UNITED STATES OF AMERICA
Before the
SECURITIES EXCHANGE COMMISSION

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

POST-HEARING BRIEF OF MICHAEL R. PELOSI

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POST-HEARING BRIEF OF MICHAEL R. PELOSI

Pursuant to the Rule 340 of the Securities and Exchange Commission's ("Commission" or "SEC") Rules of Practice and the July 6, 2011 Order in this matter, Respondent Michael R. Pelosi ("Pelosi") is filing this Post-Hearing 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 this matter 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 the 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.[2]

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

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

[2] Throughout this brief, the Respondent will cite the witness testimony at the hearing on this matter by noting the individual witness and then the specific page(s) in the transcript. Pelosi pp 605 to 606 and 1006 to 1035.

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 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.[3]

C. Halsey's Business Operations

Upon assuming his position at Halsey, Mr. Pelosi soon discovered that its daily business 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. He also learned that a great deal of time was devoted to the drafting of quarterly client letters.[4]

Additionally, Mr. Pelosi learned that Halsey had no written compliance or supervisory policies and procedures, and the Firm did not conduct any e-mail, correspondence, order or pricing reviews nor did it have a record retention policy.[5] This included a failure to have supervisory review and approval of their client letters.[6] This situation existed despite the fact that Mr. Zoldy and Mr. Julian had been senior officers at major financial institutions that

3 Pelosi 1035:1-7, Zoldy 179:2-3 and Julian 470:11-16.
4 Pelosi 1035:8-1038:10, 1043:19-24.
5 Rynne 134:17-25, Rourke 53:2-5, Zoldy 243:23-244:9 and Julian 528:8-18.
6 Rynne 134:14-25, Rourke 52:18-53:5, Zoldy 322:18-324:17 and Julian 567:2-21.

would have formal, structured compliance and supervisory policies and procedures.[7] This was genuinely disquieting to Mr. Pelosi.

1. Halsey's Failure To Establish Compliance and Supervision Policies and Procedures

Halsey's failure to have written compliance and supervisory procedures violated the requirements of Adviser's Act Rule 206(4)-7, Compliance Procedures and Practices. SEC guidance on Rule 206(4)-7 provides that Halsey's procedures should provide for:

> The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.
>
> and
>
> The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction.[8]

Further, the Firm never conducted annual reviews of the firm's operations for compliance purposes pursuant to Rule 206(4)-7.[9] Adviser's Act Rule 204-2, Books and Records to Be Maintained by Investment Advisers, addresses Halsey's record keeping requirements and Rule 204-2(a)-7, thereunder, states:

> Originals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security.

Rule 204-(a)(16), in pertinent part, states:

> All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts....

Rule 204-2(g)(3) requires advisers that maintain records in electronic formats "to maintain and preserve the records, so as to reasonably safeguard them from loss, alteration, or destruction." Halsey failed to have any procedures in place to address the above requirements and also failed to maintain many of these required records.

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7 Mr. Julian had been a colleague at BA and Mr. Zoldy had worked at Cititrust. Zoldy 175:19-176:1 and Julian 469:24-470:1.

8 SEC Release No. IA 2204, Final Rule: Compliance Programs of Investment Companies and Investment Advisers (Dec. 17, 2003), Section II, A, 1.

9 Zoldy 315:22-316:6 and Julian 525:10-526:9.

Mr. Julian, Halsey's Chief Compliance Officer, readily admitted that Halsey's procedures were inadequate:

> I will tell you that from 2003 until -- until 2009 that the firm's compliance practices were in with the full benefit of hindsight inadequate and I take full responsibility for that.[10]

The noted rules involve some of the most fundamental procedural and supervisory requirements under the Advisers Act and establish the necessary framework for an investment adviser to develop proper disclosure and retention policies for their client communications, to review and monitor them properly and to revise their procedures, when appropriate.[11] The absence of such procedures at Halsey was not simply a rule violation, but a delinquency that resulted in inconsistencies and inaccuracies in client communications and a failure to create and maintain its most basic records.

2. Halsey's Operational Failures

As a result of Halsey's procedural failures, Mr. Pelosi soon learned that the Firm had serious operational problems in valuation and reconciliation. Proper pricing of portfolios is a requirement under the Federal securities laws, and, at Mr. Pelosi's prior employer, this was done daily through automated means by a separate department.[12] As Halsey had no written compliance procedures, it had no written procedures for establishing security prices, for ensuring a uniform approach to pricing or for providing its clients with a uniform portfolio valuation in their Client Letters.

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. Further, while various automated pricing services were readily available, Mr. Zoldy, by himself behind closed doors, reviewed all pricing and, at his discretion, made changes where he deemed appropriate.[13] He also manually priced Halsey's fixed income securities on a monthly basis. None of this was reviewed by anyone else at the Firm. Mr. Zoldy used three sources for his manual pricing-Schwab, a price list from IDC (a pricing service) and one compiled by a broker ("Broker"). This Broker also executed many of Halsey's fixed income orders. This was an obvious and undisclosed conflict that Mr. Zoldy admitted in testimony.[14] 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.[15]

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, the portfolio

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[10] Julian 526:6-9.

[11] SEC Release No. IA 2204, Final Rule: Compliance Programs of Investment Companies and Investment Advisers (Dec. 17, 2003), Section II, A, 1.

[12] Investment Advisers Act Rule 206(4)-7 and Pelosi at p 611:15-18 and 1051:13-21.

[13] Zoldy 187:7-15, 261:18-22.

[14] Zoldy 413:12-414:16, Julian 560:4-561:8, Frois 833:4-838:6 and Pelosi 670:10-673:9.

[15] Pelosi 761:5-9.

assistants would begin to manually reconcile those accounts that were to be reviewed that month with the firm's system.[16] This manual pricing and reconciliation procedure often lead to inaccuracies in Halsey's client portfolios and its performance reports.[17] 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. By this time, which was over a year after Mr. Pelosi was terminated, Halsey had finally developed a written set of procedures.[18] Despite this, the SEC still found their systems to be in violation of Rule 206(4)-7 in the exact areas that Mr. Pelosi had registered concern:

> 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, its antiquated systems, internal pricing of fixed income, pricing without review and manual entries (which often lead to errors) resulted in serious Rule 206(4)-7 violations and were then justifiably a serious concern to Mr. Pelosi.

