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UNITED STATES OF AMERICA
Before the
SECURITIES EXCHANGE COMMISSION

In the Matter of MICHAEL R. PELOSI, Respondent.	Administrative Proceeding File No. 3-14194

PRETRIAL BRIEF OF MICHAEL R. PELOSI

JOHN R. HEWITT
Of Counsel and On the Brief

McCARTER & ENGLISH, LLP
245 Park Avenue, 27th Floor
New York, New York 10167-0001
(212) 609-6800
Attorneys for Michael R. Pelosi

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PRE-TRIAL BRIEF OF MICHAEL R. PELOSI

Pursuant to the Rule 222(a)(1) and (2) of the Securities and Exchange Commission's ("Commission" or "SEC") Rules of Practice and the March 14, 2011 Scheduling Order in this matter, Respondent Michael R. Pelosi ("Pelosi") is filing this Prehearing Brief. In this case, the Commission's Division of Enforcement is alleging that Mr. Pelosi has willfully violated Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act").

The allegations against Mr. Pelosi ("Pelosi") originate with his employment from 2005 to 2008 as an investment adviser at Halsey Associates, Inc. ("Halsey" or the "Firm"), an investment adviser registered with the Commission under the Advisers Act. Specifically, the Staff's alleges that from 2005 through August of 2008 Pelosi knowingly or recklessly misreported account performance returns to his investment-advisory clients and that he repeatedly provided false account performance returns to clients in quarterly and annual correspondence by exaggerating account gains and minimizing performance losses. They further allege that Pelosi misrepresented performance returns across various asset classes, and consistently inflated the total account performance returns for quarterly and twelve month periods.

The Staff alleges that, over the course of more than three years, Pelosi reported annual portfolio performance results in more than 250 instances and quarterly performance results in more than 210 instances. Of these performance representations, Pelosi inflated performance results more than 75% of the time. The size of the inflated results ranged from 0.01 percentage point (1 basis point) to more than 4.64 percentage points (464 basis points) and, in more than half of the instances, the results were overstated by more than 0.25% (25 basis points).

Based on the facts and law specified below. Mr. Pelosi denies these allegations and requests that, after an appropriate hearing on this matter, it be dismissed in its entirety.

I. Factual Discussion

A. Background

Mr. Pelosi is currently a Senior Portfolio Manager with YHB Investment Advisers, Inc. ("YHB") in West Hartford, Connecticut, and, in this role, manages investment portfolios for approximately 30 YHB high net worth and institutional clients. Mr. Pelosi is a life-time resident of the Waterbury, Connecticut area, and, in 1986, graduated Magna Cum Laude from the University Of Connecticut ("UConn") with a Bachelors of Science Degree in Finance with a minor in Economics. While an undergraduate at UConn, Mr. Pelosi worked part-time for the Bank of Boston ("BB"), and, upon graduation in 1986, accepted a full time position with BB. Thereafter, Mr. Pelosi simultaneously sought and obtained a MBA from UConn (also Magna Cum Laude) and a CFA, completing the CFA Certification in 1991 and the MBA in 1994.

At BB, Mr. Pelosi's first full-time position was as a credit analyst, and, after several promotions, he was made a portfolio manager in 1988. In this role, he managed approximately $100 million in assets for approximately 80 clients. In the early 1990s, Mr. Pelosi received a series of promotions, advancing to become a Senior Portfolio Manager and managing several hundred million dollars in assets for over 200 clients. He was later made the Team Leader for the BB Technology sector and a member of the BB Investment Strategy Committee. In addition to these responsibilities, Mr. Pelosi was later asked to manage one BB fund-the 1784 Asset Allocation Fund-and to co-manage a second-the 1784 Small Cap Equity Fund. He was named a Senior Vice President of Bank of Boston in the late 1990's , and, at that point, was managing over $ 350 million in assets.

BB was acquired by Fleet Bank ("Fleet") in 1999, and, in addition to the above responsibilities, Mr. Pelosi was made a member of the combined bank Investment Policy Committee. Shortly thereafter, he was also made Co-Head of Columbia Large Cap Core Equity Team and a Senior Vice President. The Bank of America ("BA") acquired Fleet in 2003, and, after this acquisition, Mr. Pelosi continued in the various roles noted above. In addition, his team was asked to manage one of BA's largest equity funds-the National Strategic Growth Fund.[1] At this point, Mr. Pelosi was managing over $2 billion in assets.

After assuming a senior role at Fleet in 2000, Mr. Pelosi was regularly approached by Fleet and later BA to relocate to New York or Boston, and to relinquish his individual advisory work so as to focus more on his other responsibilities. However, Mr. Pelosi desired to remain in his hometown, and was reluctant to relinquish his individual advisory work as he valued and thoroughly enjoyed it. After extensive consideration, Mr. Pelosi determined that he did not desire to move, or to give up his individual advisory relationships. As a result, he began a discrete review of possible employment opportunities in the Central Connecticut area.

B. Halsey Employment

Over the course of the next year, Mr. Pelosi reviewed various employment opportunities including starting his own advisory firm, joining a local bank as its Chief Investment Officer and becoming a partner and a portfolio manager at Halsey Associates, Inc. ("Halsey"), an investment advisory firm located in New Haven, CT. In considering the option of starting his own firm, Mr. Pelosi had consulted with Ken Julian ("Julian"), a Halsey partner and former BA colleague. In these discussions, Mr. Julian expressed an interest in having Mr. Pelosi interview with Halsey. Mr. Pelosi later accepted this invitation and had extensive discussions with all current Halsey partners and more detailed conversations with Mr. Julian and Jim Zoldy ("Zoldy"), another Halsey partner. Through these, he learned that Halsey had primarily high net worth and small institutional clients with assets of $750,000,000, and its founding principals had either recently retired or were soon intending to retire. Halsey was then in a managerial transition from its founding partners to a second generation of leadership which then consisted of Mr. Julian and Mr. Zoldy.

As a result, Halsey was seeking experienced portfolio managers ("PMs") and was quite eager to have Mr. Pelosi, a seasoned and successful manager, become a part of their organization. In their discussions, Mr. Julian and Mr. Zoldy emphasized that they were intent on adding new portfolio managers to restore the firm to its previous structure of 5-6 PMs and were desirous of seeking new business. They also noted that, by virtue of recent retirements, their

[1] Among his many responsibilities, Mr. Pelosi was also involved inthe development of model portfolios at BB, Fleet and BA.

account load had grown beyond any previous level at Halsey and presented a significant challenge to them. In response to this, Mr. Pelosi suggested that Halsey develop a model portfolio as he had done in his work at the banks. A model portfolio would ensure that each client portfolio reflected the firm's best thinking in a timely way and create greater efficiency in handling Halsey's account load. Mr. Zoldy and Mr. Julian expressed great interest in implementing this at Halsey, and also agreed on Mr. Pelosi's suggestion to add new research tools for its analytical use. Mr. Zoldy and Mr. Julian also described their monthly portfolio management investment meetings where they would work jointly on research initiatives. Mr. Julian and Mr. Zoldy also promised that, although Mr. Pelosi was expected to bring in accounts himself (which was a departure from the founder's hiring practice), they would share with him a portion of the firm's accounts, including those of a retiring partner. Mr. Pelosi would also become a full partner within five years with a 20% interest in the firm.

