# Implications of Growing Institutionalization of the Stock Market

by

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## 1. Introduction

This paper will be devoted to the growing institutionalization of the stock market in the U.S.A., the likelihood it will continue, its consequences for the market and the economy, and its implications for new regulatory policies. The institutionalization of the stock market, associated with the growing market dominance of a comparatively small number of financial institutions and the declining relative importance of the millions of individual investors, is generally regarded by members of the financial community, by securities market regulators and by legislators as one of the most important problems currently confronting the stock market.

The market role played by financial institutions differs of course among countries, but is generally substantial in developed nations with major stock markets. Even for the less developed countries with stock markets still in the early process of evolution, there seems to be considerable interest in the impact of institutional (as compared with individuals') stock ownership and trading on market liquidity and economic efficiency.

The analytical materials presented or referred to in this paper are based partly on earlier published studies which I have conducted, partly on an up-dating of those studies, and partly on a comprehensive investigation of the changing role of the individual investor in the stock market which I am now carrying on in collaboration with a colleague, Professor Marshall Blume. Since the results of this current investigation are still confidential and in some cases still tentative, I shall use them mainly to make qualitative checks on the validity of the conclusions drawn from earlier (and less satisfactory) analyses.

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## 2. Trends in Institutionalization of Stock Ownership and Trading

Before considering the implications of the institutionalization of stock ownership and trading,it is useful to present a brief outline of the historical and prospective trends in institutional importance in the U.S.A. stock market--the one market for which the data are readily available. The New York Stock Exchange estimates that the proportion of the share volume of trading on that Exchange accounted for by institutions (inclusive of personal trust funds and intermediaries) was 45 percent in 1974, about the same as in 1971. That figure is raised to over 50 percent if the ratio of institutional and intermediary to total NYSE trading is expressed in value rather than in share terms. The NYSE figure for the first half of the 1950's corresponding to the 45 percent in the early 1970's averaged about 20 percent. As a proportion of public NYSE share volume (i.e., excluding trading by NYSE members), the institutional and intermediary share was close to 60 percent in the early 1970's contrasted with less than half that figure in the first half of the 1950's.

All these percentages are inflated by including in the institutional total, trading by non-member broker-dealers, non-financial corporations and perhaps also custodial accounts of commercial banks. However, correction for these deficiencies would probably lower the percentages only moderately and would not significantly affect the sharp upward trend indicated in the relative importance of institutional trading. The absolute volume of individuals' trading on the NYSE, it should be noted, also went up over most of this period but not so rapidly as institutional trading.

The impressive growth in the relative importance of institutional trading in the decade and a half ending in 1965 was mainly a reflection of

the rapid increase in institutional stock holdings. This in turn reflected the accelerated inflow of funds to these institutions and a substantial rise in the proportion of their portfolios invested in stock. After 1965, though these other factors were still at work, a major new influence in the increased importance of institutional trading was a sharp growth in their portfolio turnover. Until 1965, institutional portfolio turnover had shown a trend pretty much like the market as a whole. Certain institutional groups, notably mutual funds, had a somewhat higher turnover rate than the market as a whole, while other institutional groups had very much lower rates. All institutions combined had less turnover than the market as a whole.

Starting in late 1965, there was a marked divergence between the trends in portfolio activity of institutions and the rest of the market. From that time to 1969, while the turnover rate for the market as a whole went up less than 50 percent, institutional groups--including mutual funds, pension funds and insurance companies--either doubled or trebled the turnover of their common stock portfolios. In 1969, the turnover rate for all institutional groups other than personal trust funds was higher than the close to 21 percent average for the New York Stock Exchange as a whole, and the rate for mutual funds had reached a high of over 50 percent. After a peak in 1969 which was almost matched in 1971, the upward movement in institutional turnover appeared to have abated with a steady decline through 1974, but by 1975 as the market improved half of the decline in turnover subsequent to the 1969 peak was made up, and institutional turnover was again well above the average for the market as a whole.

Even personal trust funds, which are still the least active major group of institutional equity investors, increased their turnover rate

from 1.6 percent in 1965 to five percent in 1969, the last year for which transactions data by such funds are available. Personnel trust funds, it might be noted, though dominating institutional stock holdings in the early 1950's, were being edged out of first place in the value of stockholdings by private pension funds in the early 1970's. At the end of this period they accounted for only a small fraction of institutional trading with their stock transactions a small fraction of those by private pension funds alone.

