

In the slab of 13 States between the Mississippi River States and the coast, not including Texas, the total savings amounted to \$560,000,000.

And so it was that Founders became very much of an imposing edifice, completely unregulated. It became also a national institution. There were 90,000 stockholders, scattered through 44 States. Founders at its peak controlled or held a dominant position in companies that had resources in excess of \$2,000,000,000.

Within 3 years after its peak this Founders Group had declined, and the losses to the public were staggering. We will go into those losses later, with your permission. But I might say now the losses amounted to some \$390,000,000 considered on an over-all basis. As a matter of fact the losses in the case of some companies were even greater; the losses in the case of some companies were in excess of 90 percent, and in the case of one company, in which \$133,000,000 were paid in, the loss was complete. In 5 years that company lost its entire capital. Well, now, that is a slight exaggeration. It did have \$132 at the end of that time.

Senator WAGNER. When you speak of "companies" you mean companies indicated on this chart you have handed around to the members of the subcommittee?

Mr. STERN. Yes, and which I will take up in some detail a little later on. I am trying now to give you a general impression of what happened in connection with the Founders Group, what it meant to the American public. The losses to the public were much greater than \$370,000,000. The American public poured out money in a great stream, into the various branches of the system, which we will describe in more detail later on, through the purchase of stock; but the figures we now give you are the figures of money actually paid into the company itself.

The people who bought stock bought at a higher price than was charged to insiders. These were the figures representing money paid into the company by the public.

Senator TOWNSEND. Then as I understand you, the public was purchasing the stocks of these companies.

Mr. STERN. That is correct.

The rise and fall of Founders was the subject of some 6,000 pages of testimony and some 900 exhibits which were greater than the testimony itself. It was one of those gigantic jobs done by the Commission; and I can speak of it with enthusiasm because I had nothing to do with it. I merely came in to present the case at the public hearings. But it was a tremendous job, and had taken over a year of preparation prior to the public hearings.

Senator WAGNER. And I think the evidence was not always easy to secure.

Mr. STERN. Yes; and not only that, but the creative imagination of William R. Spratt, Jr., who worked long and earnestly on this matter, and I might say died as a victim of the Founders study. It was his constructive imagination that brought about a reconstruction of this situation so that we are able to present it as a lucid picture, as I think we can here; and because the picture is so large and the techniques so unusual, we will give you just the high spots. We could not hope to go into the particulars. The various ramifications are so great that we can only give you the high lights.

Starting with the men behind this Founders Group, the two original promoters were Christopher F. Coombs and William R. Bull. Coombs within a year had been discharged in bankruptcy in a case involving the failure of a Wall Street investment house of which he was a partner. Bull was and I think is today a Bridgeport security dealer, and he was then of quite limited means.

In 1925 these men were joined by two others, Frank B. Erwin and Louis H. Seagrave. Erwin was then a security salesman. He had, like Coombs, been one of the bankrupt concern's partners. Seagrave was earning a very modest salary in charge of sales of securities for a security affiliate of the First National of Boston.

I take these four men because they were the controlling inner circle and at the top of the pyramid shown on the chart. There were always these four men until 1928, when Bull dropped out of active direction of these things, and in 1928 the inner circle remained with Coombs, Erwin, and Seagrave. And Seagrave was the man who was known to the public. Mr. Seagrave became the prominent executive in the group, but Mr. Coombs was really the man with the great outstanding interests.

The \$500 with which the group was started was furnished by Bull. Coombs did furnish something; he furnished what was called good will of a defunct organization—the good will and what were certainly the outstanding liabilities of a defunct investment concern. These were the assets at the birth of what was later known as American Founders Corporation, the first functioning company in the group. The \$500 was all there was in the way of cash and assets then. But the \$500 did not stay there very long because it was borrowed by a company in which Mr. Bull was interested. This seems to have been a tradition.

If you gentlemen of the subcommittee will look at the chart a minute I should like briefly to sketch the way the organization started. First, I have the American Founders Corporation, which is the second company in the pyramid shown on the chart. That company was founded in January of 1922. The other company that existed at that time was International Securities Corporation of America, the first of these two columns of companies at the left. These two companies were all there were to the Founders Group for quite some time. International Securities Corporation of America was said to have been formed in 1921, but that was just on paper. It had no real existence until 1922.

