Senator WAGNER. I do not like to interrupt you, but I want to be informed on this. Was he trading with his own money and with his own securities or was he using the portfolio?

Mr. STERN. No; this was his own private enterprise. This man, who was a high officer in a company that lost $70,000,000 out of $78,000,000 paid in by the public, had succeeded in making, in trades of the preferred stock of that company, nearly $1,000,000—the actual figures are $941,000—and he did that between 1933 and 1937.

I think it is rather interesting that while the officers were trading they held out to the public that "the shares of American Founders Corporation are essentially an investment for the long pull, as they always had been. They should be owned outright and regarded as a relatively permanent investment. Market fluctuations may be ignored."

The general portfolio losses ran to $130,000,000, and undoubtedly some of this was caused by market declines, but not all of them. Some were caused by other transactions, which I will now go into very briefly.

As I said before, this story is so long that I will just take up briefly what happened in the case of the three largest losers: The General Investment Co., the United States Electric Power Corporation, and the United Founders Corporation.

As you gentlemen will recall, the advertising by the group emphasized that they were independent of investment bankers—in fact, the statement was made that United Founders and subsidiaries formed the largest independent group of the kind in the United States and that it is not dominated or controlled by any bank, investment banking house, or other institution.

Now, as stated, that might have been correct, but the fact is that they did proceed to put millions of dollars in affiliated companies which were controlled by investment bankers and with the disastrous results that I am now about to mention.

I asked, "Why did you advertise that you were independent of investment bankers? What did you fear?"

They said that they feared that the public might think that what had happened abroad might happen here.

Now, what had happened abroad was told in a book at the time. This book was written by Mr. Leland Rex Robinson, and Mr. Leland Rex Robinson had been an officer of one of the group companies—in fact, he had been president of the Second International Co. Mr. Robinson pointed out as an earlier evil in the British companies that there were connections with banking houses and that these banking houses were not above using these affiliated companies as a dumping ground for issues which the public failed to absorb.

Then Mr. Robinson added:

> It speaks much for the growth of professional ethics that in London a repetition of such practices seems hardly conceivable and an enlightened public opinion has fostered a position of greater independence among institutional investors holding investment trusts.

Let us see what happened to General Investment Corporation. The General Investment Corporation was formed with Harris Forbes. Harris Forbes had probably put out more securities than any other investment banker in the United States during that particular period. Members of Harris Forbes became officers of the General Investment Corporation. The General Investment Corporation was this company in which $78,000,000 was paid in and $70,000,000 was lost. The bankers were given control of this company, although the Founders group had the largest single interest in it.

Now, I think it will be probably as illuminating as anything else I can do to run briefly over some of the transactions that happened and the amount of the losses in those transactions.

The Associated Gas & Electric Co. is a company which recently has gone into bankruptcy, and Harris Forbes & Co. were the bankers for that company. Harris Forbes turned over its entire utility portfolio to General Investment Corporation. That was the start. Their entire utility portfolio was turned over to the General Investment Corporation.

Senator WAGNER. When you say "turned over," the General Investment Corporation must have paid for that?

Mr. STERN. Exactly, sir. I should have said that.

Senator WAGNER. Yes.

Mr. STERN. That is, Harris Forbes subscribed and the General Investment Corporation took the money and bought the investment portfolio of Harris Forbes.

Senator WAGNER. At the market price?

Mr. STERN. At the then market price, which was substantially in excess, apparently, of fundamental prices and asset value.

Among the securities that were taken over from Harris Forbes were 51,000 shares of common stock of Associated Gas & Electric, and they paid $3,000,000 for that, and the Associated Gas & Electric investment was later increased to $15,000,000, acting under the advice of Harris Forbes, with Harris Forbes being the Associated's banker at that time.

Of that $15,000,000, $14,437,000 was lost.

Then a more complex story, but I think we can follow it, is the case of the Central Public Service Corporation. Immediately after the formation of General Investment Corporation about 30 percent of the assets were invested in a utility, into the Portland Electric Power Co. So that General Investment then found itself in the possession of an electric company, but it had no particular facilities for running it.

It thereupon sold Portland Electric to Central Public Service, which was a holding company. Central Public Service was a banking client of Harris Forbes. Central Public Service raised the money to pay for Portland Electric Power in large part by a new issue of securities, which Portland Electric Power Co. put out.

This bond issue was an issue of $16,000,000 and that about doubled the oustanding indebtedness of Portland Electric Power.

