

The control of that company was held by a loosely affiliated group of individuals and bankers who held probably 30 percent of the stock, but 30 percent in many instances is working control, because proxies are sent out and not all stockholders come in, anyway.

They agreed to sell that 30 percent for a price of about from \$3.60 to \$3.70 a share, and in the contract by which they agreed to do that they specifically covenanted that the value of the securities would be around \$2.80 a share, thereby recognizing a differential for the control value of almost a dollar a share.

Now, the company was in such shape that its investment adviser and counselor testified in the Federal Court that he had advised the directors that the only thing to do was to liquidate the company and to hand back to the stockholders whatever share of the assets were left for them. Instead of doing that, they sold this control and the provision in the contract was that they had to deliver the resignations of the directors, and they did just as Mr. Cook indicated before. The old directors, upon the payment of the purchase price for this control block of stock, and one by one as they resigned, elected the nominees of the purchasers.

Now, these purchasers were lawyers who had been convicted and are now serving time in the Lewisburg Penitentiary. They are lawyers who had no substantial assets, and their method of buying this control was this: They organized a Canadian company which they called Northern Fiscal Co., Ltd. They had previously participated for commissions in the looting of the other trusts, but this was a venture of their own, and they gave to that company some penny gold stock that they had paid about \$1,800 for, but which, of course, amounted to many thousands of shares and looked well. They gave also a thousand dollars in cash for organization and legal fees in return for the entire common stock—that is, the entire stock which had the right to vote.

They thus had invested in that corporation less than \$3,000, and what they did was to have that corporation sell to an agent—I would term him a stooge of theirs—\$500,000 of its preferred stock, and then he in turn entered into a contract with the new directors of the Insuranshares Co. to sell Insuranshares that \$500,000 par value block of preferred stock for \$500,000 in cash.

Now, that meant that Insuranshares had given up five-eighths of all of its assets, and substantially all of its readily salable assets, for preferred stock of a company which had total assets of only \$3,000.

That could not be permitted, so in order to give the Northern Fiscal Co. the appearance of having assets, they had the Northern Fiscal Co. receive this common stock of Insuranshares—precisely the same type of thing that Mr. Cook has described—and then have it receive the sum of about \$350,000 in cash. This meant that the net result of that transaction on that day was that Insuranshares had sustained an initial loss, any way you want to figure it, of at least \$115,000, and had bought its control stock for the benefit of these lawyers when I say it had sustained a loss of \$115,000, that is on the assumption that whatever assets were put in the Northern Fiscal were at least available to sustain some value for its preferred stock. But that is a pretty broad assumption, because the preferred stock had no voting power except in certain events which did not and were not expected to take place, and consequently all of the assets of Insuranshares were

in the hands of persons who had indicated their good faith by stealing \$115,000 at the outset.

Now, the arrangement for that seems almost fantastic. This New England Fund stock held by Insuranshares was practically cash, but it had to be taken to Boston and delivered to the officers of the New England Fund before it could be cashed. The banking firm that was advancing \$310,000 to these lawyers, who did not have more than a few thousands of dollars of their own, wanted to receive that \$310,000, or most of it, back the very day that it advanced it. For that reason there was a special arrangement that one of the Boston lawyers should go to the Insuranshares office, start this transaction on its way, and then immediately take an airplane from Newark to Boston and carry with him this New England Fund stock, and in Boston arrangements were made that the New England depository would keep open a little later than usual so that this block of its securities could be cashed at once. The result was that on the very day of the conspiracy the persons who had advanced the money were in substance repaid, plus a commission for their actions, and the conspirators were in charge of the company.

Now, as to directors, it can be said that at least these new directors who came in were individuals, were men, who might at least have the semblance of honesty, but everyone knows that you can get a director who has no scruples of any kind. I might mention that the cost of the five directors was \$100 apiece. They did it for that. I do not believe they knew what they were doing. Their occupations were such that you would not think they were financial men.

That left this group of conspirators in control of Insuranshares. They thought it would not look right for the balance sheet to show that it had a \$500,000 investment in a newly organized Canadian company that no one had ever heard of. They thought it would look much better if they could show that they had control not only of Insuranshares, but that it had bought some other trust, so they entered into negotiations to buy another trust. They were not interested in the slightest whether the assets of that investment trust were worth the price that they would have to pay for its stock, because it was not their money that was going to the purchasers.

