

advertise that they are very conservative, and they say: We are making millions of dollars with securities, and they say they made \$43,000,000.

What was that \$43,000,000? They would organize company A and then investment trust B. Then A would take the capital securities of investment trust B at 20 and sell them to the public for 40 and then after A had the 40 they would show on their books they have that much profit. That is not profit but money raised.

But they did actually do that. They have company B sell its new security issues to company A, not at 40, which they could have realized on the market, but for 20, and then company A sells to the public for 40, and company A's showing is: We made \$20 a share profit, and company B makes a showing where they have \$20 a share capital. So that the \$43,000,000 was not \$43,000,000 profit but capital raised from the public, but it was put on the books and said to be profits. That was the rigamajig of this.

Senator FRAZIER. Then it was just a bookkeeping profit?

Mr. SCHENKER. Yes. Instead of putting it on the books as capital, they sold stock to one of the companies for 20, when they got 40 on the market, and that company sells it to the public for 40, and then A company says: We made \$20 a share profit, and B company says: We have \$20 a share capital. It was bookkeeping acrobatics.

Senator WAGNER. Where did the individuals come in, Mr. Stern?

Mr. STERN. That is another question.

Senator HUGHES. Did the option take care of that?

Mr. STERN. There were several things there.

Senator HUGHES. I take it the public that was buying those stocks must have had more than the inducement of the representation that the companies were making money. Were they not getting dividends at the same time?

Mr. STERN. Of course they paid substantial dividends. They also showed, which was very excellent in those days, earnings per share which were naturally high, because that was entirely within their control.

One other thing: In 1929 they showed those huge advances in the prices of securities based upon those fictitious earnings. So you can see the trouble that Mr. Schenker has so excellently explained. The difficulty with a situation of that kind is that it is harmful to everybody. If company A got only 20 instead of 40, and company B got 20, then if company B could show earnings, its stocks would go up. But later there would have to be other companies brought into the picture so that they could keep up the process of trying to justify the early inflation.

Senator Wagner, you asked about the amount of profits the individuals had. The market price of those securities, as to which the first thing was used, was \$173,000,000. The group companies paid \$76,000,000. That meant a spread of \$97,000,000, or that much possible diversion into the hands of the insiders of the group companies.

Now, as to the individual insiders, there was \$54,000,000 of this \$97,000,000. That is, the insiders paid \$54,000,000 under the market. Now, of course they did not make profits to that extent because some overstayed their market and were left with some of the securities. As a matter of fact they did not fare very badly. Mr. Coombs, who was bankrupt in 1922, took \$4,000,000 in cash out of

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earnings from his securities in 1928 and in 1929, after the crash, his securities were worth between \$20,000,000 and \$30,000,000. The others did not do quite as well as that, but quite well I would say. They all made very substantial earnings, and the potentialities were some \$54,000,000.

Senator HUGHES. By way of manipulation?

Mr. STERN. Yes. There was a second method of making profits and that method was by just shifting from one company to another. I think that might best be shown by way of illustration, and while it is not the most important instance yet it is one of the most fantastic.

Mr. Chairman, I should like to also have this chart in the record;

Senator WAGNER (Chairman of the subcommittee). The chart you have heretofore been using, as well as that chart, may be made a part of the record.

(The chart entitled "Performance and Control of the Principal Companies of the United Founders Corporation Group" and the chart headed "Intercompany Transactions in International Securities Corporation of America, Class B, Common Stock" and the chart headed "Intercompany Transactions in United States Electric Power Corporation.")

Senator WAGNER (chairman of the subcommittee). You may proceed now with your statement.

Mr. STERN. If you will look at this chart you will find American Founders Corporation had purchased securities of International Securities Corporation of America. It had those securities at \$8.62. It sold some to Second International Securities Corporation, which then sold later to United Founders Corporation. It sold some to United States and British International Co., Ltd., which then sold later to United Founders Corporation. Second International sold some to Investment Trust Associates, which sold to United Founders Corporation. So that by this whirligig method they all were sold, in this way.

