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THE SMALL INVESTOR AND DEMOCRATIC CAPITALISM

Remarks
of

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THE SMALL INVESTOR AND DEMOCRATIC CAPITALISM

One of the well recognized chief elements in the efficiency and productivity of the American economy is the fact that for many decades we have been a world leader, if not the world leader, in bringing a dollar to market for investment, cheaply, quickly, surely in required volume and in a multitude of interlocking ways tailored to the financial needs of every kind of commercial requirement. Perhaps the most important aspect of all has been that a worthwhile business could depend on the availability of equity capital, when needed, at an auction price reasonably related to existing values and potentials.

That, if you will excuse my sounding a bit trite, is democratic capitalism: general dependence upon wide participation of the public in the ownership of the means of producing goods and services.

As an important aside, let me observe that the benefits of democratic participation in free enterprise go well beyond the provision of a ready flow of equity funds, although that is critical. First, there is no incentive to good management like stockholders outraged at bad management. And in a widely-held company losses will bring out such reaction because stockholders -- unlike debt holders -- share in losses as well as profits.

But we appear to have been sliding into a situation in recent years, in which there has been a substantial withdrawal of the public from the equities markets. The statistical base for this widely-held belief, like the statistical base for much of the characteristics of stock market trading, is thin. Nevertheless, some available statistical evidence supports this belief.

--In 1973, for the first time on record, the New York Stock Exchange estimated that there had been a decline in the number of Americans participating directly in the equities market. It was a decline of some 800,000 according to the Exchange's estimate, out of 32-1/2 million.

In the first quarter of 1974 alone there was a further estimated decline of the same magnitude.

--In the early 70's there was a steady stock liquidation by odd-lot -- mainly individual -- investors. In 1972 these represented only 4.6 per cent of total NYSE volume. It was 21 per cent in 1960.

--The present ratio of odd-lot transactions to total NYSE volume has declined to half what it was in 1968.

While this is by no means as much data as one would like to have, there is in addition a large and respectable body of expert supporting opinion. This came out in hearings earlier this year by the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on proposed legislation to require increased disclosure by large institutional investors of their activities in the market. The ultimate purpose of the proposed legislation was indicated by Senator Williams, one of the sponsors. He asked:

> "Isn't the general feeling that disclosure of transaction activity is necessary in part in response to the facts of life in the disappearing individual investor. . .?"

Chairman Garrett of the Securities and Exchange Commission indicated that he accepts the idea that there has been a withdrawal of the individual from the stock market, but has doubts about the reasons:

> "Some persons apparently believe that one reason individuals have gotten out of the stock market is that they felt themselves at the mercy of large institutions, which played on inside information...raided the market and all sorts of things...We have no information that these abuses are going on..."

The most eloquent statement was by the representative of the Committee on Publicly Owned Companies. The existence of this newly-formed Committee, claiming to represent nearly 500 companies with over $40 billion assets, and organized to plead for improved access to equity financing, is in itself interesting. The Committee representative said they had been in touch with hundreds of company executives, who were

> "...deeply distressed...They felt keenly that they are being starved out of the capital markets. They are extremely alarmed at the withdrawal of the individual investor from the marketplace..."

James J. Needham, Chairman of the New York Stock Exchange, told the Subcommittee the proposed legislation would "work to bring the individual investor back."

It seems to me, therefore, that there is apparently a problem of withdrawal of the small saver from investment in common stocks, and that it is perceived to be a serious problem. As I will be indicating, I think that such a trend should be turned around, and I want to make some suggestions -- among a number of other measures that might be taken -- as to how the banking system can help bring the individual investor back to equity investment.

I cannot undertake in a few minutes here today to debate the many pros and cons of the effect, if any, of the growth of large-scale institutional investors on small investor participation in the stock markets. Certainly, the existence of large pools of funds -- constantly replenished by flows of money to bank trust departments, pension funds, mutual funds and others -- is a valuable means for marshalling savings for investment. Thus, the question to be explored today is not whether the large institutional investor should be restrained, but by what means the small investor can be brought back, in large numbers, to direct participation over a broad range of the equities markets.