The group remained with these two companies, American Founders and International Securities, and this continued until 1926. In 1926 the experience of International Securities had been such that Second International Securities Corporation was created. Thereafter, in 1928, they began to start more and more companies. They created United States and British International Company, Ltd., and American and General Securities Corporation.

In 1929 the thing really began to expand in enormous drives. Then they added United States Electric Power Corporation along with General Investment Corporation and American & Continental Corporation and United Founders.

It is not necessary to comment on any of these for the moment, except a company near the bottom, which is Founders General Corporation—the second from the bottom on the left-hand side.

Founders General Corporation has a history that is very unfortunate in connection with the group because that was a wholly owned distributing concern, and the expenses of that concern were so handled, the ease with which they could raise money through it, it presents one of the most important features of the tragic fate of the Founders Group. But I will come back to that a little later on, if I may.

One of the things that I think will interest you gentlemen of the subcommittee is the way in which, as the group grew, all restrictions were thrown to the winds. They started off, in the case of International Securities Corporation of America, advertising that it was the first investment trust—and you will see that over here on the left of the chart—as I say, they started advertising in the case of International that it was going to be an extremely conservatively run corporation, that it was going to be limited in four ways: that they could invest only in seasoned securities; could not buy control of corporations—that they would be free from the burdens of control; that they would be purely investment companies.

Senator WAGNER. Did they mean by that that their charter so limited them?

Mr. STERN. Unfortunately the charter did not contain such a provision. Their bylaws did, but as you know the bylaws were subject to modification. They advertised diversification of securities. They indicated they had to have great quantities of different kinds of securities, and that that applied to industry as well as to countries. And, finally, and this is one of the most important points, they advertised they would be independent of investment-banker domination. And that was one of the most important points that they disregarded.

One by one they scrapped these restrictions. It may not be fair to say they scrapped them because what actually happened was this: They advertised in the case of International Securities, and they built up the goodwill of Founders, on the idea they were to be conservative; and they furthermore built up the idea that these restrictions existed. But as new companies came on they scrapped the principle of seasoned securities, they scrapped the principle of diversification, they scrapped the principle of not buying majority control, and finally and emphatically they scrapped the principle of banker association, as we will show, with very disastrous results.

I think the facility with which they —

Senator TOWNSEND (interposing). Did they start out by paying dividends?

Mr. STERN. Yes. I was going to touch on that very briefly because otherwise the story will get too long.

Senator TOWNSEND. All right.

Mr. STERN. The growth of the system is a matter of great interest. At the end of 1926 they had raised \$38,000,000. At the end of 1927 they had raised \$40,000,000 more, working it up to \$77,000,000. At the end of 1928 they had raised \$153,000,000, and at the end of 1929 they had raised \$686,000,000, and if you deduct the criss-cross holdings they had raised \$500,000,000 by that time. But the great growth was in 1928 and 1929, when they had raised these vast sums of money.

Senator WAGNER. Are you going to tell us how they raised this money?

Mr. STERN. Yes.

Senator WAGNER. And where they raised it?

Mr. STERN. Well, I was going to tell you something of the technique they used, otherwise it would prolong this story. If you gentlemen of the subcommittee are interested in any particular facts we will get them for you. I am trying to compress this Founders' story in 1 hour. If you gentlemen want any further elucidation we will be glad to give it.

Senator WAGNER. Was it as the result of newspaper advertising?

Mr. STERN. Newspaper advertising and the work of salesmen. The sales technique of Founders was marvelous. They were very skillful, but generally what they did was to put themselves across with two main features.

Senator WAGNER. That was a large sum of money to raise, and I take it some very persuasive tactics must have been used.

Mr. STERN. You will see in a minute how they did it.

Senator TOWNSEND. Do you mean that this \$500,000,000 was capital in the way of cash paid into them by people all over this country?

Mr. STERN. Either by them or it represented the market value of securities put in by various concerns as they came along. For instance, in the case of one of these companies, which was the United States Electric Power Corporation, and the General Investment Corporation, the original subscriptions were in cash, but there were immediate exchanges for securities.

Senator TOWNSEND. The mechanics of the situation is the matter I am interested in, and that is that the \$500,000,000 was paid in to them in cash originally from stockholders all over the country?

Mr. STERN. That is correct.

Senator TOWNSEND. Now then, they of course invested that money that they had received. Did those people who paid in the \$500,000,000 receive stock in the company in return for the money?