Harris Forbes floated the bond issue. Both Portland Electric Power Co. and Central Public Service went into reorganization a few years after that. As a matter of fact, at the time Portland Electric Power Co. was sold to the General Investment Corporation, which was the group company, Portland Electric Power Co. was not in very good shape. It had been getting along, but not too well.

The ultimate loss in that transaction——

Senator WAGNER. Was that a bond issue of the Portland Co.?

Mr. STERN. No, sir. General Investment bought the stock of Portland Electric Power Co.; then turned over Portland Electric Power Co. to this other corporation, Central Public Service, the holding company, and then lost their shirts on the holding company.

Senator WAGNER. Did they buy the entire issue or did the public participate?

Mr. STERN. Well, Senator, perhaps there are two things that I ought to clear up about that. First, the General Investment Corporation bought the stock of the operating company, which was Portland Electric Power Co. Then Portland Electric Power Co. was turned over to Central Public Service, which issued its stock to General Investment Corporation. Is that clear?

Senator WAGNER. Yes.

Mr. STERN. Now, it was on that stock of Central Public Service that General Investment Corporation took its loss, but the way Central Public Service raised the money to finance its own affairs was to have the underlying company, the Portland Electric Power Co., float a bond issue, and that issue was sold to the public by Harris Forbes. That was part of Harris Forbes' banking business.

What actually happened in that was that the original investment was about $20,000,000; $8,000,000 cash was paid back by Central Public Service to General Investment Corporation, and that left them with a $12,000,000 investment in it. They ultimately got out of it $70,000.

Mr. Blumner reminds me that in discussing Associated Gas, which General Investment purchased from Harris Forbes, I had neglected to state that that stock had not cost Harris Forbes anything, but had been given to them when they undertook the banking business of the Associated system, and that, according to the Federal Trade report at the time, it was doubtful whether that stock had any asset value at the time it was taken over—in other words, that the write-ups in the Associated Gas & Electric were such that there was probably no value for the common stock, and there certainly is not any today.

Senator WAGNER. Well, Harris Forbes received how much for that stock?

Mr. STERN. $3,000,000, but they then got them to take further issues—either got them to take or advised them to take—of Associated Gas & Electric, so that the ultimate investment in Associated Gas & Electric was $15,000,000.

Senator WAGNER. You said this stock did not cost Harris Forbes anything.

Mr. STERN. That was only part of it, the part that cost $3,000,000.

Senator WAGNER. But Harris Forbes received $3,000,000?

Mr. STERN. Yes. It is fair to Harris Forbes to say that at that time there was perhaps a market which ostensibly justified that. Whether the market value truly justified that price, this record does not show.

There were certain European companies which I will quickly go over. There was the Westphalia Co. That company owed some money to the Deutsche Bank. The Deutsche Bank and Harris Forbes had gone into certain transactions together, and General Investment purchased half of a debenture issue there, and the loans that the company had borrowed from the Deutsche Bank and other banks were paid off, but the General Investment sustained a loss of $3,000,000 on a $7,000,000 investment.

The next situation was the Southwest Electric Co., which was a power company operating in Berlin. In that particular company Harris Forbes and a subsidiary of the General Investment Corporation, which was called the United States & Overseas, bought these debentures of this Southwest Electric Co.

The United States & Overseas, which was one of these group companies, and a subsidiary of the General Investment Corporation bought a $9,000,000 participation in the Southwest Electric venture, and they took over from Harris Forbes a participation of $1,800,000 additional.

Harris Forbes agreed to take back that $1,800,000 of debentures, on demand, but conditions did not improve in Germany and no one called on Harris Forbes to take it back, because the United States & Overseas was run by Harris Forbes' men, and General Investment Corporation was run by another Harris Forbes' man.

Harris Forbes had some technical defense, perhaps, to that commitment, but whether the defense was good or bad, no one will ever know, because Mr. Addinsell, of Harris Forbes, as vice president of the General Investment Corporation, drew up a contract with Mr. Granbery, of Harris Forbes, as president of the United States & Overseas, wherein they sold the commitment to the General Investment Corporation. The General Investment Corporation then took over the commitment and incurred the loss.

Senator WAGNER. Was that German company a government owned company, do you know?

Mr. STERN. No, sir. It had been originally, but it had been sold out.

Then there were investments in French companies, and all that need be said about it is that the loss in these investments, which were in electric utility companies, was $3,000,000 out of $4,000,000.

Finally, there was the situation of the South American Railways Co., and I would like to stress that a little bit. Later Mr. Schenker can finish the story on that, because the end of that story came in later years, but the South American Railways Co. had this situation: There was a subway in Buenos Aires and Harris Forbes had helped finance the preferred stock of the Terminal Co. that was interested in this subway. It became necessary to get construction funds, and Harris Forbes said to these gentlemen, "We will float an issue for you."