The second investment trust was Bond and Share Trading Corporation and they concluded that they would buy the control of that company for the sum of about \$153,000, and they did not even want to go to the trouble of arranging to get a temporary loan from a bank that had money enough to pay \$150,000, so they had what we term a razzle-dazzle check.

They had Northern Fiscal issue a check on its bank for \$131,000. Of course, the check could not have been certified and, of course, it could not have been cashed. There was no such sum of money in the account. They had Northern Fiscal also deliver whatever cash it had, and it had about \$20,000. This cash with the worthless check made a total of \$153,000. Northern Fiscal loaned the cash and the check to Insuranshares and Insuranshares by contract agreed to buy the stock of Bond and Share, and what they did was to deliver to the sellers of the controlling stock the twenty-odd thousand in cash and the \$131,000 worthless check, which, of course, gave Insuranshares the controlling stock and control of the board of directors.

Now, the sellers were not interested in whether that check was worthless or not. They contend that they thought it was valuable, and we probably should give them the benefit of the doubt and assume that they thought it was valuable. But they had already made an arrangement that they would buy from Bond and Share Trading Corporation substantially the most valuable securities of the investment trust and would pay for them with that worthless check, and that was done.

That left Bond & Share with the worthless check, and that looked a little bit bad, so they had Bond & Share buy from Insuranshares \$175,000 par value of this worthless preferred stock of Northern Fiscal which had been given to Insuranshares in place of and instead of its valuable assets.

Well, theoretically the \$131,000 worthless check was too small, by some forty-odd-thousand dollars, to pay for that \$175,000 block of Northern Fiscal stock, so Bond & Share not only gave Insuranshares the worthless check but it also gave Insuranshares the forty-odd-thousand dollars, which it obtained from selling such portion of its portfolio as was readily salable.

That left Insuranshares in possession of the worthless check, which it had borrowed from Northern Fiscal, and the \$40,000. Insuranshares proceeded to pay Northern Fiscal the twenty-odd-thousand dollars that it had borrowed and to give back to Northern Fiscal the worthless check that Northern Fiscal had delivered.

We thus find that the worthless check originated with Northern Fiscal, went all the way around the circle, and came back into Northern Fiscal and was canceled without ever having been presented to a bank at all.

Now, in that transaction we find that Insuranshares lost money, that Bond and Share lost money, and that Northern Fiscal lost money, and there is no reason whatever why the transaction should have taken place except that which was testified to in the Federal court. That was that these various people charged commissions for each and every step in this transaction, with the result that they were paying nothing and they were obtaining individual returns by reason of the thousands of dollars in commissions that were paid out to them.

That being so, of course they looked around for other investment trusts, because it was a very lucrative thing that could not possibly fail in their estimation, and they came to the Burco Incorporated investment trust. That was a company on which stock had been sold to the public for around five millions of dollars. Through various means the value of those securities had declined to not more than a million and a half dollars. In fact, some people say not more than three-quarters of a million—But under no circumstances could you say that they were worth over a million and a half, and in the court trial there was substantially no dispute that the value could not exceed one million and a quarter.

There were preferred shares outstanding which were entitled, upon liquidation, to receive one million and a half dollars, and from that you can, of course, see that the common stock was under water. It was like the Continental stock. The assets of the investment trust would have had to increase substantially in value before the book value of the common stock was worth zero.

Under those circumstances the owners of the controlling block of that common stock entered into a contract to sell that controlling

block for \$340,000, and that sale was consummated. Now, of course, that means just as it meant in every one of these other cases, that the investment trust itself would have to pay that outrageously high price, and they had a plan and method whereby just that occurred.

There was a corporation which was organized to control petroleum concessions in Venezuela. They were concessions that probably had some value. What the value is would be hard to determine, because it would depend upon how much oil could be obtained, what the cost of drilling would be, what the cost of refining and shipping would be, and it would also depend on whether they could organize a selling organization that could go out and sell the products of that company in world markets in competition with existing situations.

It was one of those things where one would have honestly to say that if millions were spent and competent management was consulted the petroleum concessions might become very, very valuable.

On the other hand, their value had been determined to some extent by an American company, which had attempted to exploit it and had given up the venture as a bad risk.

