No. 02-1175

In the Supreme Court of the United States

MARTIN D. FIFE AND
FAROUK A. KHAN, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioners' fraud was "in connection with the purchase or sale of any security," in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), or "in the offer or sale of any securities," in violation of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a).

2. Whether the preliminary injunction entered against petitioners was based exclusively on inadmissible evidence.

3. Whether petitioner Fife was an "investment adviser" as defined in the Investment Advisers Act of 1940, 15 U.S.C. 80b-2(a)(11).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-21a) is reported at 311 F.3d 1. The memorandum and order of the district court (Pet. App. 59a-81a) and the amended preliminary injunction order and order freezing petitioners' assets (Pet. App. 22a-58a) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on November 6, 2002. The petition for a writ of certiorari was filed on February 4, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

The Securities and Exchange Commission (SEC or Commission) brought this civil law enforcement action in the United States District Court for the District of Rhode Island against petitioners and others, alleging, *inter alia*, that petitioners engaged in securities fraud, in violation of Section 17(a) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. The Commission also alleged that petitioner Fife engaged in fraud as an investment adviser, in violation of Section 206(1) and (2) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6(1), (2). After a hearing, the district court found that the Commission had made out a prima facie case that petitioners engaged in those violations, preliminarily enjoined petitioners from further violations of the provisions, and froze petitioners' assets pending a final adjudication of liability. Pet. App. 22a-81a. The court of appeals affirmed the district court's judgment. *Id.* at 1a-21a.

1. During 1999 and 2000, defendant Michael A. Clarke raised approximately $51.75 million from five investors, first on behalf of an entity called Brite Business, S.A., and later through Brite Business Corporation. Clarke promised extraordinary returns, such as a $20 million profit in the first 12 banking days. Pet. App. 3a.

Petitioner Fife agreed to manage and invest Brite Business funds in return for a commission. Fife testified during the SEC's investigation that he was to develop a "balance sheet enhancement program," under which investor funds would be pooled and leveraged by purchasing Treasury Bills on margin and then invested

in Third World development projects. The profits from those investments, which Fife claimed would be from 30% to 100% per year, would then be distributed to investors. Pet. App. 4a.

In October 1999, Fife established a brokerage account in the name of Brite Corporation at the Rhode Island branch office of Raymond James Financial Services, Inc., and deposited $44.5 million of the investor funds into it. Fife was the signatory on the account, and his acquaintance Dennis S. Herula, a Raymond James employee, was the designated registered representative. Pet. App. 4a. Mary Lee Capalbo, an attorney and Herula's wife, established a separate brokerage account at Raymond James (the Capalbo Account), on which she was the signatory. *Id.* at 5a.

In March 2000, Brite entered into an agreement with Rheaume Holdings, which was represented by Robert Curl. Under the agreement, Rheaume invested $12.5 million in Brite. On May 8, 2000, Fife wrote a letter to Curl and Rheaume in which Fife stated that ensuring "the safety, security, monitoring and auditing of our client funds is and always will be my primary function. So without hesitation I state to you that absolutely your deposit is safe, secure, unencumbered, will not be invested without your authorization, can not be moved, or withdrawn without your approval." Pet. App. 7a. He stated, with regard to the enhancement program, that "I myself have been successful for the past six months doing the same placement of funds." *Ibid.* And he further represented that there would be "no risk of loss" and that Rheaume would receive benefits from its investment in the next two weeks. *Ibid.*

Almost immediately after Rheaume's investment was in Fife's control, he began transferring funds from the Brite account to the Capalbo account. Pet. App. 8a. By

September 2000, Fife had transferred $15.5 million from the Brite account to the Capalbo Account, where it was invested in securities in the form of money market shares. *Id.* at 5a-6a. Neither Curl nor anyone else at Rheaume authorized those transfers and securities purchases. *Id.* at 8a.

Of the $29 million remaining in the Brite account, $27.3 million was returned to investors. Three investors received back all of their money plus additional amounts, but Rheaume received only a few thousand dollars of its $12.5 million. Another investor, Rashad Mohamed Mahran Al Bloushi, also got back only a small portion of the amount he had invested. Pet. App. 5a.

