

**UNITED STATES COURT OF APPEALS  
FOR THE THIRD CIRCUIT**

SECURITIES EXCHANGE COMMISSION)	)	
("SEC" or "Commission")	)	
	)	
Vs	)	No. 07-1031
	)	D.C. No. 97-cv-02257
	)	
JOHN GARDNER BLACK, Pro Se	)	
("Appellant")	)	

**APPELLANT'S REPLY BRIEF**

With the exception of this case, never in the history of securities litigation conducted before any district court in this circuit, or in any published opinion of this Court of Appeals for the Third Circuit, has an alleged securities violation been allowed to proceed without at least a statement that the security in question was "offered, purchased or sold" at non-market values or that the value of that security was misrepresented to the detriment of the investor. In this particular case, the United States Securities Exchange Commission, acting ex

*parte* and without notification to Appellant, requested that the District Court for the Western District of Pennsylvania issue a temporary restraining order and asset freeze. That District Court, acting *ex parte* and without notification to Appellant, issued the SEC's requested orders predicated upon a complaint ("Complaint") that the SEC knew, should have known or was willfully blind in not knowing was being filed fraudulently. The Complaint alleged that Appellant was violating the securities laws by following a business practice specifically required by federal regulations. The results of those orders were:

1. Shareholder value of over \$269 million in the Collateralized Investment Agreement ["CIA"], a value determined pursuant to federal regulations and legal precedent in this Circuit, was jeopardized and a loss of tens of million in dollars lost by investors.
2. Three debt free and profitable corporations owned by Appellant, with a combined value of over \$35 million were seized, looted, liquidated, and placed into bankruptcy. (The bankruptcy trustee and court would later admit and determine that the owners of the CIA did not receive its fair value.)

3. Appellant, after pleading not guilty to a grand jury indictment and executing a Joint Stipulation of Facts ("JSF") in which the government admitted to the elements of securities fraud, was incarcerated for a term of 41 months and ordered to pay restitution in the amount of \$61 million.

On April 16, 2007, almost ten years after the institution of these proceedings, the SEC has filed a brief ["Brief"] with this Court in which it admits to the elements of securities fraud.

### **THE FACTS**

1. The CIA was a security. This fact has been determined by the district court and upheld by this Court.

2. The CIA was an investment contract as defined by the US Supreme Court in *SEC v Howey*, 328 U.S. 293 (1946). The US Supreme Court has held [*Securities Exchange Commission v Edwards*, 540 U.S. 389 (2004) ] that:

The test for whether a particular scheme is an investment contract was established in our decision in SEC v. W. J. Howey Co., 328 U. S. 293 (1946). We look to "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." Id., at 301. This definition "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." Id., at 299.

That Court would go on to say:

...when we held that "profits" must "come solely from the efforts of others," we were speaking of the profits that investors seek on their investment, not the profits of the scheme in which they invest. We used "profits" in the sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.

3. A total of \$233 million was invested in the enterprise ["Enterprise"] through the CIAs. [Complaint ¶ 21]

4. Attached as an exhibit to the Brief was the document titled "Joint Stipulated Factual Basis Pursuant to FRCRP 11(f)". This document was executed between the government and Appellant on January 24, 2000.

5. The net forced liquidation value of the Enterprise, as admitted and stipulated in the JSF, was \$171 million. [JSF, ¶53]

6. The return on assets, as admitted and stipulated in the JSF, was 14%. [JSF, ¶53]

7. Neither the Complaint nor the JSF states the value of the CIA. Significantly, neither the Complaint nor the JSF states that Appellant ever misrepresented the value of the CIA. The district court, this Court and the United States Supreme Court have held that an investment contract's value is based upon a reasonable expectation of profits to be derived through the efforts of others.

