**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

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| **In the Matter of** | : | |
| **MICHAEL R. PELOSI,** | : | Administrative Proceeding<br>File No. 3-14194 |
| **Respondent.** | : | |

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# DIVISION OF ENFORCEMENT'S
# PREHEARING BRIEF

Respectfully submitted,

DIVISION OF ENFORCEMENT,
by its attorneys,
Richard M. Harper II
John J. Kaleba
U.S. Securities & Exchange Commission
33 Arch Street, 23rd Floor
Boston, MA 02110

Dated: May 27, 2011

# INTRODUCTION

In this matter, the Division of Enforcement (the "Division") alleges that from 2005 through August 2008, Respondent Michael R. Pelosi ("Pelosi") willfully misreported account performance returns to clients in quarterly and annual correspondence by exaggerating account gains and minimizing performance losses. The evidence will show that, Pelosi, one of three portfolio managers at Halsey Associates, Inc. ("Halsey"), a small investment advisory firm in New Haven, Connecticut, sent hundreds of client letters to firm clients falsely inflating their account performance. The evidence will also show that some of these false inflations were over 400 basis points. In at least 91 instances, these false inflations were over 100 basis points.

The evidence will also show that when the Halsey firm confronted Pelosi in August 2008 about his misrepresentations of account performance, Pelosi lied, blamed his administrative staff, deleted evidence, and then, ultimately, admitted to willfully misrepresenting account performance.

Because Pelosi willfully provided his clients with regular client letters falsely exaggerating gains and minimizing client losses, he defrauded and deceived his clients, breaching the fiduciary duty owed to them. As a result, the Division requests that the Administrative Law Judge ("ALJ"):

(i) make findings that Pelosi violated Section 206(1) and (2) of the Investment Advisers Act; and

(ii) based on such findings, issue an order pursuant to Section 203 the Advisers Act and Section 9 of the Investment Company Act, as appropriate, (a) requiring Pelosi to cease and desist from committing or causing violations of and any future violations of Section 206 of the Investment Advisors Act, (b) requiring Pelosi to pay an appropriate penalty; (c) imposing an appropriate bar prohibiting Pelosi from associating with any investment adviser or serving on a registered investment company; and (d) imposing such other remedial relief as the ALJ deems appropriate.

## STATEMENT OF FACTS

The Division expects the evidence will show:

### A. Halsey Hires Pelosi As An Experienced Portfolio and Client Manager

Halsey is a small investment advisory firm located in New Haven, Connecticut. Robert W. Halsey, a former Chief Investment Officer of the Yale University Endowment Fund, founded the firm in 1967. By mid to late 2004, the Halsey firm had at least three full-time portfolio managers who also were owners of the firm. These included Jim Zoldy ("Zoldy"), the firm's President, Ken Julian ("Julian"), the firm's Executive Vice President, and William Curran. Zoldy and Julian were the firm's younger partners, and Mr. Curran was an older partner who subsequently retired three years later in 2007.

During the 2004 timeframe, Halsey was looking to hire an additional portfolio manager to share the firm's existing clients and to expand the firm's capacity to take on new clients. To that end, Zoldy and Julian began searching for potential partners who would share not only the portfolio and client management responsibilities, but also ownership of their privately-held firm. As will be explained by Zoldy and Julian, they were looking to find a suitable candidate that would "fit" the firm's existing investment philosophy and management practices. In recruiting for the new portfolio manager, they were looking for the candidate to "fit" Halsey, rather than change it.

As part of this search Zoldy and Julian interviewed Respondent Pelosi, who was then a Senior Vice President and portfolio manager at Bank of America/Columbia Management Group. By 2004, Pelosi had been with Bank of America (f/k/a BankBoston and Fleet Boston Financial) for approximately 18 years, ever since his graduation from college in 1986. From approximately 1998 through 2004, Pelosi had been managing investment accounts for individual bank clients as a portfolio manager within BoA's Columbia Management Group. In that position, Pelosi reported account portfolio performance by sending his clients a computer-generated performance report that was provided to him by BoA/Columbia Management.