In the meantime the Guaranty Trust loaned the company the money to construct a subway, and the construction proceeded apace, and the Guaranty Trust began to get a little restless and from time to time it extended its loans, Harris Forbes stating, "We will float an issue of securities."

The October 1929 crash came and the loan was extended to December 1929.

Well, Harris Forbes never floated an issue of securities of the Terminal Co. At that time the Terminal Co. probably did not have sufficient credit to support the flotation of the issues, so what happened was that General Investment first loaned the money to pay off the Guaranty Trust and then later formed a new company called South American Railways, and South American Railways then issued securities which were guaranteed by General Investment.

Now, gentlemen, that involves so many companies that perhaps I had better make that clear again. What happened was that originally Harris Forbes had agreed to issue securities for the Terminal Co., but the Terminal Co. issues had no market, and, accordingly, Harris Forbes finally—the Harris Forbes' man being the president and the Harris Forbes' men being the majority of the board of directors of General Investment Corporation—had General Investment Corporation guarantee the bonds, and on that guaranty the securities were issued and Harris Forbes was relieved of this embarrassing commitment.

The proceedings did not turn out happily, however, for General Investment Corporation. General Investment Corporation lost $6,000,000 out of an investment of $14,000,000.

Senator WAGNER. You would not call that transaction a bail-out, would you?

Mr. STERN. Senator, it has the appearances of a bail-out.

Senator WAGNER. May I ask you if the General Investment Corporation is one of the corporations about which it was advertised that they were independent of investment bankers?

Mr. STERN. No, sir; that was not one of the corporations, but what they did advertise was that the United Founders group was independent.

Senator WAGNER. That was an affiliated company?

Mr. STERN. That was an affiliated company of the group.

In the case of General Investment Corporation, $53,000,000 of the $70,000,000 loss was incurred in investments in which Harris Forbes had some special interest either as banker or because securities had been in their subsidiaries or because they originally floated them or because they had a commitment—$53,000,000 loss out of $70,000,000 in securities in which Harris Forbes had some special interest.

At the conclusion of that hearing I asked Mr. Burroughs, who was a senior executive of Harris Forbes as well as president of General Investment.

> Could you formulate for us, Mr. Burroughs, the reason why you don't think it is a good idea for investment bankers to be tied up to investment trusts?

Mr. Burroughs replied:

> I think it is too difficult for any human being to be sure that he is protecting both classes of investors. I think he may be perfectly honest in his effort to be sure that he is dealing fairly with the investment trust, but I don't think it is possible for him to do it, and I think it is a bad idea for the investment bankers to have an investment trust affiliate.

I understand the law does not go quite as far as that. The law simply keeps control over the conflicting relationships and subjects such a relationship to the regulations of the Commission. Is that not correct, Mr. Schenker?

Mr. SCHENKER. There is only one correction, Senator. The bill which we hope will become a law has that provision in it.

Mr. STERN. That is a correction which I readily accept.

The loss in the General Investment Corporation was $70,000,000 out of $78,000,000, but the classic story of what happened in association with investment bankers comes in the United States Electric Power Corporation.

That was the corporation, which you gentlemen will see at the top of the right-hand side of the chart, which was formed a few days after General Investment Corporation, and in that corporation, gentlemen, $133,000,000 was invested, and at the end of the time $132 was all that was left of it.

Senator WAGNER. Which one is that?

Mr. STERN. The United States Electric Power Corporation.

Senator HUGHES. How was it invested?

Mr. STERN. I was going to tell you that, Senator. What they tried to do was to purchase the control of the Standard Gas System, and they walked into what had been a fight for control. I take it that the time is so short that I cannot tell you much about this extraordinary fight for control, but what happened was that a group of investment bankers combined with Founders to put this money into this United States Electric Power Corporation, and Founders had the largest interest, and Founders finally had a controlling, majority interest.

United States Electric Power Corporation succeeded in purchasing a divided control with H. M. Byllesby & Co. of the Standard Gas System. But in order to get that divided control they had to spend more money than even $133,000,000, both in buying up Standard Gas and in finally buying out an outstanding interest, a New York firm called Todenberg-Thalmann & Co., and in order to do that they paid a huge sum of money and had finally to be carried along by the banks, put up all the stock of the company as collateral; and when they could not pay, the stock was sold out and United States Electric lost its entire portfolio.

