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The Institutional Investor Disclosure Act: An Analysis of the Consumer Benefits

Financial intermediaries such as bank trust departments, insurance companies, pension funds, mutual funds, endowment funds, and foundations manage one-third of the securities investments in the United States. Congress is now considering legislation that would amend the Securities Exchange Act of 1934 to require frequent disclosure of the portfolio holdings and transactions of these institutional investors. Such disclosure would involve a major extension of the reporting jurisdiction of the Securities and Exchange Commission (SEC) and a wide expansion of the pool of centrally located and publicly available data on securities holdings and transactions.

1. SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 64, 92d Cong., 1st Sess. 70 (1971) [hereinafter cited as IIS REPORT].


3. At present three institutional investor disclosure bills are before Congress. S.2234, 93d Cong., 1st Sess. (1973) [hereinafter cited as S.2234], was submitted on July 25, 1973, by Senator Williams for himself, and Senators Brooke, McIntyre, Proxmire, and Tower. S.2683, 93d Cong., 1st Sess. (1973) [hereinafter cited as S.2683], is the Securities and Exchange Commission's (SEC's) proposed modification of S.2234. Letter from Ray Garrett, Jr., Chairman of the SEC, to Senator Williams, Dec. 13, 1973 (on file with the Yale Law Journal). H.R. 13986, 93d Cong., 2d Sess. (1974) [hereinafter cited as H.R. 13986], was submitted on April 4, 1974, by Congressman Moss for himself and Congressmen Broyhill (N.C), Eckhardt, and Luken. The Senate bills have been referred to the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, and the House bill will probably be referred to the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce. Senate and House hearings are planned for spring, 1974. Interviews with Alton B. Harris, Chief Counsel to the Senate Subcomm. on Securities, and Harvey A. Rowen, Special Counsel to the House Subcomm. on Commerce and Finance, in Washington, D.C., Mar. 20, 1974.


In 1969, institutional investment managers in the United States controlled about $696 billion in assets. Bank trust departments controlled about $255 billion, insurance firms about $246 billion, and other institutional investment managers outside SEC reporting jurisdiction about $88 billion. The amount controlled by managers subject to SEC reporting jurisdiction was about $107 billion. However, the SEC actually required reporting on only $61 billion, principally the funds managed by registered investment companies. The proposed legislation would thus expand the segment of the capital market represented in SEC holdings and transaction reporting from $61 billion to $696 billion. A current survey of institutional investor practices and trends is available. Hearings on the Impact of Institutional Investors in the Stock Market Before the Subcomm. on Financial Markets of the Senate Comm. on Finance, 93d Cong., 1st Sess., pt. 1 (1973) [hereinafter cited as Finance Hearings].
The legislation's proponents have stated two general purposes of the proposed disclosure: the prevention of fraud and manipulation by institutional investment managers and the education of consumers about the performance of the portfolios being managed in their behalf. If prevention of fraud and manipulation were the major purpose, the need for legislation would be questionable. For example, a recent study casts doubt on the often heard argument that institutions are responsible for the "two-tier" market, a condition of the stock market in which a few stocks favored by institutions sell at artificially high price-earnings ratios, while all other stocks are allowed by the market to seek their own price-earnings ratios. Moreover, recent statistical analyses conclude that disclosure under the federal securities statutes is of little or no benefit in preventing fraud and manipulation.

5. The term "consumer" as used in this Note refers to the purchaser of investment management or investment advisory services. It includes individual investors using the investment advice of broker-dealers. In the case of mutual funds, pension trusts, and other institutional purchasers of management and advisory services, the term is meant to embrace not only the fund’s officers but also its shareholders or beneficiaries.


7. U.S. Treas. Dep’t, Public Policy for American Capital Markets, BNA 1974 Sec. REG. L. REP. No. 239, at D-1, D-12-14 (Feb. 13, 1974) (prepared by James H. Lorie). Much of the general, substantial decline in the prices of common stocks since 1968 can be explained on the basis of normal economic relationships. As the rate of inflation increased, the expected rate of inflation increased with a consequent increase in nominal interest rates. And predictably and naturally, as the nominal cost of debt capital rose, the cost of equity capital rose. In the absence of a general expectation of rapidly rising profits, the increased cost of equity capital has been reflected in declining price-earnings ratios. Although some stocks have much higher price-earnings ratios than others, this has always been true. Institutional investing is not plausible as an explanation of a phenomenon which existed before institutional investing became so important.

Id. at D-14. Specifically, with respect to charges that institutional investors act in concert to manipulate the markets, the study stated that its analysis indicates that the incidence of parallel trading by institutions is not more common than such trading by individuals and that, in fact, institutions do not blindly play "follow the leader" but buy and sell to and from each other. Id. at D-13.


9. Whatever may have been the origins of the two-tier market, the phenomenon now seems to be fading. See, e.g., Vartan, New Forms of Competition Knock on Wall Street’s Door, N.Y. Times, Jan. 6, 1974, § 3, at 57, col. 8; Wolman, Banks Stir Controversy as a Stock Market Force, N.Y. Times, Oct. 7, 1973, § 3, at 3, col. 5.

