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

SECURITIES AND EXCHANGE COMMISSION)	
)	
Plaintiff)	
)	Civil Action No.
vs.)	97-2257
)	
JOHN GARDNER BLACK,)	
DEVON CAPITAL MANAGEMENT, INC., and)	
FINANCIAL MANAGEMENT SCIENCES, INC.,)	
)	
Defendant)	

Transcript of: Ex parte motion for temporary restraining order.

Date: September 26 1997.

Before: William L. Standish, U.S. District Judge.

Reporter: Colvin Vogel, Official Reporter
1031 U.S. Courthouse
Pittsburgh, PA 15219
(412) 261-4095

APPEARANCES:

ON BEHALF OF THE SEC:

Michael J. Newman, Esq.
Deborah Siegel, Esq.

Also Present: William R. Meck

PROCEEDINGS

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THE COURT: Good afternoon.

Mr. Newman, what are you going to tell me about this.

MR. NEWMAN: Well, Your Honor, we provided the court with extensive documents regarding what we believe occurred here. But just to summarize, this case involves a registered investment adviser Devon Capital Management and its principal, Mr. John Black, who has their primary office in Tyrone, Pennsylvania. And they manage approximately 340 million dollars of client money. Most of Devon's clients are local school districts who were investing municipal bond offering proceeds with Mr. Black. We believe that Mr. Black has lost and/or misappropriated approximately 70 million dollars of his advisory client money, the principal. And most of the activity has occurred in connection with an investment called a Collateralized Investment Agreement which is a form of security that Mr. Black has put most of his clients money into.

THE COURT: I read the complaint, and I'm not sure I understood what he was doing with this.

MR. NEWMAN: Basically what he has is a contract under which he agreed to pay the clients a certain amount of interest over a fixed period of time, usually two years. The principal is guaranteed so that in two years the client

1 is to receive back the principal. And what Mr. Black is
2 representing to clients what backs this contract are a pool
3 of securities that are equal to the value of the investment.
4 And what we believe happens is, as I said, the money, a
5 substantial amount of money, has been lost primarily through
6 trading losses. And the way Mr. Black is concealing this --

7 THE COURT: He is buying securities that are going
8 down in value, then he's trading them again and suffering a
9 loss.

10 MR. NEWMAN: He is taking the client money, using
11 it to buy securities which are supposed to be equal in value
12 to the amount of money invested. Through these security
13 transactions he is losing money. He lost 50 million dollars
14 based on records he provided to our examination staff. The
15 way he is concealing this loss of principal is that he is
16 taking a security that is part of a collateral for this
17 investment contract, a collateral mortgage obligation,
18 called an inverse floater. He is taking it at value of 83
19 million dollars. And our examination staff has by
20 contacting market makers and third parties determined the
21 actual value of the inverse floater or collateral mortgage
22 obligation is only about 11 or 12 million dollars. So he's
23 trying to use this overvaluation to conceal from his
24 customers or his clients what actually happened here. And
25 this loss of collateral has led to a number of security law

1 violations. We believe that in raising or obtaining
2 additional advisory clients he is not disclosing to the
3 client that he has this loss of principal. When they invest
4 with him, they basically have bought into a 30 percent loss
5 because of the existing losses in the account. He is not
6 disclosing to the client the trading losses he suffered, and
7 Devon's financial condition.

8 THE COURT: What does he give the client when they
9 buy this? Does he give them a certificate or something?

10 MR. NEWMAN: They sign an investment advisor
11 agreement with Devon. And Devon -- I'm trying not to
12 complicate this too much -- Devon has, through an affiliated
13 entity, again controlled by Mr. Black, FMS, enters into this
14 collateralized investment agreement which we attached as an
15 exhibit to the declaration.

16 THE COURT: Do you have that?

17 MR. MECK: Yes, sir.

18 THE COURT: FMS stands for?

19 MR. NEWMAN: Financial Management Sciences, Inc.
20 That is basically an affiliated company of Mr. Black. He
21 owns that and owns Devon.

22 THE COURT: Both?

23 MR. NEWMAN: Yes, Your Honor.

24 We believe he is using Financial Management
25 Sciences to help facilitate what occurred here because

1 basically one entity -- he controls both of the companies,
 2 and he's using Devon to facilitate these securities
 3 transactions. And what happens in addition to the advisory
 4 fees that clients pay, Devon, based on investment advisory
 5 services, Mr. Black has also structured -- this FMS, this
 6 affiliated company, pays an additional advisory fee to Devon
 7 for its activities, and that is not disclosed to the client.
 8 And also his use of this company, FMS, has led to client
 9 custody problems in violation of the Advisors Act. He is
 10 not supposed to have custody of the clients funds. He is
 11 using FMS to actually deposit and maintain the client funds.