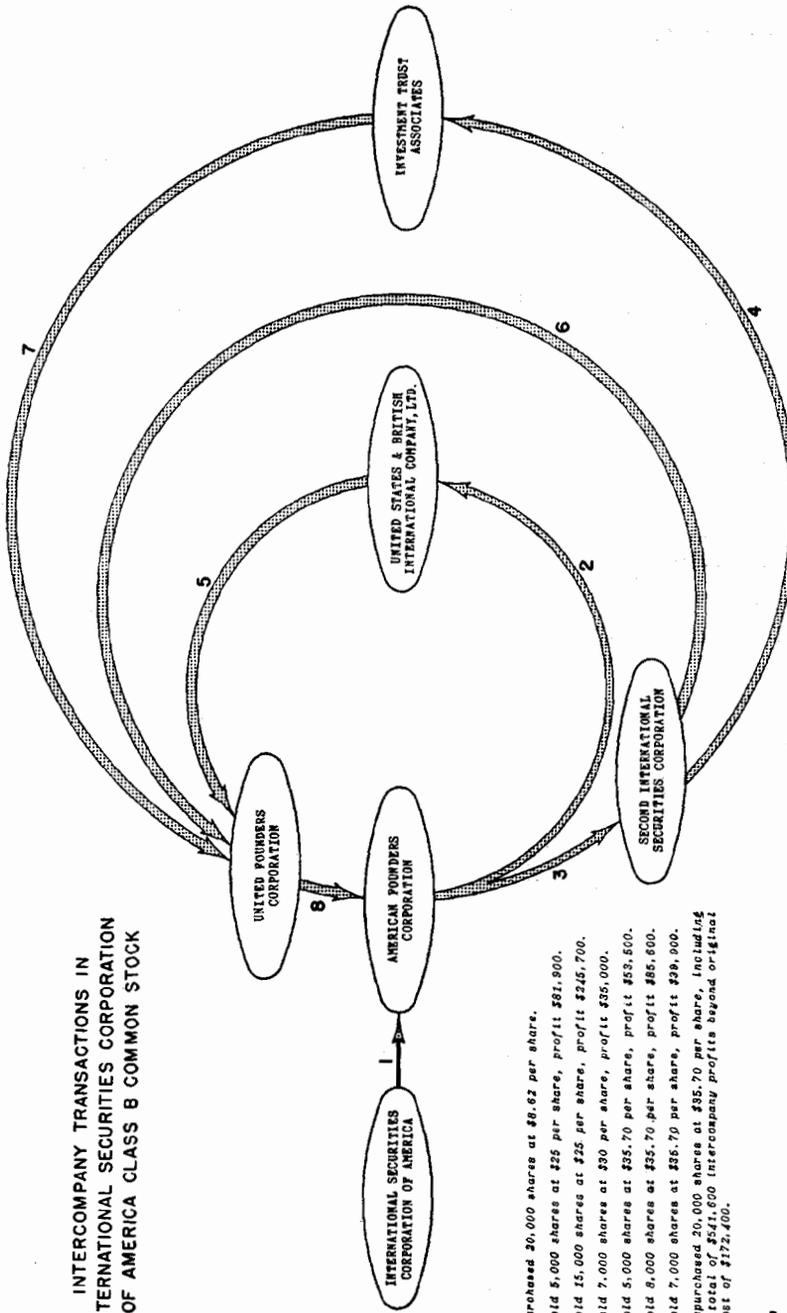
Originally those stocks were on the books at \$8.62 a share. At the end of this transaction, which took several months, they were back in American Founders at 35. Of course they were not profits at all. The sum of \$600,000 went to inflate the income account of these different companies by this process. Sometimes they were a little bit more complex in their technique, as is shown by this second smaller chart which I believe has been made a part of the record.

Senator WAGNER (chairman of the subcommittee). Yes; that was ordered made a part of the record along with the other two charts.

Mr. STERN. In this second chart the technique was a little bit more devious. There the United States Electric Power Corporation—and, Senators, if I go too fast stop me, because this was a rather complex transaction, both in the way it was handled and in the way it was recorded.

The American Founders Corporation held certain stocks of United States Electric Power Corporation. It gave rights to purchase those stocks to its stockholders. Among those stockholders was United Founders Corporation. United Founders Corporation had then rights to buy some 990,000 shares. Those rights it waited with until the very last day on which rights could be exercised and then sold them to an affiliate for \$5,000,000. Then the affiliate exercised the rights, as you can see by the broken line on the chart; it subscribed for the