10. Professor George J. Benston of the University of Rochester conducted an empirical analysis of stock prices on the New York Stock Exchange before and after enactment of the Securities Exchange Act of 1934. He used statistical regression techniques to test the hypothesis that the Act contributed to the prevention of fraud and manipulation. The conclusion of this study, then, must be that the disclosure requirements of the Securities Exchange Act of 1934 had no measurable positive effect on the securities traded on the NYSE. There appears to have been little basis for the legislation.
The Institutional Investor Disclosure Act

Institutional disclosure, however, would help the consumer of investment management services shop for the portfolio manager who meets the consumer’s specifications of risk and return at lowest cost. The Institutional Investor Study, published by the SEC in 1971, concluded that techniques of risk and return evaluation made possible by the availability of holdings and transaction data would be of use in such an evaluation of portfolio managers. However, the Study did not elaborate on the specific ways the data and techniques could be of use or on the process by which the benefits could be disseminated to a large number of consumers. A major reason for these omissions is that both the theory and commercial applications of risk and return analysis were new and not widespread at the time of the Study. This Note analyzes the benefits of institutional investor disclosure by examining theoretical and commercial developments since the Study. It recommends enactment of institutional disclosure legislation which provides for reporting of the disclosed data by portfolio and which subjects asset categories in addition to common stock to transaction disclosure. It also recommends that the disclosed data be available from the SEC in consolidated, standard format, computer-readable form in order to facilitate use by investment advisers. Each element of


Professor George Stigler reached a similar conclusion about the 1933 Act some years ago. Stigler, Public Regulation of the Securities Markets, 37 U. CHI. J. BUS. 117, 120-24 (1964) [hereinafter cited as Stigler]. His conclusion is widely accepted by economists. R. Posner, Economic Analysis of Law 199 (1972) [hereinafter cited as Posner].

A.A. Sommer, Jr., a SEC Commissioner, delivered a comprehensive rebuttal to these criticisms in a speech before the Conference Board. Address by A.A. Sommer to the Conf. Board, “Required Disclosure in the Stock Market”: The Other Side, SEC News Release, Sept. 27, 1973. Sommer does not dispel Benston’s conclusions, however, principally because Sommer invokes no empirical data refuting Benston’s findings and does not refute Benston’s theoretical foundations. Sommer simply asserts that he does not believe the results. Id. at 5. Moreover, he appears not to have fully evaluated Benston’s article, since he attacks Benston at one point on the basis that “the knowledge that a report is going to have to be filed which could result in significant liability will discipline the earlier disclosure and assure its integrity.” Id. at 7. However, Benston’s point is that even if there is such an effect on disclosure, it has made no measurable difference with respect to fraud and manipulation. Benston 152-53.

11. The term “risk” refers to variance in the return on a given investment. It is the dispersion of less likely outcomes around a most likely outcome. An investment is deemed riskless if a given level of return is guaranteed: an investment becomes increasingly risky as the chances increase that the return will differ from the expected value. IIS REPORT, supra note 1, at 400-01.

12. Id. at 1-4. This reference includes a useful list of other studies of institutional investment managers, dating back to 1906.

13. Id. at XIII.

14. See, e.g., id. at XIII, 360-74.
cost of these provisions is identified and analyzed. It is argued that the incremental costs they entail are small and possibly negligible.

I. Capital Market Theory

The Institutional Investor Study's recommendation that risk and return data be made available to consumers of investment management services was based on capital market theory. Capital market theory seeks to explain the determination of prices of capital assets in a free market system by examining the expected return of different investments in relation to their risk. The central notion is that the price of an asset is a function of both its expected return and the variability of that return.

Two principal elements of the theory are portfolio theory and the capital asset pricing model. Portfolio theory examines the question of investing in different assets by describing each person's investment decisions in terms of that person's total portfolio. One of the principal conclusions of portfolio theory is that an individual asset's value can be properly determined only by examining the asset's effect on the expected return and risk of the whole portfolio of which it is a part.

For example, a portfolio equally divided between savings bonds and high risk securities might well subject an investor to the same risk level as a portfolio consisting entirely of medium risk securities. Furthermore, since the prices of the several securities in a portfolio may vary in different directions, or at least at different rates over time, the riskiness of the whole portfolio is typically less than the average

15. See, e.g., id. at XIII, 400.

The expected return on a whole portfolio, on the other hand, is merely the weighted average of the expected returns on the securities composing it. Therefore, diversifying a portfolio among various securities, instead of investing in only one kind of security, will reduce the risk an investor must bear to attain any given expected return on his portfolio.17

The capital asset pricing model provides a basis for determining the value to an investor of different portfolios. It enables an investor to evaluate past results by examining the risk and compensating return of his portfolio and to plan his future investments by specifying the level of risk and expected return he wishes to maintain. In using the model, the investor first specifies the categories of assets which may be used to constitute the portfolio. A "market portfolio" for those categories must then be established. The market portfolio is the core of the model.

The market portfolio is a portfolio that includes each individual security from the asset categories, with the quantity of each individual security proportional to its market value.18 For example, in examining portfolios made up of corporate bonds and common stock, the asset categories would be corporate bonds and common stock. The market portfolio would be a portfolio made up of all common stock and corporate bonds, each issue being held in the same proportion that the total market value of that issue bears to the total market value of all common stock and corporate bonds. The capital asset pricing model provides a basis for planning and evaluation by permitting comparison of the risk and return of a portfolio with one standard, the market portfolio.19 The usefulness of the market portfolio rests on two factors. First, its riskiness and expected return can be varied by borrowing or lending. If the investor desires a lower level of risk than that of the market portfolio, he would place a fraction of his funds in that portfolio. He would place the rest in a risk-free investment, such as a savings account. If the investor desires a higher return and risk level than that of the market portfolio, he would borrow to invest more in the market portfolio, thereby leveraging his position in the portfolio. The second factor of the market portfolio's usefulness is that the various combinations of borrowing or lending from the