Mr. STERN. Yes.

Senator TOWNSEND. Then they invested that money in different stocks of course.

Mr. STERN. Sometimes, of course, and that was the technique I am going to discuss later. The insiders came in first and bought or committed themselves to pay or did not commit themselves to pay or were allotted stock with the opportunity to buy. Sometimes it was done that way. Ultimately the public came in.

Senator TOWNSEND. But did they receive this much money in cash from the public?

Mr. STERN. Very frequently what happened was this: When the insiders bought they were given allotments, and frequently they did not take them up until after the market had reached a certain price, and then the securities were sold to the public and they simply took their profit.

Senator TOWNSEND. I understand that method, but what I am trying to get at is this: According to your statement they received \$500,000,000 in cash from people all over the country.

Mr. STERN. That is right. Some of them may have been people connected with the organization, and some of them may have been people throughout the country. But ultimately they had \$500,000,000 cash capital paid in.

Senator TOWNSEND. What was the picture that they held out to the public? How were they going to make their profit?

Mr. STERN. Might I show you that a minute or two later? I would rather take that up in the regular course of presentation of this picture.

Senator TOWNSEND. The reason I am asking you the question now is this: I have to leave the room pretty soon to attend a meeting of another committee.

Mr. STERN. Very well. I will take it up right now. The way they got their cash was to advertise two things: One was the great conservatism of management; and the other was, their huge profits. That is how they got their greatest amount of cash.

Senator TOWNSEND. And their management was buying other stocks to put into their portfolio?

Mr. STERN. Yes, sir; the idea they sought to convey to the American public, and that idea was inaccurate, was that they were a very conservative crowd, and that they were able to show huge profits by means I intend to go into later. It is all covered in these reports, but at the moment I wanted to high-light it for the subcommittee.

Senator TOWNSEND. I take it in the early formation of the companies they started out to pay dividends to people who had put in the \$500,000,000?

Mr. STERN. That is correct, but that was of course when they were very tiny, and I am in advance of my story a little by saying this: They started out with the rather ingenious idea—whatever we may think of it: There was the holding company, American Founders Corporation, and it was the management company to manage International Securities, and International Securities at that time was the company advertised as the investment trust. International Securities was able to show a very handsome return on its capital for the simple reason it had no expenses. The expenses were all assumed by American Founders. Well, quite naturally you would ask, what about American Founders? It showed excellent returns, too, but that showing was made by reason of the simple fact that it did not charge expenses to income but capitalized or deferred them. They did that with the ordinary as well as the extraordinary expenses. They started out by showing inflated earnings, and they had other devices I will show you and show you how they actually started and how they succeeded. It was done with the livery and trappings of lawyers and accountants. It was made to appear there were all the safeguards, and it came about one by one that the safeguards did not apply, and one by one they were evaded. That is the way they conveyed the idea of huge earnings, and when we analyzed it we found that the conservatism was not there, and the earnings were not there, except by shuffling round from corporation to corporation.

Senator TOWNSEND. Suppose we had not had a crash in the market, would the companies have continued to have made money? Was it possible for them to make money if the market had stayed up?

Mr. STERN. My personal opinion is this, that as the Founders began to be operated it required a continuing market for security distribution to enable them to do anything like what they claimed. They made money, not so much by speculation in the market, but made it by shifting securities from one company to another in the group and calling the result profits.

Senator HUGHES. They did not actually sell those securities?

Mr. STERN. Yes; they sold them. But that is another story also I want to come to later on.

Senator HUGHES. I would like to hear it connectedly.

Mr. STERN. I had expected to spend a little time on that interesting phase of this story.

Senator WAGNER. I understood you to say that when any of the companies contemplated issuing additional securities some insiders got first choice; that they were allotted securities which they were probably not obligated to take.

Mr. STERN. That is correct.

Senator WAGNER. Out of options on those shares. And then the insider could watch the market, and if the value in the open market increased they could exercise their option.

Mr. STERN. That is correct.

Senator WAGNER. And thereby make a profit just by reason of being an insider.

Mr. STERN. That is correct. I was going to give you one or two instances of that.

Senator WAGNER. There is one other question I wish to ask and then you may go along with your story: Those securities went upon the stock exchange, did they not?

Mr. STERN. I think some of them were on the Boston market and perhaps the curb exchange.

Senator WAGNER. But not on the New York Stock Exchange?