The Halsey situation appealed to Mr. Pelosi as it represented an opportunity to play a pivotal role in the development and expansion of this established firm near his home without the problems and risks of a start-up. He would also have an ownership interest in the firm that would progressively increase until he became a full partner. Further, as he valued and enjoyed the close relationships that came with managing portfolios for individuals and small institutions, this would allow him to continue in that work. He would also be intimately involved in the development of Halsey's model portfolio and would participate in collaborative research with his two partners. After lengthy consideration, Mr. Pelosi accepted a PM position with Halsey in April 2005.

C. Halsey's Business Operation

Upon assuming his position at Halsey, Mr. Pelosi discovered that its daily operation was considerably different than what he had anticipated. Contrary to his understanding, Mr. Zoldy and Mr. Julian each conducted their own separate research and exhibited little interest in a collaborative approach. Mr. Pelosi's efforts to initiate the use of a model portfolio, to hold weekly meetings, secure new analytical software or add to the PM staff also received little attention.

Additionally, Halsey's written compliance or supervisory policies and procedures were limited in scope and Mr. Pelosi learned that the firm did not conduct any e-mail, correspondence, order or pricing reviews nor did it have a formal record retention policy. This situation existed despite the fact that Mr. Zoldy and Mr. Julian had been senior officers at major financial institutions that had formal, structured compliance and supervisory policies and procedures.[2] This was genuinely disquieting to Mr. Pelosi.

Further, Mr. Pelosi was surprised to learn that Halsey's fixed income strategy involved illiquid, lower rated fixed income and preferred securities. Mr. Zoldy executed the majority of the preferred purchases for the Firm's clients, while Mr. Julian, working primarily through a broker at RBC Capital Markets ("RBC Broker"), executed most of the municipal and corporate bond orders. Mr. Zoldy also made it clear to Mr. Pelosi's clients were expected to participate in these investments, although they had no previous experience with them.

[2] Mr. Julian had been a colleague at BA and Mr. Zoldy had worked at Cititrust.

Pricing was yet another revelation. Proper pricing of portfolios is a requirement under the Federal securities laws, and, at his prior employer, this was done daily through automated means by a separate department.[3] Halsey did not have any definitive compliance procedures or other written policies for establishing security prices, for ensuring a uniform approach to pricing or for providing its clients with a uniform portfolio valuation in its quarterly or annual letter. Halsey's portfolio pricing occurred just once a month, was done manually and only those accounts that were to be reviewed that month or roughly one third were reconciled.[4] Further, while various automated pricing services were readily available, Mr. Zoldy, by himself behind closed doors, manually priced Halsey's fixed income securities on a monthly basis. This was never reviewed by anyone else at the Firm.[5] Mr. Pelosi was quite uncomfortable with this situation and discussed it with Mr. Julian, the Chief Compliance Office, who expressed concern but did nothing to address it.

Halsey's manual reconciliation of its client accounts on a monthly basis was another issue. Mr. Pelosi's prior experience was that reconciliations were done daily through the bank's automated systems. At Halsey, upon the completion of the pricing process (including the manual pricing of fixed-income investments by Mr. Zoldy), the portfolio assistants would begin the process of manually reconciling those accounts that were to be reviewed that month with those in the firm's system.[6] This manual pricing and reconciliation procedure often lead to inaccuracies in Halsey's client portfolios and its performance reports. Manual pricing for equities was eliminated in March 2008 by the employment of an Advent system that automatically updated all equity prices, although fixed income pricing was still done manually behind closed doors by Mr. Zoldy.

The SEC also found Halsey's reconciliation and portfolio management procedures to be problematic. Halsey was examined by the SEC Office of Compliance and Inspections from October 19, 2009 to January 29, 2011 and the SEC found:

> Halsey also lacks standard operating procedures in two areas; reconciliation and portfolio management. The staff believes that the firm should adopt written procedures documenting its processes of reconciling client account assets with custodial records as reflected in the firm's Advent system. The staff also believes that the firm should adopt written procedures documenting client reviews, meetings, and changes to client guidelines.
>
> Failure to know and follow adopted policies and procedures, and failure to adopt policies and procedures that reflect all critical elements of the advisory business is inconsistent with the requirements of Rule 206(4)-7.

Halsey's procedural failures in this area, antiquated systems, internal pricing of preferreds without review and manual entries (which often lead to errors) soon became a serious concern to Mr. Pelosi.

[3] Investment Advisers Act Rule 206(4)-7.
[4] Later, Halsey upgraded its Advent system to permit daily equity pricing.
[5] Mr. Zoldy used three sources for his manual pricing-Schwab, a price list from IDC (a pricing service) and one compiled by the RBC Broker. This broker also executed all of Halsey's fixed income orders.
[6] Halsey's system was an old Advent system.

D. Client Letters

Halsey had more than 500 clients with three PMs and three portfolio assistants to compile, draft and review their client quarterly letters ("Client Letters"). Previously, it had had 5-6 PMs with an equal number of assistants to perform this responsibility. As a result, this process now took a considerable portion of each month at the Firm which detracted from the firm's research responsibilities. The Client Letters were drafted by the portfolio managers with the assistance of the portfolio assistants and sent on a revolving basis so that roughly a third of Halsey's clients or some 165 clients were sent letters each month. As Halsey had no written procedure to guide its PMs in the composition and content of these letters and Mr. Pelosi had not received any definitive instruction in this from Mr. Julian or Mr. Zoldy, Mr. Pelosi initially designed a letter that was based on those currently used at the firm. These Client Letters contained initially a general discussion of the portfolio's performance over the last quarter, accompanied by the actual performance categorized by security on a quarterly and annual basis.

Depending on the portfolio, these categories could be equities (which included stocks and mutual funds), common stocks (if no mutual funds), taxable bonds, non-taxable bonds and preferreds. The latter three were sometimes included in a Fixed Income category. Some letters would provide this performance in a table, while others had them in a paragraph discussion. The remainder of the letter contained a review of the specific changes made in the portfolio during the last quarter. The Client Letters were accompanied by a detailed portfolio appraisal, which included the cost basis and current market value of each security and the total portfolio. Clients also received monthly statements from the independent custodian (Schwab), and could view their portfolio and its activity anytime at Schwab on-line. Schwab's on-line account statements contained real time detailed portfolio information including the quantity of the security held, the current dollar market worth, the current quote, the change in dollar value per share, the original cost basis, the actual dollar gain/loss and the actual percentage gain/loss. Schwab's account information would also provide the market worth, the cost basis, gain/loss and percentage of gain/loss for the total portfolio.

After the Advent upgrade to Halsey's systems, its portfolio assistants created the first draft of the letter and took the portfolio performance information in it from the firm's Advent System. Mr. Pelosi would then review these letters and make changes where he deemed appropriate. He would supplement the discussion of portfolio activity with a business description of equity positions added and the basis for their purchase, and a brief commentary of current economic and market conditions.[7] For his review, Mr. Pelosi was provided a performance report called the discounted cash flow report ("DCF Report") for the current quarter and another report, the time weighed return report ("TWR Report"), containing performance information on a quarterly basis over the previous year.[8] In his Client Letters, Mr. Pelosi used the quarterly performance information in the DCF Report as it was his understanding that this was Halsey policy. Due to the difference in the type and overall purpose of these reports, the

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[7] The Client Letter also included a report of the current market conditions called the Economic and Monetary Review written by Mr. Pelosi. Mr. Pelosi shared the responsibility for some new accounts with either Mr. Zoldy and Mr. Julian, and he solely managed most of the accounts that came from Columbia. In instances when an account was shared with another portfolio manager, both managers reviewed the reports for that client.