17. Note, Regulating Risk-Taking 1315-16.
19. Id. at 210, 242.
market portfolio trace out a baseline of return versus risk that can be used as a comparison standard for planning and evaluating the operation of a portfolio.20

20. A graph can be used for illustration of the capital asset pricing model. Assume an investor is considering how best to invest his funds among corporate bonds, mortgages, and common stock. His task is to consider the alternative compositions of his portfolio so that for each level of return he might seek, he maintains minimum risk, or, conversely, for any level of risk he is willing to endure, his expected return is maximized. The alternative portfolios would consist of varying combinations of corporate bonds, mortgages, and stocks and varying individual selections of securities within those categories. Using portfolio theory, the risk and return of the possible portfolios can be calculated. The result of the calculations is the efficient frontier, the locus of points representing the maximum return possible for each level of risk.

For the moment, the dashed line, RN, and the points on RN, may be ignored. Higher return can be obtained only by assuming higher risks. Portfolios A and B lie on the efficient frontier; no higher return is obtainable at their levels of risk. Thus, portfolio C is inefficient because portfolio A provides higher expected return at the same level of risk. Portfolio D is infeasible; there is no combination of bonds, mortgages, and stocks that can be expected to produce D's return at D's level of risk.

When the possibility of borrowing or lending is introduced, the shape of the efficient frontier changes. R is the return on a risk-free asset and the rate at which funds may be borrowed. Portfolios along line MR can be obtained by combining the risk-free asset with portfolio M, and portfolios along MN can be obtained by leveraging

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Empirical testing of the capital asset pricing model has shown that it is a valuable tool for portfolio planning and evaluation. The model views the consumer's net benefit from a portfolio as the return (the appreciation or depreciation of the portfolio plus any distributed earnings) minus the costs incurred in operating the portfolio. The three components of cost are the cost of excess risk, transaction costs, and management fees.

For each given level of expected return on a portfolio, there is a minimum risk that need be endured. This is the risk associated with the given return on the borrowing-lending baseline of the model. Risk in excess of the borrowing-lending baseline thus results in a dollar cost.

Transaction costs are the brokerage commissions, dealer charges, and other fees paid when securities are sold or acquired. Management fees are the charges made by investment managers to their clients.
for operation of the portfolio. Fees for research are usually billed as a separate item under management fees. However, compensation to brokerages for research is usually incorporated in the brokerage commission.

Return and cost calculations can assist investors in both planning and evaluating investments. In planning, the investor can determine which combinations of assets under consideration yield the highest return at each level of risk. The investor then uses the risk level he seeks, or the return he must attain, in order to construct the best possible portfolio. Since no excess risk will result from the maintenance of the best possible portfolio, subtraction of the estimated management and transaction fees from the expected return yields the net benefit.

This planning approach is useful to investors for several reasons. Before the advent of capital market theory, the effects of risk had not been as precisely measurable as those of return. Capital market theory facilitates quantification of the effect of risk (as well as of return) in designing portfolios. Moreover, the theory permits identification of the best allocation of funds among different categories of assets. For example, the decision to allocate portions of a fund among bonds and stocks has historically been made on the basis of separate analysis of each category. The effects on total return and total risk of different divisions have been analyzed only in a rough, elementary way. Furthermore, specification of risk and return gives the consumer of investment management services a detailed basis on which to make comparisons of the services of different investment managers or brokers by making it possible to set a benchmark of expected return and costs against which the portfolio and its manager may be evaluated after each quarter's results are in.

Analysis of risk and return permits detailed diagnosis of the factors affecting portfolio performance. The consumer can determine to what extent actual results are due to his own specifications of return and risk and to what extent they are due to the costs incurred by the investment manager. It makes it easier for consumers to determine

25. Management fee arrangements are discussed extensively in IIS REPORT, supra note 1, at 225-66 (investment advisory complexes), at 476-83 (bank trust departments), and at 670-84 (life insurance companies).
26. SECURITIES INDUSTRY STUDY, supra note 24, at 60-62.
27. Id.
29. LORIE & HAMILTON 245-46.

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when and why they should change investment managers, or, if the consumer makes his own investment decisions, the source of advice.

A striking example of the use of capital market theory for planning and evaluation is its applicability in constructing performance, or incentive, fees.\textsuperscript{30} Whether or not a performance fee is involved, specification of risk and return by the consumer and the investment manager provides a detailed basis for judging the objectives and results of the investment process and permits consumers to identify those investment managers who produce the highest net benefit from portfolio operations.\textsuperscript{31}

Analysis of risk and return enhances the possibility of increasing the net benefit of each person entitled to a share of the portfolio. Thus pension fund participants, fund trustees, and individuals who construct their own portfolios can benefit when their portfolio is subjected to such analysis.

II. Application of Capital Market Theory

Practical application of capital market theory requires a large amount of securities market data. Although the theory currently enjoys wide commercial use, lack of data has stymied further development of commercial applications.

A. Data Requirements

An important step in applying capital market theory is establishing the indexes necessary to estimate the return and risk of the market portfolio for the asset categories being considered. The popularly known common stock indexes, such as Standard & Poor's "500" Stock Index, are examples of indexes used as proxies for the market portfolio of common stocks.\textsuperscript{32} To calculate the index for a particular type of asset, a statistically dependable sample\textsuperscript{33} of the market values of the securities in that asset category must be obtained and maintained over time.\textsuperscript{34} Measurement of return also requires knowledge of the

\textsuperscript{30} F. Modigliani & G. Pogue, A Study of Market Line Investment Performance Fees, April 1973, at 1 (working paper, Alfred P. Sloan School of Management) (also on file with the Yale Law Journal) (quoted by permission of the authors) [hereinafter cited as Modigliani & Pogue].

