"DIVERSIFORM DISHONESTY"

ADDRESS

of

EDWARD H. CASHION

Counsel to the Corporation Finance Division,
Securities and Exchange Commission

before the

NATIONAL ASSOCIATION OF SECURITIES COMMISSIONERS

Chicago, Illinois

Saturday, November 17, 1945.

DIVERSIFORM DISHONESTY

Mr. Chairman, members of the National Association of Securities Commissioners, Ladies and Gentlemen:

At past meetings you gave me the opportunity to discuss with you certain aspects of fraud and dishonesty in connection with securities transactions. It is a problem which undoubtedly will be present in our economy so long as there exists a scramble for profits and power. It is a problem which day in and day out increases your responsibilities and burdens as it does ours. So long as there is any money in the public pocketbook, those who would promote ventures for their own profit will engage in fraudulent and deceitful practices in spite of any statutory attempt to prohibit them.

We are all fairly familiar with the great variety of fraudulent schemes designed to circumvent the various Federal and State securities laws in selling securities. We have been very successful in bringing to justice those who indulged in such schemes and, as Chairman Purcell said to you yesterday, "We may all be justly proud of the extent to which fraud has been suppressed."

In addition to its disclosure requirements the Securities Act of 1933, as you well know, was designed to prevent fraud in the distribution and sale of securities. The fraud prevention and disclosure provisions of that Act were strengthened by the enactment of the Securities Exchange Act of 1934. Last year I discussed Rule X-10B-5 adopted by the Commission under the latter Act. I stated I thought there was no difference in protecting people from purchasing securities from dishonest promoters than there was in protecting persons from selling their securities to insiders who persuade investors to give up their securities by techniques as vicious as those used by dishonest promoters. I have heard it said that my discussion on that subject was provocative. I have heard protestations made in answer to charges brought by the Commission, bottomed upon alleged fraud upon the seller of securities, that that type of fraud is a new concept. I did not think it a new concept at the time the Rule was adopted, nor do I think so today. Fraud and dishonesty in connection with securities transactions, however varied, however diversiform, are none the less fraud and dishonesty.

I would like today to follow fraud in its general sense beyond that practiced in the ordinary purchase or sale of securities. "Fraud, indeed, in the sense of a court of equity" says Mr. Justice Story, 1/ "properly includes all acts, omissions and concealments which involve a breach of * * * trust * * *". Having in mind fraud in this generic sense I propose to discuss with you some of the applications of Section 36 of the Investment Company Act of 1940. 2/ That Section authorizes the Commission to seek an injunction in the proper United States District Court against any person for gross misconduct or gross abuse of trust in respect of any

---

1/ Story Eq. Jur. § 187; *Moore* v. *Crawford*, 130 U.S. 122, 128.

2/ Section 36. 15 U.S.C. 80a-35.

registered investment company which such person serves in any of certain designated capacities. If the Commission's charges of gross abuse of trust are established, then the Court is obliged to enjoin such person, either permanently or for a period of time, from acting or serving in the designated capacities.

In discussion the applications of Section 36, let it be recalled that the Investment Company Act is the result of abuses and defects uncovered in an exhaustive study made by the Commission. Let it be clear that the investment company industry itself recognized the existence of those abuses and defects and joined the Commission in urging the passage of the Act. Let it be very clear that the terms and provisions of the Act were worked out in conference by the representatives of the industry and the Commission with the approval of the Congressional committees concerned. Let it not be unclear that I am very appreciative of the fact that investment companies are vitally associated with our national economy although relatively few of them are more than 20 years old. As of June 30, 1945 the total assets of all registered investment companies, excluding fixed and semi-fixed trusts, installment investment plans, face-amount certificate companies and companies in process of liquidation and dissolution, aggregated approximately three billion dollars. The assets of companies excluded from that figure run into several hundred millions of dollars. At the end of 1944 there were 371 investment companies registered with the Commission. The number of security holders of investment companies has been sharply increasing since the advent of the Act and in the Spring of this year there were two million persons scattered throughout the country holding such securities. These figures are of importance, not only in considering the relation of investment companies to our national economy, but are of vital importance in considering the concept of the investment company business -- a business which provides a medium for public investment in common stocks and other securities -- a business designed to administer a pool of money belonging to a large and widely scattered body of investors. These figures are of importance not only in considering the investment trust business, but in giving consideration to particular investment companies and to those who make up their managements. Managements after all assume the high responsibility of administering other people's money.

Basically the problems of the industry flow from the very nature of the assets of investment companies. Those assets for the most part consist of cash and securities which are usually completely liquid and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by an unscrupulous management.