The control of these concessions was an asset in the corporation, which had authority to issue hundreds of thousands of shares of stock. Three hundred seventy-five thousand shares of stock was issued for about 60 cents a share, although that was disguised by several different contracts. I am referring to the net actual cost.

Senator WAGNER. Yes.

Mr. FULTON. And being purchased at 60 cents a share these shares of the oil company were sold at something over \$2 a share to Burco, which, of course, gave the conspirators a sufficient sum of money not only to pay the \$340,000 but to take for themselves over \$100,000 in commissions, and it left Burco Incorporated with an asset which, so far as legal proceedings are concerned, the prosecution or the plaintiff would have to establish was not in fact worth what Burco paid for them.

In order to do that we had to obtain, and were fortunate enough to obtain, through the Department of Justice's long arm and large subpoena power, the evidence in Canada and elsewhere as to that petroleum concession. The ordinary litigant might or might not have been able to obtain that. I doubt very much that they would have.

However, after obtaining that we had to convince the jury that there was no good faith in the transaction, that it was not just an honest mistake in judgment, and the jury did so conclude and those persons are now convicted.

Now, after all of these transactions had gone on there was beginning to be quite a bit of discussion of these particular trusts in the street and elsewhere, and the original conspirators became alarmed and they concluded that they would sell their interest in Northern Fiscal, which now controlled, directly or indirectly, through these associates and otherwise, Insuranshares and Bond and Share, and Burco, and they went to one of the conspirators, who in my opinion was the most brazen and who was still willing to carry on despite indications of trouble brewing, and said to him, "We will sell you our common stock in this Northern Fiscal Co. It has no asset value, but it has control value. It enables you to do what you will with these particular trusts."

He agreed to pay them a sum of between \$50,000 and \$60,000 for 60 percent of that common stock. He said he was not interested in the other 40 percent, which, of course, obviously had no control or asset value, providing they would let him make Northern Fiscal finance that payment.

It was done in this way: He sold to Northern Fiscal some Canadian penny gold stocks for the sum of \$50,000 or \$60,000 and took from Northern Fiscal cash and securities which it had in its portfolio, which in turn he delivered to those persons who were selling him the 60 percent of the common stock.

Now, that kind of thing can go on indefinitely, in the sense that as one management has taken part of the portfolio and wasted it and is beginning to believe that it should not continue in management, it can arrange for the sale of the company in its then crippled state, to some still more predatory management, which would go on and complete the thing. Ultimately you would find that there would be a tendency to have a chain of investment trusts, which in the last analysis would mean that all of them would lose.

Now, I regard these particular people as amateurish, for this reason. I thought I might be able to point out how they could have done it if they wanted to and would have made our task in convicting them much greater. Instead of organizing a company, such as Northern Fiscal, with penny gold stock and other assets of less than \$3,000, if they had been men of means, they could have bought indirectly and separately sufficient shares of stock in an existing corporation to have controlled that company. They could then indirectly and separately, and in such a way that it would have been extremely difficult for us to prove it, have caused that corporation to buy the controlling stock of Insuranshares, and when we came to the vital problem of proving the intent and of disproving the defense of mistaken but honest business judgment, it would have been practically impossible to do it.

It would be easier for us to do it with the grand jury powers, because we can subpoena all records, but it would, even for us, be a considerable task.

In this instance we were assisted, even with all our powers, and even with the amateurish actions of the people who were doing this, by the fact that the S. E. C., through Mr. Schenker and Mr. Smith and others, had conducted extensive examinations and had discovered a great many of the facts, and through the additional fact that the securities department of the stock exchange had likewise conducted examinations and, through their control over members of the stock exchange, had obtained documents and evidence which ordinarily, in an ordinary civil case, would not have been within the power of the plaintiff to produce.

Senator WAGNER. The stock exchange authorities were cooperative, were they not?

Mr. FULTON. They not only were cooperative, but they did a splendid job in ascertaining the facts, and so did the Securities and Exchange Commission, and we started really with the benefit of what they had done and then proceeded beyond that.

Now, the ordinary litigant has broad powers, especially in the Federal court today, under the new Federal rules, but, in the last analysis, it is difficult for any plaintiff to find out what the facts are if he does not know something of what they are before he begins. In complicated cases, where you have a great number of corporations

and a great number of transactions, it is very, very difficult for a litigant to ascertain what they are before he starts, and even though he may have sufficient powers to obtain the facts if he knows what to look for, in the ordinary instance he would probably miss them in the complicated cases.

