

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

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

JOHN GARDNER BLACK,
DEVON CAPITAL MANAGEMENT, INC., and
FINANCIAL MANAGEMENT SCIENCES, INC.,

Defendants.

CIVIL ACTION NO. 97-265
97-2257

DECLARATION OF WILLIAM R. MECK

I, William R. Meck, hereby declare as follows:

1. I am employed as an Assistant District Administrator in the Philadelphia District Office of the United States Securities and Exchange Commission (Commission). My primary duties include overseeing the Philadelphia District Office ("PDO") examination program for registered investment advisers and mutual funds to ensure their compliance with the federal securities laws.

2. Under my supervision, members of the Commission's examination staff conducted a regulatory compliance examination of Devon Capital Management, Inc. ("Devon"), a registered investment adviser, from August 25, 1997 through August 28, 1997. During that examination, PDO staff members visited Devon's offices, reviewed its books and internal records and met with its principal, John G. Black.

3. I make this declaration based upon my personal knowledge or information and belief, in support of the

PLAINTIFFS
EXHIBIT

Commission's Motion for a Temporary Restraining Order, Asset Freeze and Other Relief against the Defendants.

4. **Devon Capital Management, Inc.** is a registered investment adviser, which has its primary office in Tyrone, Pennsylvania, and additional sales offices in Harrisburg and Pittsburgh, Pennsylvania. Devon has been registered with the Commission as an investment adviser since December 1989. Devon has approximately 100 investment advisory clients and \$345 million in assets under management.

5. **John Gardner Black**, age 53 and a resident of Pennsylvania, is the president, portfolio manager and sole owner of Devon as well as defendant Financial Management Sciences, Inc. Black makes all investment decisions for Devon. According to information provided by Devon to its advisory clients, Black has extensive experience managing money for school districts in Pennsylvania.

6. **Financial Management Sciences, Inc. ("FMS")** is an affiliated entity of Devon. FMS shares office space with Devon, and is wholly owned by Black. Pursuant to agreements with Devon, FMS holds the money and securities of Devon's investment advisory clients and pays Devon a fee for managing those assets.

Background

7. Devon's investment advisory clients are local government units (hereafter "LGUs" or "advisory clients"), the vast majority of which are school districts located in rural communities in western and central Pennsylvania. (A list of the

LGUs can be found at **Exhibit J** to this Declaration). Devon offers its advisory clients what it describes as cash management services. The LGUs invest the proceeds of bond offerings until those proceeds are needed for the LGUs' operations.

8. Devon requires each LGU which uses its investment advisory services to enter into an investment advisory agreement with Devon ("LGU Advisory Agreement"). The LGU Advisory Agreement states that Devon will provide the LGU with a fixed rate of return on its money. A sample LGU Advisory Agreement is attached as **Exhibit A**.

9. The LGU Advisory Agreement grants Devon full discretion to invest the LGU's bond offering proceeds. However, according to the express terms of the LGU Advisory Agreement, Devon is required to purchase only those investments authorized by Pennsylvania law. The LGU Advisory Agreement also provides that Devon will not take custody of the LGU's funds. Devon's advisory clients agree to pay Devon a monthly fee based on an annual rate ranging from 12 to 25 basis points (.12% - .25%) of the average month-end balance of the assets under management.

10. Devon states in the LGU Advisory Agreement that it "may direct the Client [LGU] to enter into certain transactions with FMS, a majority of the stock of which is owned by shareholders of Devon." In fact, Devon and FMS are both wholly owned by Black.

11. In promotional materials sent to prospective clients, Devon touts its extensive experience in providing investment advice to local governments, especially school districts, and

promises to provide clients with "a high level of investment performance." See Exhibit B, Devon's Proposal to Serve As Investment Adviser to Clarion School District (dated 11-7-95).

The Collateralized Investment Agreement

12. Devon has approximately \$345 million of LGU funds under management. Of this amount, Devon has invested \$233 million, on behalf of 75 LGUs, in a form of investment contract called a Collateralized Investment Agreement ("CIA"). The CIA is an agreement between Devon (on behalf of each LGU) and FMS, pursuant to which FMS provides the fixed rate of return specified in the LGU Advisory Agreement. See Exhibit C, Sample CIA Agreement on Behalf of Daniel Boone School District (dated 1-17-97).

13. Pennsylvania law requires that funds invested by LGUs such as school districts be collateralized to the full amount of the funds invested. In the CIA, FMS agrees to secure or collateralize each LGU's principal with securities having a fair market value equal to 100% of the investment. In other words, the principal will be protected. To ensure that adequate collateral is maintained, the CIA states that the value of the underlying securities will be marked to market each week.¹ See Exhibit C, Sample CIA Agreement.

