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Statement of J. L. Robertson, Vice Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking and Currency

United States Senate

on

S. 1299 and S. J. Res. 160

May 16, 1968

I appear before the Committee today to discuss both S. 1299--a bill to extend margin requirements to over-the-counter stocks--and Senate Joint Resolution 160, which authorizes a study of the activities of institutional investors by the Securities and Exchange Commission. I will comment on S. 1299 first.

S. 1299 was introduced at the request of the Board. It would extend the Board's authority over credit used to purchase securities registered on national securities exchanges to include those traded over the counter as well. Extension of margin requirements to the latter category would limit the amount of credit that could be obtained from banks relative to the market value of such securities. But it would not necessarily reduce the total amount of credit used to buy over-the-counter securities, since the Board would be empowered to permit brokers and dealers as well as banks to extend such credit in conformance with margin regulations. Thus the effects of regulation would tend more to improve the quality than to reduce the quantity of credit in this market.

As you know, the Board recently amended its present margin regulations and adopted a new regulation. These actions were intended to broaden the coverage of margin regulation and to close some loopholes that appeared to have developed. They extended margin regulations to lenders not previously covered, brought credit on certain convertible bonds under margin regulation for the first time, required an orderly bring-up over time of special low-margin subscription accounts to regular margin status, and restructured the regulations in an effort to minimize evasions.

None of these changes, however, had any impact so far as over-the-counter securities are concerned. Under the law as it now stands, the Board's authority is restricted to credit used to purchase or carry exchange-registered securities. We believe that safeguards against the excessive use of credit in the over-the-counter securities market are still badly needed to round out the protection afforded the public by margin regulation in the volatile securities area. At the same time, we can see no reason why brokers and dealers should not be permitted to extend credit to customers at regulated margins, at least on the more active and widely traded over-the-counter stocks. Therefore, in order to make margin requirements both more effective and more equitable, the Board strongly supports S. 1299.

Let me briefly outline the background and the need for this legislation, before I discuss the Board's plans for implementing the bill, as well as its long-range objectives under the authority that would be granted.

Background

Before passing section 7 of the Securities Exchange Act of 1934, the law which S. 1299 would amend, Congress determined that the financial crisis of the preceding period had been caused in part by excessive credit flowing away from commerce and industry into the stock market, largely in the form of brokers' credits used to purchase or carry stocks registered on national securities exchanges. Congress, however, also recognized that if brokers' credits alone were restricted, credits from other sources--particularly banks--would likely assume the role of the major source of stock market credit.

The 1934 Act accordingly authorized the Board to regulate both (1) credit that brokers may extend on securities registered on an exchange, and (2) credit that banks and other lenders may extend for the purpose of purchasing or carrying securities registered on an exchange. But the Act controls brokers' credits much more strictly than credit by banks and others by prohibiting brokers from extending credit on securities traded over the counter, while banks and others may lend on such securities without restriction, regardless of the purpose for which the credit is obtained. The Board commented on this disparity of treatment in its 1964 Annual Report to Congress, as follows: "The present arrangement is inequitable in its contrasting treatment of brokers and banks. In addition it limits the effectiveness of salutary controls over security credit and unnecessarily deprives over-the-counter securities of credit facilities that might appropriately be extended by brokers and dealers."

Purposes of Amendment

Adoption of S. 1299 will permit the Board to move toward a more nearly equal treatment of all lenders (brokers, banks, and others) with respect to credit extended for the purpose of purchasing or carrying over-the-counter securities. Presently, the principal regulation applying to equity securities listed on the exchanges imposes an initial margin requirement of 70 per cent. This means in effect that anyone buying a $100 stock on credit must put up $70 in cash, or in securities with an equivalent loan value. Another way of saying this is that a loan on a $100 stock can not exceed $30. It must be kept in mind, however, that these rules on margin credit for listed stocks apply only to loans that are for the purpose of purchasing or carrying such securities. They do not apply when loans collateralized by listed securities are obtained for other purposes, such as to pay taxes, meet emergency expenses, finance a business, buy a house or car, or any other of the many and varied uses for which people borrow money.

