio for 10 to 16 years. And my hunch is that it is probably too long.

Chairman GRIFFITHS. Do you think that selling off these stocks once a year is really advisable? Don't you think that must have quite a little effect?

Mr. LERNER. I wished Roger Murray had sold all of mine on January 1st.

Mr. DIETZ. First, let me say that if such turnover rates occur on the stock portfolio, I think they are too high. I feel some responsibility for the advent of the turnover cult since I so forcefully advocated better performance. However, I have always advocated a two 5-year-measurement period. Most studies of the capital markets indicate that excessive turnover may in fact worsen performance. Second, I am not sure, of course, not having looked at the figures, but I think we want to be very careful as to what we mean by turnover rates. You did not specify whether Congressman Patman indicated that they were common stock turnover rates or the entire portfolio.

Chairman GRIFFITHS. Total assets, the whole portfolio.

Mr. DIETZ. If it is total assets, and it included any amounts of Treasury bills, which would be very possible in this particular market where nobody knew whether it was going up or down, the turnover of Treasury bills, since they turn over overy 3 months—and it could be shorter—could have an astounding effect on the figures which you have just cited.

Chairman GRIFFITHS. But this was in 1968, when the market was a little steadier.

Mr. DIETZ. It was a little steadier then. But in any case, it depends—if we are taking a look at, for example, substantial sizes of bonds where they are simply coming due, you will have some turnover as a result of that. So I do not think we can ascribe it to all common stocks, I would be inclined to agree with Professor Lerner that in general the investment outlook for a stock, if you really are on the top of it, might in general be anywhere from a year to in some instances 4 or 5 years. And I would expect turnover rates of somewhere between 25 and 35 percent to be normal, but not once a year as Mr. Lerner suggests.

Mr. LERNER. Part of that, Madam Chairman, is essentially the urge for performance. As long as there is intense competition among the trustees for the pension fund business, and it is a competitive business, the principal selling device is performance. It is very hard to get performance without activity.

I would say that those are particularly aggressively well-run funds. If you move to personal trusts, the turnover is substantially less. But there a different kind of service is performed. There a concern is expressed every time the stock is traded as to what are the tax consequences of the sale, the effect of capital gains, on the trust and so forth. In the pension fund area you are not inhibited by the capital gains implication of the tax. You are interested in performance alone, pure, naked performance. We used to talk about the dilemma in security analysis between return versus risk. But the current dilemma is between performance versus liquidity.

Mr. HARBRECHT. Madam Chairman, that gives me a chance to return to a pet point of mine. I think maybe theoretically in this room

we could give a defense for that type of action. But what concerns me most is that by law we have no way of checking that kind of activity if it should be proved to have been done either unwisely or in self-interest.

There is enough law to show that you cannot use the pension fund to your own advantage. There could be prosecution, and there could be investigation by the Secretary of Labor, if a rapid turnover were somehow being engineered to put dollars into the pockets of pension trustees. But if it is merely stupidity or bad management, we have no approach to it. And this is the basic reason why I would suggest the establishment of the "prudent man" rule that I spoke of before, and to give at least to the Secretary of Labor the power to enforce that standard.

Now, what would that mean? It would mean that if financial experts could justify the disposition of the portfolio that Congressman Patman points to, then even the Secretary of Labor would not fault the management.

It would also mean that if they had behaved badly they would be forced to restore the funds that had been lost to the trust as a result of their bad management.

Chairman GRIFFITHS. I would like to ask you one last question. Do you consider pensions inflationary, stabilizing or anti-inflationary?

Mr. HARBRECHT. My judgment is that they tend to be stabilizing. Going back to the issue that I raised, which I think is a very difficult one, whether or not they have an inflationary effect on the stock market, whether or not they actually drive prices up, what effect they have in a situation like this, I think that generally they have a stabilizing effect on markets. They also segregate and sequester a large number of dollars under expert management.

Chairman GRIFFITHS. But what do they do to prices?

Mr. LERNER. I would suggest that they probably drive them down, and they are probably deflationary. I base that on the fact that we have to change the frame of reference a little bit and talk about total savings in the economy versus total investment, and things like this. The evidence that was developed years ago by the National Bureau of Economic Research says the people tend to ignore the fact that they have something in the pension fund and that they continue to save. This suggests that perhaps savings are higher than they otherwise would be. And to the extent that the savings are in turn invested in industries which give rise to further capital goods—and we have something of a capital goods shortage in this country—it helps fund the capital goods. These goods ultimately will result in more consumer goods and services being produced. In that sense pension funds in the long run have a deflationary impact.

So I would say that the savings now plus the future investment that comes down the pike probably make them stabilizing to deflationary.

Chairman GRIFFITHS. There have been a good many people who suggested that one of the problems of the pension fund, or with social security, is that people generally do not save, they rely upon those funds. In Japan at the present time aren't the people generally saving about 17.6 percent of their money? I read something

on that the other day. They are really fueling Japan's wonderful economy with their own savings.

Mr. DIETZ. I have no idea about Japan, but I think the National Bureau study was quite conclusive. And as you may know, the results, since they go against what we would tend to think, were rather shocking to them when they first did it. And so they reran the entire study doing it in a different way, and they still came up with the same conclusions.

On the general question I would be inclined to agree with the analysis just made by Professors Lerner and Harbrecht, and really have nothing to add.

Chairman GRIFFITHS. Thank you very much.

And I want to thank all of you again. I enjoyed hearing you tremendously. And I enjoy the exchange of ideas. I hope you all keep us advised as to the further information you have on the effects of these funds.

The hearing is now adjourned.

Thank you very much.

(Whereupon, at 12:05 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Thursday, April 30, 1970.)

INVESTMENT POLICIES OF PENSION FUNDS

THURSDAY, APRIL 30, 1970

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10:05 a.m., in room S-407, the Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling, economist for the minority.

Chairman GRIFFITHS. At the start of this last day of hearings I want to make a brief statement.

One of the problems of holding hearings of this type is that the people who really know what is happening with the funds do not want to tell, they want to take the fifth.

The second problem is that since this subcommittee does not have ordinary subpoena powers they just do not show up. I have had several people ask me why we have not had the SEC over here. We asked the SEC for a witness. We did not even get an answer for 3 weeks, and by that time it was too late. They were not really willing to testify.

With respect to the first matter, the executive director, Mr. John Stark, and the senior economist, Mr. Loughlin McHugh, visited with the Chairman of the Securities and Exchange Commission with a view to finding out whether or not he or some member of the Commission staff would care to testify. And I extended to them a personal invitation. But as I said, it was well after the hearing had been set before we even had an answer.

(The correspondence between Chairman Griffiths and Chairman Budge of the Securities and Exchange Commission relative to appearing before the subcommittee follows:)

APRIL 7, 1970.

HON. HAMER H. BUDGE,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: The Joint Economic Committee has had a longstanding and deep interest in the developing role of institutional investors, such as mutual funds, insurance companies, and pension funds in channeling the savings of small investors into profitable investments which will insure that the pensioners and similar beneficiaries receive their money's worth when the need arises.

We on the Committee feel that, with the increasing trend toward institutional savings, the saving-investment process must be protected to provide the

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most efficient allocation of economic resources. To this end, we are planning to examine in depth the pattern of institutional savings and investment. We shall begin with a series of hearings, starting on April 27 of this year. This first set of hearings will involve primarily the analysis of investment policies of pension funds—private and public.

In this context, we would appreciate having you or some other representative provide us with background information on the investment of pension funds. We understand that Mr. Stanley Sporkin is well versed in this area, particularly with reference to instances in which the assets of pension funds were used in ways which were of dubious value to the beneficiaries, or which were in violation of the rules or regulations of the Commission.

Mr. Sporkin might outline for us also some problem areas as far as securities market regulation is concerned. We are aware, for example, of such cases as those involving Georgia-Pacific and Riklis. We should like to find out whether the Commission considers that the practices involved in such cases are being adequately dealt with today. Obviously we should not, and will not, subject your representative to questions involving matters under investigation currently by the Commission. On the other hand, we would welcome any policy suggestions or actions which you feel would be in the public interest.

I might mention that we expect to call on a number of "private" experts in this field, as well as the government agencies, in our April hearings. If you or your staff wish to obtain further information on the plans of the Committee, the staff would be happy to respond. We have tentatively scheduled this part of the hearings for 10:00 a.m. on April 28.

I understand that the staff had a chance to talk with you about the hearings. The Committee will greatly appreciate your cooperation in this endeavor.

Sincerely,

MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., April 29, 1970.

HON. MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy,
Joint Economic Committee, House of Representatives,
Washington, D.C.

DEAR MRS. GRIFFITHS: This is in response to your letter of April 7, 1970 in which you seek certain background information from the Commission in connection with planned hearings to be held by the Joint Economic Committee on the analysis of investment policies of pension funds—public and private.

You may be assured that the Commission will endeavor to give your committee whatever assistance it can. In this regard, we have already made available to your staff information concerning certain enforcement actions the Commission has taken where pension funds have been involved. While I now understand that you will not need our testimony I want to again assure you of our desire to cooperate with your committee.

Sincerely,

HAMER H. BUDGE, *Chairman.*

Chairman GRIFFITHS. Others have thought it was peculiar that we did not include among our witnesses a representative from the bank trust departments. With respect to this matter, the staff was in touch with Mr. James Lane, Sr., vice president of the Chase Manhattan Bank in charge of investment policy of funds. He declined to accept an invitation. And since this committee does not have automatic subpoena powers we let the matter drop.

Again we hope in future hearings we shall have the cooperation of this very important segment of the pension fund field.

Let me say to you what I have said to all other witnesses. The thing that really caused me to have this set of hearings is that in a past set of hearings I found a fund with more than $500 million in it which

had been in existence for more than 30 years and never in any single year had it paid one-half the interest out.

Now, what I personally feel is that the funds have taken on a life of their own. The idea of giving anybody a pension is purely incidental. What I want to know is, what is the effect of the funds, why are these tax-free funds being accumulated, and what are they doing to this economy?

And I am pleased to have all three of you here today, because we conclude this series of hearings on investment funds departing from a more or less academic and theoretical treatment of the subject in the last few sessions.

Today's witnesses are all practitioners of investing other people's money.

Mr. Cantor is president of the Cantor Management Association, a relatively new firm whose life has been largely lived in a bear market. He formerly served as the head of the Investment Advisory Division in the Chase Manhattan Bank, one of the larger handlers of investment funds in the world.

Mr. Keenan is the international secretary of the International Brotherhood of Electrical Workers, and runs a pension fund for its members.

Sometime ago the union made a decision to invest regularly some of its funds in mortgages. We look forward to hearing his experience.

Mr. Babson, president of David L. Babson & Co., has been an investment advisor for many years. He has strong views on the proper approach to investing other people's money, particularly when the money is made available for long-term protection of income.

We are happy to have you here, gentlemen.

And anything I have said does not apply to you at all. It is very kind of you to come here. I want to thank you for your help.

Mr. Cantor, you may proceed.

STATEMENT OF RICHARD CANTOR, PRESIDENT, CANTOR MANAGEMENT ASSOCIATION, NEW YORK CITY

Mr. CANTOR. Thank you, Madam Chairman.

Much of the testimony that I am about to give is empirical in nature. I have watched pension funds invest their money for about 14 years from a few different vantage points. First as an officer of a major New York City bank which handled billions of dollars of trust business, and more recently from my own management firm, which has about $150 million in assets under supervision.

My conclusion is that as a class pension fund investors have been unsuccessful, which is really a great shame, since their less than successful practices raise the costs to corporations of providing benefits, and through the bargaining process must ultimately affect what workers receive.

What is more, despite their undistinguished records there is no evidence that their overall investing pattern, which I believe has been discredited, is going to be disregarded. Quite to the contrary, the recent action of the equity and debt market is causing a serious reaction away from whatever limited progress has been made in the last few years.

I think it is important here to mention that I have tried not to let this judgment be unduly influenced by the somewhat chaotic state of the equity and bond market today.

In today's environment it would be fairly simple to discredit almost any investment program. I try to speak from the perspective of the last 15 years.

I think it is important here to say a few words about how I would like to attack this subject. I am going to tell you who I think handles the money, although I do not think this comes as much of a surprise to anybody on the committee, and then spend a few minutes dwelling on how good the performance of these managers has actually been.

After doing that I would like to talk about performances that are available elsewhere in the investment universe, and then spend another few minutes talking about the prospect for the funds that are now handled, I think, improperly with less than advantageous result, shifting to a more advantageous type of performance.

As far as who presently handles the money, I am sure that it comes as no surprise to you that the management of uninsured pension funds belongs almost exclusively to bank trust departments. About a half dozen New York City banks probably control one-third of all noninsured pension plan business. And the banking industry as a whole has a virtual lock on the management of these funds.

How good has performance in pension funds been? During the period 1957–65 the appreciation of all noninsured pension plans has averaged about 7¼ percent. Even allowing for the rather sizable amount of assets invested in fixed income securities, the implied return on the equity portion of the investments of these corporate pension funds appears to barely approximate that of the Dow Jones industrial average. A recent study of 77 equity trust funds covering the period 1961–68 indicates that the performance of these funds almost exactly equals the Standard & Poor's 500 index. It should not be surprising to anyone that the common trust performance and pension fund results—now I am talking just about the equity portion—are so similar, since the assets are all handled by bank trust departments which despite much recent publicity, handle them in essentially the same manner.

Stated another way, the investment experience of pension funds and the banks who manage these funds is identical to the appreciation in America's largest capitalization; that is, the most mature companies.

An examination of the growth rates of earnings of the Fortune 500 companies indicates that the top 50, excluding Westinghouse, grew at 6.46 percent in the 1956–66 period, while the bottom 50 averaged 8.9 percent.

This little paragraph may appear to be an irrelevant insertion in this material. But taken in the context of my previous remarks and a few things that I will say later at the conclusion of my statement, I think it is relevant.

In the very beginning of these introductory remarks I refer to a pattern of investing. The pattern that I meant to describe is about as follows: America's largest companies have pension funds which they invest through America's largest banks, which in turn buy shares in America's largest companies, which offer less than the most

attractive returns available in the marketplace. All of this, I think, has some rather unfortunate implications for American capitalism and for the American worker.

I said at the outset that since part of my statement was going to be a condemnation of performance, at least as I have seen it, by the managers and the people who have the responsibilities for investing pension fund assets, I think I have to spend sometime discussing performance, for two reasons: (1) because it fits into the context of my statement, and (2) because it is a much maligned word, and a very much, I believe, misunderstood subject.

