

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF PENNSYLVANIA

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

PATRICK H. McCARTHY,

Defendant.

No.1:CV 99-2003

CORRECTED
COMPLAINT

The Securities and Exchange Commission alleges:

PRELIMINARY STATEMENT

1. This action involves defendant Patrick McCarthy who arranged for his law firm to receive undisclosed compensation in violation of his fiduciary duties in two municipal bond offerings by the Commonwealth of Pennsylvania. McCarthy used his substantial influence in the Pennsylvania Treasurer's Office to arrange for a securities dealer to be selected to sell hundreds of millions of dollars of U.S. Treasury securities to the Commonwealth in connection with the offerings. While advocating for the securities dealer's selection in the Treasurer's Office,

McCarthy failed to disclose that he had obtained for his law firm an arrangement to share with others in the fees generated by the transaction and that he was on a monthly retainer from the securities firm.

2. McCarthy's conduct violated the antifraud provisions of the federal securities laws. The Commission seeks a permanent injunction prohibiting him from further violations and a civil penalty.

JURISDICTION

3. This Court has jurisdiction over this action under Section 22(a) of the Securities Act of 1933 (the "Securities Act") [15 U.S.C. § 77v(a)] and Sections 21(e) and 27 of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. §§ 78u(e) and 78aa].

DEFENDANT

4. The defendant, Patrick H. McCarthy, is an attorney licensed to practice law in Pennsylvania, Massachusetts, and the District of Columbia. He was a partner in a major Philadelphia law firm from December 1991 to July 1997 and was previously a partner in another Philadelphia law firm.

STATEMENT OF FACTS

A. McCarthy's Influential Role in the Pennsylvania Treasurer's Office

5. Defendant McCarthy served as a senior advisor and fund-raiser for the former Treasurer of the Commonwealth (hereinafter "the Treasurer") in her 1988 campaign for Treasurer of Pennsylvania. Following her election, he served as the Treasurer's transition chief, working

closely with her Executive Deputy Treasurer in hiring staff members and setting up the Treasurer's office.

6. After the Treasurer assumed office, McCarthy remained a close confidante of the Treasurer and the Executive Deputy Treasurer and stayed actively involved in the day-to-day operations, decisions, and policies of the Treasurer's Office. Although McCarthy held no official title and was not employed by the Treasurer's Office, he was viewed by senior staff as the most powerful person in the office after the Treasurer and the Executive Deputy Treasurer. McCarthy had the authority to give orders to staff members and had input and decisionmaking authority, with the Executive Deputy Treasurer, on a wide range of substantive issues, including programs and personnel matters. McCarthy was also extensively involved in selecting vendors, including investment banking firms, and served as a conduit for investment banking firms seeking business from the Treasurer's Office.

7. McCarthy held himself out as a fiduciary, and senior staff members relied upon him to provide counsel and to make decisions in the office's best interests. Both the Deputy Treasurer for Finance and the Treasurer's General Counsel viewed McCarthy as their superior. The Executive Deputy Treasurer routinely instructed the Deputy Treasurer for Finance and the General Counsel to consult with McCarthy on substantive matters under consideration within the office. For example, the Executive Deputy Treasurer instructed the Deputy Treasurer for Finance to keep McCarthy informed about various debt issuance matters. At the Executive Deputy Treasurer's instruction, the Deputy Treasurer for Finance proceeded in consultation with McCarthy on the two Pennsylvania refundings at issue.

8. McCarthy's de facto authority in the Treasurer's Office made him a fiduciary to that office and to the Commonwealth of Pennsylvania. He accordingly had, among other duties, a duty to disclose all material facts and circumstances to the Treasurer's Office and the Commonwealth of Pennsylvania in connection with his activities on Treasurer's Office business.

B.. McCarthy's Relationship with Alex Brown

9. In or about June 1991, McCarthy was introduced to a senior banker who was then head of public finance for Alex. Brown & Sons Incorporated, a broker-dealer (hereinafter "the Senior Banker"). McCarthy told the Senior Banker that he assisted firms like Alex. Brown in getting public finance assignments. McCarthy stated that he had strong relationships within the Pennsylvania Treasurer's Office and promoted his ability to obtain public finance assignments for Alex. Brown from that office, among others. McCarthy proposed that Alex. Brown pay his law firm 20 to 25 percent of the revenues Alex. Brown received for work obtained as a result of McCarthy's efforts.