It is a fundamental of trust law, as with all other fiduciary relationships, that the trustee must be wholly faithful to the interest of his trust. In conscience and in equity the beneficiary, not the trustee, is the owner of the trust property. I am confident that the industry as a whole is vitally interested in seeing to it that fiduciary standards are maintained. Indeed they must be if public confidence in the investment company business is to continue.

I think Federal and State agencies charged with the administration of the regulations and requirements pertaining to the distribution of investment company shares, as well as the industry itself, are quite aware that not all the managements of investment companies are good and there is no assurance that past good managements may not deteriorate as internal personnel changes occur. This hazard can be overcome by careful investigation and constant watching of performance.

In considering the "gross abuse of trust" section of the Investment Company Act, I should like to present to you the facts of some of the less involved cases which have come before the Commission and the Courts Time will not permit a discussion of all of the cases because the facts of each are involved and complicated.

The first time the provisions of Section 36 were invoked by the Commission was in its action filed in the Federal District Court at Kansas City, Missouri in 1942 against United Funds Management Company, a face-amount certificate company, and its officers and directors. The nature of the contract which United sold was such that in the later years in which it was in force the burden of maintaining it became increasingly difficult. The management knew the company did not have sufficient reserves to provide for the payment of its outstanding certificates at maturity. Faced with these bothersome facts, the management embarked upon a campaign to switch their security-holders out of their certificates into other investments. As a part of this campaign United mailed to its certificate holders a letter stating that its reserves had been questioned. The purpose of that letter was obvious.

Here was a company whose certificate holders were being induced by the management to surrender their certificates for less than they had paid and to relinquish the benefit of the proportionately greater improvement called for by the certificates as they proceeded to maturity. This plan was calculated to relieve the company of its burdensome obligations at the expense of the certificate holders and thus to enrich the directors and officers, who were the principal owners of the equity stock. Here was a situation where the directors and officers had refused and failed to effect a plan of liquidation which would have been fair and equitable to the real owners of the trust's property.

Because of these alleged facts the Commission filed its action under Section 36 of the Act seeking the removal of the officers and directors for their gross misconduct and gross abuse of trust. In addition the Commission asked for the appointment of a receiver to conserve the company's assets and to hold them subject to the order of the Court for liquidation and distribution. The District Court issued a temporary restraining order and appointed a trustee to take over the company's assets. While our action was pending, United filed a petition in bankruptcy and was subsequently adjudicated a bankrupt.

I think this case illustrates that an investment company may not be operated in the interests of its officers or directors or in the interest of special classes of security holders. It must be operated in the interests of all classes of security holders.

Let us look at another situation. In the Spring of this year the Commission filed an action against First Investment Company of Concord, New Hampshire and its president, one Charles L. Jackman. 3/ The company was comparatively small and was dominated and controlled by Jackman. He also controlled the Northern Securities Company, a personal holding company.

Jackman had engaged in a scheme to acquire the stock of the investment company at less than asset value through his personal holding company as the ostensible purchaser by means of misleading statements in violation of Rule X-10B-5. In addition, this investment company had failed to file with the Commission or submit to its stockholders financial reports as required by the Act. The complete absence of financial information regarding the condition of the company was of great assistance to Jackman in his stock acquisition program. Lack of financial information certainly prevented the establishment of any true over-the-counter market for the company's stock. The company was charged with other violations of the Investment Company Act such as making loans to controlled affiliates and purchasing securities of affiliates. The Commission's action resulted in a final judgment against First Investment Company, Jackman its president, and his personal holding company. The judgment, which was consented to, besides enjoining the many violations of the Investment Company Act and the Securities Exchange Act, enjoined Jackman from serving or acting in the capacity of officer, director or investment adviser of the investment company. In addition, Jackman stipulated that upon liquidation of the company he would pay to the persons from whom he had purchased the company's securities the difference between the price at which he acquired the stock and the final liquidating value of the stock.

I think this case illustrates the proposition that it is gross abuse of trust for a management of an investment company to purchase company securities from its shareholders without fairly presenting adequate financial information concerning the company.

The last of my illustrations involving the application of Section 36 is the Commission's action against Aldred Investment Trust and its officers and trustees. 4/ The Trust was established as a common law trust under the laws of Massachusetts. Its investment policy, until January 1, 1944 was to invest its assets in readily marketable securities of public utility and industrial corporations. The absolute control of the Trust was vested in the trustees. To the debentures which it sold to the public were attached 100,000 common shares. In addition there were issued 112,000 free common shares which were not attached to the debentures. All shares had equal voting rights. It will be seen that the holder of the free shares had complete control of the Trust. Absent a default in interest the shareholders were not entitled to put an end to the Trust until the year 2002. The trustees, however, could terminate the Trust earlier. The trust agreement provided that no investment would be deemed improper because of its speculative character. The Trust had been insolvent since 1937. The asset value of the Trust was substantially less than its funded

---

3/ Civil Action, File No. 400; USDC New Hamp. June 19, 1945.