[8] The use of performance information by investment advisers in client correspondence is guided by a series of no-action letters issued by the SEC. See, e.g. Anametrics Inv. Mgmt., SEC No-Action Letter, 1977 SEC No Act LEXIS 1656 (May 5, 1977); Investment Counsel Association of America, Inc., SEC No-Action Letter, 2004 SEC No Act LEXIS 383 (March 1, 2004) and Clover Capital Management, Inc., SEC No-Action Letter, 1986 SEC No Act LEXIS 2883 (Oct. 28, 1986).

DCF and the TWR Report's performance information in the same period for the same investment often varied from one another.

E. Performance Information in Pelosi's Client Letters

Halsey's lack of pricing and valuation procedures, its antiquated systems and manual entry practice (which often lead to errors) resulted in Mr. Pelosi having a serious concern about Halsey's individual portfolio performance information and required him to conduct a detailed evaluation each month of the performance information provided to him. These evaluations revealed such problems as errors in asset class totals in the Performance by Asset Class Report, returns quoted in reports for the wrong period, differences in asset value between the Schwab account statements and the Halsey Advent reports, failure to enter any price at all in the Halsey reports, errors in the tables prepared for the Client Letters and account balances entered in the Halsey reports prior to the account being open. As a result, Mr. Pelosi often found the information inaccurate or untimely, requiring him to make revisions to them so as to ensure that his clients received timely and accurate performance information. This resulted in certain performance differences from the Halsey reports although they were usually small variants and often lead to a lower performance number. These revisions were completely consistent with the guidelines issued on this subject in various no-action letters by the Commission.[9]

1. Preferred Stock Pricing

One of the concerns that Mr. Pelosi had was the pricing of preferred securities. Halsey clients, at the direction of Mr. Zoldy, invested in illiquid preferred stocks with a bbb or lower rating. Preferred stocks are hybrid securities that share debt and equity characteristics. Like a bond, they promise a specified stream of cash flow (interest payments), but, like an equity, they usually rank junior to most debt obligations and are bought and sold like a stock. Preferreds are generally issued with long maturity dates (or none at all, as in the case of perpetual preferreds) and are very often callable at the issuer's discretion after a specified date. Interest is typically paid quarterly or semiannually, and interest payments often can be deferred up to a specified number of periods. These risk features are unique to preferreds, yet they also contain the basic default risks of bonds. However, the preferred risk is even greater since they are normally junior to bonds.[10]

Preferreds are also usually quite illiquid, trading a few thousand or just a few hundred shares per day, and it is not uncommon for an issue not to trade for a day or more. This illiquidity influences a preferred's value (both in the form of a liquidity discount that investors

[9] See footnote 8.

[10] While bonds are typically issued with a $1,000 par value, preferreds are often issued with a $25 par value (sometimes $10). The buyer of the bond expects to pay the agreed upon price for the bond plus accrued interest (i.e. earned but not yet paid). For example, an investor buys a bond in March that carries an 8% coupon, and it pays semiannually in December and June. In addition to the price of the bond, the buyer would also pay the seller the interest earned from December to March, or about one half the semiannual payment ($20 per $1,000 bond). However, preferreds trade flat. That is, there is no accrued interest owed to the seller. The total consideration is the price paid for the preferred, and the holder of the security on its X-dividend date receives the entire income payment. Consequently, if a preferred is sold several days before its X-dividend date for $25, it may appear to have sold at par. However, since it was sold just before the X date, it effectively sold at a discount to par since the buyer receives the income for the entire period, and, consequently, the buyer's yield on the security is greater than the coupon rate. At Halsey, Mr. Zoldy built a spreadsheet to calculate effective yields, considering the payment schedule, the current date, and the price at which the preferred was acquired. However, as the pricing was done by Mr. Zoldy behind closed doors, Mr. Pelosi did not know if or how this was factored into the preferred pricing. Even if it were factored in, the price of a preferred could still vary substantially on a daily basis as discussed below.

apply and through inefficient trading), and its volatility.[11] As Mr. Pelosi's clients had no prior experience in preferreds, he was concerned that they would not understand their pricing or their market behavior. For example, if a preferred went X-dividend several days before the end of a month, the market value of the security would decline by an amount approximating the dividend. However, the dividend might not have been paid, received and booked into the Advent system until the following month. Consequently, the market value of the Security was penalized by the amount of the dividend, without the offsetting benefit of the dividend. Moreover, the types of preferreds (and other low-rated fixed income Securities) that proved to be a cornerstone of Halsey's fixed-income approach were far more volatile than the traditional fixed-income securities that Mr. Pelosi's clients were accustomed to holding.

To address these issues, Mr. Pelosi, where appropriate, would make certain adjustments to the reported performance of the preferreds or other securities in his Client Letters which ensured that his customers would have a clearer understanding of their price and performance.

2. Cash Flow Discrepancies

Mr. Pelosi often found discrepancies in Halsey's reports on accounts in which there had been significant recent cash flows, for example, 10% or more of the value of the portfolio or an asset class. As a result, he began at an early stage to make certain adjustments in these results by performing a modified Deitz calculation. The Modified Dietz Method is a well recognized performance calculation used to determine the performance of an investment portfolio based on time weighted cash flow. It is an accurate way to measure the return on a portfolio because it identifies and accounts for the timing of all random cash flows. For Mr. Pelosi, the Deitz calculation was simple, took a short time and weighed the calculations so that, if the cash flows occurred in the first month of the quarter, for example, they would be weighed by a third. If the result of the Deitz calculation was consistent with the terms of the performance by security and the portfolio, Mr. Pelosi would use the manual calculation. He applied the same approach to any asset class where there were significant cash flows. Depending on the amount of incoming or outgoing cash, this could result in a significant change.

3. Combination of Reporting Categories

Mr. Pelosi also made adjustments in mutual fund, common stock and fixed income reporting. At Mr. Pelosi's prior firms, Client Letters, where appropriate, would include fixed income returns, total equity returns and a total return. The equity return would be relevant if there were a considerable holding of mutual funds and common stock in an account, as it combined the result of each. A fixed income category would be appropriate, where there were taxable and non-taxable bonds and possibly municipals. As a result, his clients were accustomed

[11] This complex pricing structure is further exacerbated by the maturity and call provisions of preferreds. The value of preferreds fluctuate based on perceived credit risk and interest rate risk (the longer the maturity of the security, the greater its interest rate risk), as do straight bonds. However, preferreds also trade based on the perceived likelihood of a call, since this significantly influences the effective duration of the Security and its sensitivity to changes in interest rate expectations. If investors view a call as likely, the preferred will trade based on years to the call. If they view it as unlikely, it will trade based on years to maturity. These call expectations change, often quickly and dramatically, causing fluctuations in the preferreds value. For example, in the fall of 2008, many preferreds lost more than half their value as the market quickly began to price preferreds based on actual maturity rather than call date, as it became clear that access to capital to refinance at lower rates was shut off. As a result, issues that were soon callable or even currently callable saw their effective durations elongate quickly, and prices collapsed.

to receiving an equity and fixed income return calculation which involved a computation combining the above categories.