The loss to the bankers was not so extensive in a way. The bankers bought back the stock on the sale and for a short time after the purchase of the controlling stock in the Standard Gas System the bankers received very substantial underwriting fees. I think in 1 year the underwriting fees from the system came to about $1,000,000.

That situation of United States Electric Power will be, I think, presented to you in a separate report. I should have liked, if time had permitted, to outline the story, which is really fantastic, because there had been for 5 years attempts by different firms in succession to get control of the Standard Gas System.

First there was the Byllesby concern, which is composed of Chicago bankers, and they tried to wrest away control of part of the system from Ladenberg-Thalmann. Ladenberg-Thalmann made $40,000,000 in profits, out of these attempts to wrest control away from it, and part of the time continued having the banking business. The $40,000,000 was absorbed by the Standard Gas system and by the United States Electric Power Co.

The first was Byllesby. Then came Lowenstein, the Belgian financier who finally came to his death in an airplane accident, and Mr. Lowenstein, with some other interests, among whom was Mr. Victor Emanuel, attempted to get a foothold in Standard Gas.

They did not succeed, and finally, through Mr. Riggs, who was the attorney for Founders, they came in contact with Founders, and then Founders, the Lowenstein-Emanuel interests, and some other banking interests that were brought in, formed the United States Electric Power Corporation.

Whatever the purpose was, there was no question about it that there were certain perquisites of control with an electric utility system as big as Standard, and I shall not go into that because you are familiar with it, but what the United States Electric Power Corporation did was to become a part of the fight for the control of Standard Gas & Electric Co. system.

When these gentlemen finally bought the control of it so that they owned control jointly with Byllesby, an action that was brought against Byllesby to account for the waste that Byllesby has made and the profits that were paid out was dropped, so that Byllesby was no longer liable for an accounting. They then divided the benefits of control up, but I do not think the United States Electric Power

Corporation got any of the banking business, because it did not have the facilities for the banking business, but I think they did retain the right to say who the bankers would be, and they designated as bankers their banking associates, so that the transaction bore all the earmarks of being a transaction that was undertaken to obtain the advantages of control, and the advantages of control were largely obtained by the bankers in the form of continued banking perquisites.

I wanted to tell you a little about United Founders. This United Founders was this concern at the top of the pyramid. It was formed so that the American Founders group would continue their same conservative management, as the circular put it. Out of the $300,000,000 paid in, $285,000,000 was lost.

Senator WAGNER. That was nearly all of the public's money?

Mr. STERN. Yes. That brings up an interesting question. I think this shows it is an evil which is met by the bill.

What was done was this: You see, originally security holders invested in International, Second International, United States and British, and American and General. They were subsidiary investment trusts and they were run moderately conservatively, and their losses were under 50 percent. Whether that was a good record or not, their losses were under 50 percent.

The stockholders did not get the advantage of that. They were moved from these safer positions, first to American Founders, and then up to United Founders.

Thirty-three million dollars was moved up to American Founders by exchange offers, and then $139,000,000 of stock of American Founders was moved to the top company, United Founders. So that many stockholders did not share in the lesser losses of the companies in which they had originally invested.

With reference to these exchange offers by which security holders were moved from the lower companies to the top companies, this was not merely an exchange in which the men were left to exercise their judgment. They were not told that the asset value at terms of the securities which were offered in exchange for them was very much less than the asset value of the securities which were given up. Nor were they left to exercise their discretion, because pressure was being put on them. Brokers were hired and paid commissions to bring about these exchanges.

These were exchanges by which people in the lower, safe companies were moved to riskier positions, and finally a lot of them shared this 95 percent loss in the top company.

A great deal of that pyramiding would be taken care of in the bill, and, of course, the shifting of men from one company to another would be put under supervision. I understand that there is going to be brought up in detail before the committee—the accounting practices of the Founders Companies which concealed from the public what was going on.

The thought may have occurred to you gentlemen, "Why, this all seems pretty elementary. Why didn't the people know about it?" The fact is they used what were advertised as independent certified public accountants, and they used the name of the biggest accounting firm as a so-called consulting accountant, but despite the fact that these gentlemen were used and the public was told that they had the protection of these accounting firms, what actually happened was that the public failed to receive protection.

As you have seen, all of the so-called "profits" came from the inter-company transactions, but no one could tell that. When they did speak of them they called them investment profits, but they did not tell them what part of the investment profits was due to transactions in group——.

Senator FRAZIER. What did the accounting companies get out of it for keeping the thing covered up?