Mr. STERN. I think that is correct.

Senator WAGNER. Go ahead with your story.

Mr. STERN. I would like to call attention to one other thing: Look at the top company, United Founders Corporation. That is at the very top of the pyramid. United Founders was formed in 1929. That was formed for the definite and avowed purpose of continuing the existing management. It was to continue the control of Messrs. Coombs, Erwin, and Seagrave. They exercised that control by getting one of these multiple voting stocks. They paid \$1,000,000 in securities for 33½-percent control of this enterprise. So that they were then in a dominating and secure position, at the top of the pyramid. They put themselves in control without consulting the directors of the American Founders Corporation. They told them about it after it was complete. They did not even give stockholders of American Founders a chance to come into United Founders on anything like the terms the management did.

All I want to say about United Founders now is that they cemented themselves in control and later, after advertising that it was necessary to keep the present "conservative management" which was their term in control, they sold out control to someone else, again without consulting anybody. I do not know that the selling out of control had any bad results on stockholders because most of the losses had happened by that time.

Senator WAGNER. Was that sale profitable to them?

Mr. STERN. Yes; but not in the way the transactions we will now examine were.

I am sorry that Senator Townsend is not here to hear the reasons why Founders succeeded in the beginning as it seemed to me. They stressed, as we have said the conservative policies of the company. They pointed out that they were following the best traditions of the British trusts. Their reports disclosed those large earnings. But they did indicate, I think from the term "Founders" that was used, that they were the pioneers in America, indicating they were one of the

first companies, pioneers in the United States and following the British traditions, where one could get the advantage of buying diversity if he is a small investor, without risk. They were to have these men to protect the investor. Let us see how they did it.

In the very beginning the transactions were anything but conservative. There were these two companies until 1926, American Founders Corporation, a management company, and International Securities Corporation of America which was the managed trust. The two companies were different companies but they proceeded to commingle their assets. The assets of International Securities Corporation were held by American Founders for so-called safekeeping. The safekeeping was not entirely safe. American Founders began to sell short on the market securities of International Securities which were left with it for safekeeping to accumulate an account. They loaned to impecunious sponsors—those men of little or no means had money loaned to them, or to corporations that had no record of profits but only losses. Certain individual loans ran as high as \$400,000.

When they came to the short sales they concealed them from the public by lumping together debits on short sales with the assets, so that only the net assets would be shown and no one could tell there was anything like a short sale outstanding although they were pretty large.

Then they used various methods for inflating the accounts. The methods were so reprehensible that they employed new counsel, and they said they must stop, and they did stop. In the early days, about 1926, they had stopped these earlier, cruder methods.

But the concern immediately started to use different kinds of methods, from that time on. They had used write-ups and they had done a great many things condemned under the Holding Company Act for holding companies. They had written up options. They would write up options on the assumption the price would continue on a steady level for 10 years. When accountants were asked about that they said they would not do a thing like that today but it seemed all right then. That prediction into the future happened to be disproved within 2 years. But they used a method about as bad as anything in holding companies, of writing up, and on the basis of that showing their accounts were made to appear in much better shape than they actually were.

Then they inflated their capital account by a device that was not new but certainly could not come under their classification as conservative. They issued a large quantity of stock and a large part of it was issued for notes, and they were the notes of the sponsors, who could not have paid them. So they started out by using various techniques of inflation.

The second phase started in 1926 or 1927 when they began spewing out these companies, and there again they began to concentrate on advertising their excellent research department. Now, they did have a very fine research department, which had been built up and was expensive. They had economists, and they had financial men, and they had specialists in different parts of the world. And they advertised this investment research department in their advertising matter.

But the unfortunate part about that was that the research department, as to the major activities of the group, was not consulted. The management was done by the inner circle without consultation with

the research department. And they continued to publish also the fact of their huge profits, and of course that was their big selling point.

Let us see about the investment department. It was commonly regarded as one of the best in America, they said. The head of the department said they had too heavy a job; that they had tried to police 2,000 securities and that that was too much for any investment department; that the size of it was too large to enable them to handle this thing effectively. But they did not consult it about major elements of policies.

There were large losses in the major portfolio, but as to those I will have to leave to others to tell you. That was not one of the major difficulties in the Founders' system.

In 1926 the companies began a practice which became a central fact in the Founders' history, the creation of new companies and the manipulation of their securities. And this I think is the thing that ultimately caused the downfall of the company.