In February 2005, Halsey hired Pelosi to become a portfolio manager and Vice President of the firm. The generous employment terms included: an annual salary of $120,000, a share of account fees brought in by him or assigned to him by Halsey, and the opportunity to purchase firm stock and become an owner of the firm. Upon joining the firm, Pelosi brought roughly 25 clients with him from BoA/Columbia Management. To supplement Pelosi's client list and income, Halsey assigned him existing firm clients as well.

### B. Pelosi Learns The Halsey Way Of Reporting Portfolio Performance: Client Letters Communicating Computer-Generated Performance Calculations

At the time Pelosi joined the firm in February 2005, Halsey had a standard practice for reporting account performance to firm clients. The portfolio managers were responsible for sending clients letters on a quarterly and annual basis that reported the account's periodic performance in the body of the client letter. The firm staggered the letters so that each month, each portfolio manager would send out letters to one third of their client accounts.

All of the information necessary to send out the client letters came from Halsey's client account software program called Advent. Each month, Halsey's administrative assistants would use this program to print out, for each client, (1) an Account Summary, (2) a Portfolio Appraisal, and (3) a Performance History By Asset Class ("Performance History" or "TWR" Report). The Account Summary and Portfolio Appraisal reports show a snapshot of the account's current holdings, with detail on cost, market value and income. The Performance History or TWR Report, on the other hand, calculates a percent return for each investment class and the total account over the time period covered by the report. The Performance History report calculates the periodic return using a Time Weighted Return ("TWR") calculation.

In preparing the periodic client letters, the portfolio managers would enclose the Account Summary and Portfolio Appraisal, but would not enclose the Performance History Report. Instead, portfolio managers reported quarterly or annual account performance in the body of the client letter along with performance results for comparative market indices (such as the S&P 500).

Upon Pelosi's arrival at Halsey, Zoldy and Julian instructed Pelosi on Halsey business practices, including the communication of account performance results to clients. Zoldy and Julian also instructed Pelosi that, as a rule, the client letters should report the quarterly and annual performance results as generated by the Performance History Report.

At the time Pelosi joined the firm in February 2005, Halsey had two long-time administrative assistants, Kathleen Rourke and Maureen Rynne. Following the firm's long-standing practice, each month, from February 2005 through 2008, these administrative assistants provided Pelosi with the Advent reports (Account Summary, Portfolio Appraisal, and Performance History By Asset Class) necessary to draft and send client letters.

The practice of sending clients computer-generated performance results was entirely familiar to Pelosi. For the last ten years of Pelosi's career at BoA, he sent his investment advisory clients computer-generated account performance results. At Halsey, the only difference in reporting account performance was that Pelosi was responsible for drafting a client letter and including the report-generated performance results in the body of the letter instead of sending the actual report.

### C. Halsey Staff Observes Pelosi Misreporting Performance Calculations to Clients

Sometime in late 2007 or early 2008, Halsey's administrative assistants, Kathleen Rourke and Maureen Rynne, began to notice that Pelosi's client letters reported account performance that was different than the numbers on the Advent-generated reports. They asked Pelosi about these differences, and Pelosi responded that he had a different way of calculating performance or that he had to take "other things" into account.

After first noticing Pelosi's misreporting, Rourke and Rynne began to realize that Pelosi was making routine changes to the Advent-reported performance results in client letters, which was a substantial departure from Halsey's standard practices. Concerned about the appropriateness of Pelosi's conduct, on or about August 1, 2008, Rynne and Rourke approached Halsey's President, Jim Zoldy.

### D. August 2008 Halsey Investigation: Pelosi Lies, Blames Halsey Staff, Deletes Files, and then Admits Willful Misreporting of Account Performance

Upon receiving Rourke and Rynne's report concerning Pelosi's conduct, Zoldy immediately became concerned. Zoldy informed Julian of the issue and, over the next two weeks, the two principal Halsey officers gathered additional Pelosi client correspondence and compared the letters to the applicable periodic Advent report. The results of this investigation made Zoldy and Julian even more concerned. They found that Pelosi had been systematically misreporting client account performance, most frequently inflating the performance calculations. After completing their review, Zoldy and Julian decided to confront Pelosi about the misreporting.

On or about August 14, 2008, Zoldy and Julian invited Pelosi into the firm's main conference room and asked him to explain the discrepancies between his client letters and the Advent-generated reports. At first, Pelosi acted surprised, denied making any changes to performance calculations, and deflected any responsibility for numerical discrepancies to the firm's administrative staff or system errors. This statement was an obvious lie considering that Pelosi had previously told Rourke and Rynne that he had intentionally made these changes.