14. Each CIA is for a fixed time period, usually two years. During the term of the CIA, Devon distributes back to each LGU a portion of its principal in accordance with a draw schedule

¹ A security is "marked to the market" by determining its current value based on current market prices for that security.

attached to the CIA. The last principal payment terminates the CIA. However, each LGU is entitled to a return of their full principal upon written request at any time prior to the expiration of the CIA. See Exhibit C, Sample CIA Agreement.

15. The CIA provides that Devon will effect the transfer of the LGU's funds to FMS through a "Custodial Account" maintained at Mid-State Bank and held in the advisory client's name. FMS then deposits the LGU's funds into an account maintained in FMS' name ("Main Account") at the same bank, in which the client's funds are pooled with funds invested by all of the LGUs participating in the CIA investment program. See Exhibit C, Sample CIA Agreement.

16. According to the CIA, Devon agrees to purchase authorized investments with these pooled funds. FMS places the investment securities into another FMS account called the "Collateral Account." This account holds securities which are maintained as collateral for the benefit of Devon's advisory clients who are invested in the CIA program. When interest payments and draws are to be made to individual LGUs, payments are made from the pooled assets, either directly from the Collateral Account to the LGU or from the Collateral Account to the Main Account and then to the LGU.

17. Seven of the advisory clients who have invested in the CIA, have requested to hold their own securities (or collateral) outside of the Collateral Account. In those instances, FMS and Black have allowed these LGUs to hold specified securities,

purchased with the pooled funds from the Main Account, in separate collateral accounts held for the benefit of these LGUs. When funds are generated by the investments in these separately-held collateral accounts (whether through earnings or proceeds of sales), the returns are removed from the separately-held accounts, put into the Main Account and then distributed to all of the LGUs on a pro rata basis, at the rates specified in the LGU Advisory Agreements. According to statements made by Black to PDO staff during the examination of Devon, approximately \$76.5 million of the \$233 million in client money that Devon has invested in the CIA program is being held (in the form of securities) outside the Collateral Account in accounts at three other Pennsylvania banks for the benefit of these seven LGUs. See Exhibit D, Devon's Printout of Outside Custodians as of 7-31-97.

The Fraudulent Scheme

a. The Concealment of Trading Losses

18. According to the books and records of Devon and FMS, the Collateral and Main Accounts have incurred at least \$50 million in realized trading losses from 1995 through the present. Approximately 80% of these losses occurred in 1995.

19. In the statements that Devon has provided to its LGU clients, Black has substantially overstated the value of a security held in the Collateral Account, a collateralized mortgage obligation in an interest-bearing form known as an inverse floater (hereafter "CMO"). The CMO is issued by the

Federal National Mortgage Association (Fannie Mae) with a maturity date of September 25, 2023. See Exhibit H, The CMO Prospectus (dated 2-25-93).

20. According to documents provided by Black during the examination, as of July 31, 1997, Devon managed approximately \$233 million in investor funds in the CIA program on behalf of 75 LGUs. Black stated to the Commission staff that the total value of the nine securities backing the CIAs was \$236 million, representing more than 100% of the principal that advisory clients had invested in the CIA's (\$233 million). Black provided records which reflected that total assets of approximately \$76.5 million were maintained for the benefit of seven LGUs outside the Collateral Account. Black represented that the remaining \$156.5 million under management purportedly is held in the Collateral Account at Mid-State Bank. See Exhibits I (Devon's Collateral Printout for the CIA Program dated 7-31-97) and Exhibit K (SEC Schedule of Devon Clients and Principal Amounts Invested).

21. However, as of July 31, 1997, Mid-State Bank valued the Collateral Account assets at only \$87 million. Accordingly, the shortfall between the value of the assets reported by Devon to its advisory clients who are invested in the CIA (\$156.5 million), and the value of the assets reported by Mid-State Bank as of the same date (\$87 million) is approximately \$69.5 million or 45 percent.

22. At least \$50 million of this discrepancy appears to be the result of the trading losses sustained in the Collateral and Main Accounts, as shown on **Exhibit L, Devon's Printout of Realized Gains and Losses for period from 1-1-95 to 7-31-97**. In addition, as described below, the staff believes that Black has misused an additional \$2 million in client funds to pay business and personal expenses. The remainder (\$17.5 million) is currently unaccounted for.

b. Over-valuation of the Collateral Account

23. As stated above, Black has represented to the Commission staff and to Devon advisory clients that the value of the assets held in the Collateral Account is \$156 million.