10. In July 1991, Alex. Brown agreed to pay McCarthy's law firm 20 to 25 percent of the gross revenues earned by Alex. Brown's Public Finance Department and 20 to 25 percent of the net revenues realized by the firm's Sales, Trading and Underwriting Department on assignments McCarthy provided assistance in securing for Alex. Brown.

11. Under this arrangement, McCarthy directed assignments to Alex. Brown from the Treasurer's Office and others for approximately two and a half years, through February 1994. During this period, Alex. Brown paid McCarthy's law firms a total of over \$369,000.

12. In September 1993, McCarthy successfully pushed to have Alex. Brown appointed as financial adviser to the Treasurer's Office.

C. The Fee-Splitting Plan

13. In late 1993, the Commonwealth of Pennsylvania was considering bond refundings totaling over \$1 billion. The Governor's Budget Office, which was responsible for all Pennsylvania debt issues, appointed Arthurs Lestrage & Company, Inc., a Pittsburgh-based securities firm, to be the Commonwealth's financial adviser for the refundings. The Treasurer's Office, which was generally responsible for the investment of Commonwealth funds, was charged with obtaining the investments for the escrows for the refundings.¹

14. Dennis Thiemann is the founder of a privately held consulting firm called HDI, Inc. Thiemann, through HDI served as a longtime consultant for Arthurs Lestrage. Based on his knowledge of a previous Commonwealth bond refunding, Thiemann understood that the Treasurer's office had in the past selected dealers to sell open market securities to the Commonwealth and he believed the Treasurer's Office would be selecting a securities dealer to sell the escrow securities to the Commonwealth for the Pennsylvania refundings. Thiemann also believed that the assignment could be lucrative for the dealer. In January 1994, Thiemann approached Michael Bova, head of Municipal Finance at Arthurs Lestrage, with the idea of having Arthurs Lestrage share in the revenues on the sale of the escrow securities.

¹ When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds paying lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds.

In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee payment of the old bonds.

15. Thiemann and Bova believed that the Commonwealth would view Arthurs Lestrangle as too small to handle the purchase and sale of hundreds of millions of dollars of U.S. Treasury securities for the refunding escrows. Accordingly, Thiemann proposed to Arthurs Lestrangle that he would find a larger securities dealer that could be selected to sell the escrow securities to the Commonwealth and would agree to split its revenues with Arthurs Lestrangle. The larger firm would combine its revenues from the sale of escrow securities with Arthurs Lestrangle's financial advisory fee, and Arthurs Lestrangle would receive 60 percent of the total. Arthurs Lestrangle would then pay one-third of its share to Thiemann. Arthurs Lestrangle agreed to Thiemann's proposal.

16. Thiemann then consulted with his friend John Seidman. Seidman is the founder of a privately held Pittsburgh-based consulting firm called JMS Associates, Inc. Thiemann knew Seidman had been a senior advisor to the Treasurer in her 1988 campaign and Thiemann believed that Seidman had contacts within the Treasurer's Office. Seidman and Thiemann discussed a number of potential major investment banking firms, including Alex. Brown, which bank Seidman informed Thiemann was then the financial advisor to the Treasurer's Office. Seidman was a friend of McCarthy and Seidman knew that McCarthy had a longstanding relationship with Alex. Brown's municipal securities business.

17. Seidman reintroduced Thiemann to McCarthy. McCarthy was subsequently contacted for assistance in arranging for Alex. Brown to be appointed to provide the escrow securities and for Alex. Brown to split its revenues with Arthurs Lestrangle.