After the meeting, Zoldy and Julian asked the administrative staff to collect all of Pelosi's correspondence to further investigate the scope of potential discrepancies in Pelosi's performance reporting. As the Halsey staff began to compile these records, Pelosi went to his office and deleted electronic copies of his client correspondence. The firm staff observed the deletions as they attempted to print these letters. Zoldy immediately went to Pelosi's office and confronted him. Pelosi claimed he deleted the letters by accident. Halsey was able to restore the deleted files from backup tapes. The Halsey administrative staff collected all of Pelosi's past correspondence and provided the letters to Julian, who left them on top of his office credenza as he left the office on August 14.

On August 15, Julian arrived at his office and found that a large portion of the Pelosi letters had disappeared from his credenza. Julian confronted Pelosi, who denied any involvement in these missing letters. Julian then asked Pelosi to leave the office. Before Pelosi left the office, he and Julian had a short conversation in which Julian urged Pelosi to tell the truth about what Pelosi had done in misreporting account performance. Pelosi then left the office. Soon thereafter, Pelosi called Julian and asked him to meet Pelosi outside the Halsey offices. Julian met Pelosi outside the Halsey building, and they went for a walk around a local park. During this stroll, Pelosi admitted to willfully misreporting client performance in his client letters. Pelosi did not offer any excuses or justifications for this willful misreporting. It was a *mea culpa*.

## E. Written Apologies: Consciousness of Guilt

Following the initial confrontation by the Halsey principals, Pelosi provided two written apologies to Julian and Zoldy. On August 15, 2008, after his personal admission to Julian, Pelosi emailed Julian. In this email, Pelosi wrote:

> Beyond being embarrassed and ashamed over the matter at hand, I am deeply ashamed that I didn't just tell you yesterday in the conference room. I think I had truely (sic) deluded myself into believing that it had happened in isolated instances, but when I saw for myself, I lost it.

On Monday, August 18, 2008, Pelosi provided another written apology to Julian and Zoldy. In this letter, Pelosi wrote:

> I cant (sic) tell you how many times I've wished my initial reaction was different when we met in the conference room. I was panicked, I stopped thinking clearly, and I had sincerely convinced myself that any changes that I made were isolated. I cant (sic) explain how I felt when I realized they weren't…
>
> I'm embarrassed and ashamed by the performance issue, but I cringe at my behavior after the meeting…
>
> I am overwhelmed with regret. I could not be more sorry (sic). It was a very dumb thing to do, but it was a mistake… Nothing like this will happen again. I hope you can believe that and I hope you think I'm worth a second chance.

## F. Pelosi Termination, But Agreement Not To Report Misconduct To Regulatory Authorities

On August 27, 2008, Halsey and Pelosi signed a separation agreement, terminating Pelosi's association with the firm. Under the terms of the agreement, Pelosi immediately resigned from his position with Halsey, but was compensated through September 30, 2008. The firm also agreed to buy back Pelosi's Halsey stock. In addition, according to a specific provision under the termination agreement, as long as Pelosi did not disparage Halsey or its employees, Halsey agreed that it would "not report the events leading up to and including [Pelosi's] separation to the proper regulatory authorities." Zoldy and Julian agreed not to report Pelosi's conduct because they did not want to be responsible for ending Pelosi's career. And, Pelosi did remain in the industry. Shortly after leaving Halsey, Pelosi went to work at another investment advisor, YHB Advisors, located in West Hartford, Connecticut. He continues to work at YHB today as a Senior Portfolio Manager.

In late August and early September 2008, Halsey wrote to all of Pelosi's clients, informing them that Pelosi was no longer affiliated with the firm, and that "it has come to our attention that performance results communicated to you may not have been accurate or complete." These letters provided accurate quarterly and twelve-month performance figures for the period ending July 31, 2008, as reported from Advent. The letter, however, did not explicitly disclose that Pelosi misrepresented performance results or that he had been terminated for doing so. Approximately 72 of Pelosi's clients left Halsey to join him at YHB. Only 24 remained at Halsey.