There are several recent developments--including the drastic reversal in the growth prospects for mutual funds, especially those specializing in stock, the relatively high equity ratios already achieved in pension funds,and the possible adverse effects on equity investment in pension funds resulting from the new liabilities imposed on boards of directors by the 1975 ERISA pension fund legislation--which may point to a slowing down in the growth in the relative importance of institutions in stock ownership and therefore,other things equal, in stock trading. Other developments--such as the accelerated growth of equity investment in recent years by state and local government retirement funds and life insurance companies, and the potential vesting and fuller funding of corporate pension funds--would tend to maintain the rate of growth in institutional stock ownership and trading.

Potentially of equal importance to these institutional developments in determining the relative importance of institutions in aggregate stock ownership are those factors affecting individuals' aggregate demand for stock--such as those affecting both individuals' propensity to save and their propensity to invest saving in stock. Unfortunately, not much can be said about the prospective impact of these factors except to note that there is no obvious reason to expect that they will have

a substantially different impact in the future than in the past. What seems most likely on the basis of the different developments affecting institutional and individuals' demand for stock and the recent trends in stock ownership is that the relative importance of institutional ownership will continue to increase but at a very modest rate, and it is noteworthy that the ratio of market value of all NYSE listed stock held by institutions increased by not much over 1 percent from 1972 to 1975. As a result, perhaps the most important influence on the relative importance of trading by institutions in the foreseeable future may be the trend in their portfolio turnover.

It is pertinent, therefore, to inquire into the reasons for the post-1965 surge in institutional turnover. This surge was attributable at least in part to two factors. The first was the performance cult apparently instituted by mutual funds--though followed by most of the other institutional groups--which focused on short-term investment in supposedly temporarily undervalued equities and on taking advantage of short-term band-wagon effects. The second was the ability of institutional managers to make profitable use of the reciprocal business which grew up under a system of fixed commission rates.

Some damping in portfolio turnover might have been expected as a consequence both of the cumulative weight of evidence that on the average high portfolio turnover is not associated with superior investment performance and the diminution under competitive commission rates of the free services associated with reciprocal business. On the other hand, the direct stimulus to institutional trading resulting from the lower transaction costs associated with the enactment of competitive rates would tend to stimulate the institutionalization of trading. The reduction in commission rates has been substantial especially for large institutional transactions, with the annual rate of investor savings on commissions currently estimated

at $400 million. My own judgement is that these opposing forces affecting institutional turnover are likely to be largely offsetting and overall institutional turnover will continue to be higher than that of the stock market generally but that it is not likely to continue to grow rapidly relatively to the market as it did in the second half of the 1960's.

Before leaving this subject of trends in the institutionalization of stock ownership and trading in the U.S.A., two basic points should be made since both are frequently overlooked. Both are important for any assessment of the market and economic implications of institutionalization of the stock market. First, in terms of ownership or volume of trading, institutions are mainly important on the New York Stock Exchange and particularly in the larger issues. Individuals continue to be much more important on the American Stock Exchange and on the over-the-counter markets. Institutions seem to be more risk-averse than individuals and much less likely to buy not only the smaller and less liquid seasoned equity issues but also the unseasoned new issues.

Second, while great stress has been placed in the financial community and elsewhere on the increased importance of institutions in the stock market and the relative decline of individual investors, the number of individual stock investors has continued to rise until recently and the absolute volume of individuals' stock transactions recently is fully as high as in the 1950's or 1960's--with the increase in total market volume offsetting the decrease in the individuals' proportionate share. Thus, there seems to be little basis for the fear frequently expressed in financial circles that activity and prices on the stock market will be determined in the future by a handful of institutions with little input by the individual investor. On the other hand, it is still of vital

importance for public policy to analyze the implications of the growing institutionalization of the stock market on the market and on the economy.

## 3. Institutionalization of Trading and Market Efficiency

Is an increase in the relative importance of institutional stock trading likely to result in any impairment in the quality of the stock market? The answer judged from the perspective of the U.S.A. experience would appear to be in the negative.