12 Our biggest concern -- there are a number of
 13 disclosure problems, but our biggest concern here is that we
 14 have a 70 million dollar loss in principal, we believe, of
 15 client money. We don't know what happened to all this
 16 money. We know about 50 million has been lost, associated
 17 with trading losses. We know some money has been taken out
 18 or misappropriated by Mr. Black through undisclosed fees.

19 THE COURT: For personal uses?

20 MR. NEWMAN: Personal use, and to pay a million
 21 dollar settlement he had with a former partner. We have a
 22 big chunk of money we don't know what happened to it. And
 23 that is really our primarily concern here. We believe we
 24 need to have a freeze entered, a TRO entered, until this can
 25 be sorted out. We also submitted to the court a

1 recommendation for the appointment of a trustee.

2 THE COURT: That is something -- you realize this
3 is not going to be my case.

4 MR. NEWMAN: I understand that, Your Honor.

5 THE COURT: This case has been brought to me
6 because I am the miscellaneous judge this week, and I'm
7 handling this motion for Judge Smith whose case it will be.
8 He is the judge in charge of Johnstown cases. I think it
9 should be Judge Smith who appoints the trustee.

10 MR. NEWMAN: Our concern, Your Honor, is we have a
11 substantial amount of client money involved here, and many
12 of the clients are --

13 THE COURT: Dick Thornburgh, Joy Conti or Arlen
14 Adams, there is not much they can do until Monday, is there?

15 MR. NEWMAN: Practically speaking, Your Honor,
16 that is correct.

17 THE COURT: It might be better to have Judge Smith
18 on Monday do it rather than ask me today. What if I come to
19 a different -- what if I pick somebody different than Judge
20 Smith would have picked since it is his case.

21 MR. NEWMAN: I understand that, Your Honor. Our
22 concern --

23 THE COURT: Assuming we issue this temporary
24 restraining order, you got the order in place. They would
25 be in contempt if they did anything between now and Monday.

1 MR. NEWMAN: I understand that is correct, Your
2 Honor. Our concern is to get something in place as soon as
3 possible, take over what is going to be a very complicated
4 situation involving a lot of money and a lot of requests for
5 money.

6 THE COURT: Yes, right. Let me ask you this. I
7 note this is being done without notice to the defendants.
8 It is a rule 65 -- the Rule 65 with regard to notice says:
9 If it clearly appears from specific facts shown by affidavit
10 or verified complaint that immediate an irreparable injury,
11 loss or damage will result to the applicant before the
12 adverse party or that party's attorney can be heard in
13 opposition, and the applicant's attorney certifies to the
14 court in writing the efforts which have been made to give
15 notice and the reasons supporting the claim that notice
16 should not be required.

17 What about notice?

18 MR. NEWMAN: We have not provided any notice in
19 this case because of what we believe is an extensive fraud
20 and the fact that we have an individual here who has access
21 to millions of dollars in moneys. We are concerned that any
22 formal notice could lead him to dissipate or secrete
23 investor funds. We are amenable to a preliminary injunction
24 hearing to prove our case. And as to the conduct, we are
25 concerned because of the magnitude of the fraud, again, and

1 the size of this advisor, that there is a real risk of
2 dissipation here.

3 THE COURT: All right. If you gave notice they
4 might do something before the injunction could be entered
5 and served on them.

6 MR. NEWMAN: That is correct, Your Honor. And we,
7 the Commission, has in other instances made an application
8 of this nature in situations like this.

9 THE COURT: I know that. But I just wanted to
10 make sure it is on the record why we are not giving notice
11 to Gardner or the attorneys, if he has an attorney.
12 Somebody gave us the name of -- was it you who gave Dave
13 Simpson the name of the attorney?

14 MR. NEWMAN: Yes, Your Honor. There is an
15 attorney that we have had some communications with who
16 represents Mr. Black in connection with his investment
17 advisory activities. We believe he is more a regulatory
18 attorney. He is not --

19 THE COURT: He wouldn't be representing him in
20 this litigation?

21 MR. NEWMAN: I believe that is correct, Your
22 Honor. But we haven't had any other contact with anybody
23 else on behalf of Mr. Black.

24 THE COURT: All right. Well, now there is an
25 affidavit that has been attached that supports the

1 declaration of William R. Meck.

2 MR. NEWMAN: Yes, Your Honor.

3 THE COURT: All right. Well, I am going to have
4 for the purposes of this hearing this declaration and
5 exhibits attached to it marked as Exhibit 1, and I'll admit
6 it into evidence for purposes of this hearing, just so we
7 have this on the record, the affidavit.