In 1934, the difference in treatment for credit purposes between listed and unlisted stocks was not considered important because the over-the-counter market was relatively insignificant. In the intervening years since then, however, trading volume in the OTC market has risen sharply. At the time the Securities Exchange Act of 1934 was adopted, it is estimated that the dollar value of OTC trading was less than one-sixth of that on organized exchanges. By 1961, the ratio had risen to three-fifths, and since then it is believed that OTC transactions have grown even more rapidly relative to volume on the exchanges, though no data are available. This trend is likely to be accentuated by the fact that under the 1964 Securities

Acts Amendments, firms with 500 or more shareholders and assets of $1 million, whose securities are traded over the counter, must disclose information to the public respecting their business and finances in much the same fashion as companies whose securities are registered on exchanges. This new, readily-available information has a natural tendency to attract additional investors into the over-the-counter market and increase its size and importance.

As the volume of total trading in over-the-counter markets has increased, the scale and pattern of activity in some unlisted stocks has become virtually indistinguishable from that of securities traded on the exchanges. With the increased investor interest and expanded trading activity in the over-the-counter market, it appears to us inconsistent to continue the difference in margin regulation status between exchange-traded stocks and the unlisted stocks which most closely resemble them.

It may be noted also that the over-the-counter market itself has taken on some of the characteristics long identified with the organized exchanges due, by and large, to expanded investor interest and technical advances in trading operations. This market development has produced an economic framework that facilitates the use of credit to finance the purchase of unlisted stocks. More reliable quotations of prices, the basis for ascertaining the "current market value" of securities pledged for margin loans, are now available. Further, with increased volume, the market now has a greater "depth"--a necessary pre-requisite for orderly liquidation of stock collateral in cases of default.

Not only do the preconditions exist for the greater use of security credit, but increasing investor interest and rising share prices in the over-the-counter markets suggest an environment in which overuse of credit could have seriously destabilizing consequences. From 1960 to 1967, for example, an index of prices of selected industrial company stocks in the over-the-counter market more than tripled, while the Dow-Jones industrial index rose less than 50 per cent. This kind of price action in a market that is notoriously volatile certainly suggests the need for enforcing relatively conservative standards in the extension of "purpose" credit.

Board Action if S. 1299 is adopted

S. 1299 would not directly affect the present scheme of securities-market credit controls; it would simply broaden potential coverage by authorizing the Board to encompass OTC securities within its credit regulations. For exchange-traded stocks, present margin regulations would continue to operate as they do now. Under the authority granted by the new legislation, the Board would simply extend these regulations from time to time to those OTC securities for which such regulation is deemed to be appropriate.

It is not the Board's present intention to include all or even most unlisted equities within the regulations. Many over-the-counter securities are not actively traded and, therefore, are frequently subject to less than firm price quotations. Moreover, many OTC stocks do not attract broad investor interest and probably are not suitable for margin regulations. Thinness of markets and lack of a broad investor following imply sufficient potential price volatility so that the use of credit in financing investment in such stocks should not be encouraged. Consequently, we do not contemplate any change in present requirements with respect to this large category of OTC securities.

S. 1299 permits the Board to develop specific standards which would determine the securities that should be covered. This would be done by regulation, and industry comments and suggestions would be solicited through advance publication of the proposed rules. The Board's intention would be to develop standards that will encompass within the ambit of margin regulation those OTC stocks which have market and investor characteristics similar to those of exchange-traded stocks.

At present, about 20,000 securities are traded over the counter and daily price quotations on nationally-traded stocks are disseminated to the public for 1200 to 1500 issues. The Board believes, however, that only a few hundred of these are traded in sufficient volume to assure reliable pricing, reasonable liquidity, and substantial investor and dealer interest. The Board's initial task will be to develop indexes of present and prospective market behavior to be applied to individual issues, based on such factors as the number of shares outstanding, number of stockholders, assets and earnings of the issuer, continuity of market price quotations, number of dealers that make markets in the issue, indicated volume of trading, and other factors. As already broadly stated, these measurements would be designed to limit the list of OTC securities to be included under margin requirements to those issues that are the most active, and that would meet most, if not all, of the prerequisites for exchange listing.

