"FRAUD ON THE SELLER OF SECURITIES"

ADDRESS

of

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before the

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FRAUD ON THE SELLER OF SECURITIES

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

At the St. Paul meeting you gave me the opportunity to discuss with you some of the current security frauds and the increase of our mutual responsibilities and burdens in that regard. At that time the Securities Act was only in its ninth year of existence and yet we observed that even within that short space of time the Commission had met a wide variety of fraudulent schemes designed to circumvent the Act.

You and we have found in our experience that the ingenuity of those who seek to promote worthless ventures for their own profit is not limited by any statutory attempt to prohibit their activities. As I recall it, we found that some modern promoters, superficially well-versed in the wording of the Securities Statutes, sought invariably to disguise their fraudulent sale of securities. At that time I limited myself to a discussion of fraud in the *sale* of a security. The anti-fraud section of the Securities Act proscribes fraud *only in the sale* of securities - that is, fraud on the *purchaser*. There is another class of persons, however, which needs protection from those who would take advantage of their position. This class consists of those who have a security to sell. It is about those persons I wish to talk to you today; specifically, I wish to discuss "Fraud on the Seller of Securities". It is a subject to which enforcement agencies have given thought, but a field in which we have not had an opportunity to explore to the same extent as in the field of fraud upon the buyer of securities. For that reason we do not have the same well developed pattern of corrective action and remedies that we are accustomed to in the other field.

As I see it you and we have conceived our duty as one of protecting the public from wasteful exploitation. Is there any difference in protecting people from purchasing securities from highly skilled promoters, than there is in protecting persons who have ventured into the securities field from selling their securities to persons who adopt almost as vicious a technique in persuading the sellers to give up their investment by nondisclosure and deceit? I think not.

Consequently, in today's discussion I will no more than briefly refer to a few provisions of the 1933 and 1934 Acts, solely in order to emphasize recent developments in the campaign against securities frauds.

Generally speaking, the first of the Acts, the Securities Act of 1933, was designed to bring about adequate disclosure of the nature of securities to be offered for sale to the public and to prevent fraud in their distribution or sale. Although certain securities and certain security transactions are exempted from the registration provisions of that Act, there are no exemptions from its anti-fraud section, Section 17 (a).

The Securities Exchange Act of 1934 and its subsequent amendments were designed to regulate trading in securities - the purchase and sale

of securities - on national securities exchanges and in the over-the-counter markets, and to regulate brokers and dealers. The Act and its amendments were designed to strengthen the fraud prevention and disclosure provisions of the prior Act. One step in that direction was the promulgation of a Rule by the Commission, now known as Rule X-15C1-2, adopted pursuant to Section 15 (c) of the 1934 Act. That Rule prohibits fraud by brokers and dealers in either the sale or purchase of securities. Another loophole, however, was still to be closed in the protections administered by the Commission. The step to close that loophole was taken in May 1942 when the Commission, acting pursuant to Sections 10 (b) and 23 (a) of the Act, adopted Rule X-10B-5. This Rule embodies the broad anti-fraud provisions of Section 17 (a) of the 1933 Act, and specifically prohibits fraud *by any person* in connection with the *purchase or sale* of securities. The Rule reads as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange --
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> (1) To employ any device, scheme, or artifice to defraud;
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> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
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> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security."

I choose to talk to you about this because many inquiries showing great public interest in the application of this rule have been sent to the Commission. I would like to present to you the facts of several cases. These are not hypothetical situations. I want to emphasize, however, that a recitation of the facts of these cases is not in any way to be taken as delimiting the extent of the rule. Fraud of itself is not a fact. It is but a conclusion to be drawn from facts. As Judge Lamm of the Supreme Court of this State 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." 1/

A little more than a year after the adoption of the rule, the Commission published a report on its investigation concerning "The Repurchase

