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"SECURITY FRAUDS AND VIOLATIONS"

I appreciate this opportunity to talk to you this afternoon about some of the current security frauds and violations we are encountering in the enforcement of the federal securities laws and about the increase of our responsibilities and burdens under the impact of the war effort. These problems are common to most of you in the enforcement of your own state securities laws and constitute a sound reason for increasing still further the splendid cooperation that exists today between federal and state commissions.

As compared with many of the state statutes, the federal Securities Act is a mere infant. It is now in its ninth year of existence. Yet even within that short span of time, we have met a wide variety of fraudulent schemes designed to circumvent the obvious intent and wording of the Act. The ingenuity of those who would promote worthless ventures for their own profit is not limited by any statutory attempt to prohibit their activities.

The modern promoter, superficially well-versed in the wording of the securities statutes, will invariably seek to disguise his fraudulent sale of securities as a sale or lease of something other than an orthodox stock or bond or debenture. Fortunately, however, we have the weapons to combat these subterfuges. The framers of the Securities Act, taking their cue from the long experience of state commissions as embodied in their securities laws, saw fit to include in the definition of a security such phrases as "evidence of indebtedness," "certificate of interest or participation in any profit-sharing agreement," and "investment contract."

These definitions are not static. They are flexible and are capable of being adapted to meet the constant variations conceived by the nefarious parasites on the financial blood of the public. We are thereby enabled to pierce the veil of these evasion devices and bring to light the unescapable fact that they are security transactions. Both federal and state courts have likewise used these definitions to look through the outward form of such schemes and examine their real substance. As one recent decision put it: "To consider only the formalistic aspect of these contracts is to lose sight of the background and underlying spirit of these transactions, thus seeing only the skeleton while disregarding the flesh surrounding it." That the courts have not been hesitant to examine the flesh of these transactions can be attested by the multitude of men now sitting behind steel bars or living under the constant interdict of an injunction.

Because these ingenious attempts to avoid the requirements of our statutes constitute so large a part of our enforcement work and because they are at the forefront of our never-ending battle to protect the public pocketbook from unnecessary losses, it is appropriate to review briefly some of the more important schemes used by promoters to cloak their fraudulent security transactions.

One of the most common subterfuges is the bill of sale. This involves the purported sale of oil, silver foxes, rabbits, bull frogs, parking meters, and other chattels. These schemes all have a common feature whereby the property is not physically turned over to the purchaser but is retained in the possession and control of the promoter. The promoter then operates or disposes of the property and distributes the profits among the purchasers.

Our most recent encounter with an investment contract of this type illustrates the limitless scope of the imagination of promoters. Two individuals in Massachusetts purchased two fishing vessels and proceeded to operate them for the purpose of catching fish to be sold. They then evolved the plan of selling to the public undivided interests or ship shares in the two vessels and in other vessels to be built from the proceeds of the sale. The interests sold to the public were evidenced by a regular bill of sale prepared by the Bureau of Marine Inspection and Navigation of the Department of Commerce. Needless to say, the purchasers of the ship shares had no right and no intent to operate these vessels, but were entitled to receive a pro rata share of the profits realized from the operation of the boats by the two defendants. The court had no difficulty in calling these interests securities and enjoining their sale by fraudulent means.

A second device closely akin to the bill of sale is the deed of conveyance of a tract of land. Here again the promoter usually promises to develop the land and market the produce thereof, the purchaser of the land receiving a certain percentage of the net profits of the enterprise. Rarely if ever does the purchaser actually go on the land himself and assist in its development.

Typical of this type of subterfuge is the currently popular practice of selling acreage containing "liquid gold" - or tung oil produced from tung trees growing on the land. Tung oil is an important product in war time and is used in the manufacture of paints and numerous other essential commodities. Undoubtedly, cultivation of tung trees is to be encouraged. Yet unscrupulous promoters have taken undue advantage of this fact and sold to the public thousands of acres that in the opinion of Department of Agriculture experts are unfit for tung tree production. We recently obtained judicial determination of the fact that such promotion involved the sale of securities and secured an injunction against their sale in the absence of a registration statement. In that case, acreage was sold to the public with the representation that the devotion of the land to the propagation of tung trees would bring the purchaser enormous profits. The purchaser received a contract of purchase by which the seller agreed that if the purchaser pays the purchase price the seller would convey the land by means of an unincumbered warranty deed. It appears that the cultivation of tung trees is quite a science and that the method of extracting oil from the tung nuts is one which necessarily involves the use of extremely expensive and complicated machinery. Furthermore, a large acreage is necessary before a profitable production of tung trees is possible. Thus the average investor is in no position to cultivate tung trees on the land he buys. Consequently there is executed concurrently or shortly after the execution of the "sales" contract a separate "development" contract between the purchaser and a developing company or individual. These two contracts are closely allied in practice as well as in personnel. Provisions are also made as to the

division of profits to be derived from the sale of the tung oil. When all these facts are considered, the conclusion is inevitable that these transactions amount to an investment contract rather than a mere transfer of the fee simple interest in the land. And so the court found.