8 Now, the other requirement of Rule 65 is with
9 respect to temporary restraining orders granted without
10 notice. It says that the order shall define the injury and
11 state why it is irreparable and why the order was granted
12 without notice and shall expire within a period not to
13 exceed ten days after the entry of the order. Ten days from
14 today would be October 6th, I believe.

15 MR. NEWMAN: I believe that is correct, Your
16 Honor.

17 THE COURT: And, also, it is required that a
18 hearing be set as soon as possible. I want to make sure
19 that this order complies with what the rule says.

20 MR. NEWMAN: Yes. If Your Honor will look at the
21 preamble to the order, I believe there is certain findings
22 in there that correspond to the language that you referred
23 to.

24 THE COURT: All right. The second page, page 2,
25 first full paragraph: Whereas, there is good cause to

1 believe that unless restrained and enjoined by order of this
2 court, the defendants will dissipate, conceal or transfer
3 from jurisdiction of this court assets which could be
4 subject to an order of disgorgement or an order to pay civil
5 penalties in this action. And there is good cause to
6 believe that advance notice to the defendants of the
7 Commission's application for this order would substantially
8 increase the risk of such dissipation, concealment or
9 transfer.

10 And I have considered the Commission's memorandum
11 of law in support of the motion.

12 Can I see that memorandum for a minute, Alison.

13 THE LAW CLERK: Yes, judge.

14 THE COURT: I wanted to have Judge Smith's clerk
15 look at these papers as well. See if you can get him up
16 here.

17 THE LAW CLERK: The law clerk or deputy?

18 THE COURT: His law clerk.

19 THE LAW CLERK: Okay.

20 THE COURT: Among other things that is alleged in
21 the complaint and in the Meck affidavit, I guess it is Devon
22 is misrepresenting the value of the, is it, the FMS
23 contract when he is soliciting new orders, new investment,
24 rather.

25 MR. NEWMAN: He is failing to disclose at the time

1 people are investing with him that their principal is also
2 at risk, at least 99 percent, in the CIA account, the
3 securities account.

4 THE COURT: He is saying that the securities
5 account has a value equal to the amount that they are
6 investing.

7 MR. NEWMAN: That is correct, Your Honor.

8 THE COURT: And according to your memorandum, the
9 investments that are being sold are securities within the
10 meaning of the federal securities laws.

11 MR. NEWMAN: Yes, that is correct, Your Honor.
12 The investment money --

13 THE COURT: Contracts or whatever they are called.

14 MR. NEWMAN: Yes, sir. The investment contract
15 money is being pooled in one account, then they are being
16 used to buy securities which are being maintained in one
17 account, and any interest or money earned from the
18 securities is being passed back into the account and then
19 out to the investment adviser clients.

20 THE COURT: How is he keeping -- how is he making
21 payments of the so-called interest? Does he use principal
22 in part to pay the interest back?

23 MR. NEWMAN: Well, Your Honor, they have -- that
24 is part of our allegation, to pay people back, he needs
25 new --

1 THE COURT: Pay principal?

2 MR. NEWMAN: He needs new principal. He doesn't
3 have the full amount of money in his account. He does --
4 through these trading activities, he has earned some income.

5 THE COURT: But it wouldn't be enough to pay the
6 rate of income he said he could pay?

7 MR. NEWMAN: That is correct. If everybody went
8 in and said they wanted their principal back today, they
9 would get approximately 30 percent less than what they put
10 in.

11 THE COURT: Invested.

12 MR. NEWMAN: That is right. He can't do that, and
13 he admitted to us that he can't do that.

14 MR. NEWMAN: And these are people who invest with
15 him who obviously want to secure safe investments. They are
16 investing school district money, and they want absolute
17 safety of their principal. And they are being guaranteed a
18 fixed nominal rate of return. But the safety of the
19 principal is material without a doubt to these school
20 districts.

21 THE COURT: I see. Fine.

22 (Judge Smith's law clerk enters the courtroom.)

23 THE COURT: Thank you very much for coming up.

24 Do you mind coming up and sitting here at the
25 bench. I want you to hear this. I don't know if you have

1 learned anything about it. This is going to be Judge
2 Smith's case.

3 THE LAW CLERK: Thank you.

4 THE COURT: Let me back up for a minute. Now that
5 you are hear, one of the requests -- there is a request for
6 temporary restraining order in this matter. It is a
7 securities matter. There is also a request for the
8 appointment of a trustee to manage the funds that are
9 involved here. Judge Smith will be back in his chambers, I
10 take it, on Monday. I saw him last night. He is down at
11 that academy. He's on the program tomorrow. He will be
12 back Monday; right?