I have, like Mr. Cook, not read this bill in detail, and I have no opinion as to whether the bill is, in all of its provisions, the right kind of bill. I assume it is and I assume it is being worked on, but I do not know. However, I have read parts of the bill for the purpose of ascertaining whether this bill in its present form would have prevented the frauds, and I am firmly of the opinion that it would.

Section 13 of this bill, on page 30, specifies in subsection (b) thereof that:

No registered investment company shall change any fundamental investment or management policy unless each such change is authorized by the vote of a majority of its outstanding voting securities.

Under that provision, if properly administrated, it would be illegal, and I assume also criminal, if a letter were mailed, to do the things that were necessary to be done here.

They could not have, for example, exchanged the New England fund stock which was a valuable investment, for the Northern Fiscal preferred stock without getting a vote of the majority of the outstanding voting securities, which not only would have taken time but would have meant publicity which would have been fatal.

Senator HUGHES. The voting securities there would be a majority of the common stock, and they had it in their own control.

Mr. FULTON. They had 30 percent. They could have called a meeting. The owners of that stock were a series of individuals.

Had they called a meeting and had they stated that they were going to transfer the assets from the New England fund into Northern Fiscal stock their participation in the transaction would have been so obvious that their liability would necessarily have made them pause before they did it.

Now, in addition, it must be understood that the Pennsylvania banks which owned the Insuranshare stock were not willing to make that transfer, and on the present record deny that they knew it was contemplated. If they had called a meeting for that purpose they would have had to know and in this instance they would have been codefendants in the criminal case instead, as is the situation, civil defendants in civil litigation.

Now, on page 36, in section 16, there is another provision which deals with this matter, and that is the provision that not more than one-third of the board of directors can be changed without action by the stockholders.

That would have meant that they could not have transferred the control by simply causing directors to resign and, as they resigned, by electing nominees of the new interests. That would have meant that there would have had to be a stockholders' meeting, and time was of the essence in this type of transaction. There had to be a simultaneous exchange of checks and securities. It could not be 100 percent simultaneous, because you would have had to have the new board before you could authorize taking out the portfolio for the new owners, but it was so close to being simultaneous that the whole thing could be done in an hour.

If you had to call a meeting of the stockholders to approve this it would mean that whoever put up that money to pay for the controlling stock would have had to wait for days and weeks, and in addition, with that first provision about the change of investment, would have had to take a chance of the stockholders approving the change in investment policy, and in addition to that, would have had to incur the publicity.

Senator WAGNER. The publicity is very important, too, is it not?

Mr. FULTON. The publicity is the most important feature.

The third provision I had in mind is section 17, on page 36, which refers to the purchase and the sale of securities between the investment trusts and those affiliated with it.

In each instance you can see that they sold securities to the investment trust and they purchased from the investment trust. Under section 17 they could not have done that without these attendant safeguards and attendant publicity.

For those reasons, I am sure that, whatever may be the merits or demerits of the bill generally, these particular frauds could not have been consummated.

Senator WAGNER. Mr. Fulton, you have had a chance to examine the charters of some of these organizations about which you have testified?

Mr. FULTON. I have.

Senator WAGNER. Is there any limit as to what their activities can be in relation to business transactions?

Mr. FULTON. Of course, it would be impossible to say there is no limit, because it is not infinitive, but, as you know, as a lawyer, those charters contain page after page of the most broad general powers, so that the investment trust could buy, sell, and exchange almost anything for almost any purpose. The only limit that I know of is the limit that at some point either someone like Mr. Cook or someone like the prosecution authorities would step in and say that "You have definitely done this with knowledge and intent to defraud the investment trust and not simply with mistaken business judgment." That is the only limit I know of.

Senator WAGNER. Of course, we do not want to have it understood that all investment trusts are of this type. There are very excellent investment trusts.

Mr. FULTON. There are, and in addition to that, the investment trust is a very desirable instrumentality for enabling the small investor to spread his risk, and as such should be given real consideration.

Senator WAGNER (chairman of the subcommittee). Thank you very much.

I think that we will take a recess until tomorrow morning at 10:30.