There is no theoretical or empirical basis for believing that market efficiency, and hence the quality of market prices paid or received by either institutional or individual investors, has been or will be impaired by institutional trading. A number of different analyses of the impact of institutional vs. individuals' trading in stock on volatility of stock prices or on more sophisticated measures of the market's allocational efficiency have shown no important effects. Thus, if the market's allocational efficiency is measured by the ability of the stock price structure at any time to predict the subsequent flow of per share earnings,holding constant risk and dividend payout policy, I have been able to find no significant change in the market's efficiency in the entire post-World War II period in spite of the greatly increased stock activity by institutional investors over this period. Turning to a more direct test, if we relate the relative importance of institutional net stock purchases of different stocks to the ability of the prices of these stocks to predict the subsequent flow of share earnings,we again find no evidence that institutions either add to or detract from the market's allocational efficiency. To assume that this situation is likely to change in the future

is to imply that institutions are less likely than small individual investors to make informed decisions when they buy or sell stock. Such an assumption would mean that institutions have less insight into intrinsic stock value than the rest of the market--which seems implausible. If this were true, one consequence which would be expected is that institutions would have a poorer investment performance than individuals, but in fact on the average they appear about equal.

While there is no reason for believing that the basic allocational efficiency of the market is impaired by expanded institutional trading, there is some weak evidence that sales of large blocks may have a small adverse effect on market price in the sense that prices recorded on the ticker may temporarily fall.[1] Purchases of large stocks apparently do not have a corresponding temporarily stimulating effect. The adverse price effect of sales of large blocks in 1968 and 1969, according to this analysis, seems to have averaged somewhat over .7 of one percent, but since only blocks associated with down ticks were included and total sales of the stock were not held constant, even this relatively small figure probably overstates the block effect. Moreover, the small temporary discount necessary to bring in willing buyers quickly seems to have been largely dissipated by the end of the day of the block trade.

Even this apparent temporary and short-lived effect on price, however, may be the reflection of an incomplete analysis. In a recent, more complete but as yet unpublished analysis it is found that the short-run

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[1]Alan Kraus and Hans R. Stoll, Price Impacts of Block Trading on the NYSE, Rodney L. White Center for Financial Research Working Paper No. 3-71, University of Pennsylvania. See also Securities and Exchange Commission, Institutional Investor Study Report (Washington, D.C.: U.S. Government Printing Office, March 10, 1971).

volatility of the prices of different stocks is not significantly related to the ratio of institutional to total holdings of these stocks, once longer-run price movements (and other relevant variables) are held constant; and there is no indication of any adverse effect of institutions on the market even in the short-run. Thus, the frequently cited examples of large institutional purchases and sales being associated with substantial short-run movements in stock price may simply reflect the fact that the institution involved is acting on the basis of significant new information which in an efficient market would be expected to appreciably change stock price.

If there is any short-term adverse impact of institutional trading on price, though the evidence is not at all clear, the effect is quite small and may be regarded as an increase in transaction costs to the institutional sellers of these blocks necessary to mitigate a short-term supply-demand imbalance. However, while the institution may have to pay a small cost for speedy execution of a large block, there is no significant harm to other investors on a net basis. Investors buying the stock from institutional sellers on a day of a block trade--a period when individuals and other non-institutional investors are presumably net purchasers of stock--benefit from the temporarily depressed prices.

If attention is directed to the normal bid-ask spread of stocks in which institutional investors are active rather than to the short-run effect of block trades, there is some indication that institutions by their presence in the market may reduce rather than increase transaction costs for the average investor. Thus, an earlier analysis suggests that the larger the number of institutional investors holding a position in an issue (for given values of trading volume and other relevant variables)

the smaller the bid-ask spread.[1] A more recent and more comprehensive analysis not yet published similarly indicates that holding the relevant variables constant, the higher the ratio of institutional holdings to total holdings of a stock, the smaller the bid-ask spread.

While there is no evidence indicating a worsening of stock market efficiency associated with the past institutionalization of trading, attempts have been made to point out the dangers of this trend by reference to the supposed deficiencies of the bond markets in which institutions, large transactions and dealers predominate. It has been argued that the bond markets--especially those for U.S. Government and corporate issues--are largely institutional and dealer markets; that individuals have been relatively unimportant in these markets since the 1920's as a result perhaps of factors associated with the growing institutional participation; and that, as a result, these markets are inferior to the auction markets which are associated with a large number of individual trades.