13 THE LAW CLERK: Yes.

14 THE COURT: I told Mr. Newman here that I think
15 Judge Smith ought to decide who should be appointed trustee.
16 After all, this is going to be his case. If I issue a
17 temporary restraining order, I am not going to appoint the
18 trustee and leave it to Judge Smith. Also, if I enter a
19 temporary restraining order, it is only valid for ten days,
20 and a preliminary injunction hearing has to be set. Judge
21 Smith knows his own schedule, and it would be better to have
22 him set that date rather than me. So I just want to let you
23 know where we stand.

24 THE LAW CLERK: Thank you.

25 THE COURT: Is there anything else, Mr. Newman

1 that I should --

2 MR. NEWMAN: Well, one additional matter that I
3 mentioned to Mr. Simpson, if it is possible for me to
4 discuss with you in chambers as opposed to the courtroom.

5 THE COURT: Yes.

6 MR. NEWMAN: And then if the court would like, we
7 could come back and discuss it in the courtroom then. But I
8 would want to speak with you in chambers.

9 THE COURT: I will see you in chambers. We will
10 take a recess, and we will reconvene shortly.

11 MR. NEWMAN: Thank you, Your Honor.

12 (Recess taken.)

13 (In chambers.)

14 THE COURT: As far as Colvin putting it on the
15 record, if you want we can have this part of the record
16 sealed or whatever you want to do about that.

17 MR. NEWMAN: If I could tell Your Honor what it is
18 I want to discuss, and I prefer that maybe it not be on the
19 record --

20 THE COURT: Don't put this on the record. Off the
21 record.

22 (Discussion off the record.)

23 THE COURT: We can go back on the record.

24 I'm going to -- for the record, I've talked to
25 Judge Smith about the appointment of a trustee. And because

1 Judge Smith has some acquaintance with Mr. Black, it is
2 quite likely that Judge Smith will recuse, and that another
3 judge will have to be designated. In the meantime, I will
4 continue to keep charge of the case until somebody else is
5 appointed. And I'll appoint a trustee. And I'll pick the
6 trustee. I'll appointment Richard Thornburgh from the three
7 candidates whose names were submitted to me who are Governor
8 Thornburgh, Joy Conti and Arlen Adams. Those are the three
9 candidates who have been suggested. And the SEC has asked
10 that of the three, that I choose Governor Thornburgh; is
11 that correct?

12 MR. NEWMAN: Yes, Your Honor.

13 THE COURT: Under the circumstances, that is what
14 I would do.

15 Now, as far as the temporary restraining order is
16 concerned, I think that the SEC has shown good cause for the
17 entry of a temporary restraining order without notice for
18 the reasons I have already put on record, and which are set
19 forth in the temporary restraining order itself that has
20 been submitted to me.

21 I'm going to sign the temporary restraining order
22 now. It is 2:55 p.m., the 26th of September. And I'm
23 adding a sentence to this saying this order will expire at
24 2:55 p.m. on October 6. That is ten days.

25 Okay. I hope you can read my writing here.

1 Is that all right, Mike?

2 MR. NEWMAN: I think that is sufficient, Your
3 Honor, .

4 THE COURT: Okay.

5 MR. NEWMAN: There are on blanks on the other
6 pages.

7 THE COURT: Another blank. Okay.

8 MR. NEWMAN: Pages 3 and 4 you have to write in
9 the date of the order.

10 THE COURT: Okay. I did one place. All right.

11 MR. NEWMAN: Page 3, Your Honor, and page 4.

12 THE COURT: Oh, yes. We will have copies made.
13 Dave can make copies, and also a copy for the SEC.

14 MR. NEWMAN: We would appreciate that, Your Honor.

15 THE COURT: You are going to give notice of this
16 obviously to Black and to his lawyers.

17 MR. NEWMAN: Yes, Your Honor, we will call them
18 today and let them know.

19 THE COURT: All right. Anything more for us to do
20 today --

21 MR. NEWMAN: Nothing else from our standpoint,
22 THE COURT: -- from the SEC's point of view.
23 Do you mind if I tell the clerk what we think is
24 going to happen here based on what Brooks told me, or Judge
25 Smith, that if he is going to recuse, they are going to have

1 to draw another number.
2 MR. NEWMAN: No, Your Honor, we would have no
3 objection to that.
4 THE COURT: I will talk to Jim Drach and see how
5 he wants to handle it.
6 (Proceedings adjourned.)
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11 I CERTIFY THE FOREGOING IS A CORRECT TRANSCRIPT
12 FROM THE RECORD OF PROCEEDINGS IN THE ABOVE-ENTITLED MATTER.
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