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

and Retirement of Ward LaFrance Truck Corporation Stock". Therein, it also gave its opinion on the standards of fair play imposed by the rule. In that case, two officers who were in control of the Truck Corporation, entered negotiations with Salta Corporation with a view to selling their interest and merging the Truck Corporation and Salta. Those officers during the period of negotiation, after it appeared probable that the deal would be consummated, and well aware of the figures at which it would probably be made, authorized an employee of a registered broker-dealer to purchase in the over-the-counter market for the account of the Truck Corporation its publicly held shares. This increased the percentage of their outstanding holdings and the value thereof almost as if they had purchased the shares for themselves. During that period shares were obtained at prices ranging from approximately $3 to $6 per share. None of the stockholders who sold their shares were advised that the Truck Corporation was the ultimate purchaser. They were not told of the negotiations to sell the controlling shares at approximately $45 per share, and of the liquidation of the Truck Corporation. There was no disclosure of the amount to be paid on liquidation, approximately $25. Nor were they informed of the greatly improved earnings - although they had received financial statements in 1941 which showed earnings of $2.75 per share, they were not aware that earnings per share in 1942 were approximately $15.75.

After the contract was signed, the broker-dealer was authorized to cease purchasing shares for the Truck Corporation and to purchase for Salta. Between the signing of the contract and the closing date, Salta purchased shares at varying prices as low as $6 per share. But still no disclosure was made to stockholders of the identity of the new purchaser or of the other facts concealed prior to the signing of the contract.

After the closing date the officers, who were directors as well, caused the Board of Directors of the Truck Corporation to approve the plan of liquidation and then sent an announcement together with proxies to stockholders of the Truck Corporation informing them of the director's action and of a stockholders' meeting to act on the plan of liquidation. Immediately thereafter, the controlling shares were transferred to Great American Industries, Inc., to which Salta had changed its name. The plan was accordingly approved by Great American as the majority stockholder.

It is clear that without the disclosure of the current operating results in 1942 which were known to those in control, and which were made available to Salta by them, stockholders could not have acted intelligently with reference to the sale of their stock. Moreover, to deal fairly with shareholders it was necessary to disclose the proposed liquidation and the approximate price to be paid to stockholders thereon upon that liquidation, which facts were known to the purchasers. Although shareholders were to receive the book value of their shares in liquidation, non-disclosure of the amount likely to be paid and actually paid those in control acted as a deceit upon shareholders by leaving them completely in the dark as to the real value of their interest in the corporation.

In order to conceal these facts, it was necessary that the identity of the purchasers should not be disclosed. This completed the abuse of

the use of inside information by insiders, completely shutting off any light the shareholders might have had as to what was taking place in their corporation.

There was a clear necessity for the issuer and those in control to make timely and adequate disclosure of the facts I have mentioned. The Commission held that the purchase of securities under such circumstances unaccompanied by appropriate disclosure of material facts constituted a violation of Rule X-10B-5.

After the Commission brought these facts to the attention of the parties involved, arrangements were made by the two officers and directors, by the Truck Corporation and by Great American, to pay the public stockholders the difference between approximately $35.98 per share and the cost to those parties of the shares purchased from such stockholders or the amount paid public stockholders on liquidation. Such payments amounted to approximately $165,000 and insured shareholders participation in the benefits of their company's earnings.

This is the only case arising under the Rule in which a public release by the Commission has been issued. Although no publicity has been given as yet to the facts in the cases which I am about to present, I think you will find the requirements of the Rule well illustrated with respect to the standards of fair play it imposes. In all the following cases, of course, as in the Ward LaFrance case, the necessary requisite of jurisdiction, the use of the mails or instrumentalities of interstate commerce, were present.

Let me describe some of the cases. A director, who was also an officer and voting trustee of a corporation, knew that a very favorable contract for the sale of valuable assets had been consummated and approved by the Board of Directors and that a liquidating dividend was to be paid stockholders from the proceeds of that sale. He was advised by counsel to the corporation of the applicability of state law to dealings in stock of the issuer. Nevertheless, after the approval of the contract but before the announcement of its terms and of the imminent dividend to be paid shareholders many weeks later, he purchased a considerable number of shares from the outstanding public security holders. Purchases were effected at the prevailing low prices in the over-the-counter market through registered broker-dealers, some of whom circularized stockholders from a list which he supplied. The identity of the purchaser was concealed and purchases were made without disclosing the terms of the sale and of the fact of the imminent dividend. Of course after the company publicly announced those facts, the market price of the securities was greatly enhanced.