They found that they could raise money and they began raising money heavily. In order to make the showing that was necessary they began this process of intercompany profits. That is, sometimes selling from one company to another, and sometimes, to answer your question, Senator Hughes, they would sell to insiders at a price which was very much lower than the price it was offered on the market, and while at the same time they had, through the agency of this Founders General, been busy keeping up the market.

Now, that profit to the insiders was a very substantial matter. Some of those men became very wealthy as we will see. And that was not the only bad feature. That feature of it, as may be best shown by an illustration I will take up, indicates that the public was not told that the great mass of profits was made in this way. As a matter of fact, and this is a fact in connection with Founders, from 1928 to 1930 Founders registered on its books \$46,000,000 of investment profits, with \$43,000,000 of net investment profits. All these investment profits came from transactions in group securities. There were transactions in other securities but they resulted in a loss of \$3,000,000. So that at the time of its greatest height, the time when Founders reached its zenith, \$46,000,000 of profits, which were profits made from investments, were all made in handling group securities. But the public was not told that.

The public was told that a group that is constantly familiar with the markets of many nations knows where securities are cheap. It was told that the critical days of 1929 were not worrisome days for Founders, the depression was nothing to them. They were told that one has to get a detached point of view, and to understand the companies one had to know that they had the facility to take advantage of shifting from one country to another; that if the United States was no longer a good place to invest they would move to Germany or to France or to other places. But those profits were not obtained by moving from one country to another; they were obtained within the four walls of a building, by shifting those securities from one company to another.

In the main there were two techniques by which they got those intercompany profits. In the one case they sell to the companies in the group or to insiders at a price below what the securities would be immediately sold to the public.

I think I can illustrate that first technique by the formation of General Investment Corporation. That was at a time, in September of 1929, when the stock was turned over to insiders at \$12.50 a share, which stock was immediately sold to the public at \$30 a share. The insiders were both individuals of the group companies. The result was of course that \$12.50 a share went into the capital of the company, General Investment Corporation, and \$17.50 went to other people.

Now, of course a company can hardly satisfy the stockholder who pays \$30 a share when it only has \$12.50 a share put into the treasury. The only way these companies could have expected to continue issuing those glorious earnings statements was by continuing to spew out new companies. It was one of those chain processes that once the chain is broken collapse is bound to come, and did come.

Senator WAGNER. Were those profits to those insiders appreciable?

Mr. STERN. I am coming to that. They were very substantial.

Senator WAGNER. All right.

Mr. STERN. Judge Healy has asked me to make plain, and I am glad he did, that the securities we are speaking about now, and everything that went into those \$46,000,000 of profits, were securities of the group companies, securities of companies whose names appear on this chart. Sometimes they were new issues and sometimes they were secondary issues.

Mr. HEALY. Were they portfolio securities or new issues the company was putting out.

Mr. STERN. In some cases they were portfolio securities, but we will take that up.

Mr. HEALY. But for the most part they were their own securities?

Mr. STERN. For the most part they were. But all the \$46,000,000 profits were from securities of companies on this chart.

Senator WAGNER (chairman of the subcommittee). Go ahead with your statement.

Mr. STERN. Those profits, of course, ran very high. The market price of the securities was \$173,000,000. The insiders of the group companies got them at \$76,000,000. So that the public paid more than 100 percent more than the insiders paid.

Now, of course, that created a tremendous burden upon those companies, because if a company has \$12.50 only of the \$30 paid in by a stockholder, there just is not any possibility of an earning on that, except through a miracle or by continuing this chain movement.

Senator WAGNER. Did you ascertain at all what the individual profits were in those cases?

Mr. STERN. Yes. I was coming to that. But I will take that up right now if you wish.

Mr. SCHENKER. Senator Frazier, I might explain that I worked on the report and that Mr. Stern conducted the hearings. You have to get this picture: Here they started with \$500. They organized one company and sell it to the public. Then they organize another company and sell it to the public, and then a third company. Now, you cannot sell securities to the public unless you paint a picture that you are making money. What were the two bases of purchase? In the first place, they must get the market price of the securities to pay, so that you had this underlying history of the company: this distributing company ran pools in the stock of the companies whose securities they were selling to the public, which pushes the price up. Then you had to paint the rosy picture that you are making money. Then they