The rest of the investor money was dissipated: Fife directed that approximately $8 million be used for his and others' benefit. Pet. App. 6a. He "loaned" hundreds of thousands of dollars to a friend and to petitioner Khan, on behalf of Seaview, an entity in which he and Khan were partners. *Id.* at 6a & nn.7, 9. He paid millions to other entities that were supposed to help in the balance sheet enhancement program, but which turned out to be scams. *Id.* at 6a & nn.8, 10. Fife also used $1.5 million of Rheaume's money to pay one of the other investors, whose funds were returned in their entirety. *Id.* at 5a n.4, 7a n.11. In addition to the funds that Fife misused, Capalbo and Herula took $8.6 million for themselves. *Id.* at 7a. By September 18, 2000, all of the investment money that had been placed under Fife's control in the Brite account was gone. *Id.* at 6a.

In the meantime, Fife continued to deceive Curl about the status of Rheaume's investment. In July 2000, Curl requested a report of the balance in Rheaume's account. Fife forwarded to Curl letters from Herula purporting to report Rheaume's investment plus accrued interest in the Brite Account at

Raymond James. Those reports were false because by then the money in the Brite Account was nearly depleted. After several months, Curl requested the return of Rheaume's funds, but Fife falsely told him that the money could not be returned because Raymond James was worried about large sums of cash coming into and going out of an account in a short period of time. Pet. App. 8a.

A few months later, Fife suggested to Curl that Rheaume transfer its $12.5 million investment plus accrued interest, which was supposed to be in the Brite Account at Raymond James, to an account at Charles Schwab in order to facilitate a "swift return" of those funds. Pet. App. 8a. Then he informed Curl that the money had been transferred and forwarded statements purporting to show that the money was in an account in Capalbo's name at Schwab, where it was supposed to be pooled with other investor money and invested in securities. *Id.* at 8a-9a; C.A. App. 11. No funds were ever moved to Charles Schwab or invested in securities there. Pet. App. 9a.

When Curl again requested return of the funds, Fife falsely told him that the National Association of Securities Dealers (NASD) had frozen the account. Fife offered to use the money in other finance deals once the NASD released the money, and stated that he would be able to use Rheaume's money to generate excellent returns on other project finance deals. In fact, no Rheaume money was in the Schwab account because it had all been dissipated. Pet. App. 9a.

In December 2001, Khan sent letters to Al Bloushi soliciting his further investment in a similar investment proposal. He promised huge returns "without any risk." Pet. App. 10a.

2. a. In April 2002, the SEC brought this civil law enforcement action against petitioners and the others who perpetrated the Brite scheme. The SEC charged that petitioners had violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and that petitioner Fife had engaged in fraud as an investment adviser, in violation of antifraud provisions of the Investment Advisers Act of 1940. The district court granted the SEC's motion for a preliminary injunction and froze petitioners' assets pending final adjudication of the SEC's complaint. Pet. App. 22a-81a.

b. The court of appeals affirmed the district court's grant of the preliminary injunction and asset freeze. Pet. App. 1a-21a. As to the Securities Act and Exchange Act fraud claims, the court found that the Commission's evidence established that petitioners made material misrepresentations with scienter when Fife made a series of misrepresentations to Curl about the investment program and about how he had handled, and would handle, Rheaume's funds, and when Kahn represented to Al Bloushi that the Brite investments were safe. *Id.* at 17a-18a. The court further held that the misrepresentations were made in connection with the purchase or sale of securities. *Id.* at 19a.

As to the Investment Advisers Act claim, the court of appeals held that Fife met the statutory definition of an investment adviser because he advised Curl regarding Rheaume's investment, and that he "made various transfers of Rheaume's money without prior authorization, invested money in money market accounts without prior authorization, and falsely represented the status of Rheaume's funds." Pet. App. 19a-20a. The court further held that Fife was working "for compensation," even though he had not yet agreed on the

precise terms of payment, because "he understood that he would be compensated for his efforts by a commission based on a percentage of the profits from the investments, *if successful*, pursuant to a formula to be agreed upon at a later time." *Id.* at 20a.