Regardless of this director's liability under applicable state law, our consideration was necessarily governed by Rule X-10B-5. Here, as in the Ward LaFrance case, the public security holders were taken advantage of. The director withheld facts which were essential to the formation of an intelligent judgment with respect to the value of their securities. Any clue as to the identity of the purchaser which might have led them to make inquiries of him or the company was effectively concealed. His

failure to disclose his identity of course enabled him to abuse completely the use of inside information. It follows therefrom that the purchase of securities under such circumstances unaccompanied by appropriate disclosure of material facts was a fraud upon the seller and in violation of the provisions of Rule X-10B-5.

Hence, any broker-dealers who engaged in such transactions with knowledge of such omissions violate Rule X-10B-5 as well as Rule X-15C1-2.

I am glad to say that when these conclusions were called to the attention of the director, offers of rescission were extended to all stockholders from whom he had purchased stock.

Now, as illustrative of cases involving the repurchase of securities by an issuer, let us look at this situation: A foreign municipality consulted with a registered broker-dealer with respect to the redemption of a bond issue which was in default as to interest. Arrangements were made with the broker-dealer to advertise for the municipality's bonds at a flat price considerably less than the face amount of the bonds and the past due interest thereon, and to indicate that purchases were for the account of certain banks. After a great many bonds had been so purchased the issuer, in accordance with the plan devised by the broker-dealer, redeemed the remainder of the outstanding bonds at the face amount plus the interest due thereon.

The fact that monies were available to enable the issuer to repurchase its bonds at a discount and subsequently to redeem them at their face amount plus the past due interest, was completely unknown to bondholders. The necessary non-disclosure of the identity of the issuer as the true purchaser prevented the bondholders from discovering that monies were available, thereby placing them at a disadvantage in dealing with the broker-dealer handling the transactions. But, here, not only was there a failure to disclose the identity of the purchaser, there was an affirmative representation that someone else was the purchaser which acted as a deceit upon the bondholders. There can be little doubt therefore that the purchase of securities by an issuer under such circumstances accomplished by a misrepresentation and a failure to state material facts was a fraud upon the seller and in violation of Rule X-10B-5. Furthermore, when affirmative misrepresentations and omissions to state material facts are made in furtherance of a plan or program of an issuer under such circumstances, it is my opinion that a scheme to defraud has been employed within the meaning of Rule X-10B-5.

Here is another situation involving the repurchase of securities by an issuer: A company in control of an issuer purchased units consisting of preferred and common stock of the issuer from its outstanding public shareholders. Purchases were effected in the over-the-counter market through a registered broker-dealer who circularized stockholders from a list supplied by the issuer. Disclosure was not made of the identity of the purchaser or of the fact that the shares were being purchased for the benefit of the issuer to whom they were resold at cost. Although financial statements were submitted to its stockholders annually, they were inadequate as they failed to reflect the outstanding number of shares, giving thereby no basis by which the book value of the shares

could be determined and no indication of the repurchase program. Furthermore, without reference to a profit and loss statement which was furnished only upon request, shareholders had no indication of the improved earnings. And it was those earnings that supplied the monies for the repurchase of its securities rather than being distributed to shareholders as dividends, which, in this particular case, as I recall, were in arrears with respect to the preferred stock.

The security holders of this issuer could not have made an intelligent judgment with respect to the value of their securities without timely and adequate disclosure to them of the financial condition of their company, a disclosure which should have corrected the deceit inherent in the balance sheet and included an indication of its improved earnings. And, here too, the repurchase of its shares by the issuer with its own funds not only increased the percentage but the value of the outstanding shares held by the company in control. In addition, in order to circumvent inquiries by shareholders, it was necessary to conceal the identity of the purchaser and the fact that the purchases were being made for the account of the issuer. Consequently, not only was the fact that the issuer was repurchasing completely camouflaged but the identity of the company in control which made the purchases was also effectively screened. Thus, shareholders were at a complete disadvantage in dealing with their own corporation and those in control.

The purchase of securities therefore under the circumstances I have just described, unaccompanied by appropriate disclosure of material facts, constituted a violation of Rule X-10B-5. Furthermore, when such omissions of material facts are part of a plan or program of an issuer - and those in control - to repurchase its securities at prices which they have deliberately depressed by inadequate disclosure of the financial condition of the company and by withholding dividends, the retention of which could clearly serve no proper corporate purpose, at the same time using such surplus earnings to repurchase its securities to the disadvantage of the public shareholders and to the advantage of those in control, it is my opinion that a scheme to defraud has been employed within the meaning of Rule X-10B-5.