8. This Court has held that the value of an asset is equal to the "present discounted value" of the all the future earnings on that asset. [*Lattera v Commissioner IRS*, 437 F.3d 399 (3<sup>rd</sup> Cir 2006)] This ruling is consistent with the "... fundamental principle of economics [in] that the value of an asset is equal to the present discounted value of all the expected net receipts from that asset over its life." [William A. Klein et al., *Federal Income Taxation* 786 (12th ed. 2000), *Id.*] See also *Commissioner v. P. G. Lake*,

*Inc.*, 356 U.S. 260, 265, 78 S. Ct. 691, 2 L. Ed. 2d 743, 1958-1 C.B. 516 (1958) and *United States v. Maginnis*, 356 F.3d 1179, 1181 (9th Cir. 2004)) See also Arbitrage Regulations, published by the Internal Revenue Service requiring present value accounting, [26 CFR 1.148-5(d)]

**VALUATION OF THE CIA PURSUANT TO EXISTING CASE LAW AND PUBLISHED FEDERAL REGULATIONS**

The government and Appellant have stipulated and the SEC has now agreed that the forced liquidation value of the Enterprise was \$171 million and that the return on the assets of the Enterprise, derived through the efforts of Appellant, was 14%.

Therefore, pursuant to the stipulated facts, the net profits of the Enterprise that the owners of the CIA reasonably expected to receive were \$23,940,000 annually.

Multiplication of the actuarial formula for a present value factor  $[(1+rate)^{-n}]$  where  $n$  equals the number of years from time 0] times the expected profits to be derived from ownership of the CIA yields a present value for the CIA of over \$269 million, utilizing a dividend rate of 5.50% and a present value rate of 8%.

Application of conservative valuation metrics derived from publicly traded companies in the same industry, [i.e. a price earnings ratio of 7, or a price to book ratio of 7.5] results in a value for the Enterprise of over \$1 billion.

[Note: It is only in this case that this Court has applied the valuation method advanced by the SEC, i.e. forced liquidation of assets. In *Bald Eagle v Keystone Financial*, 189 F.3d 321 (3<sup>rd</sup> Cir 1999) Judge McKee ignored the legal precedent of this Court and the US Supreme Court as well as published federal regulations when he held, "...the CIAs purchased by the School Districts were worth significantly less than their purchase price because of the shortfall in the collateral in the funds already under management..." Not only had the value of the CIA not been alleged by the SEC, application of existing case law and federal regulations produce a value far in excess of the transacted value.]

[Also note: Existing, published federal regulations, promulgated by the Internal Revenue Service preclude the

owners of the CIA from acquiring an investment in which the terms are not commercially reasonable.]

### **THE ARBITRAGE REGULATIONS**

The SEC has disingenuously claimed that the published Internal Revenue Service ("IRS") Arbitrage Regulations merely "...establishes a cap on the earnings on investments made with the proceeds of tax-exempt bonds..." The SEC is aware that the Arbitrage Regulations provide much more than just a cap. Those regulations impose strict guidelines on all municipal issuers on accounting for their investments. If a municipality, an employee or any retained consultant fails to adhere to the strict provisions of those regulations, the result is the IRS will declare the interest received by an investor on the tax-exempt bonds as taxable. ["Violation of these provisions causes the bonds in the issue to become arbitrage bonds, the interest on which is not excludable from the gross income of the owners under section 103(a)".26 CFR §1.148-0(a)]

The SEC has claimed that Appellant did not provide a specific accounting and valuation for a single investment

in the Enterprise. A single class of investments is defined in the Arbitrage Regulations as the proceeds for a bond issue used to finance a governmental purpose. Neither the SEC nor the US Attorney has ever claimed that the individual assets of the Enterprise were separate "classes" of investments. Appellant has always accounted for the investments in the Enterprise as constituting a single class because they were derived from the proceeds of municipal bond issues. [Complaint ¶17]

"Yield on a separate class of investments—(i) In general. For purposes of the yield restriction rules of section 148(a) and §1.148-2, yield is computed separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individual investment within the class is blended with the yield on other individual investments within the class, whether or not held concurrently, by treating those investments as a single investment." [26 CFR 1.148-5(b)(2)(i)]