It is not clear in what sense the market for U.S. Governments can be considered inferior to the markets which are more heavily auction in character. The Government bond market handles the largest volume of any of the securities markets at probably the lowest transaction costs, reflecting the ability of dealers with substantial capital to manage successfully the problems posed by large blocks. The market for corporate bonds is characterized by significantly higher transaction costs with more sizable bid-ask spreads, but even here there is no evidence that comparable costs

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[1] Seha M. Tinic, "The Economics of Liquidity Services," The Quarterly Journal of Economics, February 1972.

are on the average higher than those for corporate stock.

Moreover, there does not appear to be any reason to ascribe the diminished role of individuals in these markets to factors associated with the growing institutional participation. Individuals probably found U.S. Government and corporate bonds less attractive but, at least in part, because bond yields remained extremely low for several decades relative to other yields, and increases in personal income tax rates lowered further the effective yield on bonds as compared with stock. Most groups of institutions on the other hand were largely legislated out of the stock market in the U.S.A. until about 1950 and were not subject to the same income tax deterrent. With the rapid rise of bond yields in recent years individuals have become a more important part of the bond market, especially for corporate issues. Thus, for corporate and foreign bonds, the share of households in total holdings rose from well under ten percent in 1965 to 20 percent in the early 1970's.

Any inference that the comparative absence of individuals from the corporate bond market has impaired its usefulness for raising new capital for corporations is contradicted by the historical rise in the share of new corporate financing accounted for by bonds at the expense of equity securities. The rise since the 1920's has been substantial. Again, however, non-institutional factors--such as the increase in corporate income taxes which makes debt financing relatively less expensive--probably accounted for this development.

Another argument which has been made is that institutionalization of trading might harm new equity investment, apparently in part because of its allegedly adverse effect on the market for outstanding stock issues. I have already indicated that there is no reason to believe that

the market for outstanding issues would be adversely affected, and indeed the growth in institutional stock ownership in the 1950's and 1960's may have contributed to the marked rise in stock prices during this period and to the apparent decline in the relative cost of equity financing. Institutions may have had such an effect in two different ways; i.e., by adding to the overall demand for stock, and by reducing transactions costs, at least compared with small individual investors, on the acquisition of a diversified portfolio of stocks.

Turning to the relevant evidence for the new issue market, the decline in the relative importance of new equity financing immediately after the 1920's obviously had nothing to do with the institutionalization of equity markets, which really did not start until after 1950. Only starting in 1970, at a time when the institutionalization of markets was at a peak, was there a marked resurgence of new equity financing, with only a temporary dip during the depressed stock market in 1974. This resurgence has apparently not been effectively deterred by institutionalization.

While the total supply of new equity financing has probably not been depressed by the growing institutionalization of the market, the supply of unseasoned or risky new issues may have been adversely affected. It is true that institutions are more risk averse than individuals, so that, other things equal, a shift in stock ownership to institutions might be expected to lead to an increase in the cost of capital to risky seasoned firms and to unseasoned new enterprises. However, there is no reason to believe that this effect has been large and perhaps the main result may have been to reduce or eliminate an apparent historical inefficiency in

Finally, some students of finance have suggested that the rapid growth of institutional equity investment will, in the absence of a substantial rise in new stock flotations, lead to dangerously high stock prices, especially for large seasoned issues, and may require the imposition of curbs on such investment.[1] Neither our analysis nor any other I am familiar with lends much support to this concern, though there is reason to believe that the pension funds and mutual funds may have contributed to the postwar rise in stock prices of the 1950's and 1960's. So far, it appears that the growth in institutional investment may have helped to reduce the former substantial disparities between the returns on equities and those on other investments rather than to inflate stock prices in relation to prospective returns. There is no reason to expect that in the future, even if the rate of new stock flotations does not increase markedly, institutional investors as a whole would be any more irrational than other investors in bidding up the prices of stock beyond their intrinsic values.