Performance, at least by my perhaps somewhat stilted definition, and as it applies to the investment business, is some standard of achievement that is perceptibly better than the norm. The reason for my earlier comments to the effect that most banks which managed uninsured pension funds had failed to perform and therefore had been unsuccessful is because their actual results so closely parallels that of the Dow Jones industrial average and the Standard & Poor's average. Performance, then, as I would describe it, is some standard of achievement that perceptibly in some measurable way is better than that of an overall average.

There is one other comment that I have to make in talking about performance. And that is for any investor, whether it is a bank trust department, or a private investment management firm, large or small, that performance, in order to be measured properly, must be measured against that investor's entire asset base. I will talk a little bit more about the necessity for an entire asset base as we go along.

First of all, how can performance be achieved, and how can't it be achieved?

I am going to start off with a rather negative approach, because I think some things have been improperly said about the performance or the people who have been responsible for performance.

There are several points that I think this committee has addressed itself to and with which it is properly concerned. One of the ways of achieving performance theoretically is through a very, very high turnover rate.

Again, I do not think it comes as any surprise that bank trust departments, that at one time realized turnover rates on the order of 6, 7, 8 percent, have now attempted to increase those turnover rates, thinking that there is almost a direct correlation between turnover and actual performance. The mutual fund industry is running turnover rates now as high as 35 and 40 percent, and in some rather extraordinary instances as high as a hundred percent or more.

There is another way of achieving performance. And that is by taking letter equity. This technique is really simple. You have a stock selling at $40 a share. Somebody gives you letter stock which is not marketable at a discount, and you put it in the fund at current market value. It is what we used to refer to several years ago before the technique became so widely discredited as "instant performance."

Still another technique is a lead account concept. And by that I mean this—and it refers back to my earlier statement about an entire asset base—by a lead account concept I mean simply that you have so much money that you cannot possibly manage the money efficiently, but you have one account that is a public account, so that

everything that you can possibly do that is good or relevant you somehow or other rationalize into that account. That account becomes the lead or a showcase account, and as a result, you achieve some measure of performance in the name of the entire organization.

There is another way of performing which I would call statistical performance. Just before this formal part of the hearing started Mr. Babson and I were talking about the Arthur Lipper Service. Lipper provides performance statistics on every one of the mutual funds. Every time there is a statistician there is somebody who figures out a way of beating the statistics. And there are a number of people in the mutual fund industry who have developed methods of introducing their funds at the right time over a short enough time span, long enough so that its performance stands so as to come out number 1 or 2 or 3 in the country. I think this is really more statistical performance than it is actual performance.

Another part of the statistical performance syndrome is the pyramid, in which you actually show a larger gain than you show a decline, but more money is lost in the decline than is made in the gain. The way this works is, simply, you start a fund, and perhaps you start it with $100,000 or $200,000 or $500,000, and the $500,000 is successfully turned into a million dollars, which no matter how you calculate it represents a gain of a hundred percent.

And based on that gain of a hundred percent, you receive $400 million of additional assets, on which you promptly lose 30 percent, which represents a loss of $120 million. And your performance indicates that you went up 100 percent and down 30 percent, and yet you lost $120 million. It is statistical performance, it is a pyramid, and it has been part of the performance figures.

I deliberately went through this horror chamber of how performance can be achieved because I do not think it is all true. I think there are people who achieved performance during the 1966, 1967, 1968, and 1969 period in some cases solely by using the techniques of turnover, letter equity, lead accounts, and statistical performance, and every other trick in the book.

I mention these techniques not because I think they are typical of the industry, only because I think they are used by so many of the detractors of legitimate performance, and often as crutches by people who have done nothing over a period of 15 or 20 years to point attention away from the fact that they are mismanaging funds.

There is one way that has always existed and that remains as a method of satisfactorily investing funds for satisfactory performance that nobody has discredited, and that I do not think will be discredited.

In an earlier part of my statement I made a simple statement. The statement was that an examination of growth rates of the earnings of the Fortune 500 companies that the top 50, which excludes Westinghouse, grew at a 6.46 percent, and the bottom 50 grew at 8.9 percent.

I made another statement that I regard as very damaging: that most major investment institutions tend to invest only in the most mature companies.

My point, then, is simply that as a start on the road to performance, that people who are investing funds might look occasionally at

companies that are not necessarily speculative, that are not necessarily risky, that are sound investments, that have good historical records, and that are not so mature or so stagnant or so large as to make it all but impossible for them to grow at any kind of a satisfactory rate.

This has been in the past a valid means of performing. It is the way legitimate performance, at least one way legitimate performance has been achieved, and it will continue to be a way that legitimate performance can be achieved.

I think we have to spend just a few minutes looking at who can possibly provide this kind of performance, because I think there are many people. I would like to introduce a few figures. I have them in tabular form myself, and I am sure they can be made available to the committee at some point if they would like to look at them.

We spent sometime looking at performance to see whether there had ever actually been any, in other words, whether anybody had ever earned their fee in the investment business. And what we found was this. We looked at the period where the performance phenomenon really grew up and where the word became so much used and so much maligned and where there is now so much controversy over it.

We looked at the period 1967, 1968, and 1969, the good so-called performing years and one extraordinarily poor so-called performing year. And what we found essentially was this, that there was a direct and inverse correlation between performance and size of the asset base actually under supervision, that it was unmistakable, that the fit was so close as to be extraordinary. I will cite some of the figures to you.

We broke out the asset size of funds under supervision. And here we used only mutual funds, not banks and not private managers, because these are the figures that were available to us. We broke them into several different categories, $10 to $50 million, $50 to $100 million, $100 million to $300 million, $300 million to $500 million, $500 million to a billion dollars, a billion and over. We looked at the year 1967, which was really pretty much the beginning of the performance phenomenon.

And what we found was that people who were handling funds in the range of $10 million to almost $200 million managed to achieve growth rates during the year 1967 of around 60 percent. In the $3 million to $500 million category they achieved 42 percent. In the $500 million to a billion dollars category they achieved 33 percent. In the billion to $2 billion category they achieved 25 percent. And the performance of the Standard and Poor's during that year was 23 percent.

And if you want to know what the people who are investing almost all of the pension fund money achieved in that year, that is 23 percent. And I do not even have to calculate the average, it had to be. because they are the average, that is the way they invest their money.

In 1968 the fit was again so close that the people who were in the $10 million to roughly $300 million category ran 18, 19, 20 percent on the up side.

The people who ran $3 to $500 million were 7.3 percent; $500 million to a billion dollars, 7.1 percent; and a billion dollars and over. 4.7 percent. The S.&P. 500 was 7.6.

Now, in 1969 when we had a down year in the market exactly the reverse happened. The people who ran smaller amounts of money, who bought secondary companies, somewhat smaller companies, had a less satisfactory performance. And the people who ran larger amounts of money, buying the larger companies, had a more satisfactory performance.

What I am saying in effect is that there is a correlation between size and performance. And my first criteria for somebody who can perform successfully would be the criteria of an individual who was small enough to be able to control his asset base and to be able to buy some of the American medium-sized companies. And by medium size I do not mean to imply again that I am talking about speculative investments. I am talking about companies that may be doing $200 or $300 million a year in business, that may have a 19- or 20-year record of earnings progress, that may be listed companies.

We are not—lest anyone try to discredit these kinds of figures—talking about wildly speculative types of performance, or rather wildly speculative types of companies.

I have talked about how performance can be achieved and how it cannot be achieved. The people who cannot achieve it—you have to make these additional points with people who cannot achieve it—there is a necessity for elimination of conflict of interest within one management group. You cannot be all things to all people and perform successfully. I do not believe that it is possible to be in the underwriting business and at the same time offer investment management. I do not believe that it is possible to be in the mutual fund business and at the same time attempt to serve pension fund assets. I do not believe it is possible to be in the personnel trust business, investment advisory business, and pension fund business and reserve all three areas in the most advantageous possible way unless in order to sleep nights you rationalize away the fact that one of these people really does not want the best possible results.

It seems to me to be rather amusing that of all the areas of the investment business, all the people who are in the business, that one segment of the business that has the least possible likelihood of ridding itself of the various conflicts the various mechanical imperfections, and the enormous size problem, that that one area of the business has a virtual lock on all of the pension fund business.

The likelihood of any of this money shifting—I would like to say just a word about that, because there has been an awful lot of talk about split funding and funds moving out of the banks, which I think is absolutely absurd. The way the split funding that is going on works is, if a fund has $200 million to invest they may place $5 or $10 million with some smaller investment management firm or smaller asset base. This may be a rather parochial view of what is going on in the investment business, but I know half a dozen or a dozen firms located either in the Boston-New York area or the west coast area that have been identified by the various investment media over the course of the last 3 years as the so-called performers.

And I know roughly what the assets are that all those firms have under supervision. And taken altogether, even with all of the con-

versation that has been going on about splitting funds, it does not amount to enough money to really make a difference.

And I would think again that the current action of the equity market is going to result in a reaction, in other words, a return to the old methods rather than anything else.

Now, I can only comment in terms of the question which must logically be raised, and that is, why does all of this money sit where it does, if my assumptions are correct, that the handling of these funds has been less than adequate and that better returns are available, why is the money where it is?

The House Banking and Currency Committee developed some figures, I guess about 2 years ago. The figures indicate that of the five major New York banks handling trust assets, they handle a total of $60 billion roughly of trust assets. Now, here I mean all trust assets. Of those trust assets roughly 48 percent are pension fund accounts, employee benefit accounts. That is the relationship that usually exists in these five banks, about 48 percent of the trust assets in total are pension fund accounts.

Chairman GRIFFITHS. Forty-eight percent of $60 billion?

Mr. CANTOR. Forty-eight percent of $60.8 billion, or $29.3 billion is the actual figure I derive. I would not place to much weight on that figure because I think there is some statistical error in the way the reporting is done; as a matter of fact, I am sure of it.

It is interesting to note that one of those five banks with $8.4 billion in assets has no commercial business. And the relationship of its pension trust business to its total business is 8 percent.

I do not know whether these figures mean anything or not. I assume that they do.

My assumption is that you get pension trust business by being in the commercial banking business. I thing it is a valid conclusion from looking at the figures, but I will leave the committee to its own conclusion.

Chairman GRIFFITHS. What is the performance of the bank with no commercial business?

Mr. CANTOR. I have no way of really knowing that. The bank with no commercial business is obviously the U.S. Trust Co. And the only way you can get performance is by looking at some individual accounts and by common trust accounting, and that may not necessarily be representative of their total performance.

My assumption is, given the amount of dollars that they handle, that the performance is exactly identical in the fifties to the Dow-Jones industrial average, and more recently, with somewhat more progressive techniques, they have probably done a bit better to the extent that their performance is now identical to the Standard & Poor's. They have by no means achieved anything like the performance that was available in 1967, 1968.

I think really that I have concluded the formal and informal part of my remarks.

Chairman GRIFFITHS. Thank you very much, Mr. Cantor, for your statement.

Our next witness is Mr. Keenan.

We shall be glad to hear from you at this time, sir.

STATEMENT OF JOSEPH D. KEENAN, INTERNATIONAL SECRETARY, INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS

Mr. KEENAN. Madam Chairman, my name is Joseph D. Keenan. I am secretary of the International Brotherhood of Electrical Workers, the oldest and largest union in the electrical industry, with nearly 1 million members in every branch of the industry. I welcome this opportunity to discuss the IBEW pension fund investment policies.

We currently have approximately 36,000 members receiving a monthly IBEW pension check. Safeguarding their pension funds, and using them to the benefit of our members, is of primary concern to us.

Madam Chairman, I am aware of your interest also in safeguarding the welfare of America's people. This is clearly evidenced by your sponsorship of legislation to institute a national health insurance program. I commend you for this. It is a goal to which the organized labor movement also is committed.

In establishing a pension plan, certain assumptions are made in order to estimate the cost of providing the desired benefits, or to determine the benefits that can be provided for the amount of money contributed. These include mortality rates, turnover, disability, and the amount of interest that will be earned on the money placed in the fund.

All of these are important, but the interest assumption is the most important in today's pension funds. A change of 1 percent in the earnings may allow the benefits to be increased by 20 percent, or may allow a savings in contributions of a similar amount.

The vast majority of union or joint union-management administered pension plans fix the level of employer payments to the fund at a specified amount. Increases in the interest earnings of these funds are used to increase the pension benefits.

But approximately three-fourths of all pension and profit sharing plans are unilaterally administered by employers. And in the majority of these plans, the employer pays in the amount of money which is needed to keep the pension fund on an actuarially sound basis. No definite amount of employer payment is stipulated. If interest earnings increase, the amount of money needed to keep the fund on a sound basis decreases. The employer's payment is decreased and he saves the amount of money which was earned through the increased interest.

Thus, maximizing the interest return in most employer-administered pension plans does not benefit the participants, but provides a windfall for the employer by reducing the cost he expected to pay for the plan. Have you ever heard of pension benefits being increased because skillful management has produced a higher than expected yield on investment?

Madam Chairman, there is another thought that disturbs me very much, though it would be extremely difficult to document. This is the thought that some employer-administered pension funds are being used for foreign capital investment. Such use of these funds will jeopardize American jobs, and thus defeat the primary purpose of a pension—security in old age, and I think also this has many hazards.

Pension plans are a part of the collective bargaining package. Funds set aside for them are a part of the employees' remuneration, accepted in lieu of wages. They belong to the workers who are covered by the plans, and should be used for their benefit.

An excellent example of the use of pension funds in the public interest is the AFL–CIO Mortgage Investment Trust. Briefly, this is a pooled trust fund for investment in federally insured or guaranteed construction loans and mortgages. The trust is registered with the Securities and Exchange Commission. A group of prominent trade union officials well acquainted with trust fund operations serve as voluntary board members, with AFL–CIO President George Meany as chairman.

The trust helps unions invest their funds under competent management at a reasonable rate of return with a high degree of security. It also provides money for the construction of socially desirable housing so urgently needed. For many of our elderly members, because of their limited incomes, the housing shortage has become a crisis. Justice requires that we permit those who have earned the right to live out their lives in decent housing. It is entirely fitting that pension funds designed to provide security in old age also be used to increase the supply of decent housing available to them.

In performing this service, the AFL–CIO also helps provide additional and continuing employment for the construction trades and for the industries that supply material, furnishings, appliances, and services for housing.

Madam Chairman, I would like to speak now of the IBEW investment program. The IBEW pension fund has been in operation for 40 years.