### G. Halsey Reports Pelosi Misconduct After Being Fired By Informed Client

Zoldy and Julian ultimately changed their minds about their decision not to report Pelosi's misconduct. In early 2009, Zoldy and Julian disclosed the circumstances of Pelosi's termination to an important Halsey client, who immediately fired the firm. At that point, Zoldy and Julian realized that they had made a mistake in not reporting Pelosi's conduct and took corrective action. Approximately nine months after Pelosi's termination, in June 2009, Halsey submitted an amended FINRA Form U5, reporting that Pelosi had been terminated or resigned after allegations accusing Pelosi of "violating investment-related statutes, regulations, rules or industry standards of conduct."

### H. SEC Investigation and Data Showing Pattern of Exaggerated Account Performance

Following this disclosure, the Division conducted an investigation into Pelosi's alleged misconduct. As part of this investigation, the Division collected all of the Pelosi client correspondence retained by Halsey as well as the corresponding Advent reports. The Division then compared the performance data reported by Pelosi in his client letters to the performance data in the Advent reports. Consistent with what Zoldy and Julian observed during Halsey's investigation, the results showed that Pelosi systematically misrepresented account performance. Moreover, the data shows that Pelosi's misrepresentations overwhelming reported inflated account performance.

The Division's investigation collected approximately 240 Pelosi client letters. In these letters, Pelosi reported total annual performance for 298 accounts. In these reports of annual performance, Pelosi inflated account performance in 249 instances or 83% of the time. He reported deflated performance in 36 instances or 12% of the time and reported exact performance in only 13 instances or 4% of the time. If the Division accounts for the possibility of rounding by removing differences of less than 10 basis points, the data points even more strongly to an inflationary motive. When accounting for possible rounding, Pelosi inflated annual account performance in 210 instances or 70% of the time. He reported actual performance in 70 instances or 24% of the time. He deflated performance in only 18 instances or 6% of the time.

The data for Pelosi's reporting of quarterly account results shows roughly the same pattern of inflation. Pelosi reported quarterly total account performance for 261 accounts. In the report of quarterly performance of these accounts, Pelosi inflated account performance in 214 instances or 82% of the time. He reported deflated performance in 31 instances or 12% of the time and reported exact performance in only 16 instances or 6% of the time. If the Division accounts for possible rounding by removing differences of less than 10 basis points, the data points even more strongly to an inflationary motive. When accounting for possible rounding, Pelosi inflated quarterly account performance in 176 instances or 67% of the time. He reported actual performance in 77 instances or 30% of the time. He deflated performance in only 8 instances or 3% of the time.

In terms of size, Pelosi's falsely inflated performance numbers went well beyond the scope of legitimate mathematical rounding. Pelosi's client letters typically reported performance to the tenth place. In the inflation of annual account performance, in at least 51 instances, Pelosi's inflation was over 100 basis points. In at least 67 instances, Pelosi's inflation was over 50, but less than 100, basis points. In the inflation of quarterly account performance, in at least 40 instances Pelosi's inflation was over 100 basis points. In at least 39 instances, Pelosi's inflation of quarterly account performance was over 50, but less than 100, basis points.

In addition to total account performance, Pelosi also inflated the performance of individual investment categories. For example, Pelosi reported inflated performance results for common stocks, equities and bonds.

## I. Pelosi's Excuses: False or Unjustified

On July 28, 2009, Pelosi provided voluntary sworn testimony to the Division regarding the misreported performance results. As part of this testimony, Pelosi provided a variety of excuses for his misreporting and denied that he had ever willfully misreported client performance without justification.

The purported excuses or justifications offered by Pelosi are not supported by the record. For example, Pelosi offered that his reporting of quarterly results for total account performance was likely different because he used a Discounted Cash Flow ("DCF") Advent report for the reporting of quarterly performance. According to Pelosi, either Maureen Rynne or Zoldy or Julian told him to use the DCF report for reporting quarterly account performance. There are at least two large holes in this excuse, however. First, not one of the Halsey witnesses recall instructing Pelosi to use the DCF report. Second, the Division took the quarterly account performance Pelosi reported to his clients and compared it to the performance amounts in the applicable Advent DCF reports. The results showed the exact same pattern of inflation.