ARGUMENT

The decision of the court of appeals is correct, and it does not conflict with any decision of this Court or another court of appeals. Petitioners' fact-bound challenges to the court of appeals' decision do not warrant this Court's review.

1. Petitioners first contend (Pet. 10-20) that their fraudulent conduct was not "in connection with the purchase or sale of any security," within the meaning of Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5, or "in the offer or sale of any securities," within the meaning of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a). But the court of appeals correctly applied the established law concerning those provisions, as recently clarified by this Court in *Securities and Exchange Commission* v. *Zandford*, 535 U.S. 813 (2002), to the particular facts of this case. That case-specific application of settled law does not warrant this Court's review.

Petitioners argue (Pet. 15-20) that they are not responsible for false representations made by others before Rheaume's funds were initially invested, and that the false representations that petitioners themselves made were not "in connection with the purchase or sale of any security" because they occurred after the initial investments.[1] That argument, however, over-

[1] The record demonstrates that petitioners were full and knowing participants in the entire fraudulent scheme. Therefore, they violated Section 10(b) and Rule 10b-5, regardless of when or

looks the fact that Fife made unauthorized purchases and sales of securities after the May 2000 letter, which promised that he would buy and sell securities only with Rheaume's authorization. See Pet. App. 5a-6a, 8a. Petitioners' argument also ignores later false representations to Curl about other purchases in order to cover up the misappropriation of Rheaume's money, thus delaying or preventing detection of the scheme. See *id.* at 8a-9a.[2]

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whether they personally made any verbal misrepresentations, because that fraudulent scheme was in connection with the purchase or sale of securities. See 15 U.S.C. 78j(b) (prohibiting use "in connection with the purchase or sale of any security" of "any manipulative or deceptive device or contrivance"); 17 C.F.R. 240.10b-5 (making it unlawful for any person "[t]o employ any device, scheme, or artifice to defraud" or "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security"). The judgment of the court of appeals upholding the preliminary injunction and asset freeze can be sustained on that ground. The court of appeals, however, upheld the injunction based on petitioners' own misrepresentations, and, as explained in the text following this note, that determination was also correct.

[2] Petitioners' argument also incorrectly assumes that, once Rheaume had made the initial decision to invest in Brite, it made no further decision to continue or to renew that investment. Rheaume's initial investment in Brite, made in March 2000, was limited to 90 days. See Pet. App. 7a; C.A. App. 14. Fife sent his false May 2000 letter before the expiration of that 90-day period. Curl did not request return of Rheaume's funds until well after the end of the 90-day period, Pet. App. 8a, and his failure to request return of the funds at the end of the 90 days amounted to a decision to reinvest in the program. The record establishes that Curl chose to leave Rheaume's money invested in Brite beyond the initial 90-day period in part because he had confidence in Fife, based on Fife's false representations about the safety of the money. C.A. App. 9-11.

As the court of appeals explained, the May 2000 letter promised that Rheaume's money would not be transferred or used for securities transactions without Rheaume's knowledge and authorization. Pet. App. 7a. But Fife thereafter transferred money out of the Raymond James account into the Capalbo account without any authorization from Rheaume. *Id.* at 8a. And "[t]he funds in the Capalbo account were invested in securities without Rheaume's knowledge or authorization." *Ibid.*[3]

The court of appeals also explained that, later in the scheme, Fife recommended that Rheaume transfer $12.5 million to a Capalbo Account at Charles Schwab, Pet. App. 8a, and then falsely told Rheaume that those funds had been pooled with other investor funds in the Schwab account, *id.* at 9a. Fife further represented that, while the money was held at Schwab, it would be invested in money market shares. C.A. App. 11. In fact, the funds were never transferred to Schwab and used to purchase money market shares there. See Pet. App. 9a. The court of appeals correctly relied on those material misrepresentations about actual securities transactions and promised securities transactions that were not carried out to conclude that petitioners made material misrepresentations "in connection with the purchase or sale of securities." *Id.* at 19a.[4]

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[3] See also Pet. App. 6a ("As of September 18, 2000, all of the investment money under Fife's control in the Brite Account at Raymond James had been transferred out. The money deposited in the Capalbo Account was used to purchase shares in a money market mutual fund.").