The Role of the Small Investor

In the daily auction in the equities markets, the small investor, making a multitude of different decisions due to the influence upon him of numerous factors, economic and otherwise, acts as an autonomous force, showing up weaknesses or surfeits and filling gaps where finance is needed and appears to be a good risk. To be sure, the autonomous nature of this force can be, and from time to time is, lost and is replaced by herd movements, either bull or bear. But I am convinced that over time and on the average the broader the base of participation in the equities market, the more reliable that market's judgment about a particular stock will tend to be.

Be that as it may, the presence in the stock markets of the small investor is of basic importance for another reason, the reason I have already mentioned: the democratizing influence he represents in capitalism. This is something that I believe all of us -- institutional investors included -- should take very seriously. At a time of questioning, such as the present, of all of our institutions, the use of the nation's resources by free enterprise organizations cannot be expected to escape close inspection.

Given our income levels, the small investor should include most Americans. If the small investor loses confidence in the equities markets, as he appears to have been doing in recent years, and if this loss of confidence accumulates to the point where small investment in stocks becomes a minor and timid element in the markets -- instead of being a major and aggressive force as it should be -- our free enterprise system could well lose its footing. In place of standing on the broad rock of mass public participation, it will find itself perched precariously on the narrow pinnacle of the judgment of a few big investors. In the jury system, we declare that justice is too important to be left to experts in the law. In our boards of education, we declare our belief that education is too important to be left to educators. In the matter of providing the equity investment that is the financial lifeblood of private enterprise, I think there is a similarly valid belief that broad public judgment should have precedence over narrow expertise. Judgments as to where and how much and when equity investments should be made are far too important to leave entirely to the professionals. Democracy is as important to free enterprise, I think, as it is to free government.

Some
Suggestions

Now, you might well ask yourselves, what exactly does this have to do with banks, bank trust departments and trust officers?

I feel there is a significant, but by no means exclusive, role to be played by banks and their trust departments in restoring broad public participation in the equities market. I am confining myself to the contribution that I think banks can and should make because I am a bank regulator, and because the putative role of banks in this matter is a subject of considerable controversy.

As you are well aware, a few large banks have taken the initiative by offering to their customers automatic investment services which generally take one of two forms: a dividend reinvestment plan or a stock purchase plan. Under these programs the bank offers no investment advice. It facilitates the acquisition of shares selected by the customer from a designated list. An explicit transaction fee is charged for these services.

Last June the Comptroller of the Currency reaffirmed his agency's opinion that national banks legally may offer to the public automatic investment services permitting a bank customer to buy stocks, through his own designation, by means of a preauthorized monthly charge to his checking account. The particular plan the Comptroller commented upon offers the bank's customers a list of the 25 largest corporations listed in Standard and Poor's 425-company Industrial Index. Under the plan submitted for comment the bank makes the necessary deductions from the customer's checking account, effects purchases designated by the customer, through a broker, keeps the stock in safekeeping and provides a monthly statement of account. The customer can terminate his participation, altogether or with respect to any stock, at any time.

In dividend reinvestment plans, the bank acts as agent for a company's participating shareholders in receiving and reinvesting dividends in additional shares of the company's common stock, and under some plans the shareholder may authorize additional purchases of shares through a checking account deduction. Both programs draw upon banks' customer service and data processing facilities, to keep the transaction costs at a low level. Although, at present, both are rather limited in scope, I believe the convenience and the automatic nature of these plans have growth potential in the small investor market for financial services.

Marketing studies undertaken by several banks offering these services indicate they have a strong appeal to small investors who, by and large, were not active in the stock market. In fact, one bank found in an analysis of a questionnaire to all participants in their stock purchase plan that 40 per cent of the respondents did not own stock other than that purchased by this method. However, in spite of this apparent ability to attract the small investor to a very limited selection of stocks, participation has not grown rapidly. This may be in part attributable to several factors: the limited nature of the plans, the current depressed state of the stock market, and the regulatory questions posed by such plans.