4. DCF vs TWR

Mr. Pelosi used the DCF quarterly performance numbers in his Client Letters as he understood that this was Halsey's policy. Both DCF and TWR are frequently used by advisers as valuation mechanisms, and, in terms of performance evaluation, the TWR is time weighted while the DCF (which is also known as the Internal Rate of Return or IRR) is time and dollar weighted. As a result, each would often have a different performance return. This can be explained as follows:

> The TWR is time weighted only, whereas the IRR is both dollar and time weighted. As an example of the difference, consider the following example: A client gives an investment manager \$100,000 to invest for him for one year. At the end of the year the client's account is worth \$105,000. Assuming the manager invested the money at the beginning of the year and just let it ride for the entire year, both the IRR and the TWR for the year would be 5.00%.
>
> Now, assume the client gives the manager an additional \$95,000 dollars at the very end of year one. This gives the investment manager \$200,000 to invest for year two. Again the manager allocates and invests the full \$200,000 at the beginning of the year and lets it ride for the second year. At the end of the second year, the account is worth \$220,000. Both the IRR and TWR for year two would be 10.00%.
>
> What is the annualized TWR and IRR for the two year period? The TWR is (1.05 x 1.10) ^ (1/2)=(1.1550) ^ (1/2) =1.0747 or (1.0747-1)100=7.47%. The IRR is approximately {[(220,000-195,000)/147,500]+1} ^ (1/2)=[(25,000/147,500)+1] ^ (1/2)=1.1695 ^ (1/2) = 1.0814 or (1.0814 - 1)100=8.14%. This is a first order approximation of the IRR and is used for illustrative purposes only. The actual calculated IRR is 8.14%.
>
> The annualized IRR for the two year period is higher then the TWR because the investment manager had twice as much money to invest in year two when he made 10%, therefore the year two return is weighted twice as heavily. Remember, the IRR is time and dollar weighted, whereas the TWR is time weighted only.[12]

Therefore, the DCF performance figures used by Mr. Pelosi would often differ from those contained in the TWR Reports, and these and the other changes made by Mr. Pelosi in his Client Letters would, of course, lead to differences with the information maintained in Halsey's systems. Mr. Pelosi was aware of this and believed that these revisions provided his clients with a more timely and accurate understanding of their portfolio. Mr. David Audley, Mr. Pelosi's expert in this matter, will testify that Mr. Pelosi's use of these evaluation and reporting methods was completely consistent with all established industry standards.

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[12] See Time Weighted Rate of Return Key Concepts and Calculations, http://www.fpai.net/time%20weighted%20rate%20of%20return.htm.

Finally, Mr. Pelosi had no reason to create such a false impression regarding his client investments as they had consistently been profitable throughout this entire period.

F. Client Presentations

In addition to the Client Letters, Mr. Pelosi held frequent meetings with clients to review their portfolios. This included a portfolio appraisal from Advent, and a PowerPoint presentation that provided a clear picture of the client's portfolio including details of the major contributors to and largest detractors from their investment results.[13] This information included the yield of each investment in the portfolio, the actual income dollar value of each investment and the asset allocation summary that showed each asset class, the cost for each asset class, the cost basis for each asset class, the market value for each asset class and the income that each class would generate.

G. Discussions with Kathleen Rourke and Maureen Rynne Regarding Performance Adjustments

Two Halsey portfolio assistants, Kathleen Rourke ("Rourke") and Maureen Rynne ("Rynne"), each had separate conversations with Mr. Pelosi in 2008 regarding his adjustments to the performance figures in his Client Letters and/or PowerPoints. In each case, the assistant was preparing PowerPoint presentations for Mr. Pelosi's clients and noticed that some of the figures that they were using in the PowerPoint were different than those in the Halsey system.

In early 2008, Ms. Rourke inquired with Mr. Pelosi about this, and he responded that he had a different way of calculating the performance figures. Shortly thereafter, Ms. Rourke questioned him again on this, and he responded that "Well, I have to take other things into consideration." Ms. Rynne also noticed in this time period the difference in performance numbers when she was preparing a PowerPoint presentation for Mr. Pelosi and, in response to her inquiry, he responded that "he used a different calculation".

Evidencing his belief that he was acting in complete conformance with all regulatory requirements, Mr. Pelosi was openly making these adjustments to his clients' performance figures and readily discussing them with the two assistants that worked with him for over a year before he was confronted by Mr. Zoldy and Mr. Julian about them.

H. Pelosi's Success At Halsey

Mr. Pelosi's clients in his prior employment had experienced a long and successful investment relationship with him and, as a result, had developed a strong working bond with him. Consequently, Mr. Pelosi was able to secure many of his former clients for Halsey which substantially expanded its assets under management. Mr. Pelosi was successful in bringing 26 of his former relationships into Halsey with over $66,000,000 in assets. Additionally, during his Halsey employment, Mr. Pelosi was given the primary responsibility for the firm's investment strategy. Based on his research and analysis, he initiated coverage of 21 new common stocks for potential inclusions in Halsey client portfolios which represented 90%

[13] Mr. Pelosi would also send PowerPoint presentations to his clients for their quarterly reports.

of the new investments made by Halsey's clients in this time frame. As a result, Mr. Pelosi's clients continued to experience genuine success with Mr. Pelosi at Halsey.

I. Meeting Regarding Performance Adjustments

Despite Mr. Pelosi's success at Halsey, his relationship with Mr. Julian and Mr. Zoldy had deteriorated substantially over this period. This was due in large measure to the breakdowns and shortcomings in the collaborative investment process discussed with Mr. Pelosi during his interviews, and the failure of Mr. Julian and Mr. Zoldy to provide the various improvements and changes that had been represented to Mr. Pelosi. Mr. Pelosi had also questioned the pricing and reconciliation process, and the lack of redundancy and controls with respect to other important firm functions. As a result, Mr. Pelosi was alienated from Mr. Zoldy and Mr. Julian and was frequently excluded from their discussions and meetings. By early 2008, Mr. Pelosi was seriously considering leaving Halsey.

In early August of 2008, Mr. Julian and Mr. Zoldy convened an unannounced meeting with Mr. Pelosi and presented him with copies of several Client Letters where the investment results were at variance with those in the Advent System. At this brief meeting, Mr. Pelosi, when questioned about them, did not acknowledge these changes as being his, as he was genuinely confused by the extent of the revisions presented to him. As discussed above, when Mr. Pelosi had revised certain performance figures, he had done so selectively. As a result, he wanted an opportunity to review the letters before further discussion of them.

J. Pelosi E-mail and Memorandum

In the next several days, Mr. Pelosi had several brief discussions with Mr. Julian about this situation, but Mr. Julian and Mr. Zoldy refused to meet jointly him to review it in detail. This situation continued throughout August, and, as a result, Mr. Pelosi became increasingly concerned that his revisions, which were designed to provide his clients with a better understanding of their portfolio's performance, were being misinterpreted as an attempt to deceive his clients. In this time, Mr. Pelosi, based on his limited meetings with Mr. Julian, wrote one memo to Mr. Julian and Mr. Zoldy and one e-mail to Mr. Julian apologizing for his conduct at the first meeting.

In the e-mail, Mr. Pelosi states that "Beyond being embarrassed and ashamed of the matter at hand, I'm deeply ashamed I didn't tell you yesterday in the conference room". He further states that he had "truly deluded himself into believing it had happened in isolated instances but when I saw for myself I lost it." In the memo, Mr. Pelosi makes a lengthy apology for his "initial reaction" when he met in the Halsey conference room with Mr. Zoldy and Mr. Julian. He states that he is "embarrassed and ashamed by the performance issue" but that he 'cringes" at his behavior after the meeting. He noted that he is "overwhelmed with regret" and that "it was a very dumb thing to do, but it was a mistake".