D. Pelosi Client Letters

As noted, Mr. Pelosi learned that the drafting of client letters encompassed a considerable amount of PM time at Halsey. 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 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.

Prior to his Halsey employment, Mr. Pelosi had no experience in drafting Client Letters[19] and, upon his Halsey employment, was provided only a brief review by Mr. Zoldy and

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16 Halsey's system was an old Advent system.

17 Frois 846:11-20, 851:2-854:7 and Pelosi 656:15-657:8.

18 Respondent's Exhibit 3.

19 Neither Mr. Zoldy nor Mr. Julian ever even inquired about his experience in writing such letters. Julian 566:22-567:1 and Zoldy 322:9-16.

Mr. Julian on writing them. In so doing, the use of the TWR report (addressed below) was discussed but neither individual placed any particular emphasis on the composition or required content of the Client Letter.[20] Certainly, there was nothing stated then or at any time in the next three years that would have lead Mr. Pelosi to understand that its use was mandatory. Consistent with this is the fact that, in addition to the absence of appropriate procedures, Halsey never generated an internal memo, policy statement, e-mail or any other document addressing the drafting of Client Letters or the use of the TWR Report in them.

Additionally, some Halsey accounts were shared between Mr. Pelosi and Mr. Zoldy or Mr. Pelosi and Mr. Julian, and, in these cases, both PMs were to conduct a review of the draft Client Letter prior to sending it to a client. In the joint reviews by Mr. Zoldy and Mr. Julian of Mr. Pelosi's letters, neither one in three years ever found fault with or offered commentary on the letters that Mr. Pelosi had drafted.[21]

As there was no written procedure or direction addressing Client Letters, Mr. Pelosi was then left to his own devices to compose them. In so doing, Mr. Pelosi requested the information and reports that Mr. Zoldy, the Firm's senior principal, utilized in drafting his letters, believing that this would certainly provide him with all the information necessary to compile them. This information included an Account Summary, a Portfolio Appraisal, a quarterly report entitled Performance By Asset Class-Discounted Cash Flow Gross of Fees ("DCF Report") and an annual report entitled Performance By Asset Class-Gross of Fees ("TWR Report"). Mr. Pelosi reasonably assumed that this performance information should be incorporated into his client letters, and, throughout his entire Halsey employment, used these reports and this data for this. This included the DCF Report that he logically thought was to be used for the quarterly data.

Mr. Pelosi designed a letter that was based on those currently used at the firm. These 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.

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[20] Zoldy 207:20-208:6 and Julian 484:1-14.

[21] Zoldy 324:24-328:7-13 and Julian 568.11-569:8.

After the May 2008 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. For his review, Mr. Pelosi used the DCF Report for the current quarter and the TWR Report, containing performance information on a quarterly basis over the previous year. Due to the difference in the type and overall purpose of these reports, the DCF and the TWR Report's performance information in the same period for the same investment often varied from one another.[22]

E. Adjustments to Performance Information in Pelosi's Client Letters

Halsey's failure to have proper valuation and reconciliation procedures, its antiquated systems and its manual entry practices resulted in Mr. Pelosi's serious concern about Halsey's reporting of individual portfolio performance information and required him to conduct a detailed evaluation each month of the performance information provided to him.[23] These 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. There were also instances where Mr. Pelosi himself made transcription errors such as when templates were used to save time.[24] As a result, Mr. Pelosi often found it necessary to make revisions to Client Letters so as to ensure that his clients received timely and accurate performance information. This did result in certain performance differences from the Halsey reports although they were usually small variants and often lead to a lower performance number.[25] The major areas in which Mr. Pelosi made adjustments in the Client Letters are addressed below.

1. Preferred Stock Pricing

One of Halsey's pricing problems occurred in preferred stock pricing. Halsey's fixed income strategy involved illiquid, lower rated fixed income and preferred securities including illiquid preferred stocks with a bbb or lower rating. Mr. Zoldy executed the majority of the preferred purchases for the Firm's clients, while Mr. Julian, working primarily through the Broker, executed most of the municipal and corporate bond orders. Mr. Zoldy also made it clear to Mr. Pelosi that his clients were expected to participate in these investments, although they had no previous experience with them.

This lead to a concern by Mr. Pelosi about the accuracy of the pricing of preferred securities. Preferred stocks are hybrid securities that share debt and equity characteristics. Like

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22 Pelosi 616:2-663:25, 1043:19-1046:21 and 1067:23-1083:6

23 Pelosi 642:6-14, 761:5-9 and 1050:19-1051:21.

24 Pelosi, 645:3-651:8, 1074, Zoldy 332:24-351:22, Rynne 148:1-167:14, Frois 859:13-885:12, Rourke 61:5-88:8.

25 Pelosi 702:25-703:18 and Respondents Exhibits 4 to 6.

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.[26]

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 apply and through inefficient trading), and its volatility.[27] 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 be 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.

This is exactly what occurred at Halsey as Mr. Zoldy verified in testimony:

Q In the pricing process at Halsey, were ex-dividends added back into the price of the stock?

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[26] 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.

[27] 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.

A We did not add them back into the price. We did not -- the proper terminology is accrue dividends. We did not accrue dividends for either preferred or common stocks.[28]

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.[29]

This corrective action taken by Mr. Pelosi was addressed in Mr. David Audley's Expert Report ("Expert Report") as follows:

> Another class of shortcoming that many systems share including the Advent system at Halsey is their inability to handle all the security types that may be in a client portfolio. For example, many systems do not explicitly handle preferred stock. So a user of such a system would likely enter the preferred stock in its system using the code of another security type. With this, a position can be shown, and, with proper pricing, a P/L can be recorded and performance measured. However, this totally eclipses any automated handling of corporate actions. As a result, in the case of preferred stock, the dividend has to be handled through manual entry – a journal entry into the ledger. This is done when the dividend is paid. However, in the period between the stock going ex-dividend and its payment, few people realize that the price in the market will be reduced to reflect the dividend. At the same time, the books and records will show a loss until the dividend is paid and the journal entry is made. The PM should show the correct economic effect of this corporate action in his Client Letter, since the dividend will be paid. This would be in variance even with the custodian report as the market price and position would reflect a loss, even though a payment is pending.
>
> (I should note the following for ex-dividend reporting. As of the 2001 AIMR Performance Reporting Standard (Association for Investment Management and Research – now known as the CFA Institute), which complies with the GIPS (Global Investment Performance Standard) specification; that to be in compliance with this standard it is required that accrual accounting be used for *performance reporting* as of January 1, 2005 (this is the ex-dividend issue) even in variance to cash reporting – such as in a custodian report)[30]

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28 Zoldy 211:17-23.