It was born out of necessity, as some of our employers began setting up retirement and death benefit programs. The IBEW officers and members, feeling that this was an attempt to draw workers away from the union, decided we should set up our own program in order to be competitive in our organizing campaigns.

At the 1927 international convention in Detroit, the IBEW pension plan was formally adopted. Benefits were set at $40 a month: members' payments into the fund were set at 37 cents a month. It is important to note that the IBEW pension plan's only source of funds is the per capita payments from its members.

The plan went through troubled years at first: there was little actuarial experience to guide its administrators. But it did develop. It has been amended several times and currently pays qualified members a benefit of $2 a month for each full year of continuous covered membership. It also provides a disability benefit for members who are totally disabled, and pays a death benefit of $1,000 to the member's beneficiary.

The IBEW international officers have been chargd by the IBEW constitution with the responsibility for investing and reinvesting IBEW funds, including purchase, lease, or sale of real estate, all subject to approval by the international executive council.

The officers have always held these funds as a trust and have believed that their investment philosophy should be to safeguard the fund's principal and at the same time seek a rate of return at least equal to the actuarial requirements.

The international officers also believe, as a matter of principle, that it is not always a requirement that the highest possible rate of return be realized. Given the choice between an investment in an A.T. & T. bond paying 9 percent, and in an 8½ percent investment in an FHA or VA home loan for a young couple starting out in life, the IBEW will select the home loan.

The officers also believe they should take advantage of opportunities to make investments which will increase work opportunities for AFL-CIO members. An example of this policy is our investment in construction loans. The IBEW has a large membership in the building and construction trades. We extend loans to qualified developers for the construction of office buildings, apartments, shopping centers, industrial facilities, et cetera, providing the developer has a commitment for the permanent loan, and providing the construction is by 100 percent union labor.

This type of investment can be rolled over approximately every 18 months, and the objectives of the IBEW are reached again and again.

Here in Washington, D.C., the IBEW financed the first housing rehabilitation program sponsored by Cardinal O'Boyle. The properties at North Capitol and K Streets are for low and moderate income families and area residents were given priority. The workmen employed in this project were provided by Project Build. This is a manpower program funded by the Department of Labor and sponsored by the Washington Building Trades Council, AFL-CIO, to provide construction jobs for minority group workers.

The IBEW reserves a portion of its funds for what is known as a "purchase-leaseback." In this type of investment, a developer will assemble suitable land, and construct various types of facilities. The facility is then leased to a responsible tenant, and the IBEW purchases the entire package.

The lease will require rental payments to the IBEW for periods ranging from 20 to 30 years. All expenses for operation of the facility are paid by the tenant. At the expiration of the lease, control of the entire property reverts to the IBEW. Typical tenants in IBEW-owned properties are Kaiser Aluminum, Federated Department Stores, Dennison Manufacturing Co., REA Express, Safeway Stores, and Grand Union Food Stores.

Yields from investments of this type are commensurate with other long-term investments, with the added inducement that at the end of the lease there is a definite residual value. All of these facilities are new facilities and must be constructed with 100 percent union labor.

Another type of investment is the purchase of the land underlying existing buildings. Typical examples of this are the Statler Garage and the Quebec House. An interesting feature of this type of investment is that upon termination of the long-term lease, the residual value reverts to the IBEW. Since the value of land has appreciated over long periods of time, this appreciation can be available when members age 25 or 30 today approach retirement age.

About 10 percent of our investment is in corporate bonds, purchased for long-term guaranteed income. With few minor exceptions, the issues selected are chosen from public utilities. We believe that this industry, as a borrower, is in as strong a financial position as any in the United States, and that its strength guarantees payment of

both interest and principal. In addition, the IBEW represents some 200,000 members employed by public utilities.

The IBEW believes that a modest investment in the common stocks of large industrial companies also has a proper place in our pension fund administration, as a hedge against inflation. Our portfolio could be characterized as being dominated by blue chip stocks, again heavily oriented toward public utilities.

Our rate of turnover is extremely low. We believe that any attempt to outmaneuver the daily fluctuations in stock prices has no place in pension fund management. And my personal opinion is that playing the market is just like playing the horses, it is on past performance, and the condition of the horse or the company at a given time.

Some of our pensions funds are also placed in Government bonds and time deposits, as short-term investments, while awaiting delivery of long-term investments.

By far the major portion of our pension fund investment—more than 50 percent of it—is in mortgages. About 15 years ago, after reviewing its investment portfolio, the IBEW made a basic policy decision to increase its purchases of real estate mortgages. We decided that FHA-insured and VA-guaranteed loans would be the appropriate vehicles to implement the program.

We look upon an investment in a self-liquidating mortgage as a partial hedge against inflation, particularly in periods where interest rates are rising. The required monthly payments are available to reinvest in mortgages which carry a higher rate of interest. But more important, it helps to increase the supply of critically needed houses.

In each city where our program is operating, a leading mortgage banker contacts local builders and arranges construction financing. After the homes are built and sold to approved buyers, the IBEW purchases the mortgage. Each month we receive a check and a report on collections and delinquencies from the mortgage bankers.

Our investment in the first year of the program amounted to $12 million. At the present time, the IBEW pension fund and its affiliated funds own approximately 16,000 owner-occupied, single-unit home mortgages. They are valued in excess of $250 million. It is our intention to invest about $40 million in FHA's and VA's during 1970.

Madam Chairman, one of the cities in which the owner-occupied, single-unit housing program is operating is your home city of Detroit. As of the first of this month, the IBEW and affiliated funds owned $28 million of such investments there. We are currently financing more than 2,000 home owners. Our representatives in Detroit are James T. Barnes and Co., and Citizens Mortgage Corp.

We are also providing construction financing in Detroit for two FHA projects being built under FHA section 221(d)(3). The total of this construction financing is more than seven and a half million dollars.

In addition to its housing program in the United States and Canada, the IBEW has supported our Government's program to provide low-cost housing in the Latin American countries. It has financed such housing in Mexico City; Bogota, Colombia; and Caracas, Venezuela. These loans are guaranteed by the State Department.

In the administration of our funds, our aim is to build an investment program of security with reasonable yields, and at the same

time to use our funds, wherever possible, in the cause of civic betterment. To this end we have helped to provide financing for slum clearance, for urgently needed Government insured or guaranteed housing, for schools, churches, and hospitals.

While doing this, we have also helped to achieve long-range union employment goals, and to return the benefits of union investment to the union investors.

That completes my statement, Madam Chairman.

Chairman GRIFFITHS. Thank you very much, Mr. Keenan. I think you have a logical objective, and I think you have represented the members, both the retiring members and those who are presently working. And you have helped the subcommittee.

Mr. Babson, we shall be glad to hear from you at this time, sir.

STATEMENT OF DAVID L. BABSON, PRESIDENT, DAVID L. BABSON & CO., INC., BOSTON, MASS.

Mr. BABSON. Thank you, Madam Chairman.

I was very much interested in Mr. Cantor's comments. And while mine may be somewhat different, I do not want them to sound as though "the performance" of the funds under our firm's management has not been effective.

Our firm is an independent investment counsel firm. We have no allegiances or alliances with anybody. Our firm is wholly owned by our partners. We have been in business 30 years. And we supervise $1,500 million in assets.

So with these brief explanatory remarks I go on to my statement.

I am really delighted that you asked me to appear. And I am very happy to accept the invitation.

There are real problems in the investment management field these days. And they apply with equal force to all types of institutional investments, whether they be those of colleges, endowments, insurance companies, mutual funds, or public and private pension funds.

During the past 25 years the investment management industry has grown from a relatively obscure field into one of the country's largest service activities in terms of dollars. At present, an estimated $700 billion of the national wealth—equal to about one-fourth of the total—consist of debt and equity securities held by institutional investors.

These managers of the public's savings must compete with one another in the investment process and—in doing so—they are all subject to the same general forces. This close interrelationship has, in recent years, encouraged the wide acceptance of some disturbing new investment practices which are detrimental to the public interest as well as to the sound growth of the economy.

We have already mentioned the decline going on in the securities markets. But I wonder if people realize how serious it is. During the past 18 months the prices of bonds, once considered the most secure of all investments, have dropped on balance by 25 percent. During the same period stocks, as measured by the leading market yardsticks, have lost 25 percent of their value. But this 25 percent decline in high quality stocks does not begin to measure what has been going on at the speculative end of the market.

This is the largest drop—almost collapse—that we have had in my lifetime in the investment field, which incidentally began in June of 1932, the week the Dow average reached the lowest point in the century.

Since late 1968 the shares of thousands of lower-grade companies have dropped 50–90 percent in price, while the asset values of hundreds of mutual funds have dropped from 30 percent to as much as 70 percent. Some of these funds have lost 25–30 percent of their value in the month of April alone.

Now we have had previous periods when speculative excesses became over-blown only to be punctured a short time later. But what was different this time was that the Nation's major institutional investors—with vast billions of assets under their supervision—became involved in, and even sponsored, the speculation.

In the past, large-scale trading activities in the stock market were carried out by individuals or small groups. The amount of money under their command was thus limited. Even the notorious pools of the late 1920's—which led to regulation of the securities markets—involved "penny ante" stakes compared to the huge chunks of capital that fiduciaries have recently began using to run stocks up and down.

This is clear from the SEC's figures on turnover ratios. For private noninsured pension funds, the annual rate has grown in an almost steady progression from a traditional figure of less than 10 percent in 1962 to 25 percent in the final quarter of 1969.

The open-end mutual fund have lifted their turnover ratio even more—from 17 percent in 1962 to an unbelievable 52 percent in the latest reported quarter—and some have been churning their portfolios at a 100 percent to more than 300 percent pace in each of the past 3 years.

All this has been done under the guise of performance investing. This popular technique of portfolio management—which is merely a glib euphemism for speculation—has led old-line fiduciaries, who would have cringed at being labeled as gamblers or traders in the past, into what has amounted to a national crap game.

In the performance approach to investing, potential capital appreciation takes precedence over potential risk. And the so-called "time horizon" used in judging the investment merits of a given holding has narrowed from years to months, to weeks—even to days. As one corporate pension fund manager was quoted:

> In today's market, we figure 10 percent in two weeks is better than 30 percent a year from now.

The widespread willingness of professional investment managers to take huge short-term risks with other people's money reflects their growing incentive to speculate. In the mutual fund field, the incentives are obvious and are a matter of public record. Individuals sponsoring successful mutual funds have amassed enormous personal fortunes almost overnight.

There is also a strong incentive for pension funds to speculate. The carrot in this case is the big cost reduction which an improved portfolio return (income and capital gains combined) can make in the annual contributions that pension funds siphon off from corporate profits.

In the past several years, company managements have become increasingly conscious of how much their earnings can benefit from capital appreciation in their pension assets. So more and more have been actively seeking outside performance managers for their retirement funds.

Indicative of their attitude, almost the first question they ask us when they come to our offices is "How much growth have you been able to achieve on the funds under your supervision?"

In an interesting article in Dun's Review in January 1969 the manager of a corporate pension fund, covering some 280,000 employees, reportedly made this revealing comment:

> We divided up most of the assets between three banks, but we also set aside two pieces. One piece we gave to a fund management investment firm, to see what they could do, and the other piece we decided to manage ourselves. Then—clearly and loudly—we announced to the banks, the investment firm and to ourselves: "This is a horse race and we're going to be watching to see who comes in first."

It is ironic that corporate management believes it is investing—and not speculating—when it uses shareholders' assets to build a new plant. Yet the same management may be willing to play games with the assets of its employees' retirement funds in the hope of reducing the company's annual contributions.

This attitude has spread—belatedly—to the public pension funds. An informative article in the February issue of The Institutional Investor Magazine covers some recent developments in the investment management of state retirement systems. The program of the State of Oregon, the article says, is "leading the way." It has hired three investment advisers, giving them complete discretion, no strings attached. The article then goes on:

> After two years the State will begin to adjust its cash flow of new moneys on a basis to the counseling houses that have performed best.

Another article from the Los Angeles Times, dated November 16, 1969, quotes one of the three Oregon managers in discussing the approach being followed since the new set-up began last July 1:

> Capital Guardian Trust of Los Angeles, which runs one-third of the Oregon portfolio, has been in and out of two stocks in the four months. One of them was National Homes which "it bought at 19 or 20 and sold at 27. * * * We'll buy some backbone stocks like Borden and Carnation—but there'll be some more National Homeses, too."

Now, some people always want to speculate, and some speculation helps to make for more orderly securities markets. It may even be appropriate for a professional investment manager to speculate for someone else with his knowledge and consent. However, much of the institutional speculation in the past several years has been done with funds that have been set aside by, or for, unsophisticated individuals whose primary need is sound investment and who cannot afford the risks of speculation.

The market excesses of 1967 and 1968 are still in the process of being liquidated. The decline in stock prices during the past 16 months represents a paper loss in the Nation's financial assets of over $200 billion. This is more—in terms of dollars—than was wiped out in the Great Crash of 1929–33.

As I said earlier, however, the public does not yet seem to be aware of the magnitude of the collapse. When it realizes what has happened—and why—its confidence in those institutions which have engaged in reckless speculation is bound to be shaken.

I want to make it clear that there are many pension funds—along with numerous other investing institutions—which have continued to exercise sound investment policies throughout the entire performance game. They should not be condemned for the past folly of the crowd.

I am sure you realize that investing is not a science. It is not even an art. The most important ingredients are experience, judgment, and common sense. When institutional investment managers start trading their portfolios back and forth, they are deviating from their primary fiduciary responsibility.

The balance between potential investment return and the risk involved in seeking that return must be weighed carefully. A basic question about pension fund management—as well as about any institutional investment operation—is to what extent the beneficiaries of the fund should be protected against unwise policies and decisions on the part of the fund's managers.

And aside from the potential financial losses that may be incurred, the continual churning and trading of the Nation's corporate assets is a disservice to our capitalistic system. It also distorts the expectations of investors—particularly the less informed—who have been led by the performance seekers to believe that their holdings should increase in value by 15 percent, 25 percent, or even more each year. For example, a letter dated this March 31, from a securities house to an institutional client of our firm stated:

> Our performance objective is to provide a compounded return of 20 percent annually.

Over the long run the growth of investment values has to be related to something basic rather than simply pulling a figure like 20 percent per year out of thin air. In the final analysis, the annual rate of return from the typical list of stocks must reflect the growth of the economy as a whole, and, more specifically, the expansion in corporate earnings and dividend-paying ability. How much is this?