(Thereupon, at 12:35 p. m. an adjournment was taken until tomorrow, Thursday, April 4, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

THURSDAY, APRIL 4, 1940

UNITED STATES SENATE,
SUBCOMMITTEE ON SECURITIES AND EXCHANGE
OF THE BANKING AND CURRENCY COMMITTEE.
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Maloney, Hughes, Miller, Downey, Townsend, and Frazier.

Senator WAGNER. The subcommittee will come to order. We will hear Mr. Carl S. Stern.

STATEMENT OF CARL S. STERN, ATTORNEY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. STERN. Mr. Chairman and gentlemen of the subcommittee— Senator WAGNER (interposing). I think you had better give your full name. As I understand it you have been one of the special attorneys who have studied the investment trust matter on behalf of the Securities and Exchange Commission, or appointed by them for that purpose.

Mr. STERN. Not quite, sir. My name is Carl S. Stern. I am one of the legal staff of the Securities and Exchange Commission. I was called into this Founders study after the preliminary work of investigation had been done, and I conducted the public hearings. I make this explanation because I do not want to come under any false representations, I wanted to keep within the limits of my connection with the investment trust study, for I merely conducted the hearings in connection with the Founders study. I had no part in the preparation of the reports, except a very tiny one—of reading them over and making suggestions. But I have recently refreshed my recollection so as to re-present this story very much abridged to the committee here.

Senator TOWNSEND. You had no part in the preparation of the reports as I understand you?

Mr. STERN. A very small part, that of reading them over to revise them, or to suggest revision here and there. My work was entirely with other parts of the matter. As I have said, I conducted the hearings, and am fully conversant with the facts.

Senator WAGNER. And what you will tell us is in connection with your conduct of the investigation?

Mr. STERN. Yes.

Senator WAGNER. And the facts themselves?

Mr. STERN. That is correct. I was assigned to this from another branch of the Commission, and my part in it was limited to what I have said. I wanted to make that clear to the members of the subcommittee for the very good reason that I do not know as much about the general investment trust study as do a great many other men here, and my knowledge is more or less confined to the Founders system, to what I discovered there.

Senator WAGNER. Tell us about that.

Mr. STERN. In order that you might have some idea of this complex situation we have had these charts prepared, which give you the appearance of the Founders group as that group existed in 1929. This story is quite a different story from that already told to the members of this subcommittee; this is not a story where there was gross or crude fraud. This is a case in which the techniques, such as were used, were refined and which was the art rather of the prospectus writer and the skill in manipulation rather than in crude handling. However, the results for the stockholders were even perhaps more detrimental than in some of the cruder cases.

Senator TOWNSEND. Your first heading states that the United Founders Corporation was formed in February of 1929, and that the capital raised was \$301,741,000. Will you state how that capital was raised?

Mr. STERN. Yes, sir; but I did not want to bother with this chart at this time; rather than go into the details just at the moment I wanted to give you the general picture. I will take it up from time to time, and will start at the beginning. The story of Founders starts out with two men and \$500. It starts in 1922. One man put in \$500, and the other man was a bankrupt, recently discharged from bankruptcy.

Senator TOWNSEND. Who were they?

Mr. STERN. They were William R. Bull and Christopher F. Coombs. From this small beginning, in 7 years the group had become the largest group of investment companies under a single control in this country, or as far as the investment-trust study disclosed, anywhere in the world.

By 1929 the capital paid into the 13 companies shown on that chart by the public exceeded \$500,000,000.

Now, so that the subcommittee may get some appreciation of what this \$500,000,000 amounted to in comparison with other concerns handling investment funds, I should like to state briefly that there are 564 principal savings banks in the country, and that only one of them exceeded that figure, and that is the Bowery in New York City, and the Bowery's resources as of January 1, 1939, were \$583,000,000; that out of 14,931 commercial banks and trust companies in the United States, only 16 had resources in excess of \$500,000,000; that of the 306 leading life insurance companies, only 12 showed total assets exceeding \$500,000,000. So that of all these savings banks, commercial banks, trust companies, and life insurance companies in the country, only 29 had assets as great or greater than Founders had at its peak.

Looking at it from another point of view, in the six Southern States of North Carolina, South Carolina, Georgia, Florida, Alabama, and Mississippi, the total savings in savings institutions, including postal savings, savings banks, and commercial banks, were \$484,000,000.