24. One of the securities in the Collateral Account is a CMO, which Black valued at \$83 million as of July 31, 1997. However, according to a market maker and an institutional purchaser of CMOs, this CMO had an actual market value of significantly less as of July 31, 1997.

25. Lehman Brothers, Inc., the market maker of the security, valued the CMO at \$12,362,916 on July 31, 1997 and \$11,751,232 on August 29, 1997. See Exhibit N, Declaration from Lehman Brothers (dated 9-25-97). Another large mutual fund complex also provided the Commission with valuations for this CMO, as of July 31, 1997 and August 31, 1997, of \$12,492,000 and \$13,104,000, respectively.

26. In addition, the account statements for the Collateral Account sent to FMS by the custodian bank, which reflect

valuations made by the custodian bank, report a market price of approximately \$14 million for the CMO. See Exhibit J, Mid-State Bank Account Statement for the Collateral Account (ending 7-31-97).

27. During the Commission's examination of Devon, Black explained to Commission staff members how he had arrived at the reported value for the CMO. Black stated that he based his valuation on all future income that the instrument could earn if held until maturity. Black admitted to the Commission staff during this conversation that he could not cover the collateral guarantee to preserve 100% of client investments if the portfolio were sold at the time of the examination.

28. By overvaluing the CMO, Black has been able to maintain the appearance that client investments are safe and being maintained at 100% of fair market value, as required by both Pennsylvania law and the CIA. As previously stated, Devon furnishes clients with monthly statements prepared by Black, or at his direction, that show account values equal to 100% of the principal amount invested plus the accrued interest earned to date. These statements do not reflect any shortfall in the Collateral Account.

c. Misrepresentations and Omissions

29. Black has continued to accept new clients for investment into the CIA program after significant trading losses were incurred without disclosing to these new clients that, as a result of the shortfall in the portfolio, the funds that the new

clients invested into the CIA program were immediately diluted by as much as 45 percent. Further, Black is not disclosing to new or current advisory clients the trading losses or the principal deficit in the Main and Collateral Account.

30. In addition, since 1996, Devon has received \$185,000 in undisclosed advisory fees through its relationship with FMS. These fees are paid from pooled client funds held in the Main Account and are in addition to the \$449,000 of disclosed advisory fees that the advisory clients pay directly to Devon pursuant to the LGU Advisory Agreement.

31. In 1997, in order to provide information to their auditors, at least two LGUs requested information from Black concerning the identity and value of the collateral for their investment in the CIA. Knowing that this information was being requested on behalf of the LGUs' auditors, Black, on at least two occasions, provided collateral statements for the LGU's CIA investment in which he reflected the inflated value for the CMO. See Exhibit M, Letters to Devon from Daniel Boone School District (dated 6-30-97) and Blacklick School District (dated 7-1-97).

d. Misuse of Client Funds

32. Black has signatory authority to withdraw and transfer securities and money in the Main and Collateral Accounts. Based on a preliminary review of FMS' and Devon's bank records and general ledgers, it appears that Black has used this authority to pay the business expenses of FMS and Devon, including legal, payroll, accounting and other expenses, and make to payments to

himself. These payments were made from LGU/client funds to benefit Devon, FMS or Black and were in excess of the fees that Devon is entitled to receive from the LGUs/clients pursuant to the Advisory Agreements. There is no indication in Devon's promotional or investment advisory materials that Black ever disclosed these expenditures to Devon's advisory clients. See Exhibits B, C and E.

33. Between January 1996 and August 15, 1997, Black withdrew a total of approximately \$1.2 million of LGU/client funds from the Main Account, which funds were used for the benefit of Devon, FMS and Black. For example, in September 1996, Devon, acting by and through Black, paid \$400,000 from LGU/client funds to a former partner as part of a settlement in a lawsuit filed against Devon. In addition, Black used LGU/client funds from the Main Account to pay Devon's and FMS's business expenses, including salaries and rent.


34. In addition to the \$1.2 million, as part of the legal settlement, Black also transferred \$600,000 of Treasury securities from the Main Account to a separate escrow account, established at Mellon Bank for the purpose of paying Black's former partner approximately \$120,000 per annum for five years.

35. Black has personally received funds as well. From 1996 through the present, he has received approximately \$214,000 from FMS' payroll account, and \$72,000 from Devon.

36. It appears that, due to the shortfall in the portfolio, Devon must continue to attract new funds for investment in the

program, in order to fulfill its entire obligations to current advisory clients in the CIA program. The need for new client money to invest in the securities described herein may become more acute in January 1998, when client investments of \$120 million mature.

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information and belief.


William R. Meck

Dated: September 26, 1997