29 Pelosi 646:23-648:12.

30 Respondents Exhibit 29-Expert Report at p.3.

The Expert Report then states:

> One of the issues in this matter is the correction of errors by Mr. Pelosi in the Halsey system and its performance reports. I have addressed how the PM has a responsibility to address such errors when they occur to ensure that clients receive accurate information in communicating performance through client letters (as mandated by the AIMR standard). I have also cited the reasons why these errors might happen (I used the case of the pricing of preferred stock and the issue of corporate actions – dividend payment). Mr. Pelosi in taking corrective action in reporting performance to his clients acted according to the AIMR standard, which was in effect during the period of question. That is, he reflected performance by accrual accounting vs. cash accounting. (Brief, see 1. E. 1. Preferred Stock Pricing)[31]

The Division has employed in its Division Exhibit 46 the use of a publication by the CFA Institute entitled: GIPS-Global Investment Performance Standards[32]. Division's Exhibit 46 recites certain reporting standards that are applicable to this situation and, in particular, notes on its page 9 in Item I B1 that:

> ACCRUAL ACCOUNTING SHOULD be used for dividends (as of the ex-dividend date). (Emphasis in the original)

Mr. Pelosi's adjustments to the preferred pricing was then a recognized and appropriate reporting adjustment, was in accordance with AIMR (later CFA Institute) Standards and GIPS standards and was fully consistent with his reporting responsibilities to his clients.

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. Mr. Pelosi believed that it was important to ensure that there was an appropriate adjustment in his Client Letters for this. This was consistent with his use of the DCF Report which was described by Mr. Julian in his testimony:

> Q. What was the purpose of receiving the discounted cash flow report?
>
> A The discounted cash flow report as I referred earlier had beginning and ending dollar values cash flow information in dollars in addition to performance information on a percentage basis and it could be helpful to the portfolio manager to look at both reports to look for any differences in performance numbers that

31 Ibid at p. 4.
32 Division's Exhibit 46.

would normally be a reflection of a substantial in flow or outflow of cash during a three month period.[33]

Consistent with his responsibilities as a portfolio manager, Mr. Pelosi recognized the importance of these cash flows, and, as a result, he began at an early stage to make certain adjustments in performance results by executing a modified Deitz calculation.[34] 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.[35] Mr. Pelosi in his testimony discussing Respondent's Exhibit 25 reviewed a series of instances where he had employed this calculation to provide more accurate performance information in particular Client Letters.[36]

The Expert Report also addressed the use of this calculation:

> There are many methods for calculating performance – all of them legitimate in their appropriate context. So what is the appropriate method for Mr. Pelosi in reporting to his clients? Again we turn to the AIMR Standards...
>
> The AIMR specifically recommends two methods as appropriate where portfolio pricing is not done on a daily basis. These are the modified Dietz method and the unitary valuation method, which is called the modified BAI method. Mr. Pelosi used the modified Dietz method in his computations which was in full compliance with the AIMR standard.[37]

The proper accounting for cash flow was also addressed in the Advent Help Guidance which is Division's Exhibit 11. In this, the following guidance is offered:

> Ideally, a TWR is computed by calculating a Simple Rate of Return between each cash flow, and linking them. However, cash flows can occur on a daily basis, and reconciling your portfolios and calculating a simple rate of return every day is very time-intensive. The AIMR-Performance Presentation Standards recognize this, so you can use the following approximation technique to arrive at a time weighted return.
>
> **1** Divide the evaluation period into sub-intervals whose boundaries are dates more easily valued such as month or quarter ends.
>
> **2** Calculate an IRR for each sub-interval and then link the results.

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33 Julian 482:14-25.

34 Pelosi 645:6-14 and 656:15-657:8.

35 See also, generally, Carl R. Bacon, Practical Portfolio Performance Measurement and Attribution (Wiley 2008); Bruce J. Feibel, Investment Performance Measurement (Wiley 2006).

36 Pelosi 1046:22.

37 Respondents Exhibit 29-Expert Report at p. 4.

In other words, if an account is being reviewed for the period 5/31/07-831/07, and a significant cash flow occurs on 6/23/07, Advent suggests running performance for the period 5/31/07-6/22/07 and then 6/23/07-8/31/07, and then linking the two results.[38]

Halsey's systems, however, were incapable of performing this type of calculation so Mr. Pelosi utilized the Deitz calculation. For Mr. Pelosi, this 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. Its use was fully consistent AIMR standards and again was completely in conformance with his reporting responsibilities as a portfolio manager.

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 to receiving an equity and fixed income return calculation which involved a computation combining the above categories.[39]

The Expert Report addresses this practice as follows:

The AIMR provides for reporting composites across asset classes – bonds and stocks, for example – with the composite performance calculation being made on an asset weighted basis. (see Brief, I. E. 3. Combination of Reporting Categories) Mr. Pelosi complied with these standards.[40]

Mr. Pelosi's combination of these categories is then in conformance with AIMR standards and is completely consistent with his reporting responsibilities to his clients.

4. DCF and TWR

Mr. Pelosi used the DCF quarterly performance numbers in his Client Letters as he understood that Halsey used this for its quarterly reporting. He did not use it because he necessarily thought that it was a superior methodology, but rather it offered greater transparency into the performance calculation than the TWR report as Mr. Julian noted above. This transparency and detail provided him with an efficient means to review and verify the data on Advent. The DCF (which is also known as the Internal Rate of Return or IRR) Report showed

38 Division's Exhibit 11 at Bates No. 004719.
39 Pelosi 648:7-23.
40 Respondents Exhibit 29-Expert Report at p. 5.

beginning and ending market value, purchases and sales, cash inflows and outflows, realized and unrealized gains during the period, and interest and dividend income. The TWR report simply provided a return. Mr. Pelosi was closely reviewing the performance results that were being provided to him because he had concerns about how the system was being maintained and the frequency of adjustments that were being made to it. As noted above, these concerns were well-founded.