18. In or about mid-January 1994, McCarthy telephoned the Senior Banker at Alex Brown. McCarthy explained that the Commonwealth planned to issue advance refunding bonds

but that its financial advisor, Arthurs Lestrage, was too small to sell the escrow securities. He then offered the Senior Banker a proposal: Alex Brown could be named the escrow provider if it would agree (1) to take all of the financial risk associated with the sale of the escrow securities and (2) to pool revenues with Arthurs Lestrage and allocate 60 percent of the total revenues to Arthurs Lestrage. McCarthy also told the Senior Banker that the Treasurer's Office was dissatisfied with the size of the markup that another broker-dealer had charged for the escrow portfolio on another recent Commission refunding, and indicated that Alex. Brown would have to provide the escrow for a markup in the range of three to five basis points. (A basis point is a hundredth of a percentage point.) The Senior Banker received approval from his superiors at Alex. Brown to provide the escrow securities, and, at McCarthy's instruction, thereafter contacted Arthurs Lestrage.

D. McCarthy Lobbies to Have Alex. Brown Selected as Escrow Provider

19. After McCarthy learned that Alex. Brown was willing to make the payments to Arthurs Lestrage, he lobbied to have Alex. Brown selected as escrow provider in the upcoming refunding. In so doing, McCarthy had a conflict of interest because he had an arrangement with Thiemann to receive a portion of the pooled Alex. Brown and Arthurs Lestrage fees. At no time did McCarthy disclose this arrangement to the Treasurer's Office or the Commonwealth.

20. The Deputy Treasurer for Finance opposed Alex. Brown's selection. He believed that the Treasurer's Office could purchase the escrow securities on its own without having to pay a markup to a securities dealer. The Deputy Treasurer for Finance and the Treasurer's General Counsel, were also concerned that Alex. Brown, as the Treasurer's financial advisor, would have

a potential conflict of interest if it were allowed to sell escrow securities, as a principal, to the Commonwealth.

21. McCarthy, without disclosing his conflict of interest, used his influence in the Treasurer's Office to overcome the senior staff's objections. In or about late January 1994, he and the Executive Deputy Treasurer informed the Deputy Treasurer for Finance that Alex. Brown had been selected as escrow provider.

E. The March 1994 Refunding

22. After Alex. Brown agreed to split its fees with Arthurs Lestrage, McCarthy instructed the Senior Banker to discuss with the Deputy Treasurer for Finance the transaction and the markup that Alex. Brown was going to charge on the escrow securities for the upcoming refunding.

23. The Senior Banker met with the Deputy Treasurer for Finance in early February 1994 and suggested that Alex. Brown be permitted to charge a markup of five basis points in price, emphasizing the risks that Alex. Brown would assume by purchasing the Treasury portfolio and selling it to the Commonwealth. The Deputy Treasurer for Finance would only agree to a four basis point markup, but the Executive Deputy Treasurer and McCarthy overruled him based on the Senior Banker's assertions. The Treasurer's Office thereafter agreed to pay Alex. Brown a markup of 4.5 basis points (or .00045) in price.

24. The refunding was priced on March 16, 1994. The Senior Banker had his staff mark up the escrow securities by a factor of .0045, or 45 basis points instead of the 4.5 basis points to which the Senior Banker had agreed with the Treasurer's Office. When the Deputy Treasurer for Finance brought this fact to the attention of the Senior Banker the next day, the

Senior Banker claimed that the Deputy Treasurer for Finance was wrong, and that Alex. Brown had charged only the agreed-upon 4.5 basis point markup.

25. The Deputy Treasurer for Finance also raised this issue with McCarthy, who pointed out the Senior Banker's credentials and experience in these matters and supported the Senior Banker's assertion that only a 4.5 basis point markup had been charged. McCarthy told the Deputy Treasurer for Finance that he was wrong.

26. Despite the overcharge identified by the Deputy Treasurer for Finance, the refunding closed on March 30, 1994.

F. Wolf, Block Receives a Share of the Pooled Fees for the March Refunding

27. After the closing, Alex. Brown and Arthurs Lestrage divided up their fees according to their 60/40 fee-split agreement. Alex. Brown's revenues related to the sale of the escrow securities totaled almost \$2.4 million, while Arthurs Lestrage was paid \$210,000 for serving as the Commonwealth's financial advisor. After the 60/40 fee split, Arthurs Lestrage received approximately \$1.56 million, and Alex Brown received approximately \$1 million.