[4] As the court of appeals observed, Khan was Fife's "partner" in the investment program. Pet. App. 10a, 18a. He participated in Fife's fraudulent scheme, *id.* at 10a, and received proceeds from it, *id.* at 6a n.7. Khan was thus a participant in that fraud and liable

Contrary to petitioners' contention (Pet. 10-15), the court of appeals' decision is consistent with established law construing Section 10(b)'s "in connection with" requirement and is squarely supported by this Court's decision in *Zandford*. Although petitioners cite various court of appeals and district court decisions (Pet. 10-11, 14-15) which they contend conflict with the decision in this case, petitioners' claim of conflict (to the extent that they explain it) is based on the mistaken premise that no securities transactions occurred after petitioners' misrepresentations. Moreover, all of the lower court cases cited by petitioners predate this Court's recent decision in *Zandford*.

The *Zandford* decision fully supports the holding of the court of appeals in this case. In *Zandford*, the Court reiterated its long-standing view that the securities laws "should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.'" 535 U.S. at 819 (quoting *Affiliated Ute Citizens* v. *United States*, 406 U. S. 128, 151 (1972), and *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1963)). And the Court specifically endorsed the SEC's long-standing position "that a broker who accepts payment for securities that he never intends to deliver, or who sells customer securities with intent to

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under Section 10(b) and Rule 10b-5 for that fraud even though he did not personally make any verbal misrepresentations before any securities transactions. See note 1, *supra*. Furthermore, Khan made fraudulent offers of securities to investor Al Bloushi, see Pet. App. 10a, and he therefore violated Section 17(a) of the Securities Act, which does not use the phrase "in connection with the purchase or sale of any security," but instead requires that the fraud be "in the *offer* or sale of any securities." See 15 U.S.C. 77q(a) (emphasis added). Khan's violation of Section 17(a) provides an independent basis for the relief awarded against him.

misappropriate the proceeds, violates § 10(b) and Rule 10b-5." *Ibid.* (citing *In re Bauer*, 26 S.E.C. 770 (1947), and *In re Southeastern Securities Corp.*, 29 S.E.C. 609 (1949)).

Petitioners engaged in the kinds of fraudulent activity that the Court in *Zandford* held are "in connection with" the purchase or sale of securities. When, without authorization, Fife sold money market shares in the Capalbo account so that he and Khan could use the money for unauthorized expenditures, Fife sold "customer securities with intent to misappropriate the proceeds." 535 U.S. at 819. And when Fife falsely promised to sell Rheaume's $12.5 million investment and use the proceeds to purchase money market shares at Schwab, he acted much like a stock broker who "accepts payment for securities that he never intends to deliver." *Ibid.*[5]

Although no securities were actually purchased in the Schwab Account, the false promise to purchase securities that the defendant has no intention of delivering is a violation of the Section 10(b) and Rule 10b-5. See *Zandford*, 535 U.S. at 823-824 (citing *Wharf (Holdings) Ltd.* v. *United Int'l Holdings, Inc.*, 532 U. S. 588 (2001)). Moreover, the subsequent misrepresentations that the promised transactions had occurred (see Pet. App. 8a-9a) were a further aspect of the fraud. See *SEC* v. *Holschuh*, 694 F.2d 130, 143-144 (7th Cir. 1982).

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[5] The only difference is that Fife did not "accept payment" at that time because he already had possession of and had spent most of Rheaume's funds, and Capalbo and Herula had taken the rest. In the situation described by the Court in *Zandford*, the fraudulent promise to purchase securities allows the broker to obtain the funds that he plans to misappropriate. In this case, the fraudulent promise to purchase securities allowed Fife to conceal that he had already misappropriated Rheaume's funds.

In short, petitioners engaged in a protracted course of conduct, involving various real and purported transactions in securities, for the purpose of diverting the money invested by Rheaume into secret unauthorized transactions that benefitted petitioners and others. Thus, this case, like *Zandford*, involves "a fraudulent scheme in which the securities transactions and breaches of fiduciary duty coincide. Those breaches were therefore 'in connection with' securities sales within the meaning of § 10(b)." 535 U.S. at 825.