Very often in making these so-called transfers of land in fee simple, the skillful and adroit promoters will employ all the rules of psychology and appeal to the nobler and higher sentiments of mankind. In selling the groves of tung trees, the promoters were careful to point out the advantages of erecting a home and relaxing midst the tung trees on one's acreage, while contracting with the company for perpetual care of the trees. Thus one was free to golf, hunt, fish and really enjoy a carefree life while waxing wealthy from the "liquid gold" of tung oil. Even more lurid were the representations recently made by certain promoters who were engaged in the solemn task of selling securities relating to cemetery lots. The promoters had acquired at low prices a large area of land which they proceeded to divide into approximately 35,000 cemetery lots. These lots were then sold to the public on an investment basis. We alleged that statements were made to the effect that the money from the sales would be used to make the cemetery a Garden of Eden. These improvements were to include a replica of the Taj Mahal in India at the slight cost of \$1,000,000, an illuminated electric fountain, hidden music, temples, a tower of memories, rest pavilions, artificial pools and fountains, and bird sanctuaries. More than \$500,000 had been sunk by the public into these parcels of heaven on earth before we secured a consent injunction against sales of such unregistered securities.

Another type of artifice frequently used to evade regulation involves an investment by the purchaser with the seller, who purports to act as "agent" for the purchaser in seeing that the purchaser gets a return on his investment. All the efforts are made by the so-called "agent." A slight modification of this device is illustrated by the "trading pool," wherein the purchasers pool all their money. The promoter manages this "pool" and receives a certain percentage of the profits obtained thereby.

I do not need to add that there are countless variations of these various devices for selling securities in disguise. Some involve leases rather than outright sales of property. Others involve elaborate clubs and organizations for the making and sharing of profits. Suffice it to say, however, that they all bear a common denominator. In each case, the purchaser lays out money on the assumption and expectation that the investment will return a profit without active effort on his part, but rather as the result of the efforts of someone else. That concept is the very essence of a security and our statutes, in describing securities to include investment contracts and profit-sharing agreements, merely spell out some of the more common forms in which that concept appears in the activities of the ingenious promoters.

But our statutory definitions are sufficiently broad, I believe, to cover practically any device conceivable by promoters in their attempt to circumvent regulation. Our primary task, therefore, is to secure evidence that the investor is seeking to make a profit through the efforts of some one else connected with the enterprise. Once that is established, it is then only a question of fitting the transaction into one of the basic categories outlined in the statute.

This function is undoubtedly one of the most important that we perform under our securities statutes. A prominent New York City attorney has recently published an account of his law practice in which he places a low valuation on work of this sort, alleging that it is necessary only "to protect morons who buy securities without making inquiry" and that it is unnecessary for intelligent persons like himself and his clients to be so protected. I have no sympathy with this view and believe that it is decidedly in the minority. I need point only to the fact that intelligent people as well as the so-called morons are only human beings. And these highly skilled promoters are past masters at the art of playing on the human foibles. Many nationally known bankers, clergymen, lawyers and public prosecutors have been duped by suave salesmen into pouring their money into dry oil wells and gold mines excavated in sand dunes. As one court recently said: "Many in this world of ours desire to make money without effort. Men and women in all professions, busy men and women with good incomes, have an innate desire to increase their income or their principal. They do this by so-called investments. They venture into realms of which they know nothing." As long as this innate desire exists and as long as there are shrewd promoters to take advantage of that desire, there will ever be a need for us to bring to light the ugly truth about these pipe dreams of fortune. You and I well know that in the glaring light of publicity and disclosure, these promoters fade from sight, unable to secure from the public the necessary funds to continue.

This duty of protecting the public from needless and wasteful exploitation is especially important during these days when our nation is engaged in a life-or-death struggle. We are faced with the absolute necessity of putting into the war effort all the money and capital that can possibly be spared. Never before has there been so great a need for so worthy a contribution in so short a time.

All of us, as loyal Americans, have been anxious that the knowledge which we have acquired and the techniques which we have developed in the field of security regulation be utilized in the fight in which the nation is now engaged. I deeply believe that we can and do make a substantial contribution to the common effort. As our old friend Bob Kline, so well pointed out in his talk to you two years ago, the desperate need for investment capital in the war-time economy places upon us not only the paramount duty to give all we can personally but also makes our statutory duty of preventing security frauds and violations an extremely necessary and patriotic duty. If we, through the enforcement of our various state and federal securities statutes, can prevent investment capital from being wasted in fraudulent, fly-by-night schemes, we will have made a very important contribution to the national effort.