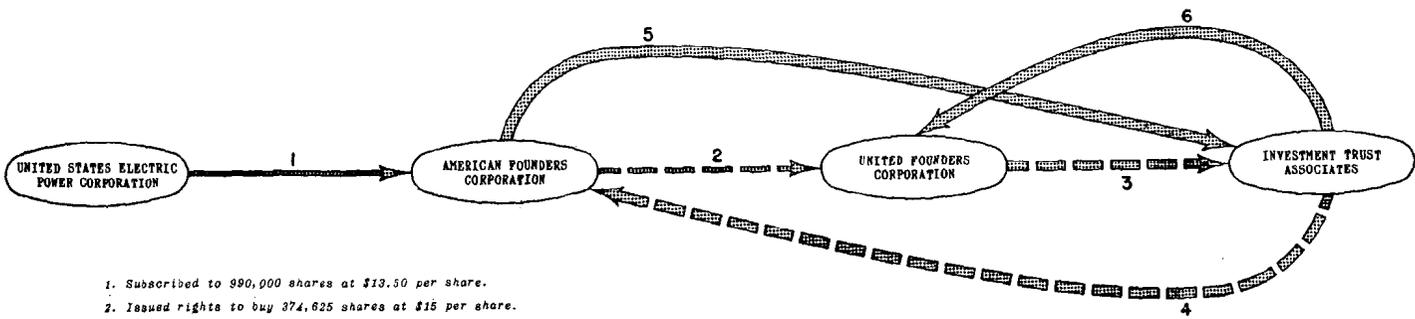
INTERCOMPANY TRANSACTIONS IN
INTERNATIONAL SECURITIES CORPORATION
OF AMERICA CLASS B COMMON STOCK



1. Purchased 20,000 shares at \$8.62 per share.
2. Sold 5,000 shares at \$25 per share, profit \$81,900.
3. Sold 15,000 shares at \$25 per share, profit \$245,700.
4. Sold 7,000 shares at \$30 per share, profit \$35,000.
5. Sold 5,000 shares at \$35.70 per share, profit \$53,500.
6. Sold 8,000 shares at \$35.70 per share, profit \$85,600.
7. Sold 7,000 shares at \$35.70 per share, profit \$99,900.
8. Repurchased 20,000 shares at \$35.70 per share, including a cost of \$51,600 intercompany profits beyond original cost of \$172,400.

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INTERCOMPANY TRANSACTIONS IN UNITED STATES ELECTRIC POWER CORPORATION RIGHTS AND COMMON STOCK



- 1. Subscribed to 990,000 shares at \$13.50 per share.
- 2. Issued rights to buy 374,625 shares at \$15 per share.
- 3. Sold rights for \$5,619,384 and recorded proceeds as dividend.
- 4. Tendered rights for exercise.
- 5. Rights exercised at \$561,937 profit to American Founders Corporation.
- 6. Repurchased by United Founders Corporation for \$11,276,212, including a total of \$6,218,774.50 of recorded intercompany profits and income beyond initial subscription price.

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stock from American Founders, it exercised those rights, and then 3 days later sold them back to United Founders.

Well, United Founders recorded that it had made \$5,000,000 profit in that transaction. It was not a profit of \$5,000,000. They called those rights dividends and they were recorded on the books of American Founders as dividends, not even as investment profits. That was \$5,000,000 by the mere process of passing it from one company and back again.

There were varying processes in these techniques. There were those two forms, one of selling to insiders on options far below the market; and the other form, that of running them around through the companies. Those two forms were forms by which United worked up this \$46,000,000 profit. And I might add that the \$46,000,000 does not include \$5,000,000 of dividends I have just discussed. And that would have brought it up to \$51,000,000 made out of these inter-company transactions.

I think one of the things important in connection with United Founders Corporation that complicates us as much as it probably did them, is this: There is something almost narcotic about these figures, so that they became almost meaningless to them.

Gentlemen, this question of the manipulation of profits assumed many forms and the techniques that were used were extremely skillful.

Frequently the profits would be routed to one company just at the end of the fiscal year, so that the report would look good. In other instances the profits would be routed to a company to sweeten a public offering that it was just about to make. Thus, in one transaction where Investment Trust Associates was just about to offer its stockholders rights to buy additional shares of its stock, profits of \$2,700,000 were routed to it within 4 days prior to the issuance. The other companies in the group made \$4,000,000 on the offer of the securities to other companies in the group, so that the transaction was very skillfully recorded and used at the time it was necessary to show the profit.

Witness after witness, when they were questioned on the stand, expressed emphatic disapproval, in retrospect, of what had happened, and one of them at least stated that he was astonished to find, although he was a director, that the transactions had had anything like this magnitude—in fact, several of the directors stated that they just did not know this kind of process was going on to anything like that extent.

Senator WAGNER. Did any of those who so testified participate in these manipulations of profits?

Mr. STERN. Some of them did.

Senator WAGNER. Were they surprised at their own manipulations? Is that what you mean?

Mr. STERN. I think, Senator, that a lot of people at that time had a notion that this was what was called an underwriting, although the essential difference between this and an underwriting was that they never assumed responsibility; for instance, in the General Investment Corporation case, between that spread of \$12 and \$30 there was not any binding subscription on the part of these gentlemen, and they did not take up other allotments until after a market had been established for about 15 days.

Senator WAGNER. Did you ascertain whether or not the market was established by wash sales at all?