Division's Exhibit 11, the Advent Help Guidance, begins with the following:

> **About Performance Calculations**
>
> With Axys, you can run two types of performance reports. Performance reports that calculate an Internal Rate of Return (IRR), and the Performance History reports that calculate a Time Weighted Return (TWR)...Performance measurement in Axys is designed to comply with the CFA Institute's GIPS.[41]

It then devotes three pages to the manner in which Axys utilizes IRR including a page devoted to Discounted Cash Flow IRR. Thus, one of the very exhibits used by the Division and the very system employed by Halsey, Advent, establish that discounted cash flow calculations play a significant role in explaining portfolio performance. Advent also maintains that the calculations and methodologies that it performs (including the DCF calculation) is compliant with GIPS standards which is a further validation of the DCF approach.

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 is time and dollar weighted. As a result, each would often have a different performance return.[42]

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. The Expert Report definitively addressed the use of such performance figures:

> Another issue raised is that concerning the calculation method for reporting performance. (Brief, see 1. E. 2. Cash Flow Discrepancies and 4. DCF vs. TWR) There are many methods for calculating performance – all of them legitimate in their appropriate context. So what is the appropriate method for Mr. Pelosi in reporting to his clients? Again we turn to the AIMR Standards. In the 2001 Performance Presentation Standard, compliance is specified as follows:
>
> Valued at least monthly beginning January 1, 2001

41 Division's Exhibit 11 at p. 1.

42 Pelosi 1081:14-1083:6, Julian 481:13-24, Zoldy 181:15-24, 357:15-358.8.

Firms must use time-weighted rates of return **adjusted for daily weighted** cash flows for periods beginning January 1, 2005. (Emphasis made in the specification, not by this author.)

Must use trade-date accounting for periods beginning January 1, 2005

Accrual accounting must be used for dividends (as of the ex-dividend date) for periods beginning January 1, 2005

(For a complete discussion of the calculation methods for performance and the issues addressed by the AIMR see any standard textbook on the subject. One standard that we use in our graduate course at the Johns Hopkins University is by Noel Amenc and Veronique Le Sourd: Portfolio Theory and Performance Analysis, John Wiley & Sons (2003). We refer to this book as "A&L" below.)

The AIMR provides for reporting composites across asset classes – bonds and stocks, for example – with the composite performance calculation being made on an asset weighted basis. (see Brief, 1. E. 3. Combination of Reporting Categories) Mr. Pelosi complied with these standards.[43]

Division's Exhibit 46, GIPS-Global Investment Performance Standards, notes on page 11 in Item II B3 that "Firms should value Portfolios on the dates of all LARGE EXTERNAL CASH FLOWS" (Emphasis in the original).

The use of the DCF Report and its performance data is then consistent with AIMR and GIPS standards and was appropriate for Mr. Pelosi's use in the Client Letters.

5. Pelosi Summary of Client Letter, TWR and DCF Data

Mr. Pelosi has reviewed the Client Letters, the TWR Reports and the DCF Reports provided by the Staff and has developed several relevant summaries of them. In this analysis, it is important to remember that, as discussed below in Section I, the accuracy of the TWR and DCF Reports is highly questionable as the Respondent has established that the data in these Reports is inaccurate due to innumerable additions and changes in them from their creation to the presentation. Nevertheless, these reports will be analyzed here to demonstrate that even under these circumstances, there is no material differences between them.[44] The average difference between the quarterly returns quoted in the available Pelosi letters and the returns reflected in recently generated TWR reports is 0.31%. The same difference compared to the DCF methodology is 0.30%. The average difference between the annual/ytd return quoted in the available Pelosi letters and the returns reflected in recently generated TWR reports is 0.36%. The same difference compared to the DCF methodology is 0.21%.

43 Respondents Exhibit 29-Expert Report at p. 4 .

44 Respondent's Exhibits 4 to 6.

These differences are not material, and this becomes even clearer when considering Columns H and O of Exhibit 6. These reflect the difference in returns between the DCF methodology and the TWR methodology for the quarterly and annual/ year to date periods respectively. Subtracting the quarterly TWR returns from the quarterly DCF returns for the same period produces differences ranging from -5.6 to + 1.3 between the two methodologies. Performing the same exercise for annual periods produces a range between the TWR and DCF returns of -6.5 to +6.8. In other words, these two broadly accepted methodologies for calculating investment results produces a wide range of returns between them, far more than any alleged overstatement of returns contained in Pelosi's letters (though several Pelosi letters understated returns by more than this amount). If the differences in results generated by these recognized methodologies compared to each other establish an acceptable tolerance of variances, then there should be no concern with the much smaller average difference of 0.21%-0.36% indicated from the pool of available Pelosi letters compared to those two methodologies.

Here, the median quarterly difference between the return expressed in the available Pelosi letters and the recently generated TWR reports is 0.2%, and 0.1% vs. the DCF reports.[45] The median annual/ytd difference is 0.3% for both the DCF and TWR results compared to those quoted in Pelosi's letters. Consideration of the median is especially useful in this case because , as we have demonstrated, many of the larger differences (i.e. the outliers) were simply the result of using one client's letter as a template for another client's letter for the same period without updating all the data (template, or copy/pasting errors). These cases are clearly described in column B of Respondent's Exhibit 4.

Respondent's Exhibit 5 includes a histogram[46] which groups into ranges the quarterly and annual differences between returns quoted in the available Pelosi letters and those reflected on recently generated DCF and TWR reports, across all 300+ observations included in the document production. Several conclusions can be drawn from this information. First, Pelosi understated annual results by more than 3% far more frequently than he overstated them by that amount. Results were understated by more than 3% nine times on a DCF basis, while they were overstated by that amount twice. On a TWR basis, results were understated by more than 3% six times, while they were overstated by that amount four times. Compared to both the DCF and TWR methodologies together, Pelosi understated returns by more than 3% a total of fifteen times, while he overstated by that amount six times. This is hardly a pattern suggestive of an individual intent on systematically overstating returns.