Mr. Pelosi wrote this e-mail and the letter, as he had been encouraged by Mr. Julian to accept the responsibility for any differences that they had found. He was lead to believe that, if he did this, he would have the opportunity to make an appropriate analysis and to convey this situation to his clients. He was capitulating so as to secure more time to properly communicate with his clients and to find another job.

Mr. Pelosi's e-mail and memo were written in the most stressful of circumstances and are profusely apologetic. However, the apology is directed toward his conduct at the meeting and his failure to disclose to them his use of these performance figures. It is not an admission that he was attempting to deceive his clients. Rather, he was asking for an opportunity to explain these figures to Mr. Zoldy, Mr. Julian and, if needed, to his clients. While there was every reason to provide him with this opportunity, he was never given it.

K. Memorandum of Understanding

On August 27, 2008, Mr. Julian and Mr. Zoldy, again without prior notice, confronted Mr. Pelosi with a Memorandum of Understanding which, among other things, provided for his resignation and for a release of all claims against Halsey and its officers. It further stated that "As long as this expectation is met, Halsey will not report the events leading up to and including this separation to the proper regulatory authorities". He was required to sign it at that time without benefit of counsel or further consideration or the offer would be withdrawn.

While Mr. Zoldy and Mr. Julian had refused to discuss this situation with Mr. Pelosi, they had conferred with an attorney on it and apparently determined that the matter needed to be reported to the regulators. However, Mr. Zoldy and Mr. Julian would not report this, if Mr. Pelosi would cooperate with them. Mr. Pelosi, while expressing regret at making the revisions in the Client Letters without discussing them with Mr. Julian or Mr. Zoldy, did not believe that he had done anything wrong and consistently expressed his desire to explain his reasoning for them. Now, without the benefit of counsel, he was being coerced to resign without establishing his position. Though he had significant concerns about the legality of the document, Mr. Pelosi was led to believe that it had been drafted by an attorney. Left with no alternative at this point. Mr. Pelosi signed the memorandum.

L. Motives for Mr. Zoldy and Mr. Julian

Mr. Zoldy and Mr. Julian had hired Mr. Pelosi pursuant to a written contract that provided for him to become a partner with a 20% holding in the firm within a five year period. Although not in writing, they represented to Mr. Pelosi that they would initiate the use of a model portfolio, secure new analytical software or add to the PM staff. This never occurred. Mr. Pelosi also found Halsey's operations to be antiquated and its operational and compliance practices to be a potential problem. As Mr. Pelosi was vocal in his concerns, he had alienated Mr. Zoldy and Mr. Julian by 2008, and they had virtually isolated him from their working relationship.

It was apparently at this point when the two Halsey assistants approached Mr. Zoldy with their concerns about Mr. Pelosi's performance reporting. Under such circumstances, it could be anticipated that Mr. Pelosi, an officer of the firm, would be informed of the matter, allowed to review it in appropriate detail and then discuss and resolve it with his colleagues. Instead, Mr. Zoldy and Mr. Julian confronted Mr. Pelosi with this issue, did not provide him with any ability to analyze or explain it and, through the memorandum, coerced his resignation. In so doing, Mr. Zoldy and Mr. Julian removed what they clearly now viewed as a problem in their business, eliminated the requirement to make him a 20% partner and retained 26 new clients with $66,000,000 in assets.

M. Zoldy Pricing Adjustments

After Mr. Pelosi left the Halsey firm, Mr. Zoldy and Mr. Julian sent Mr. Pelosi's clients a letter explaining his departure and noting that some performance results previously provided may have been inaccurate or incomplete and included performance figures that purported to be accurate.

Mr. Zoldy and Mr. Julian had Ms. Frois, another portfolio assistant, initially draft these letters for their review. In at least two instances, Mr. Julian reviewed a draft letter from Ms. Frois that contained performance information from Halsey's Advent report and approved each letter. This was noted by a check mark on the drafts. These letters were then given to Mr. Zoldy who struck certain of the performance figures and substituted lower figures. When Ms. Frois questioned Mr. Zoldy on these changes, he said that the system was wrong to use these figures. In one instance, the performance was lowered from 26.3 to 12.2%. The revised letters were then sent out to clients.

In October of 2006, a client of Mr. Zoldy made a substantial deposit to its Halsey account. Shortly after this, Mr. Zoldy sent them a Client Letter containing the account's performance figures. Thereafter, the Bank of America (custodian for the account) notified Mr. Zoldy that it could not reconcile to the performance that he had reported to the client. Mr. Zoldy then instructed Ms. Frois to delete certain transactions in the account and re-run the performance. When that was done, he instructed her to replace the transactions. Ms Frois was very uncomfortable with this situation, so she copied the original performance in the asset history report, and marked on the report "Per Jim, delete transactions, and re-run performance". This was then placed in the file of the institutional investor.

II. Legal Analysis

A. Alleged Violations

The Staff is alleging that Mr. Pelosi's providing the discussed performance information in the Client Letters was fraudulent in violation of Sections 206(1) and (2) of the Advisers Act. Section 206(1) of the Advisers Act makes it unlawful for an investment adviser to employ a device, scheme, or artifice to defraud any client or prospective client. Scienter, "a mental state embracing intent to deceive, manipulate, or defraud", is required to establish violations of this section. SEC v. Steadman, 967 F.2d 636, 641, 641 n.3 (D.C. Cir. 1992) (quoting Ernst & Ernst v. Hochfelder. 425 U.S. 185, 194 n.12 (1976)); see also Aaron v. SEC. 446 U.S. 680, 686 n.5 (1980).

Recklessness may also satisfy the scienter requirement in Section 206(1). See SEC v. Steadman. 967 F.2d at 641-42. See also In re David Disner, 52 S.E.C. 1217, 1222, 1222 n.20 (1997); Hollinger v. Titan Capital Corp, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (examining recklessness as an indication of scienter). To meet the scienter requirement, recklessness must be "'highly unreasonable' and ... represent[] 'an extreme departure from the standards of ordinary care ... to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38. 47 (2d Cir. 1978) (quoting Sanders v. John Nuveen & Co. 554 F.2d 790, 793 (7th Cir. 1977)).

Section 206(2) of the Advisers Act makes it unlawful for an investment adviser to engage in any transaction, practice, or course of business that operates as a fraud or deceit on any client or prospective client. Scienter is not required to establish a violation of Section 206(2) of the Advisers Act; a showing of negligence is adequate. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); SEC v. Steadman, 967 F.2d at 643 n. 5; Steadman v. SEC, 603 F.2d 1126, 1134 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981). Negligence is the failure to exercise reasonable care. In re Warren Lambert, 2008 SEC LEXIS 937 at *69 (April 28, 2008).