\textsuperscript{31} LORIE & HAMILTON 249-58.

\textsuperscript{32} Id. at 249. Standard & Poor's "500" is a value-weighted index of prices of 425 industrials, 25 railroads, and 50 utilities, all of which are listed on the New York Stock Exchange. Id. at 62, 249.

\textsuperscript{33} A statistically dependable sample is one large enough to provide an accurate estimate of the characteristics of the whole population.

\textsuperscript{34} LORIE & HAMILTON, supra note 16, at 51-54.
magnitudes of distributions, such as dividends or interest.\textsuperscript{35} At present only common stock indexes and some limited bond and commodity indexes are available.\textsuperscript{36} Indexes for other forms of security participations and for combinations of securities (for example, an index for portfolios containing stocks, municipal bonds, and corporate bonds) have not been developed\textsuperscript{37} because market value and return information on a statistically dependable cross section of most securities are not available.\textsuperscript{38} For example, even though a great many bond trades are reported, the available indexes are limited and statistically unreliable because many major trades take place directly between the parties involved and are never reported.\textsuperscript{39} In fact, even the available common stock indexes have been criticized as being only rough approximations of the total market they represent.\textsuperscript{40}

In addition to market value and return information for calculating indexes, the application of capital market theory requires return and cost information on a statistically dependable sample of other portfolios. This information is essential in determining a fair estimate of the costs to subtract from the baseline portfolio when evaluating an actual portfolio. Since the baseline portfolio of the capital asset pricing model incurs no actual costs of excess risk, transaction costs, or management fees, an estimate of such costs must be deducted from the baseline portfolio's return in order that a fair comparison with an actual portfolio be made.\textsuperscript{41} The actual costs of a sample of other portfolios is the logical source for such an estimate.

Return and cost data on other portfolios also make it easier for consumers to determine if they could get better investment management services elsewhere. Further, to the extent the market involved is efficient, so that expected return is the same for any selected level of

\begin{thebibliography}{9}
\bibitem{35} Id. at 63-64.
\bibitem{36} Typical bond indexes are those available from Moody's, Fitch, Standard Statistics, and Poor's. See, e.g., id. at 211-12. Typical commodity indexes include the Dow Jones Futures, Dow Jones Spot, and Reuter United Kingdom. See, e.g., Commodities, Wall St. J., Apr. 11, 1974, at 22, col. 2.
\bibitem{38} See Interviews cited \textit{supra} note 37.
\bibitem{39} See Interviews cited \textit{supra} note 37.
\bibitem{40} \textit{Lorie & Hamilton}, \textit{supra} note 16, at 249-50.
\bibitem{41} Modigliani and Pogue state the problem of establishing a fair estimate of expenses: The performance comparison between a fund and its comparison index will be meaningful only if the index represents a viable investment alternative to the fund. The standard should not represent a theoretical and unobtainable target but an alternative in which the fund assets could have been invested. Modigliani & Pogue, \textit{supra} note 30, at 39.

Unfortunately, however, "at the present time there is no precedent for reducing the return on the comparison standard to reflect a reasonable level of fund operating expenses." Id. at 30.

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risk, cost minimization becomes critical to maximizing the net benefit from investments.\footnote{42}

Calculation of the return and cost for other portfolios in a given period requires several items of information. First, each holding and its market value must be known as of the beginning and end of the period. Second, distributions such as dividends or interest for each holding must be known. Third, the sum of the management fees must be known. Finally, the sum of the transaction costs is needed.\footnote{43}

In summary, full use of the capital asset pricing model requires a wide sample of data. In order to apply the model to all categories of assets, data on the market value and distributions (such as dividends or interest) of a dependable sample from each category is needed. In order to permit fair use of the baseline and to permit consumers to compare costs, the period’s starting and ending holdings and market values, distributions, management fees, and transaction costs are needed for a dependable sample of portfolios.

B. \textit{Current Commercial Applications}

The limited public availability of holdings and transaction data has restricted the feasibility of commercial application of capital market theory to firms that have private access to the operating data on a large number of portfolios. Typically, these firms obtain this data from their brokerage or planning and evaluation clientele. Their applications of capital market theory, which have been confined by available data to stock analysis,\footnote{44} include in-house evaluations,\footnote{45} mutual fund evaluation,\footnote{46} construction of portfolios,\footnote{47} and services

\footnote{42} See LORIE \& HAMILTON, supra note 16, at 106-08. Wells Fargo Bank and American National Bank \& Trust Company in fact manage certain funds on the principle that the stock market is sufficiently efficient to warrant a strategy of simply buying and holding a portfolio at the desired level of risk or return. Trading in search of gains on underpriced or overpriced securities is considered futile and is eliminated. Laing, \textit{Bye-Bye Go-Go}, Wall St. J., June 7, 1973, at 1, col. 6.

\footnote{43} IIS REPORT, supra note 1, at 409-10: SHARPE, supra note 20, at 94. Periodic holdings data is necessary in order to calculate the costs due to excess risk, since the riskiness of the total portfolio is calculated by determining the riskiness of each security in the portfolio. A succinct exposition of the elements that constitute transaction costs is available in F. Black \& M. Scholes, \textit{From Theory to a New Financial Product}, Jan. 1974 (working paper of the Graduate School of Bus., Univ. of Chicago) (also on file with the \textit{Yale Law Journal}).