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[45] In probability theory and statistics, a median is described as the numerical value separating the higher half of a sample, a population, from the lower half. The median can be used as a measure of location when a distribution is skewed, or when one requires reduced importance to be attached to outliers, i.e. because they may be measurement errors. The median is used primarily for skewed distributions, which it summarizes differently than the arithmetic mean. Consider the multiset { 1, 2, 2, 2, 3, 14 }. The median is 2 in this case, as is the mode, and it might be seen as a better indication of central tendency than the arithmetic mean of 4. Calculation of medians is a popular technique in summary statistics and summarizing statistical data, since it is simple to understand and easy to calculate, while also giving a measure that is more robust in the presence of outlier values than is the mean. See, generally, "Median," http://en.wikipedia.org/wiki/Median.

[46] A histogram represents a frequency distribution. The intervals are placed together in order to show that the data represented by the histogram, while exclusive, is also continuous. The histogram provides important information about the shape of a distribution. See, generally, "Histogram," http://en.wikipedia.org/wiki/Histogram.

Further, of the more than 300 total quarterly observations available, more than half the differences fall between -0.2 and 0.2, regardless of whether those differences are measured relative to a DCF report or a TWR report. Nearly 75% of the differences fall between -0.4 and 0.4. More than 40% of the returns quoted in the available Pelosi letters either exhibit no difference relative to Advent reports or understate client returns relative to those reports.

Moreover, looking at all the data in the broadest possible light, across both quarterly and annual time periods and both DCF and TWR methodologies, more than 40% of the returns quoted in the available Pelosi letters exhibit essentially no difference compared to recently generated advent reports (-0.1 to 0.1) or are understated relative to those reports (514 observations within range of 0.1 to -3.1/ 1,256 total observations =40.9%). Clearly, there is no intent to mislead clients here because there is no pattern of overstating results, as there are nearly as many instances of no differences or understatements as there are instances of overstatements.

Not only is there no pattern across the entire data set, but there is also no pattern evident within each client's set of letters. Unlike the Division's Exhibits 26 to 33, Mr. Pelosi organized his spreadsheet by client, so that each client's entire record is easily discernable. This was done to provide a definitive listing of client letters which is the only logical and relevant way to present this information. In other words, a client can only be mislead if there exists a clear, consistent pattern within his specific communications. No such pattern exists here.

6. Division's Summary

The Division's summaries, even if we assume that the underlying data is accurate, do not support an materiality claim as to the variance in data that was examined. In Division's Exhibit 29 more than half of the quarterly differences between the results reported in Pelosi's letters and the recent Advent reports fall between -0.2% (understated) and 0.2%. This is true of both the TWR and DCF comparisons (135 observations within that range /261 total observations and 131/261 for the TWR and DCF comparisons respectively). As for the outliers around this range, the way the Division chose to group the data does not reveal that Pelosi understated returns by more than 3% multiple times more than they were overstated by that degree. This data is clearly not suggestive of a pattern of misleading Pelosi's clients.[47]

Looked at another way, 44% and 42% of the annual TWR and DCF differences respectively are less than 20 basis points or are understated, according to the division's own data. Again, this is not indicative of an intent to overstate results. Moreover, if the deficiencies in the compilation of the Division's review were corrected, the differences would compress even closer to zero, even before considering the other issues described in column B of Respondents Exhibit 4.

Significantly, the way that the Division chose to present their data does not allow one to observe whether a pattern of overstatements exists within a specific client's record. For a client to be misled, such a pattern would, of course, be necessary.

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47 Division's Exhibits 26 to 33.

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. 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.[48]

G. 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.[49] As a result, Mr. Pelosi's clients continued to experience genuine success with Mr. Pelosi at Halsey.[50]

H. Halsey's Reaction to Mr. Pelosi's Performance Adjustments

1. 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 late 2007 or early 2008, Ms. Rourke inquired with Mr. Pelosi about this, and he responded that he had a different way of calculating the performance figures.[51] 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".[52]

In these discussions, Mr. Pelosi responded without any hesitation and did not instruct Ms. Rourke or Ms. Rynne to conceal his actions or to refrain from speaking to anyone about them. For a substantial period before he was confronted by Mr. Zoldy and Mr. Julian, Mr. Pelosi was then openly making these adjustments to his clients' performance figures and readily

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48 Mr. Pelosi would also send PowerPoint presentations to his clients for their quarterly reports. Rynne 123:18-22, Zoldy 571:23-24.

49 Pelosi 1038:11-25, 1042:4-20.

50 Pelosi 1094:4-10.

51 Rourke 39:1-3.

52 Rynne 124:17-21.

discussed them with two assistants that worked with him. This unquestionably evidences that his intention in these adjustments was to assist his clients in having a better understanding of their portfolio information, and this conforms with all regulatory requirements.

2. Zoldy Meeting with Rourke and Rynne

Although Mr. Pelosi continued to use the adjustments to the performance figures, it wasn't until on or about August 1, 2008 that Ms. Rourke and Ms. Rynne met with Mr. Zoldy to discuss these.[53] The delay in this allegedly resulted from their hesitancy to report a senior person at the Firm although there is absolutely no evidence of any pressure placed upon them by Mr. Pelosi.[54] Another reason cited by Ms. Rourke for this meeting was to ensure that she was not blamed if any mistakes were made. In this meeting, Mr. Zoldy registered concern about the situation and initiated a review of Mr. Pelosi's Client Letters and related information. This review allegedly lead him to have enough concern to speak with Mr. Julian about it which they did traveling back from a client on or about August 7, 2008.[55]

3. Zoldy and Julian Client Letter Review

From August 7 to 13, 2008, Mr. Zoldy and Mr. Julian conducted a review of Mr. Pelosi's client letters and the supporting data. In this, Mr. Zoldy claimed that 20 letters were reviewed, while Mr. Julian testified that 40 had been evaluated.[56] (It is estimated that Mr. Pelosi sent some 500 Client Letters during his Halsey tenure.[57]) This review was not documented in any way and, ultimately no spreadsheet analysis, memorandum, notes or other documentation was created to substantiate it. However, Mr. Zoldy and Mr. Julian consulted with counsel about this situation on 3 or 4 occasions in this period. Mr. Zoldy and Mr. Julian determined that the situation warranted a meeting with Mr. Pelosi which occurred on August 14.[58]

4. Meeting With Pelosi Regarding Performance Adjustments

On August 14, 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 meeting, Mr. Pelosi, when questioned about them, did not acknowledge these changes, as he was genuinely confused by the extent of the revisions presented to him. As a result, he wanted an opportunity to review the letters before further discussion of them. The meeting was recessed with the parties each agreeing to review this in more detail.[59]