During the past half century—a period which includes about every type of social, political, and business condition—both the economy itself and total profits have risen at an average yearly pace of 5 percent.

The fact is that, over an extended period, annual appreciation rates of 20 percent are one-in-a-million long shots, and even 15 percent involves plenty of skill, lots of luck and some dreaming.

Relatively few companies have been able to increase their earnings at as much as a 10 percent annual rate for very long. In a sample of nearly 600 industrial companies, for instance, our firm found that only one out of every five had a growth rate of 10 percent or better for the 15 years from 1953 to 1968. And only a handful have done so consistently year in and year out.

It seems absurd for investment managers to expect to outperform the most successful corporations in the United States by a wide margin. The record shows that an overall return of 8–9 percent annually from capital appreciation and dividends combined is a reasonable expectation and that a return of 10–12 percent can be achieved through

45-800—70——15

careful long-term portfolio selection and without assuming inordinate risk.

The Alice-in-Investorland climate of 1967 and 1968 is now a part of history. The trip back to reality is turning much of Wall Street into a financial disaster area. Let us hope that some valuable lessons have been learned from these follies.

In the years ahead, pension fund management faces an important task in providing for a growing army of pensioners. In assessing the outlook for how this field will perform its function, three specific questions are worthy of attention.

First, what about the widely discussed shortage of securities? Will there be an adequate supply to meet the investment demand created by the estimated $12–$14 billion annual net flow of contributions into all non-Federal retirement programs?

Second, how can the investment managers of pension funds best conserve the future buying power of beneficiaries against the effects of inflation?

Third, should there be legal safeguards to protect the beneficiaries of these funds against conflicts of interest on the part of their managers?

Looking at these problems:

1. First, the supply of securities: The universal investment view of the late 1960's was that the future demand for common stocks would far exceed the supply, thus pushing share prices upward at a rate in excess of the historic norm. The shortage of stocks would be based on—

(*a*) An accelerating accumulation of savings seeking investment outlets; and

(*b*) A continuing shift in the emphasis of pension funds and other institutional investors away from debt and into equity-type securities to protect against inflation.

In my opinion, this particular concern is unfounded and should be dismissed. The real problem in the years ahead will be finding enough capital to finance the economy's growth. In the 1970's more debt capital will have to be created than the entire $1.7 trillion in debt outstanding today.

Because of a growing shortage of loanable funds, the past year has seen a major shift from debt to equity financing on the part of corporations. From 1960 to 1964, for example, around 20 percent of all new corporate financing was of the equity type. By 1969, the proportion had more than doubled to 42 percent.

With the cost of money at the highest level in history, corporate issuers are likely to continue shifting from straight debt offerings to partial or total equity financing. In 1969, the new supply of stocks began its first major upswing in decades. As we move along in the 1970's, the supply of both equities and debt securities should continue to be sufficient to meet the demand. The real problem is where is the money coming from?

2. Protecting pensioners against inflation:

This is the most serious problem facing the investment managers of pension funds. During the past century, the dollar has been depreciating at an average annual rate of 2 percent. At this pace, it lost half its value every 35 years. Several years ago, the rate of decline

doubled to 4 percent annually, a pace which cuts the dollar in half every 17 years. More recently, the downtrend in the dollar's value has quickened to 6 percent, a rate which halves the dollar every decade.

One does not have to hold a Ph.D. in economics to understand the reasons why the rate of inflation has tripled since 1960. Two underlying trends are primarily responsible for—

(*a*) The uncontrollable upsurge in Federal, State, and local government outlays; and

(*b*) The power of unregulated unionism to force a wage increase pattern on the Nation that is several times greater than the rate at which productivity can be improved.

There is not much hope that today's inflation rate can soon be reduced to less than 4 percent unless——

(*a*) Congress becomes really determined to hold down the growth of government spending—and not just for one year, but for the next 3, 4 or 5 years; and

(*b*) The ability of unions to obtain inflationary pay increases is curtailed by legislative or other means.

Most people are keenly aware that high-grade common stocks have been effective offsets to the historic 2 percent rate of inflation. Throughout most of the past century, the total return on stocks—dividends and capital growth combined—has averaged 9 percent annually, leaving an "after-inflation" return of 7 percent. Bonds, mortgages, and other debt investments, on the other hand, have averaged a return of less than 5 percent—providing a net constant-dollar return of only 3 percent. Thus, common stocks have been over twice as effective as debt investments over the long run.

Under the present 6 percent inflation pace, however, debt securities are yielding 9–10 percent to give an "after-inflation" return of 3–4 percent. This is slightly more than the net return that can currently be expected from common stocks, based on the long-term trend of their capital appreciation and dividends.

But even though bonds are now as attractive as stocks—especially for investment portfolios which must pay out fixed-dollar obligations—it is ironic that many pension fund managers still cling to the notion of the late 1960's that stocks at any price are better long-term investments than bonds at any yield. The realities of the marketplace may slowly bring about a change in their attitude.

3. The third problem, conflicts of interest in the investment management "industry":

This third problem has arisen as the need and demand for investment advice has mushroomed over the years. Potential conflicts of interest exist throughout the investment management profession as they do in many other areas, and I have attached an article on this subject that discusses this subject in more detail, and it could be made a part of the record if you would like it.

Chairman GRIFFITHS. Thank you. I will indeed make it a part of the record.

(The article referred to for inclusion in the record at this point follows:)

THE INVESTMENT MANAGEMENT "INDUSTRY" AND ITS PROBLEMS[1]

For over a decade, our Staff Letters have pointed out that the U.S. economy is the first in history to employ more workers in providing services than in

[1] By David L. Babson Co., Inc., investment counsel, Boston, Mass.

producing goods. Among the fastest growing of all services is the investment management "industry," i.e. the broad area of offering financial advice to individuals and institutions.

This field's rapid expansion and today's heady speculative climate are fostering a host of serious new problems. Most of these involve the conflicts of interest which are cropping up almost daily as traditional lines of demarcation between investment functions become increasingly blurred. Not only are established firms diversifying into new areas, but more and more outsiders are being attracted into the business. In short, everyone now seems to be getting into everyone else's specialty.

For example, a number of investment counsel firms, including several of the largest and oldest, have been bought out—some by life insurance companies, others by a bank holding company, one by the nation's largest brokerage house (which may also form and promote its own mutual funds), still another by a mortgage lending company. Last year, a leading university set up an investment firm to supervise its endowment portfolio, manage a mutual fund and offer its counsel services to others.

Several mutual fund management companies have been acquired by industrial conglomerates pushing their way into the financial area. At present, the biggest retailer in the country is about to bring out its own mutual fund to be sold through its insurance subsidiary (which has over twice as many salesmen as the largest independent mutual fund organization).

In addition, a stock exchange member firm specializing in institutional sales is planning to "go public." Another brokerage house is setting up a holding company to offer a full line of financial services (investment advisory, mutual funds, etc.). And finally, legislation now pending in Congress would permit banks to offer the public a new type of security similar to mutual fund shares.

These radical and far-reaching developments raise serious questions for institutional and individual investors seeking independent and unbiased advice. Following is a description of the growth and scope of the investment management "industry" and the new problem areas which its rapid expansion is creating:

1. DEMAND FOR INVESTMENT ADVICE

There are no definitive statistics measuring the size of the investment advisory field. However, total outlays for this service have probably been rising in line with the growth of the equity assets held by all financial institutions (not listed separately in the following table are closed-end investment companies, banks, state and local retirement programs and common trust funds):

MARKET VALUE OF STOCKS HELD BY FINANCIAL INSTITUTIONS

[Dollars in billions]

	1968	1965	1955 [1]	Annual average increase 1955–58 (percent)
Personal trusts	$80.1	$70.4	$28.5	8
Private pensions	59.6	39.7	6.1	19
Mutual funds	50.9	33.5	7.2	16
Insurance companies	27.5	21.1	9.0	9
Foundations	15.8	14.1	6.0	8
College endowments	9.0	6.4	2.6	10
All institutions [2]	257.8	197.6	66.3	11

[1] Estimated.
[2] Institutional holdings as percent of estimated market value of all common and preferred stock outstanding in the United States.

Source: Securities and Exchange Commission.

The huge growth in assets under professional management has been accompanied by a steep uptrend both in the employment rosters of investment firms and in the number of individuals who own common stocks either directly or indirectly via mutual funds. The pertinent statistics are shown below:

NUMBER OF PEOPLE INVOLVED IN THE INVESTMENT FIELD

	1968	1965	1952	Percent increase 1952–68
Financial analysts	11,907	9,740	3,237	+270
Brokers	188,700	128,900	68,200	+175
Shareholders (millions):				
Direct	26.0	20.1	6.5	+300
Mutual fund	9.1	6.7	1.4	+550

The need and demand for investment advice have been stimulated by just about everything that has occurred in the political, social and economic arenas over the past two decades.

Among the most important are the enormous growth of money and credit, the powerful upsurge of the economy, the virulent inflation and the resultant flight from fixed-dollar assets, the new industries emerging from the huge expansion in research and development activities, the rising level of education, the growing intrusion of the government in business and individual affairs and the intensifying competition for investment results.

2. SOURCES OF INVESTMENT ADVICE

Most readers are probably aware of the various major sources of investment advice, but it may be helpful to list and describe them:

Banks and trust companies

It took years for many of these institutions to rebuild their investment management reputations following the debacle of the 1920's and 1930's. But they have been working diligently to improve their overall competence and are doing a better job than ever.

They have expanded their services by providing "agency" supervision and establishing common trust funds to handle small trusts more efficiently. Their principal problems are (a) attracting and retaining capable personnel in this era of skyrocketing salaries, and (b) overcoming the difficulty which large organizations experience in handling highly personal client relationships.

Brokers

These give investment advice to more people than all other sources combined. Many member firms have developed extensive and competent analytical departments, particularly to assist their big-volume institutional customers.

A number of brokerage houses sponsor and manage mutual funds and more are planning to do so. The potential conflicts of interest here are obvious. Most firms also supervise portfolios of individual customers. Some charge a fee for this work and credit against it the commissions generated by security purchases and sales in the account.

Since investment brokerage is basically a merchandising business, its primary objective—like that of all sales operations—is to build the volume of transactions. It is difficult for an adviser in any field to make objective recommendations when his compensation is determined by sales commissions. Many of today's new problems would not exist if the functions of brokers and investment managers were as clearly delineated as those of, say, druggists and doctors.

Bulletin services

The avalanche of free brokerage house literature and the mutual fund boom of recent years have held back the growth of investment "advisory letters." Also, SEC restrictions on advertising have clipped the wings of those which formerly relied upon blatant "come-on" solicitation. But the better bulletin services are still popular, principally as a source of check-up information for do-it-yourself investors.

Investment counselors

Started in the 1920's, this comparatively new profession specializes in supervising portfolios on a personalized and continuous (rather than on a wholesale or occasional) basis. Its advice is predicated on the respective merits and

suitability of various investments relative to the needs and objectives of each individual or institutional client. Counselors receive their compensation in the form of annual fees and they do not participate—either directly or indirectly—in commissions on security transactions.

This rapidly growing service was built on the basic premise that a portfolio manager should not engage in any activity which could interfere with his ability to render independent and unbiased advice or which might conflict with the interests of clients. In our opinion, this premise is as sound today as it has been for 40 years despite the recent wave of counsel firms selling out to other financial organizations.

Mutual funds

As our Staff Letter of October 17, 1968 pointed out, a growing segment of the industry has been diverting the original mutual fund principle into a method of channeling public savings into organized trading operations. This has been continuing despite warnings on every hand of unusually high speculative risks. Many "performance" funds have experienced a sharp drop in their per share asset values, which have plummeted two to three times faster than the stock market averages.

A major portion of the industry, however, still adheres to the original mutual fund principle. Regular, periodic purchases of the shares of high-grade, well-run funds having a sound investment policy is the most practical and effective medium of professional supervision for millions of investors of moderate means. While mutual fund management generally is the most expensive form of advice, it gives such investors practical benefits they cannot obtain in any other way.

3. THE NEW PROBLEM AREAS OF INVESTMENT MANAGEMENT

As is the case in nearly every rapidly expanding area, all is not coming up roses. The new sore spots stem from the same origin as the burgeoning demand forces at work in this field—i.e. from the accelerating inflation which has increasingly turned Wall Street's attention away from investing to speculating.

This trend, progressing at a creep in the 1950's and then at a walk in the early 1960's, has finally turned into a gallop in the past several years. The net result has been the stock market excesses, critical personnel problems, the trading turmoil and fast profits. These in turn, have been triggering more and more greed, proliferating conflicts of interest and sinking standards of ethics throughout the financial community.

The age gap

For the past dozen years, these Letters have pointed out the abnormal age gap developing within the investment field. Many of today's difficulties can be traced to the dearth of newcomers into this profession during the discouraging era of the Depression and World War II, when there was also a mass exit of experienced hands.

As investment activity perked up in the 1950's and then took off in the 1960's, thousands of college and business school graduates poured into the field, leading to a bizarre age-mix. A rough estimate is that 10% of today's investment personnel are 45 or older, 25% are between 35 and 45, while the other 65% are in their 20's and early 30's.

Competence and judgment are not the product of age alone. But there is a high correlation between experience and the ability to assess the risk factor. Investors whose exposure has been limited to a period when low-grade issues have far outrun top-quality stocks have no idea of how violently psychology can shift or of how radically the patterns of an extended bear market can differ from those of a long bull move.

Half of today's Wall Street salesmen and analysts have come into the business since the last big break in prices took place in 1962. Because of the shortage of older personnel, many of the new recruits—who have known only the heady climate of the recent speculative boom—have been placed in management and policy-making positions.

For example, a while back we had lunch with a highly-publicized "performance" manager whose fund had typically jumped umpteen per cent in the previous few months (it has also typically plummeted 25% this year). We asked how he had made out in 1962. "Oh, I was in college then, but I'll never forget that 1966 crash—that was a real shocker!"

Uninhibited by painful memories, today's army of new salesmen and advisers has added tremendously to the whole speculative atmosphere. They lead their followers to expect far too much in the way of capital appreciation. Of course, excessive promises are made by veterans as well as rookies. Here is a quotation from a published interview with the manager of a mutual fund sponsored by a leading medical society:

"(We are) committed to a 15% annual growth rate and are setting sights on a 25% yearly gain as a realistic and attainable goal."