Addressing materiality in Section 206 claims, the Seghers case noted:

> We have stated that "the standard for misrepresentation is whether the information disclosed, understood as a whole, would mislead a reasonable potential investor." *Trust Co. of Louisiana* v. *NNP Inc., 104 F,3d* 1478, *1490 (5th Cir. 1997).* "[A] statement or omitted fact is 'material' if there is a substantial likelihood that a reasonable investor would consider the information important in making a decision to invest." *ABC Arbitrage Plaintiffs Group* v. *Tchuruk, 291 F,3d* 336, 359 *(5th Cir. 2002)* (quotation marks and citation omitted).[14]

Relevant case law addressing various instances of fraudulent acts that violate Section 206(1) and 206(2) all contain facts involving a clear design to deceive existing and potential clients for a specific fraudulent purpose or extraordinary recklessness in such a

[14] SEC v Seghers, 298 Fed. Appx. 319, 328 (5th Cir. 2008).

situation. For example, the adviser in the Merrimac matter provided a false track record to maintain its existing clients and to gain new ones. The SEC noted the following:

> Merrimac obtained clients partly by using a false track record in the presentations made to Performance clients. For each of Merrimac's presentations, Performance provided its clients with a Management Report including performance data for Merrimac's portfolio of funds under management for the preceding five-year period. According to these Management Reports, Merrimac had a cumulative annual rate of return ranging from 20.2% to 20.5% for its portfolio, which substantially exceeded the performance of the S&P 500 index during the same time period. These performance numbers placed Merrimac's portfolio in the highest 2% of all of the money managers in the Performance database. In addition, these Management Reports frequently included a single page synopsis on each investment adviser called a Manager Watch. The Manager Watch for Merrimac stated that Merrimac managed $200 million of client funds for 10 clients and was founded in 1993. In addition, the Manager Watch contained graphs and charts providing and analyzing Merrimac's cumulative annual rate of return for the previous five years. The Manager Watch was based on information that French and Merrimac provided to Performance. Merrimac also provided each prospective client with a brochure. These brochures contained a summary of Merrimac's investment methodology and contained the same performance data for Merrimac described above.[15]

The respondents were found to have the requisite scienter and to have violated Section 206(1) and 206(2) of the Advisers Act.

In the Keifer matter, the adviser made misleading commentary in numerous advertisements:

> From July 1997 to January 2000, SKA and Kiefer represented in numerous advertisements that SKA had outstanding performance returns and significantly outperformed various stock indices, including the S&P 500 and the Rusell 2000. SKA and Kiefer disseminated, or caused others to disseminate, these documents to clients, prospective clients, solicitors who referred clients, and Nelson. The advertised performance returns for 1983 through 1996, however, were materially false. The advertisements falsely implied that SKA's performance history reflected actual trading in client accounts and that it had been in business since 1983. SKA and Kiefer did not manage any client assets from 1983 to 1993, and, therefore, did not achieve any performance returns during those years. Further, SKA's advertised performance for 1983 to 1996 did not reflect its actual performance. In fact, Keifer copies those performance returns from a book written by another money manager. Thus, SKA willfully violated,

[15] In re Merrimac Advisors Co., et al, Investment Advisors Act of 1940 Release No. 1977, Investment Company Act of 1940 Release No. 25195, 2001 SEC LEXIS 2007, at *4-*5 (Sept. 27, 2001).

and Kiefer willfully aided and abetted and caused violations of, Sections 206(1) and 206(2) of the Advisers Act. [16]

In these, the respondents were found to have the requisite scienter and to have violated Section 206(1) and 206(2) of the Advisers Act.

B. Pelosi's Lack of Scienter, Recklessness or Negligence in His Client Letters

In his Client Letters, Mr. Pelosi's sole intention was to ensure that his clients had a clear and accurate understanding of their portfolio's performance. The adjustments that he made to the performance information in these letters were designed to enhance this understanding and do not remotely approach the actions recited above that were found to have the requisite scienter, recklessness or negligence that is required for a violation of Sections 206(1) or 206(2). Even if this information was inaccurate, it is important to understand that the publication of inaccurate information is not a basis for a scienter claim.

> '[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter. The party must know that it is publishing materially false information, or the party must be severely reckless in publishing such information. Seghers, 298 Fed. Appx. at 331 (quoting Lovelace v. Software Spectrum, 78 F.3d 1015, 1020 (5th Cir. 1996).

In analyzing this situation, it is important to assess Mr. Pelosi's conduct in light of the overall circumstances before, during and after his Halsey employment. Mr. Pelosi had been an investment manager since 1988 with some of the largest and most prestigious financial institutions in this country and has held roles of great responsibility without a hint of questionable behavior.

Prior to joining Halsey, Mr. Pelosi took great care to ensure that Mr. Julian and Mr. Zoldy:

- were intent on reestablishing the firm to its former organizational structure;
- would establish a research-intensive investment process in order to assure attractive investment opportunities for their clients;
- would purchase a foundation of analytical tools and software, as it had none;
- would adopt a model portfolio;
- would assign Mr Pelosi to manage existing Halsey relationships; and
- would work collaboratively in their research.

[16] In re Stan D. Kiefer Assoc., et al, Investment Advisors Act of 1940 Release No. 2023, 2002 SEC LEXIS 723 at *5 (March 22, 2002).

These were important to Mr. Pelosi as he wanted to ensure that Halsey's organizational structure and operational systems would meet his requirements and that he would play a significant role in the firm. When he received these assurances, Halsey became an ideal candidate. He accepted the position, fully expecting a second challenging and rewarding career.

Instead, Mr. Pelosi found something quite different, as he discovered a firm with:

- an antiquated monthly manual pricing and reconciliation process;
- an unusual fixed income/preferred investment strategy;
- problems in portfolio and performance pricing;
- no compliance or supervisory policy or procedures;
- no reviews of correspondence, trading or pricing;
- no desire to work in collaboration; and
- no redundancy or controls with respect to important firm functions.

When Mr. Pelosi joined Halsey, he never received any written guidance or direction as to portfolio evaluation or client communications including Client Letters. Based primarily on informal guidance provided by Halsey's portfolio assistants, Mr. Pelosi had secured earlier drafts of Client Letters and used these as models for his letters. He also believed, based on this guidance, that the quarterly performance information in them should be based on the DCF Report that was provided to him for each account. This appeared logical to him as it was a quarterly report, while the TWR Report was an annual report. As Mr. Pelosi's expert will testify, both are commonly used and well recognized methods of performance reporting.

Mr. Pelosi also was concerned about the reported price of the preferred stock held by his clients as they were unfamiliar with this security and its unusual characteristics. He therefore made timely adjustments to ensure that the pricing properly reflected the dividend status, call provisions and liquidity. He made adjustments to particular asset classes through a Deitz calculation when he knew that a substantial cash flow had recently occurred in an account. Again, this was a commonly used mechanism in making such adjustments. He also would combine mutual funds and common stock into an equity category and taxable and non-taxable bonds into fixed income when it appeared appropriate. This was perfectly appropriate and was a common reporting mechanism that was used in his prior employment. All of this will be fully supported by the expert witness, Mr. Audley.

These changes are also more consistent with Mr. Pelosi's explanation than with any attempt to show false returns. They do not reflect any fraudulent design as Mr. Pelosi had no need to create fictitious performance information as his client's investments had performed well over this period. They are not remotely close to those addressed in <u>Merrimac</u> and <u>Keifer</u>, where the respondents' representations to their clients and the public were blatantly false.

In fact, Mr. Pelosi's use of alternative performance information had been openly discussed by him with the two portfolio assistants, Ms. Rourke and Ms. Rynne. Further, Mr. Pelosi shared certain accounts with either Mr. Zoldy or Mr. Julian and, in these instances, each would review the Client Letter prior to it being sent to the client. Until these letters became the subject of the discussion in August 2008, neither Mr. Zoldy nor Mr. Julian brought this issue to his attention. Prior to August 2008, Mr. Pelosi then was wholly unaware of any concerns that Halsey or its principals would have had about his use of the DCF Report or the other methods of performance reporting used by him.