Mr. Pelosi then immediately initiated a review of his Client Letters, and, in so doing, accidentally deleted certain of them. Upon doing this, he immediately spoke with Ms. Susan

[53] Zoldy 218:17-219:7, Rynne 126:15-25 and Rourke 40:6-41:7.
[54] Pelosi 1092:10-15, 1093:21-24 and Rourke 38:23-25, 60:12-14.
[55] Zoldy 219:8-25 and Julian 574:7-21.
[56] Zoldy 355:20-23, 359:24-360:1, 362:10-16 and Julian 581:3-12
[57] Pelosi 1139:9-1141:9,1151:5-1153:21.
[58] Zoldy 366:22-370:11 and Julian 492:1-493:6.
[59] Zoldy 222:2-223:22, Julian 493:6-495:15 and Pelosi 1099:9-1102:10.

Frois, a portfolio assistant, who together with Mr. Julian was then able to restore these letters through the Firm's back-up tapes.[60] The existence of the back-up tapes was well known at the Firm, and Mr. Pelosi was well aware of them. The deletion then was a simple accident as any attempt to destroy such records in light of the tapes would have been pointless

5. Pelosi E-mail and Memorandum

Mr. Zoldy left on a business trip on August 15, and, in the next several days, Mr. Pelosi had several brief discussions with Mr. Julian about this situation. On August 15, Mr. Julian meet briefly with Mr. Pelosi in his office and, based on his commentary, Mr. Pelosi believed that Mr. Julian was suggesting that a way to resolve the situation would be to admit that he had made the changes. In a later meeting that day outside the office, Mr. Pelosi admitted to Mr. Julian that he had made certain changes in the Client Letters. In this time, Mr. Pelosi, based on Mr. Julian's comments, wrote one e-mail to Mr. Julian and one memo to him and Mr. Zoldy 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".

The reason that Mr. Pelosi wrote this e-mail and the letter was that he had been encouraged by Mr. Julian to accept the responsibility for any differences that they had found and 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 Mr. Pelosi with this opportunity, he was never given it.[61]

6. Memorandum of Understanding

Mr. Julian and Mr. Zoldy allegedly conducted a further review of the Pelosi Client Letters after the August 14 meeting although there is no record whatsoever of any such analysis. In this, neither Mr. Zoldy nor Mr. Julian consulted with any expert for assistance in their analysis. In the period from August 14 to 27, 208, Mr. Zoldy never sought to meet again

60 Pelosi 1102:11-1105:21 and Frois 903:1-904:20.

61 Pelosi 707:9-708:11, 744:20-746:2, 1221:22-1230:9, Zoldy 366:7-20 and Julian 506:11-507:21.

with Mr. Pelosi on this subject although in the August 7 to 27, 2008 period, Mr. Zoldy and Julian consulted with counsel 3 or 4 times on this situation.

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 also noted that Mr. Pelosi would agreed not to make any disparaging commentary about Halsey. 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 the memorandum at that time without benefit of counsel or further consideration or the offer would be withdrawn.[62]

As noted, Mr. Zoldy and Mr. Julian had conferred with an attorney at least 3 or 4 times and determined that the matter needed to be reported to the regulators. However, Mr. Zoldy and Mr. Julian in the Memorandum agreed that they 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.[63] Mr. Julian and Mr Zoldy then filed a false Form U-5 with FINRA which failed to reveal the circumstances surrounding Mr. Pelosi's termination.[64]

I. Halsey Record Keeping Failures

1. Number of Client Letters

The Division bases their fraud claims on 240 Pelosi Client Letters, but, actually, Mr. Pelosi issued some 500 letters. The Division used Mr. Zoldy to verify the 240 letters used by it and he testified that they had been retrieved from Mr. Pelosi's archival files on August 13, 2008.[65] The Division has done nothing else to validate these Client Letters as the basis for their claims. These 240 letters were analyzed by the Division and used to develop Division Exhibits 26 to 33 that, among other things, attempt to compare the quarterly and annual performance reporting in these letters to those in Halsey's records. These reviews note the percentage of letters that reflect inflated or deflated percentage differences. In Division's Exhibit 26 entitled Data Sheet of Pelosi Performance Reporting and Halsey Time Weighted Return 2005-2008, information from the Client Letters and TWR Reports is presented in chronological order with no further organization as to client or account. No explanation other than Mr. Zoldy's is offered for the use of these letters and reports. A detailed review of Division's Exhibit 26, as well as the Division's related exhibits, does not reveal any selective sampling of the Client Letters or any pattern or model used in this analysis.

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62 Respondent's Exhibit 13

63 Zoldy 370:1-378:20, Julian 586:5-590:9 and Pelosi 1131:9-1133:5.

64 Zoldy 382:4-18 and Julian 517:-518:12

65 Zoldy 235:24-238:3

Mr. Pelosi has made a detailed analysis of the Client Letters that were provided to him by the Staff as part of the Rule 230 production. He also has compiled an extensive amount of data relating to them in Respondents Exhibits 4 to 6.[66] In this, he has discovered evidence of some 80 more Client Letters, and, his computations, based on his knowledge of the issuance of these letters, have established that there were some 500 Client Letters in total sent by him from 2005 to 2008.[67] When questioned about the missing letters, neither Mr. Zoldy nor Mr. Julian were able to offer any insight into this although they verified that record keeping was the Firm's and not Mr. Pelosi's responsibility.[68]

It is apparent that the Division is missing approximately 50% of the Client Letters and that these are necessary to verify the claims that they are making. As noted, the Division is asserting that certain percentages of the performance information in the 240 letters are inflated. In order to make such a claim, it is necessary to have all the relevant documentation. The Division's Summary Witness, Mr. Jacques, testified that he was unaware of any other letters, and that his computations would likely change if there were any additional letters.[69] Certainly, an additional 250 letters could have a substantial affect on his computations. Therefore, the data and information that is contained in Division's Exhibits 26 to 33 has, by the Division's own admission, no probative value.

2. Advent System Capabilities-Failure to Maintain The TWR and DCF Reports

There is yet another serious record keeping problem that is fatal to the Division's allegations in this matter. Halsey used the Advent system to compile its client's account portfolio information and to create the reports at issue-the DCF Reports and the TWR Reports. Halsey was required to maintain these reports by Rule 204-2(a)(16).