A growing rate of institutional equity investment might, of course, be detrimental to the economy, totally apart from the dangers of an unduly high level of stock prices, if--because of faddism, excessive speculativeness, or other reasons--the structure of stock prices were distorted in such a way as to diminish market efficiency and the stability of stock prices were adversely affected. Again, however, the evidence referred to in this paper suggests that institutions were about as efficient in their equity investments as the market as a whole and did not adversely affect market stability. As a result, market efficiency considerations do

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[1]For example, see Raymond W. Goldsmith, Financial Institutions, Random House, Inc. New York, 1968. Dr. Goldsmith suggests that it may become necessary to set upper limits on the share of funds that at least some groups of institutional investors may invest in common stock.

not seem to provide any justification for new securities regulation limiting the role of institutional equity investors.

## 4. Other Issues

The preceding discussion has suggested that there in no cogent evidence as yet that the rapid growth of institutional equity investment in the U.S.A. has had any undesirable effects on the efficiency of the stock market. It is conceivable, of course, that this conclusion might be altered if individual equity investors were to virtually disapper from the market but no such outcome appears to be in prospect even in the distant future. However, there are important other issues which have also been advanced to support the need for controlling the level or rate of growth of institutional equity investment and associated institutional policies and practices.[1]

The concentration of power over portfolio companies (corporations whose shares are owned by the institution) implicit in the growth of a number of giant organizations oriented toward equity investment has been a basis for concern totally apart form the other economic implications of the growth in institutional equity investment. Excessive concentration of power not only may have adverse economic consequences but is frequently regarded as detrimental for non-economic reasons. However, it is known that institutions have not been especially active stockholders and have usually indicated their reaction to portfolio company management by purchasing or selling the company's shares rather than by attempting to influence its policy. They are presumably somewhat more

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[1]This discussion of policy issues is based largely on Irwin Friend, Marshall Blume and Jean Crockett, Mutual Funds and Other Institutional Investors: A New Perspective, McGraw-Hill Publishing Company, 1970.

active than the smaller individual stockholder and considerably less active than the very large individual stockholder. There is, however, always the danger that as institutional investors own more and more of the available stock and it becomes more difficult to dispose of the larger and larger blocks of stock involved, they may take a more dominant role in the affairs of portfolio companies. This danger does not seem to be sufficiently great to warrant restrictions on the size of institutional investors in the foreseeable future.

proportion of stock in a portfolio company that can be held by a single institution. Thus, in the U.S.A., mutual funds (and other diversified management investment companies) are already restricted in 75 percent of their investments to holdings not exceeding 5 percent of their assets or 10 percent of the voting stock of the portfolio company. Moreover, if a mutual fund owns more than 5 percent of the stock of a portfolio company, most transactions between the fund and the company require prior SEC approval. Comparable types of restrictions might be enacted for other institutional investors, but, in the absence of data on the investment policy of such investors, especially in the pension funds, we have little basis for assessing the need for, or effect of, such a legislative change. Moreover, there are generally not the same liquidity grounds to justify such restrictions as there may be for mutual funds. What does seem to be urgently required is the periodic tabulation of portfolio and other data from pension funds and other important groups of equity-oriented institutional investors. Fortunately, such information should become

available shortly as a result of the enactment of the Securities Act Amendments of 1975. Under present plans, periodic reports made public under this legislation will provide data for individual fiduciaries. ¶ If institutional equity investors continue to increase in relative importance and also participate more actively in the affairs of portfolio companies, it may become desirable to enact further restrictions on the role they play in these companies. Even under such circumstances, however, it is not clear that there would be adequate reason to limit the size of the institutional investors. Mutual funds and other institutional investors for which data are available exhibit significant economies of scale in their operating costs; large funds seem to have fully as good investment performance as the smaller ones. The reduced operating costs of the larger organizations may be offset, to some extent, by increased investment inflexibility. Perhaps the best approach to avoiding the dangers of monopolistic control of portfolio companies by large institutional investors would be to strengthen, when necessary, the current limitations on the percentage of voting stock of individual portfolio companies that may be held by certain institutional investors and to extend such restrictions to other institutional investors.