We must therefore scrutinize with ever-increasing care the statements and actions of those who would divert money away from this all-important need and use it in the promotion of their fraudulent schemes having no relation whatever to the war effort. It is undeniable that this war is indeed a field day for these expert and unscrupulous promoters. They not only have available their ordinary appeals to the gullibility of the investors but they are also fully equipped with tall tales about the importance of their enterprise to the war effort and the assured profits to be made from investing in a concern dealing with a scarce commodity. War time necessity also places in the hands of these promoters of enterprises bearing

some actual relation to the war program another potent appeal, the accuracy of which is practically impossible even for the most prudent investor to discover. Military secrecy often forbids the publication of material facts concerning the existence of government contracts and the nature of the products being manufactured by the company selling securities. This affords the opportunity, full advantage of which has already been taken, for promoters to withhold essential information and give prospective purchasers the false impression that large war contracts have been entered into and that great profits are to be expected. This is combined with a burst of patriotism, emphasizing the fact that military necessity forbids full disclosure.

One scheme we recently uncovered illustrates this new type of activity. In conjunction with the Department of Justice, we obtained an indictment which charged the following facts: A corporation was formed with the war-like name of General Ordnance Company, Incorporated. The principal promoter assigned to the company a patent covering a new type of mechanical fuse designed for use on anti-aircraft projectiles. Preferred stock was sold to the public by means of various misrepresentations, including statements that the fuse had been developed and was ready for test, when development work had actually been abandoned. The indictment further alleged that it was also falsely represented that the company had substantial orders from the United States and foreign governments. Approximately \$75,000 was obtained from investors through the sale of this stock. Previously, in 1938, this same promoter had been enjoined at our instance from selling unregistered stock in another ordnance company.

In addition to the contribution that we of the various state and federal securities commissions can make in the way of preventing wasteful securities frauds, the war has also afforded us the opportunity of rendering valuable constructive service to the production agencies which are immediately behind the man behind the gun. Many thousands of war contracts are being made by our government with corporations financed in whole or in part by the War and Navy Departments or by loans from the R.F.C. and the Defense Plant Corporation. It is not surprising that those seasoned veterans who come to mind when we think of securities frauds should sometimes appear as respectable officers of newly-formed corporations, seeking to place their allegedly trained personnel and established plants at work on lucrative government contracts. Some of these are undoubtedly motivated by a sincere desire to assist in winning the war. But there are others who never change their color. Situations of this sort require the closest scrutiny and investigation of the companies with which such individuals are associated. Agencies such as the Securities and Exchange Commission and the various state securities commissions have developed a technique for mastering the intricate facts of corporate and financial situations which it is difficult to acquire. In placing our records and trained personnel at the disposal of the production and military agencies which have problems such as these we help to expedite the war effort. By giving first call upon our facilities and manpower to those agencies, we play a part in the battle of production. And, unless the battle of production is won, there can be no battles at the Russian front or in the Solomon Islands.

Naturally the war looms larger and larger in the work of all of us. Matters relating to the national defense have and deserve to have priority above everything else. Despite that, I think that we have continued to make large advances in the protection of the public investor. The old weapons

have been used to advantage, and new weapons have been forged out of the material at hand. We can still well afford to protect the public from loss while utilizing our resources to the fullest possible extent in the war program.

Because the need is now so great for harnessing to the war effort all funds available for investment, we must be constantly vigilant against the diversion of such valuable capital into fraudulent promotional adventures. At the same time, however, the manifold devices conceived by clever promoters demand adequate manpower to investigate and combat them effectively. This problem of adequate investigative and enforcement staffs, capable of meeting the ever-increasing duties forced upon them, is one that is becoming more and more urgent as the war continues.

This leads me to stress, in conclusion, the necessity for our working together more closely than ever before. All of us are losing essential men to the armed forces. That is as it should be. But these losses should not in any way hinder or lessen the effectiveness of regulation and enforcement of our statutes. These losses clearly will not have that effect if we learn to cooperate and pool our resources and personnel to the fullest degree in order to combat the forces that would steal vital investment capital.

We of the S.E.C. have already streamlined our organization in order to operate more effectively under the present trying conditions. I assume that many of your state commissions are also considering changes in your internal organization. But reorganization alone will not solve all the problems. It is only when we have efficient organizations working in close cooperation with each other that we will be able to achieve our aims and duties with any degree of success.

I therefore ask you to consider, as a practical necessity rather than as an abstract ideal, the creation of still closer ties among our various commissions, state and federal. If we do not have such cooperation, we shall have lost one of the battles on the home front against waste of needed capital.