Further, Division's Exhibit 46, GIPS-Global Investment Performance Standards, notes at Item 1A1 at page 9:

> All data and information necessary to support a Firm's performance presentation and to perform the required calculations must be captured and maintained.

However, the Advent system is, as Ms. Frois testified, "not a record keeping system".[70] While it is capable of maintaining client account portfolio records on an ongoing basis, any new entry updating this account information automatically eliminates the data that it replaces.[71] This was evidenced in the testimony of Ms. Frois and others, when they addressed certain Advent reports that should have been identical but actually had different data.[72] In this testimony, two copies of these supposedly identical reports had been provided by Halsey to the

66 Pelosi 756:22-757:10 and 1134:14-24.
67 Pelosi 1139:9-1141:9 and 1151:5-1153:21
68 Zoldy 330:1-10, 245:16-246:2 and Julian 569:13-571:25.
69 Jacques 462:6-463:16.
70 Frois 847:21-23.
71 Frois 847:25-848:10, 877:7-18, 899:3-7, Expert Report, Audley 1279:8-1280:2.
72 Pelosi 1157:2-17, Rourke 76:24-84:25 and Rynne 158:3-160:23

SEC on different dates and, in the interim, certain new entries had been made in the reports. This resulted in the new data replacing and eliminating the old data.

At Halsey, new data was entered into the TWR and DCF Reports on a monthly basis. In this case, Rule 204-2(a)(16) would require Halsey to maintain a separate hard copy record of each DCF and TWR report that existed at the time the Client Letters were being composed. Not surprisingly, Halsey failed in this record keeping responsibility as no such records were ever maintained.[73] This is not simply a rule violation but a delinquency that prevents the adviser, as well as the SEC and the Respondent, from properly assessing the data in the relevant TWR and DCF Reports. Without such information, no proper analysis can be made to determine the basis for the performance information used in the Client Letters.

J. 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.[74]

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.[75]

II. Legal Analysis

A. Alleged Violations

The Division alleges that from 2005 through August of 2008 Mr. Pelosi knowingly or recklessly misreported account performance returns to his investment-advisory

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[73] Frois 879:8-21, Rynne 122:16-19, 169:7-170:9, Rourke 36:23-37:1, 44:24-45:4, Zoldy 233 :19-234 :2.

[74] Zoldy 392:7-397:4 and Frois 909:11-913:8

[75] Frois 893:23-900:23

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.[76]

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 or recklessness and materiality are the primary considerations in analyzing violations of Section 206(1). 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 as well as materiality 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).[77]

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[76] The vast majority of the facts discussed in the Legal Analysis are addressed in more detail in Section I, Factual Discussion. Where new facts are discussed or emphasis is desired in this section, a citation will be provided for them here.

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

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 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.[78]

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

[78] 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).

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, and Kiefer willfully aided and abetted and caused violations of, Sections 206(1) and 206(2) of the Advisers Act. [79]

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 Intention 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).

1. Halsey Had No Formal or Informal Written Procedures or Guidance For the Content of the Client Letters

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 Division bases their fraud claims on Mr. Pelosi's alleged failure to adhere to Halsey's guidance for the content of its Client Letters. Their principal focus is on Mr. Pelosi's use of quarterly data from the DCF Report instead of the TWR Report, which they maintain was the established standard. The Division however has failed to establish that any standard existed at Halsey for the content of its Client Letters.

[79] 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).

Halsey, although required by Rule 206(4)-7 to have written compliance and supervisory procedures, had no procedures whatsoever in place during Mr. Pelosi's entire employment, including any procedures relating to client communications. SEC guidance on Rule 206(4)-7 provides that Halsey's procedures should provide for:

> The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.
>
> and
>
> The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction.[80]

Halsey's failure to comply with these established standards for the content of its client communications violated Rule 206(4)-7.

Halsey also did not even have any informal procedures in place for the drafting of its Client Letters. If the content requirements of Halsey's Client Letters was such a significant issue, the Firm certainly would be expected to have issued some written informal guidance on this subject. There was none.

Halsey also did not conduct any supervisory review of its Client Letters, and thus did not monitor these communications for adherence to any policy, written or unwritten or for any conduct that would have been considered inconsistent with its standards. Additionally, Halsey had certain client accounts that were jointly handled by Mr. Pelosi and Mr. Zoldy or Mr. Pelosi and Mr. Julian, and, thus, the letters issued for these accounts were to be reviewed jointly by each individual. While Mr. Zoldy and Mr Julian rarely reviewed these letters, they did not detect any problems in them when they did.[81] If Mr. Pelosi had violated any Firm internal policy, there certainly should be an e-mail, memo or some communication directing him to correct this. No such communication exists

No written guidance, formal or informal, relating to the use and content of the Client Letters was ever generated by Halsey. The only support for the Division's claim is the highly unreliable and conflicted testimony of Mr. Zoldy and Mr. Julian. It is their testimony that they directed Mr. Pelosi to use the TWR Report for quarterly data in their one sole review session on Client Letters when he was first employed there. However, in the three years that Mr. Pelosi was employed at Halsey, there is no documentation whatsoever to validate this claim. Therefore, the Division has completely failed to establish that Halsey developed any guidance or standard for the use of the TWR report or its data, or for that matter any report. As such, Mr. Pelosi could hardly have violated such a standard.

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[80] SEC Release No. IA 2204, Final Rule: Compliance Programs of Investment Companies and Investment Advisers (Dec. 17, 2003), Section II, A, 1

[81] Zoldy 315:22-316:6 and Julian 525:10-526:9; Zoldy 325:20-326:16 and Julian 568:11-569-12??

2. Pelosi's Client Letters Were Fully Consistent With All Appropriate Standards

As Halsey failed to establish any standards for the content of its Client Letters, the Division must evidence that Mr. Pelosi's Client Letters somehow otherwise contained misleading or fraudulent information. In fact, the content of Mr. Pelosi's Client Letters conformed with all applicable standards including those cited by the Division.