4/ *S.E.C. v. Aldred*, 58 Fed. Supp. 724, ____ F. 2d ____, (CCA 1, Sept. 17, 1945).

debt. Earnings were insufficient to meet the interest requirement on this debt. To prevent a default in interest and a possible termination of the Trust, a large proportion of interest was paid out of capital. In the latter part of 1941 the Trust had assets of approximately $2,000,000 and a funded debt of $5,900,000. That was the picture in October 1941 when one Hanlon bought the controlling block of voting stock for less than $20,000.

What were the details of his conduct and that of most of the other trustees which the Court found to constitute gross misconduct and gross abuse of trust?

Immediately after acquiring control Hanlon elected himself and certain friends as trustees and officers. He was made president of the company. Salaries were paid to trustees and officers. The office of the Trust was moved to Hanlon's brokerage office in Boston. With the Trust facing bankruptcy and unable to meet interest except by the sale of portfolio securities, Hanlon sought to effectuate various plans of reorganization which would relieve him of the pressure of the interest requirements. He was stopped at the outset by the position of the Commission that any plan would be grossly unfair which did not leave the debenture holders in full control of the Trust. Hanlon, however, continued to use capital to meet interest requirements and management expenses when fairness should have indicated the necessity of a fair recapitalization or liquidation. Finding the way blocked to any recapitalization which would leave him in control, he gambled one-third of the Trust's choicest securities in purchasing control of the Suffolk Downs Horse-Racing Track, Since this purchase involved a change in investment policy, the Investment Company Act required stockholder approval. In procuring such approval, the trustees deliberately refrained from telling stockholders anything about the race track purchase, the details of which had already been completely arranged. Such notice as was given was a masterful bit of understatement.

The Circuit Court of Appeals in sustaining the judgment of the District Court against the defendants in the Aldred case, said:

> "We have examined the record carefully, and in our opinion the only inferences permissible from the evidence and testimony presented at the trial are clearly to the effect that Hanlon and his associates during the period they had the management of the Trust were motivated primarily by ideas of personal gain. From the moment they took over they embarked upon a course of action which culminated in the acquisition of Eastern Racing Association. That transaction enabled Hanlon and his associates to elect themselves as directors and officers of Suffolk Downs Horse-racing Track, a business about which they knew nothing but which carried the certain prospect of handsome salaries."

Even eliminating the race track incident, I personally believe the other facts indicated the necessity for injunctive action.

The District Court, in order to prevent future violations by Hanlon or any other nominees he might select, appointed receivers "with the power either to reorganize the capital structure of the Trust or liquidate the Trust and distribute the assets . . ." The Court of Appeals, in affirming the judgment of the District Court, said:

> "With respect to the appointment of receivers, the appellants contend that Hanlon, as the owner of voting control, has the power, 'with which no one has any right to interfere', to supersede the enjoined trustees and elect new trustees; and that, conceding the propriety of receivership, the Commission under the statute has no authority to ask for such relief.
>
> "We do not agree with either of these contentions. Hanlon's voting control represents no equity interest in the Trust, and to permit him to remain in control would be to perpetuate the very conditions that brought about this suit. In granting relief the District Court relied upon its equity power to appoint receivers with power either to reorganize or liquidate the Trust. In the light of the circumstances surrounding this case the only effective means of protecting the interests of the debenture holders was to remove Hanlon from the control of the trust assets which do not belong to him. § 36 invokes the equity power of the Federal Court and that calls into play its inherent powers where necessary to do justice and grant full relief. The appointment of receivers in the case at bar was an appropriate exercise of the court's inherent equity power . . ."

The problem of breach of duty has apparently been of much concern to the English. In June of this year the Committee on Company Law Amendment, which was appointed before the present Labor Government came into power, recommended major amendments to the Companies Act, 1929. The amendments recommended would be applicable to all companies and would in several respects be broader than Section 36. Under the proposed amendments the Board of Trade would be empowered to appoint inspectors to investigate the affairs of a company if it appears that:

> ". . . there is reasonable ground for suspecting that there has been fraud in the promotion or formation of the company or that there has been fraud or misfeasance or breach of duty in the management of the business or affairs of the company or that the company has been party to fraud or misfeasance or breach of duty or that a minority of the members or of a class of the members has been oppressed by the majority, or that information has been withheld from members which ought reasonably to have been given to them. . ." 5/

Inspectors may be appointed also upon the recommendation of a court or upon the request of a certain number or percentage of the stockholders.