The regulations Appellant and his clients had to follow are quite clear. If Appellant had presented the market value for each individual investment as both the SEC

and the US Attorney for the Western District of Pennsylvania claim he should have done, Appellant and his customers would have been in violation of 26 CFR 1.148-5(b)(2)(i). A violation of those regulations "...causes the bonds in the issue to become arbitrage bonds..." Appellant and his companies had advised on the issuance and investment management of over \$3 billion in municipal bonds and their proceeds. Declaring those bonds as arbitrage bonds because Appellant did not follow the published regulations of the IRS could have caused over \$600 million in market value losses.

Earlier in 1997, the IRS conducted a full field audit of Appellant's corporations through December 31, 1994. The IRS issued a "no change letter" signifying full compliance with IRS regulations.

## **RESPONSE TO THE ARGUMENTS ADVANCED IN THE BRIEF**

**I. Argument: The district court correctly denied Black's Motion because he has not shown that the Commission committed fraud.**

The Commission concealed from the district court the provisions of the arbitrage regulations requiring Appellant

to present to the owners of the CIA the blended value on all investments in the Enterprise. The SEC is part of the federal government with unlimited resources and numerous lawyers. A total of four attorneys submitted the Brief. A government agency should be responsible for knowing the regulations of the government. Yet, the SEC filed its Complaint knowing that Appellant was prohibited by the government's own regulations from following the accounting methods the SEC demands.

The Commission has admitted to and the district court has found the elements of fraud. The SEC has now admitted to the Court that the book value of the Enterprise was \$171 million and has disclosed that the return on those assets was 14%. As detailed above, these elements produce a value for the Enterprise of \$269 million a fact fraudulently concealed by the SEC. Appellant cannot answer why the district court denied his motion since the SEC has admitted to the elements.

The Commission has also concealed from Appellant and the CIA owners that no other court has ever granted such broad powers that it caused the destruction of millions of dollars of shareholder value without notification and

predicated upon valuation theories and accounting practices expressly prohibited by established case law and/or published federal regulations.

**II. Argument: Black is precluded by his consents to the district court orders and by his guilty plea in the criminal case from contesting the Commission's allegations.**

Appellant Black is not contesting the Commission's allegations. Those allegations are that, according to the JSF, the book value of the Enterprise was \$171 million, the return on assets of that Enterprise was 14% and the CIAs, which the Commission stated in May of 2001 were securities[Exhibit 1], were sold to the investors for \$233 million. Utilizing established case law of this Circuit and the Supreme Court and after applying reasonable valuation metrics as noted above and as required by federal regulation, the fair market value of the CIA on September 26, 1997 was at least \$269 million. Neither Judge Ambrose, who litigated this issue in the absence of Appellant nor the government disputes this value. [Note: Appellant has been unable to secure transcripts, testimony or substantiating documents in the litigation.]

Appellant is not contesting the underlying facts of the criminal proceedings. Those facts include: (1)

Appellant did not plead guilty to the grand jury indictment alleging misrepresentation of the CIA's market value; the government moved and the district court ordered that the indictment be amended by deleting any reference to market value of the CIA preventing its litigation [Appellant Brief, Transcript, page 30]; (2) the book value of the Enterprise was \$171 million and the return on assets of that Enterprise was 14% [JSF ¶53]; and, (3) the market value of the CIA security was "...a point not agreed upon..." [Transcript, Appellant Brief Exhibit, page 30, quoting US Attorney Rodriguez]

**III. Argument: Even if Black were not precluded from contesting the Commission's allegations, his challenge to the Commission's complaint would have to be rejected because Black has not denied that he misrepresented the value of a security that served as collateral for his client's investments.**

This argument is not on point. Appellant is not arguing that the book value of the Enterprise was less than the market capitalization. What Appellant is stating is that the value of the CIA was not inaccurately reported to the owners. The blending of assets and the valuation method used, as noted above, are mandated pursuant to IRS regulations. It is the SEC which has refused to divulge the market value of the CIA, or to compensate the CIA's owners for its fair market value determined pursuant to

established case law and the federal government's own regulations and court filings. The owners of the CIA deserved to be compensated for their investment based upon "a reasonable expectation of profits to be derived from the managerial or entrepreneurial efforts of others."