We looked up this fund's record—plus 3% in 1968 and a total of 14% for the three-year period, 1966-1968. New investors read claims such as this and think they are gospel. And if anybody points out that a long-term growth rate of 15%—three times the trend of both the economy and the corporate profits—is beyond the bounds of probability, he would be widely looked upon as either a has-been or a never-was.

Salary-snopping and job-hopping

The scarcity of experienced analysts, portfolio managers, trust officers and security salesmen—combined with the soaring profits of investment firms—has rocketed the level of compensation right into the stratosphere. Seldom have more people been paid more money for making a smaller contribution to real economic progress than at present in certain segments of the investment field.

Many institutional security salesmen are making over $100,000 in annual commissions. And some of today's portfolio managers are paid more in a year or two than their predecessors earned in a lifetime. The cover of a financial magazine recently pictured one of these new Wall Street stars—age 32, 1967 earnings—$1,100,000.

Fees or commissions are frequently out of all proportion to the amount of work done or to the cost of providing the services. For example, for years almost everyone in the business, including the SEC, pointed out that standard brokerage commissions on transactions involving thousands of shares were too large. But only after the government put on the heat did the Stock Exchange take a small step in providing volume discounts.

The boom in profits and pay checks has been attracting many people into this field who are interested first in making a lot of money for themselves and second in attending to their customers' interests. And job-hopping has been taking place at an unprecedented pace. Competent people in the professions—whether medicine, law or investment management—should receive reasonable compensation for their services, but to do a really good job they have to be dedicated to giving the best possible advice. If they are, the rewards will be forthcoming.

Conflicts of interest

This is the biggest problem area in the field. The almost daily revelations of wrong-doing, impropriety and sophisticated fraud—even on the part of those in top positions in firms with long traditions of high ethical standards—suggest that both potential and actual conflicts of interest are more prevalent today than ever before.

The situation is likely to get worse as established investment firms continue to "diversify" into new financial services and more and more powerful outsiders are attracted into the field. These developments are breaking down the separation of investment functions which has long acted as a safeguard against divided loyalties and conflicts. Some of the particular problem areas are as follows:

Mutual funds

Many trouble spots have arisen because of the booming popularity of mutual funds and the opportunities for huge profits on the part of their sponsors. The Staff Letter of October 17, 1968 traced the metamorphosis of the mutual fund business since the landmark court decision of 1958 permitted management companies to go public.

The eye-popping appraisals placed on their shares are the reason why so many funds, both new and old, have shifted their emphasis from long-term investing to short-term trading. The trick is to get to the top of the "performance" list, even for a brief period—never mind how much risk is taken or what ploys are used to generate instant results. Then the money gushes in as share sales skyrocket, the firm managing the fund goes public and its promoters become millionaires overnight.

Brokers

Another Pandora's box can be the relationship between stock exchange firms and mutual funds. Some brokers have been receiving colossal commissions on the portfolio transactions of mutual funds, particularly of the fast-turnover type. These are often directed in exchange for selling the fund's shares.

This practice can lead to abuses. For example, is the salesman recommending ABC fund because he thinks it is best for his customers' needs or because his brokerage firm receives more "reciprocal" commissions from ABC than from other funds? And does the buyer have any inkling of this possibility?

A growing number of member firms are beginning to organize, manage and sell their own mutual funds. Some of these can do everything that an outright trader or speculator does—sell short, buy on margin, borrow money, use puts and calls, etc. We have never understood why the Investment Company Act was not drawn to prohibit firms that receive commissions on portfolio transactions from controlling or managing mutual funds.

Large brokerage houses, which retail securities to thousands of customers, including big institutions, and provide management services for a host of individual and institutional accounts in exchange for commissions, have a tough problem keeping conflicts of interest from getting out of hand.

When they set up their own mutual funds, they are compounding the potential conflicts. Who can tell whose interests are being represented by whom in such a tangle? For instance, when a new stock recommendation is coming, who is going to get priority—the firm's own mutual funds, or the other mutual funds and institutions who receive its research recommendations in exchange for portfolio commissions, or the private portfolios it manages or the retail customers?

This same situation can exist in any type of firm which supervises a few huge portfolios and a very large number of smaller ones. Several investment company managers, who run four or five big mutual funds, have recently taken on individuals and institutions as clients. They must find it difficult to make certain that the portfolios of the funds on the one hand, and those of the outside clients on the other, get an equal crack at the latest buying or selling decisions.

New issues

It would take pages to detail the madness taking place in the new issue market. But some inkling of the situation is apparent from the following comment by the Over-The-Counter Securities Review:

> "What worries us as much as anything is that the underwriters of new issues, often long-established and presumably reputable firms, have allowed their standards of investment judgment to sink to levels that their principals could not have envisioned a few years ago . . . Today, such standards are usually honored in the breach, especially by underwriters who have grown rich and fat by the merchandising of low-grade issues . . ."

Investment counsel

These organizations—along with banks and trust companies—have generally been free from the potential conflicts and problems we have been reviewing. However, a number of the leading counsel firms have recently been bought out—several by insurance companies, some by a bank holding company, one by a major brokerage house.

Except in the latter case, the potential conflicts here are more subtle and less obvious than those discussed earlier. There are now only a few sizable counsel firms engaged exclusively in portfolio supervision which do not manage a complex of large mutual funds or are not owned or controlled by companies in other financial fields.

As we were concluding this article, we recalled a passage in Bernard Baruch's autobiography. Because we believe wholeheartedly in the principles upon which our profession was founded, we think this quotation is especially relevant today in view of all the developments taking place. In discussing the field of investment counsel, Mr. Baruch stated:

"The emergence of this new profession of disinterested investment analysts, who have no allegiance or alliances and whose only job is to judge a security on its merits, is one of the more constructive and healthy developments of the last half century."

Mr. BABSON. In recent years the assets of many employee retirement funds have been placed under the discretionary management of

stock exchange firms and underwriting houses. The problem here is the potential conflict of interest involved when the fund manager derives income from acting as the broker on the transactions he directs as the investment adviser.

The prospectus of a well-known brokerage firm which recently made a public offering of its shares illustrates this problem. In 1969 this firm managed, on a discretionary basis, an average of $640 million in institutional capital, 76 percent of which was retirement fund assets.

The brokerage commissions on these portfolios last year amounted to $11.7 million—of which the subject firm received $10.7 million, representing 40 percent of its brokerage revenue from all sources, plus $620,000 in portfolio management fees.

The annual commissions received on these institutional accounts represented 1.7 percent of the capital under supervision, indicating that the assets were turned over at an extraordinarily high rate. The firm's brokerage commissions were on these institutional accounts 16 times larger than its management fees.

Thus, a prime question to be considered is whether or not security merchandising firms should be permitted to have an advisory decision-making capacity in pension funds on which they also receive brokerage commissions. In the medical field we do not let the doctor fill the prescriptions or the druggist write them. The doctor does not own the drug store.

Chairman GRIFFITHS. Sometimes.

Mr. BABSON. The druggist does not employ the doctor.

Chairman GRIFFITHS. I agree with you, definitely not.

Mr. BABSON. How can the beneficiaries of the funds be certain that the transactions are unbiased, well-founded and in their best interests?

In conclusion, investment management—including that of pension funds—is a vast and complex field. I have touched only upon those aspects which seem important to me.

Thank you.

Chairman GRIFFITHS. Thank you very much. You have been very frank and you have been very helpful.

Do you feel that if we followed your last suggestion and divorced the manager from the person collecting the commissions on the sale of the assets that it would be a sufficient safeguard, or do you think that there should be some publicity or some regulation on the turnover of the funds?

Mr. BABSON. I think that what is done in a public pension fund—and I assume that you could use the term "public," because there are so many people involved—should be public knowledge.

Chairman GRIFFITHS. What I keep saying is that the real truth is that the American taxpayer is setting up many of these pension funds.

Mr. BABSON. I think what action is taken in them should have publicity, also the "turnover" ratios. I do not know how detailed the disclosure should be, but certainly some information about how these funds are handled should be in the public domain. And I am convinced that this business of allowing underwriting and brokerage houses to supervise pension funds and turn them over—this particu-

lar prospectus to which I referred indicate that the brokerage house had over 50 percent operating profit on its brokerage business, and on $10 million commissions it had a $5 million profit from the brokerage that it directed, because these were discretionary accounts. Now, if this amount of capital were handled by independent counselors like ourselves, paid on a retainer basis, I would assume that our fees would be approximately what those of the aforementioned firms were—or something in the order of $600,000 to $1 million—and the operating profit would be perhaps $200,000 at the most. So I think you can see the tremendous incentive broker-underwriters have to churn these portfolios.

And in the same vein, I have never believed that the SEC should ever have permitted mutual funds to be run by brokerage houses. To me it is an absolute and direct conflict of interest.

Chairman GRIFFITHS. Would you agree with that, Mr. Cantor?

Mr. CANTOR. Partially yes and partially no. And since Mr. Babson spoke to one of my remarks, I would like to respond to this subject, if I may.

Mr. KEENAN. Could I cut in first?

Mr. CANTOR. Yes.

Mr. KEENAN. You mentioned that some of these funds are turned over two or three times a year. Do you mean that their complete assets are sold two and three times a year?

Mr. CANTOR. I think the typical change——

Mr. KEENAN. Does that mean that that goes through the brokerage firms and they pay fees on all of that?

Chairman GRIFFITHS. Yes.

Mr. KEENAN. That is an outrage.

Chairman GRIFFITHS. I agree.

Mr. CANTOR. Let me comment first of all that I recall Mr. Babson's speech at the Institutional Investors Conference a few years back. And I want to make it perfectly clear that I was in the audience that day, and that I tended to side more with his arguments than with the arguments of his opponent on the platform.

I said in one part of my statement that I think one of the unfortunate things that is going on here is that much of the progress—and I think it is real progress—that was made in the last several years is now going to be destroyed in a reaction. And the reaction is going on right now. I regard some of the comments that were made today as reactionary. I deliberately introduced a list of techniques that were used by some of the performance managers in an attempt to let this subcommittee know that while I consider myself a performance manager, I think they are as abhorrent to me as they are to Mr. Babson, and I think they are to most portfolio managers.

Let us just take one issue, the issue of turnover. I think Mr. Keenan and Mr. Babson and I all agree that turning over a fund under almost any circumstances, but not all, a hundred percent or 200 percent in 1 year is extraordinary, it is outrageous, it is too costly, and it is profiteering in some cases.

Chairman GRIFFITHS. Of course.

Mr. KEENAN. And you are shooting craps all the time.

Mr. CANTOR. But let us finish the statement.

There are financial institutions in this country that have not had a trade in one of their trust accounts in 15 years. There are banks

and mutual funds who through ineptitude, poor management, laziness, and cost cutting, have held on to shares of corporations at multiples that were extraordinary in relation to the real short, intermediate, and long-term growth prospect for those companies.

The end result has been to the detriment of individual trusts, personal trusts, accounts managed by banks investment advisory departments and pension fund trusts.

I think the problem with some of what was done, and with the comments that are now going to be made about it, is that everything—is that some of the things that were progressive, truly progressive, are now going to be passed off as speculative. Every account that was sold out, because it had been completely mishandled, and reinvested in a realistically more progressive way, is now going to be criticized because its turnover was 50 or 60 percent in 1 year, and perhaps the first year of its operation.

I take particular exception to the use of several kinds of words which, when they are examined, are prejudicial. I take exception to the use of the words "high quality," "low quality," "higher grade," "speculative," "nonspeculative." What do these words mean? If every investment in every company that is not a major American corporation that does not have 72 million shares outstanding and that does not do $850 million or $4 million worth of business a year is termed "lower grade" or "speculative," then the workers who are entitled to these pension fund benefits and the corporations who are legitimately investing money are going to be shortchanged. And ultimately I would disagree with some of Mr. Keenan's remarks, because while it is true that the corporation receives the benefit through reduced funding costs of some of these pension funds, it is also true that Mr. Keenan and his associates are completely aware of the net effect of increased equity values on the cost of funding these pensions. And if that does not become a legitimate part of the bargaining process, I would be very much amazed. So that the benefits ultimately of more progressive investment techniques are passed on to the worker in higher benefits.

Now, I made the point that it is a fact that America's most mature companies are not offering the best returns, that there are many secondary companies with proven records that are not speculative that do offer better returns, and they are not being employed in these pension funds by the major investment institutions for a whole host of reasons, most of which have to do with their corporate association's ineptitude, the amounts of dollars that they actually handle. And I hope really that in a period when the market is under stress that this kind of thing is not lost in just a whole realm of accusations of everybody who ever did anything progressive as being nothing more than a speculator, or anybody who ever ran a fund which went down more in a bad market than another fund which was more conservatively managed is accused of in effect being a speculator.

I think one of the things that really ought to be clear here—and it is apparent to me from looking at the figures, and I am sure it is apparent to anybody else that looks at them—is that one of the factors that a pension fund manager must accept if he wants to invest—and I would call it investing—for higher reward is a higher variant.

The figures that I cited to you on performance in 1967, 1968, and 1969 despite the blood bath of 1969, still indicated, when the average of those 3 years is taken together, that the advantage continued to lie with the people who invested money for higher returns. What it proved was that there was a higher variance.

Now, I would add one other factor, that one of the reasons for the higher variance is the refusal on the part of some of the people who have both legislative and in other cases administrative responsibility over the people who are investing these funds to recognize the problem and to create markets that will reduce the variance in secondary issues, or higher growth issues.

Chairman GRIFFITHS. What do you mean by "variance," sir?

Mr. CANTOR. What I mean by variance is this. I have made the statement that I think that it is possible by investing, if you will, in a typical company with $250 million in sales and 5 million shares outstanding, it is more probably in that kind of company that you are going to get a higher rate of return than if you invest in a typical company with 72 million shares doing $5 billion a year of business—now, not in every case—anybody can cite examples where that is not the case, but most economists will agree that smaller companies grow at faster rates.

It is also true that in periods of economic acceleration these companies' earnings grow at higher rates than the larger companies, and in periods of economic decline their earnings decline faster.

It is also completely logical, since at some point in time common stock prices should be related to earnings growth and earnings decline, that the common stock prices should go up more in periods of good markets and down more in periods of bad markets. And nobody should be particularly amazed at that.

It is also true that as a function of the marketplace, because there are fewer shares outstanding, the effect of going up in price and down in price is compounded, so that you get higher variances around a long-term secular growth pattern. And it is in that context that I use the word "variance."