There are now three cases that I would like to bring to your attention which also involved securities traded in the over-the-counter market. The first is this: A corporation issued calls for tenders of a portion of its bonds at a maximum acceptable price. Notices accompanying the requests for tenders gave certain information with respect to the value of the bonds. However, undisclosed to bondholders, the prevailing market price of the bonds was considerably higher than the maximum acceptable call price at the time tenders were requested.

In the second instance, controlling stockholders of a company, in accordance with the terms of the agreement whereby control was acquired, offered to purchase the shares of the outstanding public shareholders at the same price per share at which control had been acquired. Complete financial statements and a notice detailing the terms of that agreement accompanied the offer submitted to the shareholders. Again undisclosed to such shareholders, the prevailing market price at the time of the offer was substantially higher than the offering price.

The third instance involved an offer to purchase the securities of the outstanding public security holders of an issuer by a company which had recently acquired a large block of shares from former offices and directors. It was pursuant to the terms of the agreement for the purchase of that large block of shares that the same price per share was offered to stockholders. The offer set forth the details of the agreement of purchase and its time was extended in order to allow financial statements of the company to be submitted to its shareholders. And once more, undisclosed to the shareholders, the prevailing market price at the time of the offer was considerably higher than the offering price.

In such situations, shareholders are generally unaware of the higher market price. Since an offer to purchase securities at a price, accompanied by representations as to the value of the securities involved, contains an implied representation that such offering price is at least equal to the current market price, the failure to disclose the existence of a higher market price at the time the offer is made constitutes an omission to state a material fact in violation of Rule X-10B-5.

These matters were brought to the attention of the Commission after the offers had been submitted to security holders. However, the situation was rectified. All security holders who had tendered their securities and received payment pursuant to the offer were informed that a higher market price prevailed at the time the offer was made and were given an opportunity to rescind. The security holders who later tendered their securities were likewise informed and given an opportunity to withdraw.

Some of the cases I have discussed involved, among other things, the failure of an issuer to disclose that it was repurchasing its securities. We have been asked many times whether such failure is of itself a violation of the rule. Experience in such situations has shown that non-disclosure of the identity of the issuer as purchaser has generally been accompanied by other circumstances which make that omission material. Such non-disclosure, even though no affirmative misrepresentations be made, often activates schemes to defraud, particularly in those situations when the securities being repurchased are, for example, bonds in default as to interest or stock with dividend arrearages. Ordinarily, of course, disclosure that the issuer is purchasing might well be sufficient if made in annual statements to security holders or by reason of other publicly made statements. When considering such statements it would be well to bear in mind that it is imperative for them to be widely disseminated. In that connection, I call to mind a situation where valuable ore deposits were discovered on the property of a mining corporation. Announcement was made in Western mining publications but received little notice in the East where several stockholders sold their shares at the prevailing low prices. So too much reliance should not be placed upon the mere fact that some sort of public statement is made.

It is apparent therefore that philosophical treatises could be written upon the subject of material facts, the omission of which would come within the Rule, as well as about the necessity for representations upon which to predicate such omissions. Sharp tongued intent to take

advantage of security holders and to induce them to sell may well devise ways and means of avoiding any affirmative respresentations within the Rule. You can well see the closeness of such dealings to schemes to defraud. It appears to me, then, that that measure of protection Congress desired to afford the public investor can only be obtained under a flexible rule fraught with danger to unscrupulous devices of any person in connection with the purchase and sale of securities.

Although in several of the above cases the Commission took no action when rescission was extended shareholders by the violators of the rule, the need for more drastic action to protect the unwary and ignorant investor is more and more apparent. And in this connection, because of the constant increase in the number of cases, the Commission will be resorting to the remedies it has at its disposal, the injunctive process, broker-dealer proceedings and finally, criminal prosecution.

I wish to close with this statement of a jurist:

> "We do not deem it advisable to lay down any hard and fast rule. * * * Were we to do so, a certain class of gentlemen of the 'J. Rufus Wallingford' type -- 'they toil not neither do they spin' -- would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises." 2/

2/ *State* v. *Whitaker*, 118 Oregon 656, 247 Pacific 1077, 1079.