An alternative mechanism would limit institutional holdings of equity issues in portfolio companies to nonvoting stock (i.e., to stock which is nonvoting while held by institutional investors). The latter approach has the advantage of avoiding arbitrary percentage restrictions on stockholdings but has four shortcomings: First, if the institutional investors were truly divested of power by the use of nonvoting stock, it would be easier than ever for other stockholders (not necessarily aligned with management) to gain control, with a relatively small investment, of

portfolio companies largely owned by institutional investors, and proxy fights would probably be greatly encouraged. Second, it is doubtful that institutional investors with very large blocks of stock would be divested of power simply because their stock was nonvoting, since a threat to liquidate such holdings would be quite potent. Third, for mutual funds and perhaps certain other institutional investors, there is the need to ensure portfolio liquidity. Fourth, institutional investors may well be more informed stockholders than most of those permitted to vote.

Institutional ownership of large blocks of stock in portfolio companies also raises a number of questions about the need for protecting other stockholders from the consequences of institutional activities. Institutions, because of their resources, may have better and faster access to information about the company's affairs. This could work to the disadvantage of most of the other stockholders, who are typically much smaller in size. There have been many news stories to suggest that, in spite of the safeguards under present securities regulation, institutions as well as other large investors may have a significant advantage over the smaller investors in the dissemination of corporate information. It seems reasonably clear that securities regulation should attempt to ensure that no stockholder, no matter how large, be given access to important information which is not made available to any other stockholder, no matter how small.

Only one real issue seems to be in question here, Should management make available to any stockholder who seeks it significant information that would not be available to other stockholders simply because they do not request it? Despite the costs involved in interfering with the free flow of information of this type, simple equity among stock-

holders seems to require that to the extent possible no important information be given to one group of stockholders which is not given to all stockholders at the same time (or where it is given, e.g., to stockholders who are also insiders, that restrictions be placed on their ability to profit by it). Obviously, one way to minimize the costs of this policy to market efficiency would be to ensure that all important information be disseminated to stockholders as soon as feasible.

As a practical matter, dissemination of information to stockholders in a large publicly owned corporation is tantamount to disclosure to the general public. A problem arises, and exceptions to the general rule of immediate disclosure might be warranted in certain cases, when management desires to withhold information for a limited period for the company's welfare (as distinct from the welfare of a particular group of stockholders). However, since equity as well as the philosophy of securities regulation requires the fair treatment of potential as well as actual stockholders, there may be a conflict between the responsibility of management to potential stockholders (to provide relevant disclosure of material facts) and their responsibility to actual stockholders ( to maximize their risk-adjusted returns). Presumably, the legal basis for resolving this conflict should take into account the prospective damage and benefits to the two groups. The optimal resolution of the conflict depends largely on the relative responsibility management is considered to have toward actual and potential stockholders.

One tenable resolution--which rests on the premise that the basic responsibility of management is to maximize risk-adjusted return (or market value) for the company as a whole--would permit the temporary withholding of material information, so long as there is a legitimate reason

for doing so from the viewpoint of the company's welfare and no group is permitted to profit from advance knowledge. This apparently is close to the present law in the U.S.A. The rationale for this position, from the viewpoint of the potential stockholders who might be adversely affected, would be that temporary withholding of information for the company's welfare may be regarded as an ordinary market risk( which enters into the pricing of stock) and management cannot be expected to protect potential stockholders from such risks at the expense of actual stockholders. One attractive way to cut down on the prospective damage to potential stockholders is to institute a stricter construction of the legitimacy of business reasons for withholding material information and of the justified withholding period.

A second, quite different, but still theoretically tenable resolution of this conflict of interest between potential and actual stockholders would be for management again to conduct its affairs so as to maximize risk-adjuted return for the company as a whole, which as before might require the withholding of material information, but then to compensate any purchasers (or sellers) of stock who have suffered substantial losses as a result of this action. However, this second position would be extremely difficult to implement in practice, and has the further limitation that it might inhibit management in maximizing risk-adjusted return with a resulting social cost to the economy.

Institutional ownership of large blocks of stock in portfolio companies is sometimes considered to be detrimental in still another way to the interests of other stockholders and potential investors in the portfolio companies. In view of the size of their stockholdings in individual companies, institutions have been largely responsible for the

rapid growth in block transactions. The sale or purchase of large blocks of stock may at least in theory cause major discontinuities in the market, with such sales, at times, sharply reducing prices for other stockholders (to the advantage of potential investors) and purchases sharply increasing prices for other potential investors (to the advantage of stockholders). However, so long as institutional investors make as informed decisions in their sales or purchases as otherinvestors (and do not have greater access to inside information),[1] there is little reason to consider the prices at which they consummate their transactions to be less fair or less desirable than those achieved through a larger number of transactions, assuming that institutions attempt to use the best market outlets. In any case, it will be recalled that the previously discussed evidence on the impact of institutional trading on the market's allocational or operational efficiency does not point to significant costs of the trend toward block trading.