Mr. STERN. Substantial accounting fees. I do not believe they got any more, but the fact is, and that is one of the dangers of this thing, that it shows accounting firms of high reputation and distinction in the community just did not protect the public.

When they were asked on the stand about these practices they did not, of course, seriously defend them.

Now, there were certain other things designed for their protection——

Senator WAGNER. I think it would be interesting at this point to inquire as to why these accounting firms of reputation did not disclose to the public the accounting system which suppressed the truth, or were they deceived?

Mr. STERN. Senator, perhaps you had better draw your own conclusion from these two facts. I will just tell you them and you can draw your own conclusion.

Senator WAGNER. All right.

Mr. STERN. Mr. Leland Rex Robinson had written a book on investment trusts, and the book had been written on company time, and the book told what the proper accounting principles were, only the principles were not followed in this case, and they were not followed in the case of Mr. Robinson's company, the Second International.

Senator FRAZIER. I think some accountants must be like some attorneys—they will do what they are told to do if they are paid.

Mr. STERN. Senator, a lot of people did a lot of things in 1929.

Mr. FRAZIER. Yes; I know.

Senator WAGNER. But you spoke of some dates after 1929. Some of those transactions came after that date.

Mr. STERN. 1929 and 1930, but the fact that the accountants did not do their work is shown by other transactions too.

I am not holding any brief for the accountants. I do not know whether their kind of morality that went into this was higher or lower than the prevailing level. It was rather low, if this is a fair example; I have no way of telling however.

I do not want to go into the details of that, because I understand Mr. Schenker wants to go into that as part of another hearing, but I wanted to tell why it was that these enormous profits could have been concealed not only from the stockholders but from the directors, so that director after director admitted his astonishment.

Then there were other things that were seemingly for the protection of investors. There were some fairly big names, as on the directorate. The directors on the whole—a great many of them—just did not know what was going on, I think, because the concern was run in a group, consisting of Coombs, Erwin, and Seagrave.

For the protection of the stockholders there were these restrictions that were advertised from time to time. I have told you of some that were advertised. Others were advertised and actually evaded, for restrictions could be easily evaded. For instance, I told you that one company could only buy seasoned securities, defined as a company that had been in existence for 4 years. How did they get around that? There wasa company that one of them owned, and it had been operating for 4 years. They did not sell the company. They sold the name. They took out all the assets and securities and they treated it as a new company, and that was one of the ways they evaded that.

Another way was that since it was a restriction in the bylaws, the bylaws were changed.

Still another way you could get around a restriction, as they did here, was to move the public by exchanges from the restricted companies to the unrestricted companies, and the restrictions were not of very much use to them then.

Senator WAGNER. The brokerage fees are perfectly legitimate if paid in a legitimate way. Were there insiders that received these fees in these transactions?

Mr. STERN. I think the brokerage fees, while they might have been fairly large, were fairly clean, but that was not a large matter compared with the others.

Just another word and I will complete my statement. I would like to quote for a minute from Robinson's book, because it seemed to me, after I had found out that one safeguard after another designed for the protection of the stockholders had failed, it was curious to note what Dr. Robinson had said.

He said that one of the evils of the British investment trusts was—

> The struggle to enhance earnings and increase dividends even by devious processes during times of rapidly accumulating capital and of multiplying security prices. Endeavor to realize trading profits led companies into transactions which would be universally condemned today as too unsound in character to warrant serious consideration on the part of responsible investment trusts.

Then Dr. Robinson continued in language which is curiously reminiscent, now, of what Founders actually did:

> In order to realize profits from financing, dealing, issuing, and underwriting, several companies spawned flocks of new ones engaged in a vairety of promoting, financial, and investment activities, and creating a pryamid of paper values.

That, Robinson said, was the thing that had happened in British investment trusts and the thing that could not happen again today. That is exactly what did happen in Founders, and may I say that faced with the fact that this gentleman knew what had happened in the British trusts and the same thing happened over here, I thought it might be useful, for the sake of the record, to ask witnesses whether they thought these large pools of investment funds should go unregulated, and these witnesses were officers and directors of the Founders Group, and every one of the witnesses who was asked the question said that there should be regulation.

Senator WAGNER. May I ask one final question? You have read the bill that is pending now?

Mr. STERN. Yes.

Senator WAGNER. And you have had the experience that you just related to us. Is it your opinion that this legislation, if enacted into law, would prevent very considerably the manipulations you have related here, so that the public would be protected?

Mr. STERN. Senator, I have given very careful consideration to it for the last few days, and I think it may safely be said that while honesty in the last analysis is the only thing that really tells, this