

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

UNITED STATES OF AMERICA)
)
 v.) No. 99-203 Criminal
)
JOHN GARDNER BLACK)

JOINT STIPULATED FACTUAL BASIS PURSUANT TO FRCRP 11(f)

AND NOW comes the United States of America by Harry Litman, United States Attorney for the Western District of Pennsylvania, Leon Rodriguez, First Assistant United States Attorney, and Robert S. Cessar, Assistant United States Attorney and the defendant, JOHN GARDNER BLACK, and file this joint stipulated factual basis pursuant to FRCRP 11(f):

PROCEDURAL HISTORY

1. The defendant is charged an indictment with seventy-eight counts of Fraud by an Investment Advisor, in violation of Title 15, United States Code, Sections 80b-6(2) and 80b-17 (Counts 1 to 78), nine counts of Mail Fraud, in violation of Title 18, United States Code, Section 1341 (Counts 79 to 87), 34 counts of Making a False Statement, in violation of Title 18, United States Code, Section 1001 (Counts 88 to 120 and 134) and thirteen counts of Engaging in monetary transactions in property derived from specified unlawful activity, in violation of Title 18, United States Code, Section 1957 (Counts 121 to 133).

2. By agreement dated January 24, 2000, the defendant has agreed to plead guilty to the counts identified in Exhibit "A", annexed hereto.

FACTUAL BASIS

3. Pursuant to Federal Rule of Criminal Procedure 11(f), the parties stipulate to the following factual basis in support of the defendant's entry of a guilty plea:

4. The defendant, JOHN GARDNER BLACK, was the chief executive officer of Devon Capital Management, Inc. (hereinafter, "Devon").

5. Devon was an investment advisor registered with the United States Securities and Exchange Commission and was subject to the provisions of the Investment Adviser's Act of 1940, Title 15, United States Code, Section 80b-1, et seq.

6. Devon was a subchapter S corporation incorporated under the laws of the State of Maryland, with its primary place of business at 5 West 10th Street, Tyrone, Pennsylvania.

7. Beginning on or about December 27, 1993 the defendant, JOHN GARDNER BLACK, was the sole shareholder of Devon.

8. Devon was in the business of providing investment advisory services to local governmental units, primarily school districts in the Commonwealth of Pennsylvania and other states, and also non-profit organizations.

9. Beginning on or about April 20, 1992, the defendant, JOHN GARDNER BLACK was an officer of Financial Management Sciences, Inc. (hereinafter, "FMS").

10. Beginning on or about April 20, 1992, FMS was a corporation incorporated under the laws of the Commonwealth of Pennsylvania.

11. Beginning on December 27, 1993, the defendant, JOHN GARDNER BLACK, was the majority shareholder of FMS.

12. Beginning on or about October 9, 1996, the defendant, JOHN GARDNER BLACK, was the sole shareholder of FMS.

13. Beginning on or about May 27, 1994, FMS was in the exclusive business of investing funds of Devon clients pursuant to contracts between Devon and FMS, known as Collateralized Investment Agreements (CIA's).

The Investment Advisor's Act of 1940 and Related Regulations

14. The Investment Advisor's Act of 1940, 15 USC § 80b-2 (11) defined an investment adviser as:

. . . any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . .

15. The Investment Advisor's Act of 1940 set forth certain types of transactions and business practices as prohibited for investment advisors. Title 15, United States

Code, Section 80b-6 (Prohibited transactions by investment advisers) provided, in relevant part, as follows:

It shall be unlawful for any investment advisor, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly--

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction . . .

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The [Securities and Exchange] Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

16. At all times material to this Indictment, Devon, as an investment adviser was subject to rules and regulations

promulgated by the Securities and Exchange Commission pursuant to authority vested by the Investment Advisor's Act of 1940.

17. Title 17, Code of Federal Regulations, Section 275.204-2 required investment advisors to keep true accurate and current books and records relating to their advisory business.

18. Pursuant to Title 15, United States Code, Section 80b-4, records required to be kept pursuant to Title 17, Code of Federal Regulations, Section 275.204-2, were subject to inspection by officials of the Securities and Exchange Commission at any reasonable time.

19. Title 17, Code of Federal Regulations, Section 275.206(4)-4 provided in relevant part that it shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business to fail to disclose to any client "all material facts with respect to any financial condition of the adviser that are reasonably likely to impair the ability of the adviser to meet contractual commitments to the client, [or] a legal event that is material to an evaluation of the adviser's integrity and ability to meet contractual commitments to clients."

Investment Advisory Agreement

20. At all material times, the investment advisory services of Devon purported to include directing the investment of various funds held by clients in appropriate securities and other instruments, and in accordance with applicable laws.

21. At all material times, clients agreeing to use the investment advisory services provided by Devon entered into Investment Advisory Agreements which set forth certain obligations of Devon and the client related to the investment of the clients' funds.