28. Pursuant to its agreement with Thiemann, Arthurs Lestrage paid one-third of its share of the pooled revenues or \$520,891.42 to HDI, Thiemann's company. Thereafter, Thiemann paid \$175,250 to Seidman's firm JMS and \$172,000 to McCarthy's law firm for Seidman's and McCarthy's respective roles in the transaction. Following these payments, Thiemann's company, HDI, retained \$173,641.42 of the funds paid by Arthurs Lestrage. McCarthy did not disclose to the Treasurer's Office that his law firm would be compensated if Alex. Brown were selected as escrow provider.

G. The June 1994 Refunding

29. The Senior Banker left Alex. Brown after the closing of Pennsylvania's March refunding. The Commonwealth was planning another refunding, which eventually closed in June 1994.

30. In the period leading up to the June refunding, the Deputy Treasurer for Finance continued to protest that Alex. Brown had overcharged the Commonwealth on the March escrow portfolio. Because of the overcharge, the Deputy Treasurer for Finance did not want to use Alex. Brown as the escrow provider for the June refunding.

31. As before, McCarthy defended Alex. Brown against the Deputy Treasurer for Finance's protests. McCarthy told the Deputy Treasurer for Finance that he (McCarthy) would handle the discussions between the Treasurer's Office and Alex. Brown over the markup dispute. Thereafter, McCarthy and the Executive Deputy Treasurer repeatedly told the Deputy Treasurer for Finance that he was wrong about the markup charged by Alex. Brown, that it had actually been 4.5 basis points, and that it was reasonable. With McCarthy continuing to support the assertion that there had not been any overcharge on the March refunding, Alex. Brown was selected to provide the escrow securities for the June refunding.

32. Around the same time, Alex. Brown entered into a new compensation arrangement with McCarthy. After the Senior Banker's departure, McCarthy sought a \$20,000 monthly retainer agreement to be paid to his law firm by Alex. Brown. Alex. Brown agreed and McCarthy, on behalf of his law firm, entered into the \$20,000 monthly retainer agreement which took effect June 1, 1994.

33. While promoting Alex. Brown's interests in the Treasurer's Office in connection with both the March and June refundings, McCarthy knowingly or recklessly failed to disclose to the Treasurer's Office or to the Commonwealth that he had a conflict of interest arising from his payment arrangements with Thiemann and Alex. Brown. This information was material because, in carrying out the refundings, the Treasurer's Office and the Commonwealth would have reasonably wanted to know that McCarthy had an undisclosed incentive to advance Alex. Brown's interests, to keep Alex. Brown's markups high, and to ensure that the refundings closed—irrespective of the best interest of the Treasurer's Office and the Commonwealth.

FIRST CLAIM

Violation of Section 10(b) of the Exchange Act and Rule 10b-5

34. Paragraphs 1 through 33 are repeated and realleged as if fully set forth herein.

35. Section 10(b) of the Exchange Act [78 U.S.C. § 78j(b)] and Rule 10b-5 [17 C.F.R. 240.10b-5] prohibit 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, from employing any device, scheme or artifice to defraud, or from making any untrue statement of material fact or omitting 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 from engaging in any act, practice or course of business which operates or would operate as a fraud or deceit on any person, in connection with the purchase or sale of any security.

36. By reason of the conduct described above, defendant McCarthy violated Section 10(b) of the Exchange Act and Rule 10b-5.

SECOND CLAIM

Violation of Section 17(a) of the Securities Act

37. Paragraphs 1 through 36 are repeated and realleged as if fully set forth herein.

38. Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)] makes it unlawful for any person in the offer or sale of any securities by the use of any means or instrumentalities of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly, to employ any device, scheme or artifice to defraud, or to obtain money or property by means of any untrue statement of a material fact or any omission 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 to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

39. By reason of the conduct described above, defendant McCarthy violated Section 17(a) of the Securities Act.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests a judgment:

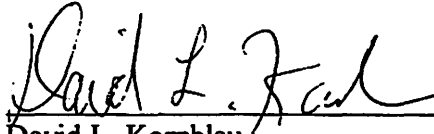
(a) enjoining defendant McCarthy from violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5;

(b) imposing a civil penalty against defendant McCarthy pursuant to Section 20(d) of the Securities Act and Section 21(d) of the Exchange Act; and

(c) granting such other relief as the Court deems just and proper.

Dated: November 17, 1999

Respectfully submitted,



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