Now, this is not surprising. It does not amaze me at all, for example, that one of the people cited ran a fund that was down 25 percent in the first quarter plus 2 weeks of this year. I think to look at a true investment record you have to look at a record of 3, 4, 5, or 10 years, and you have to understand the method of investment. And you cannot condemn it simply by saying it is speculation or involvement in lower quality securities, because that is not universally true, although I completely agree that these techniques that Mr. Babson cited and that I cited were used by some of these people, and there was no real investment in some of these cases.

Now, the last part of the argument that I made is this, that this variance, since I believe investment in these kinds of companies, both from the standpoint of the American economy and the American worker, is a desirable thing, it ends up in higher pensions, greater ease in raising money by people who need the money—I think this is a desirable thing. It would really be helpful if the people who have the responsibility would take steps to reduce some of these variances. The marketplace is treated in the same kind of capricious fashion that it was in the twenties.

It is a gambling casino that is available for anybody who wants to play. If you want to short a stock you can short a stock. If you want to do things with leverage you can do things with leverage.

Now, when we are talking about investing a hundred million dollars in uninsured pension assets in this kind of a marketplace, and more in total pension assets, with that figure growing at a phenomenal rate, and we still treat the marketplace as though it is fair game for any fool who wants to play it, and no regulation is imposed, it is completely logical that we should have higher variances than we would have if this were not the case.

If I want to sell a stock, and I represent a legitimate ownership, and that ownership is actually the ownership of a pension fund, although it would never be the Electrical Workers, from what Mr. Keenan says, there is no reason in the world why I should not have a prior interest in that sale than somebody who does not own it and is shorting it just using the marketplace as a gambling vehicle.

The fact that this kind of practice has never been eliminated I think has increased these variances. The use of leverage in accounts has increased these variances. And the fact is that many more pension funds which legitimately ought to be invested in secondary issues do not do so has increased these variances.

Chairman GRIFFITHS. Mr. Keenan?

Mr. KEENAN. I would like to know why there is no consideration given to mortgages.

Chairman GRIFFITHS. We were going to come to that question, but we will ask it right now.

Do you consider a mortgage a good investment?

Mr. CANTOR. I have a problem with that question. The problem is this, that I can answer as an investment person and I can answer on a personal level. I will give you the answer that you are concerned with.

On an investment basis I would consider it an improper investment. I would consider on an investment basis any investment improper that does not meet a market rate of return.

Mr. KEENAN. What is the market rate of return when you are above it?

Mr. CANTOR. I am sorry, Mr. Keenan?

Mr. KEENAN. What is the market rate of return if your fund is making 6 or 7 percent?

Mr. CANTOR. Right now if I have money that is fixed income money—and that is what mortgage money is—and I cannot put that money out at 9½ percent with great security, then I am just not looking.

Mr. KEENAN. You are getting 9 percent today.

Mr. CANTOR. But since I have to live in New York City, if I were to happen to make an investment in New York mortgages, I can only put them out at 7½ percent. And you are not getting 9½ percent—what I am saying is that when mortgages are attractive on a market rate of return basis, I think they should be included in investment portfolios. And there was a period of time in the mid-sixties when some of the major financial institutions began to go to mortgages, because they were attractive, because of many of the features that you mentioned.

And then they became no longer attractive on an investment basis.

Chairman GRIFFITHS. What is your answer, Mr. Babson?

Mr. BABSON. Simply, yes.

There is a new security being issued, as you probably know, by the Treasury. I would think this would be an attractive investment for a great many pension funds.

Of course, pension funds differ. We are talking in generalities. But I would think that mortgages would be——

Chairman GRIFFITHS. A reasonable investment?

Mr. BABSON. Particularly if they are liquid and salable and marketable.

Chairman GRIFFITHS. I notice that you said that you would consider a bond a reasonable investment.

What do you think, Mr. Cantor?

Mr. CANTOR. I certainly cannot—there are times when bonds are more reasonable investments than stocks. It would be most difficult for anybody in the investment business to disagree with that.

Chairman GRIFFITHS. One of the funds appearing here yesterday pointed out that they did have 6 percent in municipals, and they had moved it down to 1 percent, and they were going to get out of the market altogether.

Mr. CANTOR. Out of the municipal market?

Chairman GRIFFITHS. Yes.

Mr. CANTOR. I do not know what the investment judgments were that would lead them to that kind of a conclusion. Taken from the perspective of the last 10 years, bonds have been perfectly miserable investments. The next 10 years may be a different thing again.

Chairman GRIFFITHS. If you were a bank running the portfolio for a pension fund would you advise a pension fund to invest in tax-free municipals, if you were a bank?

Mr. CANTOR. Tax-free municipals?

Chairman GRIFFITHS. Yes.

Mr. CANTOR. A pension fund does not pay taxes.

Chairman GRIFFITHS. Of course not.

Mr. CANTOR. The answer would have to be no.

Chairman GRIFFITHS. But it seems to me that even in this there is a conflict of interest. In 1969, 90 percent of all municipals were bought by banks. We checked the possibility of just asking them to allocate their expenses to these departments. It would have increased the bank's taxes 7 percent. So that a bank is in no position to give really reasonable advice to any pension fund on whether or not to buy a tax-free municipal in any opinion. I think it is like the doctor owning a drug store.

Mr. CANTOR. That may or may not be true.

Chairman GRIFFITHS. Because it is such a tremendous advantage to the bank to have an investment that they really are in no position to suggest that anybody buy any.

Mr. CANTOR. It has never been my position to defend the practices of banks, particularly since I left one. However, I think in all fairness I ought to say here that any bank that advised its pension fund to buy municipal bonds—there are only a few extraordinary circumstances in which pension funds are removed from the banks that manage them, and I think this would probably be one of them.

It is just obviously not in that fund's best interests, being tax free, to listen to that kind of advice.

Chairman GRIFFITHS. I go along with Mr. Keenan, though, when they are selling it with an 8 or 9 percent return, a triple A bond——

Mr. CANTOR. If you are talking about corporate bonds—and that is an investment judgment——

Chairman GRIFFITHS. Cincinnati sold some last year that were paying 8 percent, triple A credit rating—to me that was a pretty good investment.

Mr. KEENAN. With no call in 9 years.

Chairman GRIFFITHS. Of course, you could not buy any. But if you had had the financial power to have bought them I think it would have been very good.

Mr. BABSON. Mrs. Griffiths, we should not get confused—unless I missed something—I have never seen a triple A tax exempt come out at 8 percent.

Chairman GRIFFITHS. Yes. This was put on before the Ways and Means Committee, they saw this. When we were about to repeal the tax exemption of tax-free municipals this was brought in as a prospectus, and we saw it. Maybe it never did sell at that, maybe something happened, but we saw it advertised.

Mr. Babson, in your discussions where you pointed out the inflation being due to Government expenditures—with which I agree, there is no question—and the power of unions to demand increased raises, you did not mention the unregulated power to increase prices, you did not include that, did you?

Mr. BABSON. I want to make perfectly clear that I have no economic or philosophical differences with the unions wanting to raise wages, that is what we would all like to do. But obviously, if the Nation's wage level rises faster than the Nation's productivity, it can only result in inflation. And I do believe that there is more competition to hold down prices than there is competition to hold down wages. And I think this is what is lacking, that there is not enough competition among the unions as there is simply between Chrysler, Ford, and General Motors, they will kill each other if they can, but the unions cooperate. And the balance of power from 30 years ago—my background is history, and I think it is a very important background in investment management really—we have swung from the worker having absolutely no power to the union leaders at least being in a cartel or monopoly position in our economy.

And unless that situation is changed, I think that we are in for a perennial, perpetual inflation, and perpetual inflation will ultimately destroy our form of government.

Chairman GRIFFITHS. We have really had inflation for about a hundred years.

But let us go back to the other question.

Mr. Keenan, will you put your answer in the record.

(The following information was subsequently supplied for the record by Mr. Keenan:)

While organized labor is not very often accused of being a cartel, unfortunately it is very frequently accused of being a monopoly by those who misunderstand the role of unions in a free modern economy. It also indicates lack of precise application of the words monopoly and cartel. Webster's defines monopoly as exclusive control of the supply of any commodity or service in a

given market. And, cartel as an association of private organizations bound by contract to cooperate in regulating production and marketing of products thus tending to restrict world markets and fix prices. It is obvious to all but a very few that the precise definition of monopoly or cartel cannot be applied to organized labor.

There is also general misunderstanding and confusion regarding power or the ability to act. Power is derived from many sources and frequently people, particularly management people, equate the absolute control resulting from ownership with the type of control rising from persuasion and influence.

In short, great damage can be done to both the economy and our free democratic society when personal biases distort perspective and propose legislation based upon misunderstanding, misjudgment and oversimplification of the problem. Good legislation requires that emotion provoking rhetoric be replaced with objective and reasoned analysis.

A classic example of overreaction was the Union Security Provision of the Taft-Hartley Act. General knowledge of the time assumed that union rank and file members anxiously sought the opportunity to repudiate their unions. The actual fact was that in 44,587 elections 97% were won by the union. The support for the union was so strong that this Section of the Act was repealed in 1951 after 3 million dollars was spent on the administration of elections and industrial relations were disrupted throughout the country.

The following points are an effort to present an accurate picture of union power and its ability to increase wages and thus cause inflation.

By definition, monopoly requires exclusive control. According to 1965 data, union membership accounts for only 28.5% of the employed workforce. Table I compares the percentage of organized labor in the United States with European economies. This clearly indicates that free economies can prosper with a much greater degree of organization than exists presently in the United States.

TABLE I [1]

Country	Union membership (millions)	Total employed (millions)	Percent of organization
Austria	1.5	2.2	68.5
Sweden	2.2	3.3	65.6
Belgium	1.7	3.4	49.9
Italy	6.3	14.2	44.4
England	8.8	22.6	38.7
Netherlands	1.4	4.0	35.9
Germany	8.0	23.7	33.7
France	3.1	10.2	29.0
United States	17.3	60.8	28.5

[1] Data for 1965.

Another measure of monopoly less exacting than exclusive control is the degree of concentration. Organized labor consists of 190 National or International Unions and 70,000 Local Unions. Traditionally, these local unions are both highly autonomous and democratic. The membership exerts its influence through elections, referenda, conventions and, in some cases, threat of decertification. These democratic principles are also required by Federal Law and enforced by the Federal Government.

On the other side, the economy is experiencing the biggest merger boom in history. Two hundred huge corporations now control almost two-thirds of the nation's manufacturing assets, a share as great as the 1,000 largest held back in 1941. These two hundred corporate giants are increasingly linked together through numerous management ties, intercorporate stockholdings and joint ventures. Their operations are bankrolled by about 20 large banks. Bank Trust Departments own about $163 billion worth of stocks, or about one-fifth of all outstanding stock in U.S. corporations and more than one-fourth of the value of stock listed on the New York Stock Exchange.

All evidence indicates an increasing incidence of administered prices, yet many still persist in the belief of the existence of a pure competitive free economy. The competition between General Motors, Ford and Chrysler has not produced any real price competition, a safer car, or a car which does not pollute the atmosphere. Safety and anti-pollution are the result of Federal legislation. The

General Motors concept of competition is limited to a multi-million dollar ad campaign featuring a broken light bulb.

Organized labor's natural response to this economic concentration was coordinated bargaining, which was met immediately with a campaign to apply anti-trust legislation to labor unions. Supporters of this anti-trust effort apparently believe single local unions of two or three hundred, or maybe even as large as five to ten thousand, should bargain directly and unassisted with corporate Goliaths such as General Electric, General Motors or Union Carbide. The economic impact of a single local union striking a giant corporation is equivalent to a mosquito biting an elephant. This concept of competition is comparable to the Romans' appreciation of the contest between the lions and the Christians.

Effective anti-inflationary policy should emphasize anti-trust efforts directed toward reducing or eliminating economic concentration and its power to administer prices.

Still another measure of power, which is really what is usually meant by monopoly, is wealth. In 1966, the latest compiled Labor Management Reporting Act statistics show all union bodies had assets of $1,839,000,000. Compare this with the 1969 assets of General Motors, Ford and Chryler.

Company:	*Assets*
General Motors	$14, 820, 095, 000
Ford	9, 199, 300, 000
Chrysler	4, 688, 214, 000
Total	28, 707, 609, 000

Income is also a basic measure of wealth. Compare the 1966 receipts of all union bodies with the 1969 sales of the big three auto makers.

Union Receipts:	
Local Unions	$1, 256, 000, 000
Intermediate Bodies	14, 000, 000
Internationals	560, 000, 000
Total	1, 830, 000, 000
Sales:	
General Motors	24, 295, 141, 000
Ford	14, 755, 600, 000
Chrysler	7, 052, 185, 000
Total	46, 102, 926, 000

Although the data is for different years and allowing for growth of both union assets and receipts, it clearly indicates that all of labor's wealth is substantially less than the big three auto makers and infinitesimally small when compared to total corporate wealth.

In brief, labor's power is not due to its exclusive control of the workforce, its degree of concentration or its wealth. Labor's strength is in its rank and file members and in its leaders' ability to understand and to meet their needs. These needs are common to all free hardworking men engaged in the day-today struggle to feed, clothe, house and educate their families. Workers have not only the right, but the responsibility to provide a standard of living which is compatible with human dignity and assures maximum development of themselves and their families. In pursuit of these goals, workers have a natural right to organize, and to adopt an organization structure suitable to promote and protect their interests. These are natural rights and both justice and equity require the government to respect and encourage them. Thus labor's strength is its mutuality of interests and not in its monopoly control of the workforce. Confusion on these points will result in a wasteful and unnecessary loss of individual freedom which could possibly cause severe economic disruption.

The second point which requires clarification concerns labor as the primary cause of inflation. In a complex inter-dependent economy, with the Gross National Product over $900 billion, it is very difficult to identify any single causative factor of inflation. However, we believe that economic statistic support our contention that labor is a victim rather than the cause of inflation.

The 1960's could be characterized as a period of increasing imbalance in our economy. Business profits soared while improvements in wages and salaries

45-800—70——16

lagged. This lack of balance is most notable in the capital sector. Capital investment, as a response to soaring profits, expanded enormously; so much so that it threatened to create a future gap between the economy's rapidly growing capacity to produce the demand for goods, services and employment.