One last set of issues revolves about the question whether the existence of equity-oriented institutions raises significant conflicts of interest between investors and management in these institutions, and whether as a result regulatory restrictions on the activities of institutional management beyond those applicable to other corporate management are necessary or desirable. The establishment of institutional investors as intermediaries between the ultimate individuals and business firms who supply and demand funds does pose a number of potential conflicts of interest which would not exist in the absence of these institutions.

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[1] Inside information here should be construed to include restricted market information about the company's stock as well as restricted information about the company's affairs.

The conflicts in the period after World War II were especially troublesome in mutual funds for reasons discussed in detail in a number of different studies.[1] Perhaps the most notable of these reasons was the customary control of fund management by external investment advisors whose interests--e.g., in maximizing the fund's size and the management fee, in setting the sales charge, in determining portfolio turnover, and in pricing portfolio securities, especially letter stock--often are quite different from the interests of the fund shareholders. In recent years, the amendments to the investment company legislation and the Government's prescription of competitive commission rates for stock transactions have significantly diminished the potential damage to shareholders by conflicts of interest in the management of mutual funds. I have discussed in an earlier study carried out in collaboration with two colleagues further measures, especially those in the field of performance disclosure, which might be taken to reduce conflicts of interest and enhance meaningful competition in the operation of mutual funds.[2]

Turning to the major institutional stock investors other than mutual funds, for pension funds--currently the most important single group of equity-oriented institutions--the corporate sponsor of the fund is quite independent of the external investment adviser (typically a commercial bank), and the corporate management and the fund's beneficiaries have similar interests in maximizing fund return and minimizing costs of operation. The conflicts of interest in insurance stock companies

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[1] E.g., see Friend, Blume and Crockett, _op. cit._

[2] _Ibid._

are probably not very different from those of most other corporations of comparable size. The conflict problems for mutual insurance organizations are presumably similar in general nature though not in specific form to those of internally rather than externally managed mutual funds. Bank trust departments, which administer personal trusts as well as pension funds, and have much larger equity holdings than mutual funds, have some of the same potential conflicts of interest as externally managed mutual funds. As a result serious consideration has been given from time to time to legislative changes which would require that organizations carrying on the trust functions of banks be separate and independent from those carrying on commercial banking operations. However, while such a requirement would certainly diminish appreciably the potential for conflicts of interest in institutional stock investment, it is entirely possible that associated losses in economic efficiency would offset and perhaps more than offset the gains in the equitable treatment of trust beneficiaries. Unfortunately, we do not possess enough information either on the extent of damage to trust beneficiaries or on the possible economic efficiencies associated with the joint operation of the commerical banking and trust operations to resolve this issue.

So far as the institutional investors other than mutual funds and bank trust departments are concerned, I have already pointed out that the absence of external advisers avoids many of the conflict problems found in the typical externally managed institutions. There is, however, one important problem characterizing other types of mutual institutions: unlike mutual funds, they can accumulate substantial amounts of surplus funds without distributing them to the owners (for example, the policyholders in mutual life insurance companies or the depositors in savings and loan associations and mutual savings banks). The situation in these mutual organizations is quite different from that in stock corporations, since the owners in the former have no transferable equity in the surplus. This is not the widely publicized problem of ownership without control. It is, rather, a relatively neglected problem of nominal ownership without any real equity interest. Among the assets of mutual institutions are billions of dollars of surplus funds that are more likely to enhance the position of the management or of future owners than of the present owners. This is especially true since the control group in the typical large mutual institutional investor, with a great many small policyholders or depositors, is probably even more self-perpetuating than in most public corporations. The problem has received some attention in recent years in connection with the conversion of mutual organizations into stock corporations. The entire issue of mutuality vs. corporate organization merits more attention than it has received, but it is of course not a special problem of equity-oriented institutional investors.