Mr. STERN. Senator, we got admissions from these gentlemen that the Founders companies were the dominant factors in the market. It was a comparatively small phase of the Founders investigation, so we did not go into the question of wash sales, but you can draw your own conclusions from these facts: In 1 year Founders General sold \$400,000,000 of group securities and in the same year it bought \$220,000,000 of securities. In the next year Founders bought back more than it sold. So that had it been important, I think we might have established pretty definitely, and I think the record leads to the sound inference, that the market was very much made by Founders General.

Of course, wash sales are not the only form of market manipulation.

Senator WAGNER. No; they are a form.

Mr. STERN. They are a form.

Senator WAGNER. I take it that since the establishment of the Securities and Exchange Commission it has become almost impossible now to manipulate in that way?

Mr. STERN. Probably so, where the Commission has jurisdiction.

Now, in order to make these profits, there, of course, had to be a very effective distributing organization, and it was the emphasis on distribution as much as anything else, I think that brought about the Founders' difficulties, because they found that they could raise money so easily, as one of the former officers of the company said, "the difficulty and the dilemma is that you can usually raise money at a time when it is least profitable to invest it"—that is, the easier it is to raise money, the harder it may be to invest it.

Therefore, there was no particular reason for creating the new company except the fact that they could raise money and there was great pressure on them to go from one enterprise into another and, also, the other pressure that it was lucrative to the insiders and essential for the making of their profits by the existing Founders companies to have this continual flow of capital.

Then there was one other feature in it. The very distribution, as you gentlemen will see on reflection, creates a vicious circle. Founders General was this wholly owned distribution concern and Founders General had a very heavy overhead. They had some 300 employees. In 3 years they had \$5,000,000 of expenses. As Mr. Seagrave admitted on the stand, in order to keep that company you had to continue furnishing them with business, so that the thing became a vicious circle. The attention was taken off investments because of distribution. As distribution grew, it had to get even bigger in order to keep this corporation alive.

There was another factor in the distribution. I think all of them deplored the fact that a company might buy and sell its own securities, but they seemed to have no difficulty with a wholly owned subsidiary buying and selling the securities and sending the proceeds up to them as a kind of dividend, and that looked good on the balance sheet and income account.

Senator WAGNER. Was that because it was a new name; or did you ascertain the reason why they could sell the stock more readily to the subsidiary?

Mr. STERN. They did not sell the stock to the subsidiary. American Founders, for instance, found it was not a very desirable thing for American Founders to buy and sell American Founders stock, but they thought there would be no difficulty if Founders General, its wholly owned subsidiary, actually bought and sold American Founders stock,

and it had the disadvantage that Mr. Schenker spoke of in the other connection.

Instead of the entire price, if they were selling stock as capital of American Founders going in as capital, part of the price came to American Founders as a profit and could be distributed as dividends, again inflating the income account at the expense of capital account.

These gentlemen, the former officers and directors, were examined as to this feature of a wholly owned distributing concern, and witness after witness condemned it in no uncertain terms. They thought the effect upon American Founders had been disastrous, and they so testified. They also said that distribution was a business entirely different from investment. The preoccupation with distribution called for entirely different methods and entirely different techniques.

We have more or less touched upon the profits to the insiders. The insiders then had this big stake in making profits by forming new companies along with the Group, but the insiders became a little bit more audacious than that. They began trading. They began trading on margin.

There were two rather distinguished economists connected with this group. They formed their own trading company, bought and sold securities on margin. These economists, who were supposed to have this detached, fine investment judgment, began buying and selling for quick turns. The investment department, in 1929, according to their testimony, instead of being used for investment had their facilities frequently used to predict short turns in the market, and they used these short turns in order to try to make profits. They did not succeed and, of course, like everybody else, they lost on the short-term trading; but not only did the economists form their little separate company, by which they traded, and lost their shirts, incidentally, but the heads of the investment department also formed their separate company, which was financed by a favored broker of the company, and these investment heads likewise traded in large quantities in securities, both company securities and outside securities, and they likewise suffered heavy losses in the end.

The fact is, however, gentlemen, that all the time while the public was being given the picture of this conservative management making its investments with skill and detachment and on the basis of science, what they actually were doing was making the so-called profits for the company out of tricky distribution, and they themselves were preoccupied with similar "profits" of distribution and with their own personal trading.

As one of the witnesses said, everybody, from the bootblacks and the office boys up to the president of the company, traded. Everybody traded.

Therefore, the picture given to the public of skill and science and detachment was a very different picture from what was happening inside.

Senator WAGNER. Of what years are you speaking now?

Mr. STERN. 1928 and 1929, Senator.

We might note one case where one of the officers, an officer of General Investment, had tradings which were fairly conspicuous. That company lost its shirt. It lost its shirt and practically everything else.