While Mr. Pelosi believes that his calculations were a fairer representation of performance, he admits in hindsight that he used bad judgment in not discussing these in more detail with Mr. Zoldy and Mr. Julian. As noted, these adjustments were not in any way related to performance concerns as his client's results were consistently strong throughout his entire Halsey employment. In fact, Mr. Pelosi is not aware of one instance where a client complained to him or Halsey about the investment performance of their portfolio.

The Client Letters went to existing clients and discussed their current portfolios. They were not solicitous in tone or manner and focused on quarterly and annual portfolio activity. His calculations altered certain of the individual performance numbers in the Client Letters but, in no way, affected the Advent system, the specific market price of any security or the value of any portfolio. Equally as important, each Client Letter was accompanied by a detailed portfolio appraisal that included the quantity of securities held in the account, the cost per unit, total value, units held and income for each holding and the entire portfolio. Clients also received separately a monthly statement from the independent custodian (Schwab) containing detailed account information, and could view their portfolio and its activity anytime at Schwab on-line.

Viewing this from a different perspective, if Mr. Pelosi was truly intent on deceiving a client on their portfolio's performance, his method was seriously flawed, as the client information in the appraisal report, the Schwab monthly account statement and the on-line Schwab account information were never altered. Practically speaking, these are the most frequently viewed sources for laymen to determine portfolio performance. Schwab's on-line account statements contained real time detailed portfolio information including the quantity of the security held, the current dollar market worth, the current quote, the change in dollar value per share, the original cost basis, the actual dollar gain/loss and the actual percentage gain/loss. Schwab's account information also provided the market worth, the cost basis, gain/loss and percentage of gain/loss for the total portfolio.

Each client then could see at any time his/her percentage gain/loss on a real time basis per each security in their portfolio as well as their total portfolio percentage return. This then could be directly compared to the performance information in the Client Letter which was also based on a percentage return. While the DCF calculation was a somewhat different assessment, any material adjustment to it that was not consistent with the Schwab percentages would be immediately apparent.

Further, if Mr. Pelosi was intent on a fraudulent design, he allowed the only evidence of this - his Client Letters - to exist untouched in Halsey's records for years.[17] This was true even after he had the discussions with Ms. Rourke and Ms. Rynne about his use of alternative calculations. Further, his open and candid response to their questions and his continuation in this practice are further evidence of his lack of scienter.

Mr. Pelosi's adjustments in the Client Letters were also consistent with his practice of regularly meeting with his clients to make detailed PowerPoint presentations on their portfolios. This information included the yield on each investment in the portfolio, its actual income dollar value, and an asset allocation summary report that showed each asset class, the cost for each asset class, the cost basis for each asset class, the market value for each asset class and the income that each class would generate.

Further, there was also no financial motivation in these adjustments. Neither Mr. Pelosi's salary nor profit sharing was dependent on the performance numbers provided in the Client Letters, and the fees that his clients paid were never affected. Finally, as Mr. Pelosi's clients had done well for decades under his investment counseling at BA, its predecessors and at Halsey, there was no need for any improper alteration of their performance figures.

Mr. Pelosi's conduct is fully consistent with ensuring that his clients received accurate and timely information at all times and is in distinct contrast to any fraudulent design such as those recited in Merrimac and Keifer.

C. Information Changes in Client Letters Lacked Materiality

Material misrepresentations and omissions accompanied by the requisite intent can violate Advisers Act Sections 206(1) and 206(2). The standard of materiality is whether or not a reasonable investor or prospective investor would have considered the information important in deciding whether or not to invest. See SEC v. Steadman, 967 F.2d at 643 (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)); see also Basic Inc. v. Levinson, 485 U.S. 224, 231-32, 240 (1988). Investment advisers are fiduciaries and have an affirmative duty of utmost good faith and full and fair disclosure of all material facts. See SEC v. Capital Gains Research Bureau, 375 U.S. at 191-94, 201.

Material misrepresentations and omissions can also violate Section 206(2) of the Advisers Act. In re Chris Woessner, 2003 SEC LEXIS 646 at *27 (March 19, 2003). See also In re F.W. Thompson Company, Ltd., 2000 SEC LEXIS 1844 (September 7, 2000) (finding that an adviser's failure to adequately disclose an IPO allocation that favors a certain group of clients may be a material omission that violates Section 206(2)). The standard of materiality is whether or not a reasonable investor or prospective investor would have considered the information important in deciding whether or not to invest. Id. at *5.

Further, a fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision and if disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. See Basic Inc., 485 US at 231-32 (citing TSC

[17] Halsey had no procedural requirements to retain these letters.

Indus., Inc v. Northway, Inc., 426 U.S. 438, 449 (1976)). Materiality is a mixed question of law and fact. TSC Indus., 426 U.S. at 450.

In assessing materiality, courts have looked to significant variants such as in the Trabulse matter[18]:

> These account statements, however, did not accurately reflect the fund's actual performance during the quarter. For example, in the second quarter of 2005, although Trabulse reported to investors collective gains of approximately $2.5 million, the fund had actually realized a net loss in its brokerage accounts of over $200,000. From 1998 through 2006, he erroneously reported to investors that there were collective gains of about $30 millon, based on investments in stocks, derivatives, and foreign currency. The fund's brokerage accounts for that period, however, shoed profits of less than $10 million. He also overstated the fund's assets in the quarterly statements to investors. As of December 31, 2006, he reported that investors' collective assets totaled more than $45 million. Again, the fund's brokerage account records and bank statements showed that the value was less than $13 million (*id.* at PP 14-15).

Amounts "under a certain threshold" such as the adjustments in the Client Letters have frequently been viewed as immaterial as a matter of law. See SEC v. Todd, 2007 U.S. Dist. LEXIS 38985 at *14 (S.D. Cal. 2007) (citing In re Anchor Gaming Sec. Litig., 33 F. Supp. 2d 889, 895 (D. Nev. 1999) (finding Earnings Per Share impact of $ 0.03 or 2.5% immaterial as a matter of law)). In particular, courts have "found that allegedly fraudulent transactions which are under one or two percent of net operating revenues are immaterial." Mathews v. Centex Telemanagement, Inc., 1994 U.S. Dist. LEXIS 7895 at *18 (N.D. Cal. June 8, 1994) (citing In re Convergent Technologies Second Half 1984 Sec. Litig., No. C-85-20130-SW, slip op. at 22-23 (N.D.Cal. Jan. 10, 1990) (holding that transactions amounting to $ 1.2 million, but which accounted for 1.5% of revenue, were not material)).

The Client Letters went to existing customers; discussed their current portfolios and were not related to any pending transaction. They were not solicitous in tone or manner, and focused on quarterly portfolio activity, describing new purchases, liquidations, market conditions, and strategy. The performance changes that Mr. Pelosi made were usually small (under 1%) and often would actually be lower than the existing Halsey numbers, Thus, the numbers themselves cannot be viewed as material.

Further, "the standard for misrepresentation is whether the information disclosed, understood as a whole, would mislead a reasonable potential investor." Seghers, 298 Fed. Appx. At 328. The performance information was part of a continuous flow of account information provided to each client from both Halsey and Schwab, its independent custodian. Each letter contained a detailed appraisal and asset allocation summary, and each client received monthly portfolio statements from Schwab. They also had continuous access to their portfolio on Schwab's web site which contained all relevant account information.

[18] SEC v. Trabulse, et al, 526 F. Supp. 2d 1001, 1002 (N. D. Ca. 2007).