The inequities of the '60's are clearly apparent now in early 1970. Capacity utilization of industrial plants is at its lowest level since 1961. The average non-supervisory worker in private manufacturing employment in April 1970 earned only $117.98 per week or $6,124 per year. However, the Labor Department reports that $6,567 are necessary to maintain a four-person family at a lower standard of living in U.S. urban areas. It is apparent that there is something fundamentally wrong with an economic system which cannot provide its workers the opportunity to enjoy a minimum standard of living. Yet, a collective bargaining settlement which would provide a 10% increase, and thereby bring annual earnings barely above the net amount necessary for a minimum standard of living, is condemned as inflationary.

The 60's have been different from any other economic period in our history. Expansion started in the early months of 1961 and continued, interrupted only by a brief pause in 1967, to 1969. Profit margins per sales dollar began to rise in late 1961 shortly after the start of the economic expansion. They continued up until 1966 when they leveled off at the peak of the previous year. Obviously total corporate profits skyrocketed with the substantial rise of profit margins and the great expansion of sales through 1966. Total corporate profits soared for five years from 1961 through 1966. They moved down a little in 1967 with the impact of tight money, but in the final three months of 1968 increased again sharply. This continued up to the January-March quarter of 1969.

A sharp increase in productivity offset wage and salary gains and unit labor costs in manufacturing industries declined in the period of 1960–1965. However, wholesale prices of the manufactured goods rose 1.7% in contrast to the 1.5% decline in unit labor costs and the Consumer Price Index increased 6.6% in this period of slightly rising labor costs per unit of the total private economy. Another indication of these trends in the shift to profits can be seen in the following:

Between 1960 and 1968, real output per manhour in the private economy rose at an average yearly rate of 3.5%, but real hourly compensation, including fringe benefits, of all employees in the private economy including supervisors and executives increased at an average annual rate of only about 2.8%.

The real spendable earnings in manufacturing were $86.22 for March 1970, the lowest since 1964, and only 10% higher than the $77.70 of 1960. This is about one percent increase per year in real spendable earnings.

These trends make it clear much improved balance is needed between the buying power of wages and salaries on the one hand and business profits and outlays for plants and machines on the other. Improved balance is essential to provide the framework for economic expansion without booms and busts. Improvements in the buying power of wages and salaries are urgently needed to provide workers a fair share of the fruits of economic progress and sound foundation for consumer markets which account for about 70% of the total national production.

Chairman GRIFFITHS. Do you think there should be any legislative control, Mr. Cantor, over investments of pension funds or over conflicts of interest as Mr. Babson mentioned? Do you think that there should be any type of legislation enacted that would help to safeguard these funds?

Mr. CANTOR. Yes, I think there are types of legislation that are necessary, or administrative actions perhaps that might be taken by the appropriate administrative agenices which would help the assets of pension funds, and I think help the assets of all legitimate investors. I would be more inclined to direct this legislation and administrative action in the direction of providing better marketplaces and better reporting techniques.

Chairman GRIFFITHS. What about the reporting techniques? Exactly how much reporting would you have if you could really have it——

Mr. CANTOR. I will tell you one of the very interesting constraints that can be placed on a manager, that there could be a requirement—we handle somewhere between a half dozen and a dozen corporate pension accounts. Obviously, given our size, none of them are enormous accounts. But one of them is a fairly good sized account. That largest account has made a very simple requirement to us. They do not place any constraint on us in terms of the amounts of trading that we do. They do require that we give them a list of every broker with whom we trade. And every time a new name is introduced they want to know what our affiliation, if any, is with that broker.

Now, they have never commented on this. But they do have the information, and it is a restraint. And they have asked for this information for I think a very good and valid purpose. I think information on trading activity ought to be available, and I think it ought to be a matter of public record in public funds.

I do not mean to imply that all trading activities are bad, or that 6 percent turnover rates are necessarily good. I do not think that they are. But this kind of information would be helpful. I think administrative accounts in terms of markets, and providing a better marketplace would be helpful.

I think, for example, it would be very interesting to know not just in the case of pension funds but in the case of mutual funds what they own in between reporting periods. It is really outrageous that a mutual fund can buy a stock after a reporting date and sell it before the next reporting date, and nowhere does the owner of that fund realize that their good performance may have resulted from a trading profit, but more likely that their bad performance, which does not show in costs against current market value, resulted from a loss, maybe an extraordinary loss, in a stock that was sold before the end of the period because they were embarrassed to admit it.

Chairman GRIFFITHS. Would you put any limit on the right to turn over the funds?

Mr. CANTOR. No, none at all.

Chairman GRIFFITHS. Mr. Babson, I will go along with you that maybe if it has been held 15 years you can turn the whole fund over once?

Mr. CANTOR. No, I would not go along with that.

Mr. BABSON. Absolutely not.

Mr. CANTOR. I think there are an awful lot of things in the way of reporting—we have taken a large pension fund, and in the first year of its management turned it over 120 percent. Now, that would seem—if somebody told me that I traded accounts 120 percent a year I would be shocked by that, and yet that is the figure.

By the way, the account reported it to us.

That means a complete turnover. It came in with 87 stocks, and when it was all through it had 27 stocks. That is what happened.

The reason for the turnover is that the account came to us in what we thought—every investment advisor realistically will think this when he gets a new portfolio—was in bad shape. We were managing the account, and we wanted new names in the account because we look at the accounts and we manage them. And what we did is, we sold everything in the accounts, and we bought new names.

Now, that is 100 percent turnover right there. If you would impose some kind of arbitrary restriction on turnover rates you are going to run into situations where people legitimately want to do things. There will be times when high turnover rates will be necessary. There will be times when the lowest possible turnover rate will produce the best possible results.

I think if the information is available to the people who are responsible for the fund, and if the information is a matter of public record, and if, as Mr. Babson suggests, the various conflict involvements that sometimes produce these kinds of situations are eliminated, it will be unnecessary to have any kind of arbitrary limit—say you can turn an account only 25 or 30 or 10 percent, I think this would be really harmful.

Mr. BABSON. I agree 100 percent with that, Mrs. Griffiths. I do not think you can legislate or administer investment judgment. But if you can remove the conflicts, it would be one major constructive step.

And secondly, we live in a self-correcting competitive economy. And responsible trustees of these pension funds are not going to continue to employ investment advisors that do a perfectly horrible job.

So that they are the ones that are going to really dictate the turnover and other administrative procedures. I agree with that. And I am sorry if I sounded as though I am in great conflict with what Mr. Cantor has said about performance. I think it would help the whole investment world if the term died and we talked about effective investment results rather than performance as though investing was a horserace. And I am certainly in agreement with everything he said.

A pension fund should not just load up with the great giants of American industry. After all, IBM was a small company at one time, and Minnesota Mining in the early 1940's was a tiny company, and it has been a wonderful investment. I have a copy of our mutual fund portfolio here, and I will mention a couple of companies that we have in it that I am sure you would agree are the type that he is talking about—Schering in the drug industry, for instance, and Reece Corp. in the labor-saving equipment field, a very high-grade old company that has paid dividends for 80 years, but which certainly is no giant. AMP, Inc., in the electronics field. These in our opinion are high-quality companies. Quality and size are not necessarily the same thing. A company can be a dominant factor in its field and be high quality but small, because its market may be small. So I think what we have been saying here seems more conflicting than it really is.

But I do disagree on one point with Mr. Cantor. I think that 1967 and 1968 are years that will not be repeated in the investment business again for a long, long time to come, that the seemingly excellent results of people who used low-quality securities—and by that I mean really low quality, risky securities—I do not think that will happen again. They moved into a vacuum, and that vacuum closed up. And I think that in the period ahead the results of good investment management are going to better the averages, but they are not going to be 6 to 10 times better than the averages. And if

in the subsequent declines—our markets are constantly fluctuating—their results are also not going to be 5 and 10 times worse than the average results on the down side.

Chairman GRIFFITHS. Mr. Keenan?

Mr. KEENAN. I would like to comment on the influence of mutual funds and their ability to control the stock and thus the internal operations of other corporations. I think that should be looked into.

Chairman GRIFFITHS. What would you think if the investor of the mutual fund or the pension fund does not approve of the management? Do you think they should move in to change the management, or sell the stock?

Mr. KEENAN. I do not know much about a mutual fund. If I buy into a mutual fund I do not have any identification with the stock that is in the mutual fund, do I? Do I have any right to ask you to——

Chairman GRIFFITHS. Let us ask Mr. Cantor.

Mr. CANTOR. The mutual fund shareholder has a proxy every year.

Mr. KEENAN. That is on the mutual. Are your holdings identified to a certain stock?

Mr. BABSON. No. You just vote for the management of the mutual fund to continue.

Mr. KEENAN. That is right, and it is in the hands of the mutual fund how they handle the stock.

Mr. BABSON. And the shareholders of no mutual fund—to my knowledge—have ever fired any management. They are the most captive group of shareholders in the Nation.

Mr. KEENAN. I do not think they are informed, they do not know what is going on, they have no way of finding out. Mutual funds are manipulating some of these companies and our people have been hurt badly by these activities.

Chairman GRIFFITHS. You can see that the true conservatives at this meeting are Mr. Keenan and myself.

Mr. Cantor?

Mr. CANTOR. Before answering the question that Mr. Keenan posed there is one point that Mr. Babson made that I would like to address myself to. I think it is really important.

He made a statement that true incompetence or true neglect will not go unchallenged by the owners of the fund for a long period of time, or words roughly to that effect. And I would disagree with that statement. True incompetence and true neglect has gone unchallenged by the owners of the fund who are in fact corporations, and the workers represented, for long periods of time, and that it is going unchallenged now and it will continue to go unchallenged unless something is done about it.

Chairman GRIFFITHS. What do you think Congress should do—how should we require more detailed reporting?

Mr. CANTOR. The answer that I would give would have to be at this point in time an off-the-cuff answer. If you ask me to think about this and then respond in writing, I would like to.

Chairman GRIFFITHS. I would be glad to.

Would you care to do the same thing?

Mr. BABSON. Fine.

Chairman GRIFFITHS. Should companies be allowed to use their pension funds to acquire control of other companies?

Mr. KEENAN. I would say no.

Mr. BABSON. I would say no.

Mr. CANTOR. And I would have to say no.

Chairman GRIFFITHS. Would the extension of the "prudent man" rule mean more concentration of pension funds with banks?

Mr. CANTOR. I do not know what "prudent man" really means. What really happens—to understand my version of how markets really work is, when there is an opportunity to make money, funds move away from the most conservative managers, and they move out to more aggressive managers, which may mean better managers, or it may mean more speculative managers, it depends on who you are talking to, or it may mean a combination of both. And during the periods of trouble funds move to safety, which is to banks, which may not be safety at all, but it represents safety.

Chairman GRIFFITHS. Somebody showed up yesterday that wanted to permit the beneficiaries of the fund to sue the trustees if they did not operate under a prudent man responsibility.

Mr. CANTOR. I think that is outrageous, because I do not know what a definition of a "prudent man" is. Nobody ever really has satisfactorily——

Chairman GRIFFITHS. A reasonably prudent man—of course nobody knows.

Mr. CANTOR. I have seen cases—now, this is probably not true in major New York City banks—but I have seen cases of people who are running pension fund assets today who are banks who had very good performance in the first quarter of this year. Probably one of the reasons is that as much as 15 or 20 percent of the money is not even invested. It is very, very difficult to lose money on cash. I suppose they were acting prudently. That could very well come under a prudent man rule. I think the term is dangerous. And I think any kind of legislation of that type could really be harmful to the banking community and to the entire investment community.

Chairman GRIFFITHS. This gentleman believes that it would force the funds into the banks. And I think it would to.

Mr. CANTOR. I think that is probably true.

Chairman GRIFFITHS. If you had the right to sue if they did not act prudently, I think it would force the funds in the banks. And I am opposed to that. I am a lawyer, and I remember they forced decedents' estates into trust departments of banks. And believe me, I do not think the heirs saved a single cent. I think that the banks took them just as rapidly as the lawyers did.

Mr. BABSON. Mrs. Griffiths, you remember also when banks had underwriting affiliates—new issue investment banking affiliates—and they used to park some of their "turkeys" in the trust accounts. And this is the same reason why I feel so strongly that if the underwriting and the brokerage houses manage pension funds, they should not participate in the brokerage on them. And they would soon lose interest in managing them if they did not.

Chairman GRIFFITHS. Do you agree with that?

Mr. CANTOR. Yes.

Chairman GRIFFITHS. I think obviously it is absolutely essential—I think it is ridiculous to permit that.

Mr. KEENAN. I think you are in a period today of the fast buck, everybody is trying to make a fast buck. And this is one of the ways mutual funds have to make it.

Mr. CANTOR. I have to interject again that some of the records of some of the well-known mutual funds that have invested for growth in a reasonable fashion over a long period of time would suggest anything but a fast buck or performance approach in a negative sense.

Mr. KEENAN. I am talking about the ones that are responsible for the fast buck, the ones that profit at the expense of decent people. You know what is going on just the same as I do and we should protect these people.

Mr. CANTOR. The only problem is that in an attempt to protect it or to get more for the people who are deserving the higher benefits, you sometimes do things like Mrs. Griffiths suggested that was done before, and that is force funds in exactly the wrong direction.

What is needed is not reaction, but some kind of creative administrative practice in legislation. If we get reaction, then we will have a worse situation than we already have.

Mr. KEENAN. But you have a protective effort. Few of these people go out and make these moves deliberately.

Mr. BABSON. Many mutual funds have manufactured their own performance.

Mr. KEENAN. That is right. And they do it deliberately. You could use your terms for it, but I have my own term on it.

Mr. BABSON. Some are excellently run mutual funds, containing high grade, sound, issues. Others are speculative mutual funds and they are well run for that purpose. But there are others that have taken advantage of the climate of the last 3 or 4 years to manipulate their funds, to the detriment of their shareholders, in my view.

Mr. KEENAN. How do you take a firm like this firm in Texas—they run up to 150 and then drop to 20 or 30. These people ought to be smart enough that they know there is something wrong in there somewhere, that you just do not take firms like *J* and *L* and milk them dry to make a quick profit on all the surpluses or assets. There is case after case of these cooperations that are——

Chairman GRIFFITHS. Mr. Cantor?

Mr. CANTOR. One way of addressing this is—I do not know the figures, but I think Mr. Babson is right. Do you know what the total assets of all the mutual funds are? Is it about $40 or $50 billion, the mutual funds in this country?

Mr. BABSON. Their assets were $54 billion at the end of 1968, and they were $48 billion at the end of 1969.

Mr. CANTOR. In terms of the characterization of people who use these overall techniques which we all decry, could we ask, if we could try to express that as a percentage of that roughly $50 billion figure, would you agree that in terms of the $50 billion that there is probably very, very little money that may be counted in the tens of millions or hundreds of millions that is run that way?