5/ Report of the Committee on Company Law Amendment - p. 101.

Where the inspectors' report indicates a prima facie case of fraud or misfeasance the Board of Trade would have the power to apply to the Court for an order to wind up the company.

Reference for criminal prosecution is provided where the Board of Trade deems the facts to justify such action.

While Section 36 of the Investment Company Act is not as broad as the proposed amendment to the Companies Act, once the charges of gross abuse of trust are established to the satisfaction of the Court it has the inherent power to reorganize or liquidate the Trust. The Aldred case is authority for this proposition.

I want to make it clear that the recitation of the facts in the cases to which I have referred is not in any way to be taken as delimiting the extent of Section 36. Like fraud, abuse of trust is not a fact but a conclusion to be drawn from facts. The terms "gross abuse of trust" or "gross misconduct" should not be limited by any hard and fast definition. Both constitute fraud in its general sense. In this connection I think a quotation I cited last year is applicable. Judge Lamb of the Missouri Supreme Court said:

> "Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition. Messieurs, the fraud-feasors, would like nothing half so well as for courts to say they would go thus far, and no further in its pursuit." 6/

The declarations of policy as set forth by Congress in Section 1 (b) of the Investment Company Act are a good guide in any interpretation of gross misconduct and gross abuse of trust. As the Court properly held in the Aldred case the interpretation of gross misconduct and gross abuse of trust as used in Section 36 will depend not only upon relevant common law principles of fiduciary duties but also upon the declaration of policy as set forth in the Act.

Congress has declared that the policy and purposes of the Act are to mitigate and so far as is feasible to eliminate certain enumerated conditions which it found adversely affected the national public interest and the interest of investors. Congress states that the provisions of the Act shall be interpreted in accordance with its policy and purposes. Congress has also declared that the national public interest and the interest of investors are adversely affected --

> "(1) when investors ... receive dividends upon, vote, ... sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

6/ *Stonemets* v. *Head*, 248 Mo. 243; 154 S.W. 108 (1913).

"(2) when investment companies are ... operated, managed, or their portfolio securities are selected, in the interest of directors, officers ... or other affiliated persons ... rather than in the interest of all classes of such companies' security holders;

"(3) when investment companies ... fail to protect the preferences and privileges of the holders of their outstanding securities;

. . . .

"(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

"(6) when investment companies are reorganized, become inactive, or change the character of their business ... without the consent of their security holders;

. . . .

"(8) when investment companies operate without adequate assets or reserves."

I believe that any substantial deviation from that codification of the fiduciary obligations imposed upon directors and officers of investment companies, ipso facto, constitutes gross misconduct and gross abuse of trust. And once such a deviation is established the power of the Court to reorganize or liquidate the Trust should not be lost sight of.

My remarks are not meant to imply that most investment companies which had been operating in this country before 1940 were guilty of unfair practices or were mismanaged. I feel we should be pleased that progress has been made by the members of the industry voluntarily to eliminate some of the major abuses and deficiencies and to improve generally standards of practice.

With personnel problems being gradually alleviated, those charged with the administration of the regulations and requirements pertaining to the distribution of investment company shares will be able to give more and more attention to the problems in the industry. To paraphrase a statement by a member of the industry, although no amount or kind of Government regulation can guarantee good investment management or insure investors against losses, the investment company industry itself can provide considerable protection against the recurrence of past abuses and excesses that characterized early investment company history. 7/

At no time in the history of the country has the bulging public pocket book looked so inviting to our perennial get-rich-quick Wallingfords. We must therefore intensify our efforts to combat the subterfuge and sharp-tongued salesmanship of those who would indulge in nefarious schemes in connection with the purchase or sale of securities. At the same time we

---

7/ Investment Companies - 1945 Edition - Arthur Wiesenberger - p. 47.

must not lose sight of the more devious hishonest practices within the corporate enterprise itself. We must be alert to dishonesty however diversiform. The prospective investor must be alerted to investigate before he invests in any venture, including an investment company, and to watch the performance of any company in which he invests. I repeat, the investment company is important in our national economy and provides a medium for public investment in common stocks and other securities; but we should never forget the limitations on conduct of management or those in control of a corporate enterprise. I close with this statement of Mr. Justice Douglas:

> "He who is in such a fiduciary position cannot serve himself first and his cestuis second... He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors *no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis.* Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation ... Otherwise, the fiduciary duties of dominant or management stockholders would go for naught; exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart." 8/

8/ *Pepper v. Litton*, 308 U.S. 295, 311 (1939).