The Division expects that Pelosi will trot out the same excuses at this hearing. The Division will be prepared to show how these excuses are either false or *post-facto* justifications. The evidence will show that, at the time Pelosi made his inflationary misrepresentations of client performance, he did so willfully and without justification.

## LEGAL THEORY

Section 206(1) of the Investment Advisers Act of 1940 ("Advisors Act") prohibits any investment advisor from, directly or indirectly, employing any device, scheme or artifice to defraud any client or prospective client. Section 206(2) of the Advisers Act prohibits any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." The Supreme Court has held that the Advisers Act establishes a fiduciary duty for investment advisors to act for the benefit of their clients. Transamerica Mortg. Adviser v. Lewis, 444 U.S. 11, 17 (1979). An adviser's fiduciary duties include "an affirmative duty of utmost good faith, and full and fair disclosure of all material facts." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-94 (1963); Decker v. SEC, 631 F.2d 1380, 1384 (10th Cir. 1980).

Pelosi is an investment adviser under the Advisers Act and, accordingly, is subject to the fiduciary duty imposed by the statute. Pelosi breached his duty of utmost good faith and failed to provide full and fair disclosure of all material facts by, among other things, willfully exaggerating performance gains and minimizing performance losses in his client correspondence. Pelosi also breached his duty of utmost good faith and failed to provide full and fair disclosure of all material facts by, among other things, failing to inform clients that he had a regular practice of making unjustified and false adjustments to account performance and that he had made untruthful statements of fact about account performance to several clients over the course of many years. Pelosi's willful practice of exaggerating client gains and minimizing client losses through the misreporting of client account performance also operated as a deceit upon every client who received this false information from their fiduciary.

## **RELIEF REQUESTED**

The Division seeks imposition of a civil monetary penalty under Section 203(i) of the Advisers Act and Section 9(d) of the Investment Company Act of 1940 ("Investment Company Act"). Under these sections, the Commission may impose a civil penalty if a respondent has willfully violated any provision of the Investment Advisers Act or the rules or regulations thereunder. *See* 15 U.S.C. §§ 80a-9(d), 80b-3(i). Where the misconduct at issue involves fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, the Commission may impose a "Second Tier" penalty of $65,000 for each act or omission occurring between February 2005 and August 2008. Because the violations here involved fraud and deceit, and because the fraudulent and deceitful conduct occurred hundreds of times over more than three years, the Division seeks a three-time, second tier penalty of $195,000.

The Division also seeks imposition of a cease-and-desist order. Section 203(k) of the Advisers Act authorizes the Commission to impose a cease-and-desist order upon any person who "is violating, has violated, or is about to violate any provision of" the Advisers Act or any rule or regulation thereunder. *See* 15 U.S.C. §§ 80b-3(k).

The Division also seeks imposition of an appropriate bar on Pelosi. Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act authorizes the Commission to bar or suspend a person from association with an investment adviser for willful violations of the Advisers Act. *See* 15 U.S.C. § 80b-3(f). Because the evidence will show that Pelosi willfully violated the Advisors Act in hundreds of communications over more than three years, and because the evidence will further show Pelosi has provided false and misleading justifications for his misconduct, refusing to even acknowledge his wrongdoing, the Division will request the imposition of an appropriate bar.

## CONCLUSION

For the reasons stated above, the Division respectfully requests that the ALJ:

(i) make findings that Pelosi violated Section 206(1) and (2) of the Investment Advisers Act; and

(ii) based on such findings, issue an order pursuant to Section 203 the Advisers Act and Section 9 of the Investment Company Act, as appropriate, (a) requiring Pelosi to cease and desist from committing or causing violations of and any future violations of Section 206 of the Investment Advisors Act, (b) requiring Pelosi to pay an appropriate penalty; (c) imposing an appropriate bar prohibiting Pelosi from associating with any investment adviser or serving on a registered investment company; and (d) imposing such other remedial relief as the ALJ deems appropriate.

Respectfully submitted,

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R.M. Harper II

Richard M. Harper II, Trial Attorney
John J. Kaleba, Senior Counsel
U.S. Securities and Exchange Commission
33 Arch Street, 23rd Floor
Boston, Massachusetts 02110
(617) 573-8979 (Harper)
(617) 573-4590 (Fax)
HarperR@sec.gov

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