\footnote{44} Compare Merrill Lynch Survey, supra note 20, at 3-18, with id. at 19-27.


\footnote{46} As one of its services, Wiesenberger Services offers evaluations of mutual funds that include designation of risk level. See, e.g., Wiesenberger Services, \textit{Mutual Fund Performance Monthly}, Jan. 1974, at 3.

\footnote{47} Wells Fargo Bank of San Francisco and American National Bank \& Trust Company of Chicago are pioneers in this field. See T. Prasil \& R. Sinquefield, American
that evaluate pension and endowment fund management.\textsuperscript{48} The client of the evaluation services is usually a fiduciary who wishes to evaluate his fund's investment manager.\textsuperscript{49} The services provide both evaluation and assistance in planning future risk and return objectives. The effect is to sharpen competition among investment managers by providing consumers with detailed comparative data that has been unavailable in the past.\textsuperscript{50}

C. \textit{Obstacles to Wider Applications}

For several reasons, development of the applications of capital market theory is stymied by the inaccessibility of portfolio holdings and transaction data.

1. \textit{Limited entry into the investment manager evaluation market.}

To obtain the holdings and transaction data necessary for cost comparisons with other portfolios, an evaluating service must accumulate the data from its own clients because the data is not publicly available. Therefore, a firm must have a large clientele in order to have a large and statistically reliable data base. The effect is to limit the number of firms that can provide such services, since economic viability for such firms depends on a large number of clients at the outset. If a publicly available base of raw data were available in easily processed form, a small computer analysis company could begin business with only a few clients.


\textsuperscript{49} Recent commentators have argued that capital market theory should be incorporated into the prudent man rule which governs the acts of fiduciaries. To the extent fiduciaries are unrestricted in their choice of securities, their individual security selections would be evaluated for prudence on the basis of the total return of the portfolio. \textit{See, e.g., Posner, supra note 10, at 196-97; Treynor, What the Courts Ought to Know about Prudence, FIN. ANAL. J., Mar.-Apr. 1973, at 11.}

More importantly, however, prudence may also require use of the theory in establishing as precise a statement of investment policy as the given restrictions, if any, allow, with follow up evaluation of conformance to such policy. Without such specification, investment planning is crude and inexact. \textit{See Lorie & Hamilton, supra} note 16, at 255; A.G. Becker & Co., \textit{supra} note 16, at 3; Merrill Lynch, Pierce, Fenner & Smith, Merrill Lynch Presents IPA—Investment Performance Analysis, undated, at 3.

2. **Exclusion of small investors.** The minimum fee that evaluation services presently charge is so high that a consumer needs a sizable portfolio for the costs of evaluation to be proportional to its benefits.\(^1\) A public data base would lower the overhead cost of investment analysis services, thereby reducing the break-even point on the fees the services must charge. It would be profitable to extend capital market theory applications to the portfolios of individuals with annual incomes well under $100,000, possibly as low as $15,000.\(^2\)

3. **Limitation of analysis to stocks.** Since the current availability of statistically dependable indexes is limited to stocks, with the exception of some narrow categories of bonds and commodities, extension of capital asset pricing model applications to nonstock assets is stymied. The importance of extension of the use of the model to nonstock assets has been forcefully argued by the researchers in capital market theory.\(^3\) Moreover, in 1968 the value of nonstock securities in the United States was more than twice as large as the value of stocks,\(^4\) and institutional investors managed over a third of the nonstock securities.\(^5\) Thus, on the basis of 1968 data, holdings and transaction data on securities held by institutional investors would represent a statistically dependable sampling of the nonstock securities of the United States capital markets. Such reporting would also improve the stock indexes now available.\(^6\)

**D. Evidence that Extended Holdings and Transaction Data Would be Used by the Private Sector**

The proliferation of commercial applications of the theory is evidence that a public data base would be used by private industry to serve both institutional and individual investors.\(^7\) In addition, the trends toward competitive brokerage rates and centralization of

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\(^1\) The minimum portfolio size that can bear the cost of these evaluation services currently appears to be about $1,000,000. Telephone Interview with Anthony P. Lewis, Vice Pres. of A.G. Becker & Co., Chicago, Feb. 4, 1974.

\(^2\) Interview with Rosky and Tate, supra note 37.

\(^3\) See, e.g., LORIE & HAMILTON, supra note 16, at 245-46.

\(^4\) Short-term claims, bonds, mortgages, and other long-term claims comprised 33.4 percent of all assets within the United States; corporate shares comprised 14.9 percent. \(\text{IHS Report, supra note 1, at 69.}\)

\(^5\) Institutions managed 32.3 percent of the short-term claims and 52.3 percent of the long-term claims. \(\text{Id. at 70.}\)

\(^6\) See p. 1280 supra.

\(^7\) For additional evidence of strong entrepreneurial interest in providing detailed, timely analyses of such public data, see Hillinger, *The $1000 Magazine: Stock Market Analysis*, Wash. Post, Nov. 11, 1973, § M, at 1, col. 5.