We recognize also that there are problems involved in relating credit regulation to the mechanics of the market that must be resolved and that require further study. Markets for over-the-counter securities are made by dealers who perform a necessary role in seeing that those markets are orderly and reliable. To perform this function, the market-maker needs access to credit on a liberal basis. Credit extended to firms that make markets in the OTC securities which are brought within the scope of margin regulation thus would probably have to be exempted from the operation of margin regulation in much the same way that credit to the specialist on the exchange--who is the counterpart of the OTC market-maker--is exempted from margin regulation today.

On the other hand, the securities dealer who makes a market in OTC securities differs from his exchange counterpart in that he is both a wholesaler and a retailer. This fact could produce conflicts of interest, especially when a firm both positions a security and extends credit on it to his retail customers. Such a firm conceivably might be tempted to manipulate market prices of the securities in which it made a market, in order, for example, to force margin calls when it needed funds. Limiting margin treatment to the most active OTC securities would largely obviate this problem because it would generally bring under margin regulation only those OTC securities in which enough different firms make markets so that there is little chance of domination by a single firm.

The Board recognizes that the formulation of standards with regard to this and other market characteristics is a difficult task and has asked for and been assured of the assistance of the Securities and Exchange Commission in the development of such regulations.

The approach of S. 1299--that is, the flexibility which would permit the Board to develop specific standards in the light of study and experience--seems highly desirable. This approach allows the Board to adapt the coverage of margin regulations to future developments in the OTC market. It is clear that the OTC market is continuing to develop rapidly. This market is particularly susceptible to automation. Plans are already underway to funnel transactions in the market through central computers, which would tend to create a more reliable market with more accurate price information. At the same time, the trend toward increasing trading activity in a wider and wider list of stocks, in conjunction with automation, may also serve to increase the range of OTC issues attracting the use of credit. These and other developments, however, cannot be foreseen accurately, so that flexibility in the enabling legislation is needed if the Board is to make appropriate regulatory adjustments as markets evolve.

Senate Joint Resolution 160

The Federal Reserve Board also recommends enactment of S. J. Res. 160. This resolution would authorize an SEC study of the investment activities of financial institutions, such as insurance companies, pension funds, mutual funds and bank trust departments. Institutional investors in the United States for many years have provided the major channel through which credit flows from savers to borrowers, and more recently they have become the dominant channel for equity funds as well. By the end of 1967, it is estimated that institutional investors held, at market value, around $130 billion of stocks, and in the last decade their net acquisitions of stocks have exceeded in value the net issuance of new stock by all corporations combined.

It is with regard to this area of equity investment by the institutional investors that our knowledge is now the most severely limited. A study of this subject would presumably require the collection of statistics from the institutions that would reveal much more than is now known about the extent and character of their equity holdings, and of the volume and pattern of their trading in the equity markets. We would support such a program of data collection. Analysis of the results should help to clarify the differences in investment objectives that exist among institutions and as between the institutions and individual investors, and permit exploration of the economic implications of these differences.

The rapid expansion of institutional participation in the equity securities markets also raises important structural questions that need investigation--questions that bear on the efficiency with which our financial system continues to serve the needs of the U.S. economy. For example, to what extent have the changing activities of the institutions induced a shift in savings flows into equities rather than debt instruments? Has the increased institutional interest in equities brought a corresponding growth in equity financing by corporations? If not, what are the impediments to increased equity financing, and what can be done to foster a better meshing of the supply and demand for the two major classes of securities--debt and equity? And what are the implications of increasing institutional investment in equities, both for the structure of the securities markets and for the availability of financing to the various classes and sizes of business enterprise?

Answers--or at least informed judgments--should flow out of the proposed SEC study, and would greatly enhance our understanding of financial flows in the American economy. The Federal Reserve System will be happy to cooperate to the extent that we can with the Securities and Exchange Commission in such a study; we will be especially interested in helping to obtain needed information relating to bank trust departments under our supervision, and in participating in other aspects of the study for which we have any special competence.