I have little to offer in the way of advice on how these plans might be more successfully marketed. Certainly a bank's allocation of resources to new products and product development must be constrained by the business environment. Furthermore, banks, like all others in the investment business, must be cautious about how they solicit business. I want, however, to offer some discussion of the regulatory environment, and my views on what future course banks might take to reach the small investor.

For the last 40 years the Glass-Steagall Act has limited banks' involvement in the investment business. The legislative history of this Act clearly shows that Congress wanted to separate commercial banking and investment banking, so commercial banks would be prohibited from speculation, directly or indirectly, in securities for their own account and would not give biased investment advice to their customers. Congress did allow banks to continue as fiduciaries and to effect securities transactions for the accounts of customers. I believe that certain investment services, if properly regulated, are distinguishable from the financial hazards that Congress desired to prohibit to banks by these laws.

The ability of banks to offer investment services to small investors has been curtailed rather than expanded in recent years by the Supreme Court's decision in I.C.I. v. Camp in 1971. This case involved a commingled managing agency account offered to the public by First National City Bank of New York. The Court ruled that such a fund was prohibited by Glass-Steagall after the plan had received regulatory approval.

The Citibank's commingled managing agency accounts gave the bank custody and investment discretion over amounts as small as $10,000. Furthermore, for an annual fee of 1/2 of 1 per cent of the account's average net assets, the Bank offered the investors investment advice which purported to be similar in quality to that of the large institutional accounts. A customer's participation was redeemable at net asset value and units were transferable only to persons who had validly appointed the bank as their managing agent. Thus, a fiduciary-like relationship was maintained between the bank, as agent, and the owners of the units, as principals. When the Supreme Court ruled in 1971 to prohibit Citibank's plan, the fund had accumulated only about $10 million with an average account of about $15,000. In spite of the small size of the fund and the severe advertising limits imposed by the Comptroller's Regulation 9, several other large New York banks were prepared to offer a similar service, but were delaying until the Supreme Court decision.

In I.C.I. v. Camp the Supreme Court found that such a commingled investment fund was distinguishable from accounts where a bank uses funds received "for a true fiduciary purpose rather than for investment" and within the prohibitions of the Act. This conclusion was reached after a lengthy discussion of the "potential hazards and abuses that flow from a bank's entry into the mutual investment business" which the court viewed as similar to those prevalent during the 1920's and which Congress intended to eliminate by the Act.

By the Glass-Steagall Act, Congress intended primarily to protect depositors and the safety and soundness of the commercial banking system from the additional risks and potential for conflicts of interest of investment banking.

The Supreme Court expressed valid concern as to possible conflicts of interest. However, I can think of few, if any, processes, political, social, or business, not surrounded by potential conflicts of interest. In my view the question is not whether some potential for conflict of interest exists, but is, instead, a question whether the likelihood for abuse is so overwhelming that it cannot be controlled or eliminated by public powers. We must also weigh the social and administrative costs of these controls against the benefits of offering small investors investment services and advice in which they will have confidence. Whether banks should be able to go beyond the automatic investment plans that some now offer to discretionary management services for smaller accounts is a question Congress may find worthwhile debating.

As I have suggested earlier, I think banks may have a special value to be taken into account as we seek solutions to the problem of making our equities markets as broad and deep -- as democratic -- as possible. This is the fiduciary character of banks. Despite the troubles that a period of strain in the financial community has brought upon a few institutions, I think there is a large reservoir of confidence still existing in the public mind toward the banks to which they daily entrust their funds, and take many of their problems. The other side of this coin is the fiduciary outlook of banks. We are looking for large-scale solutions. There are many thousands of banks, and they touch nearly all of our communities and neighborhoods. I believe that they represent, both because of the public confidence in their fiduciary nature and their own fundamental bent toward the prudent, a resource for the large-scale amassing of investment savings for use in equities that should not be neglected.

Time not only flies, it changes all things. I think the time has come to ask whether the fears -- and resulting barriers -- of 40 years ago are the same concerns that should rule us now, or whether, in view of the extensive securities industry supervisory structure and greatly strengthened bank regulatory structure which now exists, a greater role for banks in the matter of broadening participation in our equities markets should now be permitted.

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