There is also evidence of SEC policy to encourage individualized portfolio analysis services. Address by William Casey, SEC Chairman, Economic Club of Detroit, Sept. 18, 1972, at 10-11. Lorie and Hamilton provide a theoretical and empirical foundation for a more vigorous public policy of improved investment counseling, especially to individuals. LORIE & HAMILTON, supra note 16, at 261-62.
the securities markets are likely to stimulate consumer demand for such services. In a system with competitive brokerage rates, much research activity would have to be unbundled from brokerage work, creating an opportunity and a need to evaluate the research's impact on portfolio returns. There would be a similar need to evaluate the effectiveness of traders in executing trades, which could be done by comparing transaction costs among portfolios.

In a centralized market system, increased speed of reporting of price movements and added depth and breadth would enhance efficiency, making it more difficult to trade profitably on publicly available information. The more efficient the market, the less likely it is that costs incurred in seeking undervalued or overvalued securities will be adequately compensated by increased return. Consumers would need the benefit of detailed calculations of return, transaction costs, management fees, and cost of excess risk in order to ensure that they do not bear excessive costs.

Two additional developments facilitate realization of the consumer benefits of capital market theory and enhance the likelihood that holdings and transaction data would be used by the private sector. A principal development is the increasing use and understanding of computers by investment management services and their consumers. The use of capital market theory is heavily dependent on computer processing because of the volume of data involved in analyzing the alternative assets and portfolios. Another development is the proliferation of Monte Carlo simulation techniques. These techniques use computers to estimate the future income consequences of selecting alternative levels of risk and return, and so are helpful in matching a portfolio to the consumer's needs for future income.

58. Both of these trends appear inexorable. See Bacon, Rocking the Boat—Chairman Ray Garrett of SEC Seeks Change in Reluctant Industry, Wall St. J., Feb. 11, 1974, at 1, col. 1. Changes to date include a creation of a consolidated stock-ticker tape for use in all exchanges, to be operative by 1975, and gradual elimination of high minimum fees for brokerage. Id. at 21, col. 6. In addition, the SEC is gradually eliminating fixed commission rates by requiring negotiated rates on trades above a certain size. The cutoff amount is currently $900,000. By April 30, 1975, all fixed commission will be eliminated. See Address by Ray Garrett, Jr., Chairman of the SEC, to the Investment Assn., SEC News Release, Oct. 3, 1973, at 4-8.

59. Competitive rates would tend to force brokers to separate their research and trading services so that the consumer can better tailor the package of services that he purchases, SECURITIES INDUS-MY STUDY, supra note 24, at 60-62.

60. LORIE & HAMILTON, supra note 16, at 108-09.

61. This extends to the availability of portfolio analysis programs available for customer use on remote computer consoles. Telephone Interview with W. Moss Luy, Vice Pres. Wiesenberger Services, New York, Feb. 12, 1974.

III. Adequacy of the Present Disclosure Proposals

At present three institutional disclosure bills are before Congress, one written in the Senate, one submitted in the Senate at the request of the SEC, and one written in the House.63 All three proposals provide for reporting of the security valuations, distributions, transaction costs, and management fees necessary to make full use of the capital asset pricing model and to make cost comparisons among portfolio managers.64

The SEC and House versions, however, have several weaknesses that vitiate their potential consumer benefits. Only one of these weaknesses appears in the Senate version. The SEC and House set a jurisdictional test that is geared to equity holdings only. Institutional investment managers are required to report only if their total equity holdings exceed a certain threshold.65 Thus, institutions controlling massive amounts of debt securities but only a small amount of equity would be exempt. This jurisdictional definition overlooks the vital importance of data on all asset categories. In addition, all three versions require reporting of transaction data for equity transactions only.66 The legislation should adopt the Senate approach that the

63. See note 3 supra.
64. See p. 1281 supra. Section (f)(3) of the SEC version, S.2683, § (f)(4) of the Senate version, S.2234, and § (f)(3) of the House version, H.R. 13986, require reporting of market value. See S.2683, supra note 3, § (f)(3); S.2234, supra note 3, § (f)(4); H.R. 13986, supra note 3, § (f)(2). Legislative and regulatory personnel interviewed by the author stated that management fees and distributions to securities in the portfolio would fall under the “substantially related information” provision of the SEC version, § (f)(3)(B)(viii), under the Senate provision for “such other information concerning the transaction or transactions as the Commission, by rule or regulation, may prescribe,” § (f)(4)(B)(vii), and under the House provision for “such other information as the Commission determines necessary or appropriate for purposes of this subsection,” § (f)(5)(C). These personnel also state that brokerage fees, including separate commissions, are generally understood to be included under the requirements for price information on trades.
65. See S.2683, § (f)(1); S.2234, § (f)(1); H.R. 13986, § (f)(1). S.2683 and H.R. 13986 set a range of $10 million to $100 million of equity securities. Within this range they permit the SEC to determine the minimum reportable amount of equity securities in accounts over which an investment manager has investment discretion or authority. S.2234 specifies a cutoff of “at least” $10 million of securities, including equity and nonequity, as to investment managers and $5 million as to exchange members or broker-dealers. The term “at least” in S.2234 appears to mean that all portfolios larger than $10 million must be reported. Conceivably, however, “at least” may signal an intent to set a lower bound and to permit the SEC to declare the reportable size. S.2683 and H.R. 13986 would not treat broker-dealers and exchange members differently from other investment managers. Moreover, S.2683 provides a definition of “equity securities,” which narrows the definition of “equity security” already provided in § 3(a)(11) of the Securities Exchange Act, to exclude equity securities of “controlled” subsidiary companies from application of the proposed legislation as to the controlling investment manager.
66. See S.2683, § (f)(3); S.2234, § (f)(4); H.R. 13986, § (f)(3). S.2683 and H.R. 13986 set $500,000 as the minimum size of transaction to be reported but authorize the SEC to alter the cutoff as it determines necessary; S.2234 specifies disclosure of all transactions of (a) 2,000 shares or more, or (b) 1 percent of the outstanding shares, whichever is less.
cutoff level of controlled funds be measured by all holdings and not just equity, and should be modified to require that transactions in all asset categories be reported, not just equity transactions. The present provisions would prevent use of the data to create nonstock indexes.