22. Each Investment Advisory Agreement contained, *inter alia*, the following provisions:

- a) Devon was authorized to act as an investment advisor on behalf of the client;
- b) Devon promised that it would not transfer cash or securities out of the client's account;
- c) Devon agreed that it would "not take possession of or act as custodian for the cash, securities or other assets of the [clients]."
- d) On execution of the agreement, a custodian bank would be designated either by Devon, or if the client so wished, by the client, which bank would have custody of all cash, securities or other assets of the client;
- e) The agreement represented that the custodian would provide an appropriate record of all activities and provide the client with monthly statements detailing security

purchases, sales and redemptions, interest earnings and the fair market value of the assets in the account as of the last business day of each month;

- f) Many, but not all, of the agreements advised the client that they may be directed to enter into contracts invest with Financial Management Sciences, Inc., an affiliate of Devon, but only if such investment was prudent and permitted under law.

The Collateralized Investment Agreement

23. In May 1994, the defendant, JOHN GARDNER BLACK, began investing client funds using a vehicle which he called a Collateralized Investment Agreement (hereinafter, the "CIA").

24. At all material times, a CIA was a contract between Devon, on behalf of a client, and FMS as a guarantor of a specified rate of return to the client. The client was not a signatory to the CIA.

25. At all material times under the CIA, FMS represented that it would secure or collateralize the investments of the client with securities having a fair market value¹ equal to or greater than 100% of the clients' investments in the CIA program.

¹"Fair market value" is hereinafter defined as the price which property will bring when offered for sale by a willing seller to a willing buyer, each on equal footing and with complete information, and neither being obliged to buy or sell.

26. During the time period material to the Indictment, funds of approximately forty-eight school districts in the Commonwealth of Pennsylvania and those of Harford County, Maryland were invested through the CIA program.

27. At all material times, securities maintained as collateral for CIA obligations for the forty-nine clients were maintained in one or more bank accounts at Mid-State Bank which were designated as collateral accounts.

28. At no material time as of January 1, 1995, did the collateral accounts hold collateral at a ratio of 100% of the fair market value of client funds invested in CIA's.

Representations in Marketing Materials

29. The marketing of investment advisory services was performed by a sales force employed by Devon.

30. It was the function of the sales force to identify potential clients and provide them with solicitation materials. The solicitation materials ensured the safety of investments and at times, stated to prospective clients that their funds would not be pooled.

31. Parties showing interest in Devon's investment advisory services were furnished with a proposal which set forth rates of return, and the fees to be charged to the prospective client's account.

32. The proposals stated that customers funds would be invested in "United States Treasuries and Agencies," and further

stated that Devon guaranteed or assured no loss of the client's principal.

33. Many of the proposals referring to the collateralized investment agreement either quoted or paraphrased the requirement that collateral would be maintained at 100 % of the fair market value of the client's outstanding investment.

34. At times, the solicitation materials and proposals used by the sales force were reviewed and approved by the defendant, JOHN GARDNER BLACK, and also, at times, by the law firm of Kutak Rock.

Concealment of Losses

35. Beginning in February, 1994 and continuing through 1994, the Federal Reserve Board ordered a series of increases in short-term interest rates. In this same period, the London Interbank Offered Rate ("LIBOR"), an index used in calculating rates of return on investments, including those of FMS, approximately doubled.

36. As a result of this shift in interest rates, all fixed rate securities, including securities deposited as collateral for the investments of client-beneficiaries of CIA's, sustained losses which reduced the fair market value of the collateral assets below the money which would have been owed to client beneficiaries of CIA's had they all requested their monies at approximately the same time.

37. The shortfall between the face amount of the CIA and the liquidation value of assets persisted between late 1994 and September 26, 1997, when the defendant's operations were placed in trusteeship by the United States District Court for the Western District of Pennsylvania. As of September 26, 1997, the shortfall was \$61.3 million.

38. FMS funds were also used for payment of FMS operating expenses; payments to clients outside of the CIA program; settlement of a lawsuit with a former FMS shareholder; and purchases of options and futures held outside of the collateral account.

39. Although clients and prospective clients received numerous mailings from the defendant, including proposal letters, investments advisory agreements, monthly statements, and end-of-year collateral reports, the defendant, over a period of over two and one-half years never disclosed the shortfall to any clients.

Collateralized Mortgage Obligations

40. At all material times, the defendant used collateralized mortgage obligations ("CMO's") as collateral for the CIA clients.

41. From May 27, 1994 until January, 1996, the collateralized mortgage obligations were maintained in three separate collateral accounts at Mid-State Bank.

42. In January, 1996, the collateral accounts were merged. Thereafter, until September 26, 1997, the collateralized mortgage obligations were maintained in one collateral account.

43. In August, 1996, Pennsylvania Auditor General Barbara Hafer issued a letter to Pennsylvania school districts ("Hafer letter") in which grave concerns about investments by school districts in CMO's was raised.

44. As a result of the Hafer letter, a number of clients inquired whether their funds had been invested in CMO's. Devon response to client inquiries failed to disclose that client funds had, in fact, been invested in collateralized mortgage obligations.

45. At all material times, on internal records pertaining to the value of the collateral, the defendant failed to mark collateralized mortgage obligations to the liquidation value as promised in the collateralized investment agreement and in solicitation materials.