Mr. BABSON. I would say it is in the minority certainly.

Mr. KEENAN. I hope it would be.

Mr. CANTOR. I think that is an important point.

Mr. BABSON. But it is interesting that some of the biggest mutual fund complexes that have been well run over the years, proceeded to issue these new high risk funds as they were called, at the height of the speculation, and in my view this was most irresponsible. And they knew what they were doing, in my view.

Chairman GRIFFITHS. The staff tells me that about half of these mutual funds are run by the go-go people, the assets.

Mr. CANTOR. Half of the assets?

Chairman GRIFFITHS. Yes.

Mr. BABSON. I would think that was high.

Mr. CANTOR. I think it is high.

Chairman GRIFFITHS. There are proposals that pensions and other funds devote some of their money for socially useful purposes. Now, I think you could not help but notice, as Mr. Keenan said, that after all those pension funds were being used to create jobs for their working members, and that it was a socially useful purpose, it was a helpful purpose to that union. And it made very good sense to me. They are recommendations, and there are bills in this Congress, to put more money into such purposes. Those things would really build America. I feel that there is some reason for saying that that is a proper investment for pension funds. And I am not convinced by the economists who have appeared here, nor the Oregon fund, which appeared here yesterday to tell us how well we were doing, that this is an intervention with a free market, which means less productive use of the resources.

Would you care to comment? Do you think that even by legislation or through persuasion it is a proper thing to suggest that some of these funds be invested in housing or some other thing that is socially useful.

Mr. CANTOR. At less-than-market rates?

Chairman GRIFFITHS. If necessary, yes.

Mr. CANTOR. I think that is a key part of the question. If it is at less-than-market rates, I would disagree.

Chairman GRIFFITHS. What do you think, Mr. Babson?

Mr. BABSON. I agree with Mr. Cantor. The total pool of the Nation's capital, Mrs. Griffiths, whether it is in pension funds or savings banks or savings and loans, is going to be no bigger. And these rates tend to, as I say, be self-defeating. If it is attractive to the pension fund banker, if he believes that it is going to be to the advantage of the beneficiaries of his fund to invest it in mortgages, he should. I do not think that the fund should be used to force investment at below-market-rates.

Mr. KEENAN. These funds, growing at the rate they are, and the power that they have in the economy, they ought to in effect set the rates. The pension funds if they were handled right would set the interest rates. I think somewhere along the line you just cannot be chasing the dollar, somewhere along the line you have got to look back and see where our country is going. If these cities and these towns and those States cannot float their bonds, then we have to make accommodations for them.

You go into these towns or cities, these new cities or new towns, and just take the school costs and consider what it means to a family.

Now, consider the case of FHA and VA mortgages, for instance. A year ago a fellow buying a $20,000 home—not a year ago, 5 years ago—his monthly payments were about $120. Today they were up to $200. Somewhere along the line you have got to control this interest rate. And I think this is the way we could do it if the pension funds are properly handled. I do not think you can be chasing the money all the time, I think I have got to look back and see where the country is going.

Chairman GRIFFITHS. Would it control the interest rate?

Mr. KEENAN. It could.

Chairman GRIFFITHS. Do you think it would, Mr. Babson?

Mr. BABSON. No.

Chairman GRIFFITHS. Would it push it down or not?

Mr. BABSON. I do not think so.

Mr. KEENAN. This is my idea. And it is our hope in the American Federation of Labor–CIO to try to get control of a sizeable amount of the pension funds. And I think we can set the interest rate as far as housing is concerned in this country.

Mr. CANTOR. One of the things that concerned me, since I am in complete sympathy with Mr. Keenan's social objectives as he expressed them regarding housing, is a statement to the effect that you do not think legislation should be passed to require pension fund monies to be used in this direction at less than market rates almost implies that you are against the desirable social results that are involved. I am fearful that this might be a kind of counterproductive thing. I am fearful, for example, that since I believe that both labor and management are aware of the real cost of providing pension benefits, the real cost of providing pension benefits in noncontributory plans to the corporation is going to go up rather dramatically if you force pension fund investments at less than market rates. And if that happens, it is going to come out in the bargaining process, and ultimately the pensioner is going to get a smaller pension. And I wonder whether the American worker is willing to accept the eventuality of a smaller pension 20 years from now to provide single-family housing which may not be the objective of that very same American worker right now. I do not think that by saying no to this kind of a proposal that you are automatically saying that you disagree with the kind of social objectives that Mr. Keenan is in favor or. and that I think we all are.

Mr. KEENAN. What is the difference whether it is taken out in interest rates when he goes to buy anything? If he is getting a pension today and he has to pay 9 percent for credit, wouldn't it be just as well if we kept an interest rate down where we can handle it?

Chairman GRIFFITHS. What he is really saying is that you are going to ask for a higher rate of return on labor rate at this minute. If he has to pay 10 percent interest or 11 or 12 percent interest on a house——

Mr. KEENAN. That is right.

Chairman GRIFFITHS (continuing). Then he is going to have to have a higher wage rate now, this very minute.

Mr. KEENAN. That is right.

Chairman GRIFFITHS. And if you could just move that housing cost down, he would not have to have that type of wage rate now. This is the biggest cost he has.

Mr. KEENAN. Don't forget that the young person we are talking about pays the benefit for the older worker and in future years he will benefit.

Mr. BABSON. There are other costs to housing than interest. One of them is the cost of building labor.

Mr. KEENAN. Let us not get into that one.

Chairman GRIFFITHS. The largest cost is the cost of money.

Mr. KEENAN. The cost of money, the cost of land.

Chairman GRIFFITHS. By far. I have been through this. I have already held a series of hearings, and the builders came in and showed me that the real costs are the cost of money and not the cost of labor. The cost of labor is a very small cost——

Mr. KEENAN. It is down 3 or 4 percent.

Chairman GRIFFITHS (continuing). In the building of a house.

Mr. KEENAN. Onsite labor costs are down about 15 percent over the last 20 years.

Mr. BABSON. Mr. Keenan's workers must not spend very much time in building a house at their $25 an hour rates.

Chairman GRIFFITHS. Now, on this reporting business, those paragons of financial integrity, the stock exchanges and broker-dealers, have successfully resisted all the efforts of the regulatory bodies to provide current financial information on their activities. Do you think we should require a little information from them?

Mr. KEENAN. Certainly. You require it from the trade unions, I do not know why they should not get it.

Chairman GRIFFITHS. Would you say so? Would this be helpful to us?

Mr. BABSON. I missed your question.

Chairman GRIFFITHS. Would this be helpful if we could have more disclosure of the activities of the stock exchanges and the brokerage houses, would this help us with the pension funds, would this be of some assistance?

Mr. BABSON. I do not think so.

Chairman GRIFFITHS. Do you think so?

Mr. KEENAN. Yes.

Mr. CANTOR. Some of the brokerage houses are doing this on a voluntary basis. I think there are certain areas where information, if it were accurate and properly gathered and properly understood, could be helpful. I think good information about what the real costs of running a brokerage firm are and where brokerage firms make their profit would be helpful. And there must be an obvious feeling that this information is at least in the public interest on the part of some brokerage firms who are not publicly owned and who are making this information available.

So I would have to agree that this type of information would be useful. There is an awful lot of information about our business that would be useful in making markets and the whole business better understood. And I think, by the way, there is a nagging kind of a whale and minnow kind of philosophy that goes on about our business that we kind of perpetuate, because it is this cloak and

dagger stuff, we are always hiding behind all kinds of things that are completely unnecessary.

And as a result we have people like Mr. Keenan and yourself, Madam Chairman, who have the feeling that although you do not know exactly what, but that there is something sinister going on. And it does the industry a great disservice. There is something sinister going on in some cases. But in the majority of cases I think it is not. And I think we ought to have it out in the open. And I would be in favor of that.

We are a small private firm—we are a small privately owned firm, very small. If it required making our profit and loss statement available, and where our earnings come from and what our margins are on our activity in order to contribute to this, I certainly would be willing to do that. I am not going to volunteer to do it, however, unless——

Chairman GRIFFITHS. I think that the information that Mr. Babson offered in which he pointed out that a brokerage firm advising a pension fund was making more money on commissions than they were making on the retainer for advising, and that they had rapid turnover, I think that is absolutely shocking.

Mr. CANTOR. And that is the very reason that that brokerage firm should make that information available, because those statements can be—we do not know how the costs are being assigned in that firm.

I also know the firm that he has reference to reduces investment fees as commissions go up, and so the costs of management are being associated with one activity that is not getting any revenues because the commission side is getting revenues.

And I think if there were a uniform method of approaching this we might find that the profit margin on that particular account or that group of accounts is not as high as it appears to be, or it might be higher, and I think it would be worth knowing. The figures as they are right now are meaningless, because there is not a uniform reporting procedure. It would be shocking if the figures are in fact as they appear to be. But I do not know that that is the case.

Chairman GRIFFITHS. And I think it is unthinkable when a bank trust account would not appear here to testify. What are they covering up? What have they done? Is there anything wrong with their telling it? These funds are the funds of the general taxpayers of the United States. They are set up because the rest of us pay more taxes, so they are taken out tax free. I think we have a right to inquire, I think we have a right to know.

And I think they have a duty to show up and give their side of the story.

Now, I would like to ask one more question.

Mr. BABSON. Mrs. Griffiths, if brokerage and underwriting houses are going to continue to manage pension funds, then I agree with Mr. Cantor. A moment ago I said, no, I do not think additional information was needed if there are no conflicts of interest involved. But if conflicts of interest are going to be permitted, then we should have as much information about the conflicts as possible.

Chairman GRIFFITHS. And we should have some yardstick of performance on these funds, so that the people who are really re-

cipients should have a knowledge of whether or not the fund is being well managed or not.

Mr. BABSON. The selection of a yardstick of performance is going to be a pretty tough one.

Chairman GRIFFITHS. I realize that.

Mr. BABSON. Do you measure it over a week, a month, a year? My measurement would be over 10 years or 15 years. In the early days of selling mutual funds the characteristic procedure was to show a 10-year record. And then they began shortening it, and pretty soon they were selling funds on the basis of what they had done in the last quarter. So that I think it would be a ticklish question picking a yardstick. Would you measure, for instance, from 1947, when the Dow average was 160, to 1956, when it was 500, or would you measure from 1952 when it was 300 to 1962 when it was 500 in the selection of your beginning and ending years? We have all worked on this problem with our own clients for years. And as far as I know, no one has ever come up with a very satisfactory yardstick or results.

Mr. KEENAN. I would like to ask a question of Mr. Babson. I do not have much to do with the brokerage firms. But during the last three years they put out a great promotional program, brought on a number of people as salesman, trying to interest us in putting our money in their funds, and also trying to sell stock. And now I hear a report that they are closing up these operations and curtailing it all.

Now, what was the reason for that? Why was the boom? Were they trying to catch the big market, and now that the market has gone back, do they have to reduce their operation?

Mr. BABSON. I think it goes back to what I said earlier to Mr. Cantor. The 1967 and 1968 period was a something-for-nothing period, I think, in a great many aspects of national life. And I do not think those conditions will come back in a hurry. I think that the brokerage houses, like any enterprises, were catering to what the people wanted, and the people were greedy, and wanted to make something for nothing. And they catered to it. And now it is all over for a while.

Chairman GRIFFITHS. I would like to say to you, Mr. Cantor, before I close, you commented that some of these funds and bank accounts, trustee departments had not been turned over for 15 years, and that they were very poor investments. When I sat on the banking and currency committee I figured out after a few years that the FDIC was probably the greatest cover for a stupid banker that had ever been thought of. Obviously you have never tested them.

When I was a child the ability of the banker was tested when these long lines formed in front of their bank. But there is no way of testing it any more. The public does not really know whether they are good bankers or whether they are not good bankers.

I would like to ask you, Mr. Babson, one last question. Suppose you were offered an exchange of securities, mostly not market tested, for an old line marketable security which you held, and you knew that the offerer was engaged in an acquisition program. The offered security involved warrants to purchase the stock of the

offerer at, let us say, $50. The offer was made a year ago. The stock for which the warrant was issued is now selling for less than $10. Would you consider this good business judgment to accept the offer?

Mr. BABSON. It is a complicated question. I have been violently opposed to the conglomerate movement. From a social as well as economic standpoint they are bad for the United States, and bad for our system.

I never recommended a conglomerate stock. And a warrant of a conglomerate in my opinion is Chinese money. And I would not put my worst enemy in one.

Chairman GRIFFITHS. What do you say, Mr. Keenan?

Mr. KEENAN. I think it is outrageous.

Chairman GRIFFITHS. Mr. Cantor?

Mr. CANTOR. I would say no. But I am saying this from the perspective of knowing what has happened. And I think I know the incident involved, although I am not sure, but from the price depreciation and what not I can guess which incident is referred to here.

But I would like to offer this additional explanation. I feel relatively convinced that the people who did this, and who did accept this transaction, misguided or not, did it in what they at that time felt was in the best interest of their clients.

Chairman GRIFFITHS. I am sure they did.

Mr. CANTOR. The problem is that this was their cult of performance. And these people are not all stupid. They could look at this and recognize that it was Chinese money, that it had gone on for a long time, and no one knew how long it would continue. But I do not know whether it is—I guess you can fully appreciate the pressures that are brought to bear on a person making a decision like this to produce a result in a short period of time, and it is perfectly obvious that he is going to be able to do it if the game does not end in the next month. And the result is after all not for his benefit, but for the benefit of an account that he holds in trust.

And the technique is not illegal, nor immoral, perhaps just stupid. And it gets done. And it is unfortunate, but I do not think it was necessarily——

Chairman GRIFFITHS. We are going to leave this record open for some additional questions by other members of this subcommittee. and they will present them in writing, if they would like to and if you would care to respond we would be very happy to have you do so.

I would like to tell you how much I appreciate your coming here and how valuable I think your testimony was.

The funds that are being accumulated in these pension funds are beyond the imagination of most people. They obviously are playing a tremendous role in American life, and they are going to play a greater one.

Over in the other section of the Capitol there have been some pension hearings, and it has been pointed out that only one in every five persons will ever draw a pension of those for whom these pensions are accumulated. If we do not do something soon it will be too

late. We will never be able to control them. And the question that I have tried to identify is to what extent are these funds controlling American life, and to what extent will they.

I appreciate your help more than I can say.

Thank you very much.

(Whereupon, at 12:20 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.)

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