In addition, the SEC version permits aggregation of data by type of account, while the Senate and House versions are silent on the question. This aggregation renders impossible the task of calculating comparative cost data for individual portfolios. In order to identify and evaluate the various cost components of portfolio management, the holdings and transaction data must be reported by individual portfolio. Institutional disclosure legislation should therefore require holdings and transaction data by portfolio.

In order to ensure that the data are being centralized in a highly accessible form, useful to private industry, all three versions should be modified to require the SEC to report back to Congress within a certain period on the use and dissemination of the data. The report should include information as to the number of private firms subscribing to the data, and the available evidence on use of the data to assist individual consumers.

In general, the publicity provisions of the present proposals ensure adequate dissemination of the data. However, there should be a modification of the publicity provision to provide that each reporting period's data be made available within 15 days of the end of each quarter, on a set of standard format computer tapes or discs, so that private industry can incorporate the data promptly and easily into their services, at minimum cost.

67. See S.2683, § (f)(3); S.2234, § (f)(4); H.R. 13986, § (f)(3).
68. For example, consider a bank trust department that manages portfolios for 1,000 different individuals, foundations, and pension plans. If the holdings and transaction data on all 1,000 portfolios were simply lumped together, the public would be unable to distinguish the risk and return characteristics of each portfolio. This frustrates the consumer benefit of comparison among a large number of separate portfolios.
69. See S.2683, § (f)(5); S.2234, § (f)(6); H.R. 13986, § (f)(4). S.2683 provides that all information filed with the SEC will be publicly available in such form as the SEC may prescribe subject to a request for confidentiality by an investment manager in accordance with § 24 of the Securities Exchange Act. Further, any information which would identify the equity security holdings of any natural person, or his trust or estate, would be kept confidential. S.2234 provides that all information filed with the SEC will be publicly available, but establishes a special procedure for granting confidentiality which prescribes a more restrictive test than does S.2683 and requires the SEC to publish its reasons for granting confidentiality. H.R. 13986 grants the SEC permission to authorize confidentiality in accordance with § 24 of the Securities Exchange Act.
70. One of the recommendations of the Institutional Investor Study is that such information be made more "accessible in usable form" to persons outside the Commission. IIS REPORT, supra note 1, at XII.
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IV. Cost, Implementation, and Possible Adverse Effects

Institutional disclosure as recommended above could conceivably have several adverse effects. One is the possibility that a publicly available data base would lead to a proliferation of small firms offering erroneous, illiterate, or fraudulent interpretations of the data to consumers. Also, the disclosure of holdings and transactions by trustee institutions could frustrate the fulfillment of their fiduciary obligations by revealing their investment strategies to other investors. Since the costs of reporting would be passed on to the investment manager's customers, the proposed legislation might also impose excessive costs on beneficiaries. These effects could occur in nontrust situations as well. In general, investment managers could be subsidizing their own competitors and passing unnecessary costs on to their consumers.

With respect to illiterate use, reports made on a nonindividual basis—similar to mutual fund reporting services—would probably be adequately policed by the competitive pressures of the marketplace. Individualized planning and evaluation services would also be subject to registration under the Investment Advisers Act. With respect to the effect of the Investment Company Act, the Securities Exchange Act of 1934 and the Securities Act of 1933 on individualized planning and evaluation services, the SEC has recognized the problem of determining whether an advisory service that makes large-scale solicitations of relatively small accounts is actually offering individualized service. If the service provides substantially the same advice to each client, it can become functionally indistinguishable from an investment company.

In a comprehensive study of such services, the SEC has published a set of guidelines designed both to stimulate such services and to protect consumers from possible abuses. The report concludes that there is adequate provision for regulation of such firms.

With respect to cost and competition, investment managers and
fiduciaries have raised no legal or policy objections to reporting, provided the reporting requirements are uniform for all firms and trustees, reporting costs are reasonable, and the anonymity of individual beneficiaries or shareholders is preserved.\textsuperscript{77} Moreover, if the disclosure is effective in improving consumers' ability to plan and control their investments and to facilitate the implementation of consumer-oriented reforms in the securities industry, as developed in the preceding sections, then the legislation would enhance, rather than frustrate, the fulfillment of fiduciary obligations.\textsuperscript{78}

The issue of adverse effects thus devolves into one of costs. There are three elements of cost involved.