46. At the end of each school year, numerous school district auditors would request reports of the collateral being applied to CIA client accounts. The reports would contain the names of securities allocated as collateral, their CUSIP number, their par, and their coupon rate. On reports where collateralized mortgage obligations were listed, they were not marked to the liquidation value as promised in the collateralized

investment agreement and in solicitation materials, thereby concealing the shortfall in the collateral account.

47. In January 1996, the defendant, JOHN GARDNER BLACK, purchased a CMO inverse floater with CUSIP (Committee on Uniform Securities Identification Procedures) number 31359EEN7 (hereinafter, the "EEN7") for approximately \$14,130,000.00 plus accrued interest, representing 1,088,000 shares at an average price of \$14.37 per share.

48. On February 20, 1996, the defendant, JOHN GARDNER BLACK, directed the preparation of an internal collateral report used by FMS, which valued the "EEN7" at a price of \$34.00 per share.

49. On May 15, 1996, the defendant, JOHN GARDNER BLACK, directed the preparation of an internal collateral report used by FMS, which valued the "EEN7" at a price of \$35.00 per share.

50. In August 1996, the defendant, JOHN GARDNER BLACK, directed the preparation of an internal collateral report used by FMS, which valued the "EEN7" at a price of \$43.20 per share.

51. In November 1996, the defendant, JOHN GARDNER BLACK, directed the preparation of an internal collateral report used by FMS, which valued the "EEN7" at a price of \$96.50 per share. This same value was recorded on end-of-year collateral reports sent to clients and auditors in the Summer of 1997.

52. At the direction of the defendant, end-of-the-year collateral reports prepared in the summer of 1997, understated

the number of shares of the EEN7, which was allocated as collateral to the accounts of clients. This was accomplished by the preparation of multiple internal collateral reports which allocated the EEN7 in higher proportion to clients who either had already received collateral reports or had not requested collateral reports.

53. In or around September 1997, Devon clients holding CIA's had outstanding investments of approximately \$233,000,000.00. Under the correct fair market valuation of the EEN7, the assets of FMS and those held by it as collateral for the CIA's of Devon clients in or around September 1997 amounted only to approximately \$164,000,000.00, and approximately \$7,000,000.00 of FMS assets. As of September 26, 1997, the yield for the CIA portfolio was approximately fourteen percent annually.

THIS STIPULATION is hereby entered into and agreed upon by
the parties this 24th day of January, 2000.

For the United States:

HARRY LITMAN
United States Attorney
PA I.D. No. 51634



LEON RODRIGUEZ
First Assistant U.S. Attorney

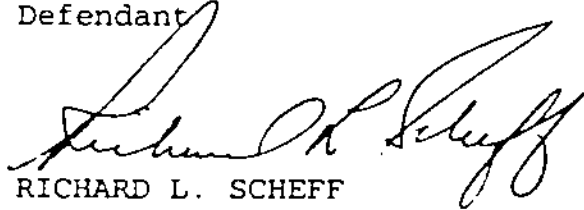


ROBERT S. CESSAR
Assistant U.S. Attorney

For the Defendant, JOHN GARDNER BLACK



JOHN GARDNER BLACK
Defendant



RICHARD L. SCHEFF
Montgomery, McCracken, Walkers & Rhoads
Attorney for Defendant

Exhibit "A"
Schedule of Guilty Plea Counts

Investment Advisor Fraud

<u>Count No.</u>	<u>CIA Date</u>	<u>Client</u>	<u>Account Number</u>
One	May 27, 1996	Bald Eagle	766117105
Four	March 23, 1995	Bentworth	766102107
Eight	June 30, 1997	Big Beaver Falls	765054101
Nine	July 5, 1994	Blacklick	767017106
Fourteen	February 21, 1997	Canon-McMillan	766119101
Eighteen	November 10, 1995	Clarion Area	766106108
Twenty-One	May 27, 1994	Clearfield Area	766081103
Twenty-Three	January 7, 1997	Daniel Boone	768076101
Twenty-Five	July 1, 1997	Elk Lake	768081101
Thirty	June 17, 1997	Hampton	766121107
Thirty-Four	August 26, 1997	Jeannette	766122105
Thirty-Seven	September 23, 1996	Laurel Highlands	765060108
Forty-Three	July 1, 1997	Moshannon Valley	768089104
Forty-Eight	June 9, 1994	Northern Lebanon	766091102
Fifty	July 1, 1997	Pen Argyl	768084105
Fifty-Seven	July 1, 1997	Penns Manor	768080103
Sixty	July 1, 1997	Riverview	768085102
Sixty-Two	July 1, 1997	Sharon City	768094104
Sixty-Four	June 10, 1996	South Butler	766114102

Sixty-Seven	August 22, 1994	Tyrone Area	766095103
Seventy-Three	July 1, 1997	Warwick	768083107

Mail Fraud

Eighty-Four	July 10, 1997	Keystone Oaks	Collateral Report
Eighty-Six	August 4, 1997	Daniel Boone	Collateral Report
Eight-Seven	August 12, 1997	Tyrone Area	Collateral Report

False Documents

Ninety-Six	January 7, 1997	Daniel Boone	768076101
One Hundred Seventeen	August 22, 1994	Tyrone Area	766095103