2. Petitioners also seek (Pet. 20-23) this Court's review of the question "whether a preliminary injunction and/or asset freeze can be based exclusively on inadmissible evidence." Pet. 20. But that question is not presented by this case. Neither the district court nor the court of appeals held that a preliminary injunction or asset freeze can be based on only inadmissible evidence. Moreover, the injunction and freeze imposed in this case are amply supported by admissible evidence, and petitioners' fact-bound contention that those orders are not adequately supported by such evidence does not warrant this Court's review.

The SEC introduced substantial evidence in support of the preliminary injunction and asset freeze, including sworn investigative testimony that the Commission had taken from Fife and Khan, an affidavit from Curl, and documents obtained from them, the authenticity of which has not been questioned. C.A. App. 9-18 (Curl affidavit and exhibits); C.A. App. 159-311 (Fife testimony); C.A. App. 312-318 (Khan testimony); C.A. App. 438-443, 455-466, 471-480 (documents). The district court directed the Commission to produce a live witness, and the Commission presented Bradford Ali, the staff attorney who had conducted the investigation, to offer the documents. But it was the documents

themselves, not the attorney's testimony, that provided the basis for the district court's decision.

3. Petitioners also mistakenly contend (Pet. 23-27) that the court of appeals erred in concluding that Fife acted as an investment adviser. Petitioners do not claim that the court's decision on that issue conflicts with the decision of any other court; nor do they explain why that fact-specific determination warrants this Court's review.[6]

The Investment Advisers Act, 15 U.S.C. 80b-6(1) and (2), prohibits fraud by an "investment adviser," which is defined to include "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." 15 U.S.C. 80b-2(a)(11).

As the court of appeals explained, Fife fits well within that definition. Pet. App. 19a-20a. When Fife recommended that Curl transfer Rheaume's funds from the Raymond James account to a money market fund at Charles Schwab, he advised a client as to the advisability of investing in, purchasing, or selling securities. More fundamentally, it has long been recognized that the Investment Advisers Act covers those who "'advise' their customers by exercising control over what purchases and sales are made with their clients' funds," which is what Fife was supposed to do under his

[6] The court of appeals' holding that the SEC made a prima facie case that Fife was an investment adviser and that he violated the antifraud provisions of the Investment Advisers Act provides an independent basis for all of the relief granted against Fife. It is thus another reason why petitioners' challenge to the court of appeals' holdings regarding Section 10(b) and Section 17(a) does not warrant this Court's review.

arrangement with Brite. *Abrahamson* v. *Fleschner*, 568 F.2d 862, 870-871 (2d Cir. 1977), cert. denied, 436 U.S. 905 and 913 (1978); see *United States* v. *Elliott*, 62 F.3d 1304, 1310-1311 (1995), as amended, 82 F.3d 989 (11th Cir.), cert. denied, 519 U.S. 859 (1996).

The court of appeals also correctly concluded (Pet. App. 20a) that Fife was working "for compensation." 15 U.S.C. 80b-2(a)(11). Fife himself testified that he expected that he "would be compensated" by receiving "a percentage of the profits" from the program. C.A. App. 198. Payment of a percentage of the profits from an enterprise is a recognized form of "compensation" under the Investment Advisers Act. See *Elliott*, 62 F.3d at 1310-1311; *Abrahamson*, 568 F.2d at 870.

Fife argues (Pet. 26) that, although he expected to be paid, he was not subject to the obligations of an investment adviser because he had not been paid at the time of his fraudulent conduct. Nothing in the text of the Investment Advisers Act specifies that payment must be received before the fraudulent conduct occurs. And it would seriously undermine the protection provided by the Act if an adviser were not covered by the antifraud provisions until after he receives payment for his adviser services. For the same reasons, Fife is not outside the Act's coverage because the terms of his payment had not yet been finalized. The Act seeks to prevent fraud by those in the business of providing investment advice, and Fife was acting in that capacity. The court of appeals therefore correctly concluded that Fife was an investment adviser.[7]

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[7] Fife may also be deemed to have received compensation because he used a substantial amount of the money that he had been entrusted to manage and invest for his own purposes, including making "loans" to his friends and an entity he controlled.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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