1. \textit{Creating and maintaining the holdings and transaction data.} In the case of virtually all institutional investment managers, the necessary holdings and transaction data are already calculated in the course of computer processing.\textsuperscript{79} The relevant measure of cost for the proposed legislation thus is the incremental cost to the firms of retrieving such data on a separate computer tape or disc, reformatting it, and sending it to the SEC. One-time and on-going costs are the two components of the incremental cost. The one-time costs would include preparing a list of asset categories and securities within those categories. The list would be necessary so that the headings used in the data from the various reporting firms would be uniform. The cost of creating the list would most logically be borne by the SEC, which, as designer of the list, would be in the best position to control and minimize the cost. There is also the one-time cost of writing the

\textsuperscript{77} Telephone Interview with Prof. Edward Malca, Econ. Prof. at City Univ. N.Y., Feb. 12, 1974. Virtually all representatives of the institutional investor industry favor holdings and transaction reporting in principle. See, e.g., \textit{Finance Hearings, supra} note 4, at 7 (testimony of Donald Regan, Chmn. of the Bd. of Merrill Lynch & Co.), at 72 (testimony of Samuel F. Callaway, Exec. Vice Pres. of Morgan Guaranty Trust Co.), and at 232 (testimony of Harold Bigler, Vice Pres. of Conn. Gen. Life Ins. Co., in behalf of Am. Life Ins. Ass'n).

\textsuperscript{78} This type of argument acquires some weight from the cases. In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961), the SEC held in a 10b-5 proceeding that while the defendant undoubtedly occupied a fiduciary relationship to his customers, this relationship could not justify any actions by him contrary to law. Even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. On these facts, clients may not expect of a broker the benefits of his inside information at the expense of the public generally. 40 S.E.C. at 916. This is not to argue that holdings and transaction data are equivalent to inside information, but simply to show that if the duties imposed by the proposed legislation did conflict with fiduciary obligations, there is precedent in the securities law for ruling in favor of the legislated duties.

computer programs that retrieve the reportable data in the reporting firms. Since individual firms manage their own data processing, the program for retrieving the reportable data from each firm's data stream would be best written by the individual firm, using the categories and headings from the SEC's retrieval list. The on-going cost of reporting would be the extra cost of running the programs. It is recommended that these costs be borne by the individual firm, to be passed on to consumers, thereby utilizing cost competition among investment managers to minimize the cost to the consumer.

With respect to the costs to individual firms, the present proposals provide the SEC with authority to keep the cost of reporting, even as recommended above, within bounds that can be borne by reporting firms and their consumers. In all three versions of the proposed legislation, the SEC is empowered to make rules that avoid duplicative reporting and to exempt firms from reporting. In addition, the SEC and House versions provide that the SEC can adjust the cutoff level on size of reportable holdings, so that smaller firms unable to make the reports are exempted. Thus, the recommendations suggested above can be incorporated without an excessive cost burden on reporting firms or their consumers. The SEC can adjust the population of reporting firms to include only firms for whom the incremental cost of reporting is low or negligible. An important consideration in these adjustments is sample size. In order to collect statistically dependable index and cost comparison data, only a small sample of the total amount of each type of outstanding security need be taken. It is possible that only a very few large firms need report in order to provide enough data. Thus, testimony on the reporting costs of the proposed legislation should relate not just to incremental data, but to the incremental costs for only those firms necessary to provide a statistically valid sampling of all securities.

The last one-time cost is preparation of a computer program for use by the SEC in collating the data from reporting firms. The program would simply consolidate data by reading directly from the tapes and

80. See S.2683, § (f)(6); S.2234, § (f)(7); H.R. 13986, § (f)(3). All three bills provide the SEC with rulemaking power to avoid unnecessarily duplicative reporting by two or more investment managers of the same accounts or under other securities laws.

81. See S.2683, § (f)(4); S.2234, § (f)(5); H.R. 13986, § (f)(3). S.2683 and S.2234 would give the SEC power by rule, regulation, or order to exempt any investment manager, any security, any class of investment managers, and any class of securities from the subsection's reporting requirements. H.R. 13986 authorizes the SEC to grant such exemptions as are "consistent" with the purposes of the bill.

82. See note 65 supra.

83. The popularly known stock market indexes are actually samples drawn from the population of all stocks. See LORIE & HAMILTON, supra note 16, at 52-54.
discs supplied by reporting investment managers. The SEC should bear the cost of incorporating this data into its data processing system and of operating the program, since the SEC, as sole user of the program, would be in the best position to control and minimize these costs.

Though there is presently no data on these computer programming and operations costs, the incremental costs involved would be minor when considered in light of the benefits of institutional disclosure, and testimony in hearings on the legislation should detail each cost element on an incremental basis.84

2. Disseminating and analyzing the data. Once the SEC has consolidated the data for a reporting period, copies of the tapes, discs, or written summaries should be made available to any person at the SEC's marginal cost. Private service firms and institutional investment managers would thus have access to a data base that could be integrated into their investment analysis services. These firms, and ultimately their consumers, would bear the incremental cost of analyzing the data.

3. Interpreting the data to consumers. Interpretation of data to consumers is a service that would be provided directly to the consumer by institutional investment managers, brokerages, and separate portfolio planning and evaluation services, and the consumer would bear the cost. Competitive pressures would tend to minimize this cost, and the substantive content of advice would be subject to SEC regulation.85

Conclusion

The law related to investments is centrally concerned with the details of the process by which information concerning investments is created, disseminated, and used. This Note has examined the proposals for institutional investor disclosure in terms of the process by which the disclosure could be of use to consumers. The Note concludes that three inexpensive provisions are indispensable to the usefulness to the consumer of the proposed legislation: extension to assets other than equity securities, reporting by portfolio, and consolidation of the data in a form readily usable by the private sector.

84. Cost reductions in portfolio management that increased the investing consumer's percentage net return by only one-tenth of one percent would still result in an aggregate benefit to consumers of $700 million, before taxes. This estimate is based on the approximately $700 billion of capital managed in the United States. See note 4 supra.

85. See p. 1287 supra.