The latter is particularly significant as Schwab's on-line account statements contained real time detailed portfolio information including the quantity of the Security held, the current dollar market worth, the current quote, the change in dollar value per share, the original cost basis, the actual dollar gain/loss and the actual percentage gain/loss. Schwab's account information would also provide the market worth, the cost basis, gain/loss and percentage of gain/loss for the total portfolio.

Each client then could see his/her percentage gain/loss on a real time basis per each security in their portfolio as well as their total portfolio percentage return. This could be directly compared to the performance information in the Client Letter which was also based on a percentage return. If Mr. Pelosi was somehow adjusting this return to embellish the returns on the account, this would be immediately apparent upon comparison to the online account statement.

The lack of materiality is also supported by Mr. Pelosi's practice of being open and accessible to his clients through regular meetings and making detailed presentations to them including account appraisals and PowerPoint summaries. These included the yield on each investment in the portfolio, its actual income dollar value, and an asset allocation summary report that showed each asset class, the cost for each asset class, the cost basis for each asset class, the market value for each asset class and the income that each class would generate. A discussion of market conditions and expectations were a focus of these meetings, as was a discussion of appropriate strategies to take advantage of those expectations.

Further, the actions of Mr. Pelosi's clients after he left Halsey unquestionably establish that his adjustments were not material under Sections 206(1) or (2) above. Shortly after Mr. Pelosi left Halsey, Mr. Julian and Mr. Zoldy sent letters to all of Mr. Pelosi's clients informing them that he had left Halsey. While not specifically stating it, the letter unquestionably conveys the point that his departure was under questionable circumstances.[19] This resulted, in part, by a sentence in the letter stating "[i]t has come to our attention that the performance results communicated to you may not have been accurate or complete." It then provides the "correct figures". This leaves no doubt that Halsey was claiming that Mr. Pelosi had previously provided them with falsely altered performance figures. Mr. Pelosi's clients then were aware of Halsey's allegation and were even provided with the old and supposedly new performance figures. Despite this, when Mr. Halsey joined his current firm, YHB, in October 2008, his clients, with very few exceptions, left Halsey and joined him there within months.

A similar situation was addressed in the Abraham & Sons[20] matter. In assessing a penalty against respondents, the court noted that the harm caused by the deception was "best indicated" by the fact that the clients all withdrew their investments. Id. at *86. This indicator is equally applicable to the materiality issue in this matter. Here, the lack of materiality is evidenced by Mr. Pelosi's clients remaining with him as they then did not consider this information material as it was not "important in deciding whether or not to invest" with Mr. Pelosi. Id. at *75.

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[19] As discussed above, Mr. Zoldy altered the performance figures downward in two of these letters.
[20] In re Abraham & Sons Capital, Inc., et al, SEC Initial Decisions Release No. 135, 1999 SEC LEXIS 187 (Jan. 28, 1997).

In light of all the information provided to Mr. Pelosi's clients, the adjustments made by him to the performance figures in the Client Letters were not material as they could not be viewed by reasonable investors as "having significantly altered the total mix of information made available" to them in this situation. Id.

III. Zoldy and Julian Credibility and Motive

The above discussion establishes beyond question that Mr. Pelosi's conduct throughout his Halsey employment was in complete conformance with all requirements of the Advisers Act. This is further supported by the conduct of Mr. Zoldy and Mr. Julian whose credibility is seriously in question in this matter. This is evidenced throughout this period and begins with certain basic compliance failures. The Commission has addressed its requirement for accuracy in pricing and performance information in Staff commentary regarding the applicable rule, Rule 206(4)-7, Compliance Procedures and Practices. The Staff noted that this Rule requires an adviser to develop procedures for:

> The accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements. Examples of conduct that policies and procedures should be designed to prevent include:
>
> - Inaccurate or misleading performance numbers;
> - Inadequate supporting documentation for performance claims;
> - Valuing client holdings and assessing fees;
> - Illiquid or fair-valued assets not valued appropriately, or not back-tested; and
> - Inaccurate computation of fees, or fees based on inaccurate computation of client assets.[21]

Mr. Zoldy, as Halsey's senior supervisor, and Mr. Julian, as its CCO, were required to be conversant with this rule and its guidelines. Despite this, Halsey did not have any procedures designed to address these. This is not simply Mr. Pelosi's belief but an SEC finding in Halsey's audit. In this failure, Halsey, Mr. Zoldy and Mr. Julian each violated Rule 206(4)-7.[22]

This rule also requires reviews of all business correspondence including e-mails, yet Halsey failed to conduct such reviews. These requirements are not highly sophisticated, difficult to implement or costly-they were elementary. This is significant as it was Halsey's failure to address these that lead to Mr. Pelosi's concern about its pricing errors and his resultant pricing revisions.

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[21] Lori Richards, Put the Compliance Rule to Work: IA Best Practices Summit, (March 15, 2004) http://www.sec.gov/news/speech/spch031504lar.htm (addressing the requirements under Advisers Act Rule 206(4)-7). See also Proposed Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IC-25925, IA-2107 (Feb. 5, 2003), http://www.sec.gov/rules/proposed/ic-25925.htm.

[22] Halsey's failure to maintain proper books and records also violated Rule 204-2.

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Section 215(a) of the Advisers Act states the following:

> Waiver of compliance as void. Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder shall be void.

When Mr. Julian and Mr. Zoldy coerced Mr. Pelosi to sign the Memorandum of Understanding, they violated this provision. Their failure to accurately report this situation in their Form ADV and on Pelosi's Form U-5 violated Section 203, Registration of Investment Advisers and Rule 203-1, Application for Investment Adviser Registration. Here, Mr. Julian and Mr. Zoldy actively concealed this information from the SEC for nearly a year. A significant question here is why Mr. Pelosi was not permitted to consult with counsel when he was asked to resign. As to motive, this resignation allowed Mr. Zoldy and Mr. Julian to secure Mr. Pelosi's clients and their assets and to eliminate the need to make him a 20% partner.

Yet another issue was Mr. Zoldy's alteration of the performance figures in the client letters addressing Mr. Pelosi's departure. Ironically, this is exactly the accusation that he was making against Mr. Pelosi. This evidences either his fraudulent design or the very system problems that were a concern to Mr. Pelosi. In all, Mr. Zoldy and Mr. Julian's unethical and illegal conduct paints a portrait of two principals acting in blatant disregard of their compliance, supervisory and fiduciary duties for their personal gain.

Conclusion

In contrast to Mr. Zoldy and Julian's conduct, nothing in Mr. Pelosi's 25 year history offers the slightest suggestion of questionable conduct. His extraordinary and flawless record is the classic story of a young man from a small town, who, through hard work and determination, rises to the height of his profession. Admirably, he then chooses his family over what certainly would have been even greater success on a larger stage.

It is at Halsey that Mr. Pelosi first experiences questionable conduct. However, this discussion establishes that this originated with Halsey and its principals. Mr. Pelosi's actions were a good faith and reasonable response to the situation that he encountered, and, even if he made errors of judgment in this, his intention was to ensure that his clients had a complete and clear understanding of their portfolios. Certainly, his actions did not have the requisite scienter, recklessness nor negligence nor were the performance adjustments material in light of all the information provided to his clients to constitute violations of Sections 206(1) or 206(2) Mr. Pelosi would then respectfully request that this matter be dismissed.

Respectfully Submitted,

John R. Hewitt
McCarter & English, LLP
Counsel to Michael R. Pelosi