[Appellant Brief, District Court Order of July 5, 2001, page 3]

The CIA was a security owned by Appellant's customers. It was the CIA's value that was material to its owners. No substantiated document filed in any court by any government official including the affidavit filed to obtain the search warrant of Appellant's offices, states that Appellant ever misrepresented the fair market value of the CIA.

#### **CONCLUSION**

Appellant is unaware of any other court opinion in which a securities violation was charged and proven without any finding that financial loss to investors occurred by a misrepresentation of that security's actual fair market value and a statement of loss attributed to the misrepresentation, as required under the Federal Sentencing Guidelines.

Appellant cannot find any other case in which a federal agency was able to obtain, without notice, court orders which caused millions of dollars in lost shareholder value and the forfeiture of three profitable, privately owned corporations, despite the fact that the respondent and his companies were complying with published federal regulations.

Regarding the criminal case the SEC references, Appellant cannot find another case in this Circuit in which an amended indictment has been declared enforceable under the Constitution. Neither the government, the SEC, the district court nor this Court can find in the record any statement or admission by Appellant that he misrepresented the market value of the CIA in the criminal proceedings, the only proceedings in which misrepresentation of market value was alleged. Likewise, there is no statement by any law enforcement agency or court as what the market value of the CIA was on September 26, 1997.

Fair market value, according to established case law in this Circuit as well as at the Supreme Court, must be

determined by valuing a reasonable expectation of profits, discounted to present value at a reasonable discount rate. To the best of Appellant's ability and limited resources, appearing *pro se*, he can find only in this case and even then only a single opinion, that the CIA's value was equal to the liquidation value of the Enterprise. That single opinion is contrary to established case law in this Circuit and at the Supreme Court and was not even alleged in the SEC's Complaint. Not only is the valuation advanced by this Court in *Bald Eagle* in conflict with all established precedent, it is not based upon sound financial accounting standards and requires a violation of existing federal regulations.

The district court has held that it has litigated the market value of the CIA, presumably on a present value basis consistent with precedent and regulations, and that court does not deny that the value of the CIA was \$269 million versus Appellant's representation of \$233 million. This Court has known the results of that litigation because the record, according to this Court's procedures, would have been advanced in any one of the numerous appeals filed in this case.

This Court must dismiss the Complaint filed without notice and *ex parte* by the Securities Exchange Commission. Since the orders issued by the district court on September 26, 1997 were issued without notification and were the functional equivalent of a default judgment causing the forfeiture of Appellant's three corporations, Devon Capital Management, Financial Management Sciences and Devon Financial Products, those orders are void. "...entry of a default judgment without proper service of a Complaint renders that judgment void." [*US v One Toshiba*, 213 F3d 147 (3<sup>rd</sup> Cir.1999) also *Gold Kist, Inc. v. Laurinburg Oil Co., Inc.*, 756 F.2d 14, 19 (3d Cir. 1985)]

April 23, 2007

Respectfully Submitted

John G. Black, *Pro Se*

CERTIFICATE OF SERVICE  
And WORD LIMITATION

I hereby certify that a true and correct copy of this:

**APPELLANT'S REPLY BRIEF**

Containing 3,062 words was sent to:

Christopher Paik  
Securities Exchange Commission  
100 F. Street, N.E.  
Washington, DC 20549

Clerk of the Court  
Commonwealth Court of Pennsylvania      No.: 128 FR 2006 Black v Pa  
6<sup>th</sup> Floor  
Irvis Office Building  
Harrisburg, PA 17120

Via first class mail, postage prepaid on April \_\_\_\_\_, 2007.

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John G. Black, Pro Se