Prior to his Halsey employment, Mr. Pelosi had no experience in drafting Client Letters and, upon his Halsey employment, was provided only a brief review by Mr. Zoldy and Mr. Julian on writing them.[82] In so doing, the use of the TWR report was discussed but neither individual placed any particular emphasis on the composition or required content of the Client Letter.[83] Certainly, there was nothing stated then nor at any time in the next three years that would have lead Mr. Pelosi to understand that its use was mandatory.[84] Consistent with this is the fact that, as noted, there are no internal memos, policy statements, e-mails or any other document addressing the content of Client Letters..

As a result, Mr. Pelosi requested and used the information and reports that Mr. Zoldy, the Firm's senior principal, utilized in drafting his letters, believing that this would certainly provide him with all the appropriate information necessary to compile them.[85] This information included the quarterly DCF Report and the annual TWR Report. Mr. Pelosi reasonably assumed that the data from the DCF Report was to be used in the letters as it was the only report with quarterly data. The Client Letters contained 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 and 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.

As discussed above, Mr. Pelosi, almost immediately upon the initiation of his sending Client Letters, discovered Halsey's problems with valuation and reconciliation, its antiquated systems and its manual entry practices. This lead to him conduct a detailed evaluation each month of the performance information provided to him.[86] These 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.[87] As a result, Mr. Pelosi often found it necessary to make revisions to the content for the Client Letters so as to ensure that his clients received timely and accurate performance information. This unquestionably resulted in certain performance differences from

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82 Neither Mr. Zoldy nor Mr. Julian ever even inquired about his experience in writing such letters. See FN 19.

83 Pelosi 1045:4-1046:24

84 Pelosi 622:24-623:10; Zoldy 404:14-19 and Julian 484:1-14

85 Pelosi 631:13-632:8.

86 Pelosi 640:20-642:14; 761:5-9; 1050 :19-1051:21

87 Pelosi 645:3-651.8, Zoldy 332:24-351:22, Rynne 148.1-167:14, Frois 859 :13-885 :12 and Rourke 61.5-8:8

the Halsey Advent reports although they were usually small variants and often lead to a lower performance number.[88]

However, each adjustment was fully consistent with the AIMR guidelines, which standard is recognized by the Division in its Exhibits 11 and 46. It included adjustments to preferred stock pricing, inclusion of cash flows based on Deitz calculations, combining certain reporting categories and, of course, the use of the DCF Report and its data. These adjustments made by Mr. Pelosi in his Client Letters were clearly designed to ensure that his clients had a clearer and more accurate report of their portfolio and not to deceive them.

While his calculations updated certain of the individual performance numbers in the Client Letters, they, 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 account information in the appraisal report, the account summary, the Schwab monthly account statement and the on-line Schwab account information were never adjusted. Practically speaking, these are the most frequently viewed sources for laymen to determine portfolio performance.[89] 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.[90] 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 after these discussions are further evidence of his lack of scienter.

There were also instances where Mr. Pelosi himself made transcription errors such as when templates were used to save time. Pelosi 1074.

[88] Pelosi 702:25-703:18 and Exhibits 4-6

[89] Bosco 1427:23-1429:8.

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

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 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.[91] 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.[92]

Mr. Pelosi's conduct is fully consistent with ensuring that his clients received accurate and timely performance information at all times, did not involve any willful or negligent acts of deception 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 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.

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[91] Pelosi 619:17-620:4

[92] Pelosi 1094:4-10, Sciana 1400:9-16: 1406:6-7; Bosco 1432:1-8 and Platano 1453:4-7.

In this analysis, it is significant to note that the Division utilized only approximately 50% of the Client Letters that had been created by Mr. Pelosi and chose to ignore highly relevant information available in their own files regarding some 80 Client Letters. By analyzing only a portion of the letters, the Division is examining only a random collection of them and is ignoring significant evidence that may be contrary to their claims. This limited analysis invalidates the charts and data shown in its Exhibits 26 to 33.

The Second Circuit Court as well as the New York Federal Courts are critical of a party's devising of its own narrow and prejudicial analysis from only preferred evidence while ignoring other available evidence. The Courts view unfavorably a party that uses only evidence that is helpful for them while neglecting evidence to the contrary. In Winkler v. Metropolitan Life Insurance Co., the Second Circuit Court stated that an "administer may, in exercising its discretion, weigh competing evidence, but it may not, as MetLife did here, cherry-pick the evidence it prefers while ignoring significant evidence to the contrary." Winkler v. Metropolitan Life Insurance Co., 170 Fed. Appx. 167, 168 (2d Cir. 2006); Clark v. First Unum Life Insurance, Co., 2009 U.S. Dist. Lexis 36054, *6 (S.D.N.Y. 2009). Similarly, in Tretola v. Secretary of Dep't of Health, Education and Welfare, the court also stated that the Administrative Law Judge (ALJ)'s "failure to give due deference to all the evidence submitted was improper, as the ALJ has a duty to consider the records as a whole. It is improper for him to base his decision on selective portions of the record." Tretola v. Secretary of Dep't of Health, Education and Welfare, 1980 U.S. Dist. Lexis 17622, *11 (E.D.N.Y. 1980). More recently, in Grant v. Roche Diagnostic Corp., the Eastern District Court disapproved of a plaintiff who could not find "evidence to support his claim" and "cherry-pick[ed] ratings and reviews from different months in attempt to craft a cognizable claim." Grant v. Roche Diagnostic Corp., 2011 U.S. Dist. Lexis 79994, *25 (E.D.N.Y. July 20, 2011).

Similarly, the Division used only a portion of the Letters that were sent out by Mr. Pelosi rather than making a comprehensive analysis based on all the information. Further, there was information available from 80 additional letters that could have been applied to the Division's analysis, but this information was ignored. Such analysis based on limited information is further invalidated by the Division's failure to show any justification, pattern or method for examining only 240 Letters, when by their own witness's admission his analysis would possibly change if all letters were taken into consideration.[93] The Division cannot use such charts and numbers derived from a limited information as a basis for their claims. The Division either must take into consideration all of the available data or cannot maintain their position based on inadequate information. The charts and data in the Division's Exhibits 26 to 33 are then limited representations of all available evidence, and therefore have no probative value.

Even if it is assumed that such data is admissible, the adjustments made by Mr. Pelosi were not material from a standpoint of the percentage variance from the TWR Reports or from the total mix of information that was available to Halsey clients. In assessing numerical materiality, courts have looked to significant variants such as in the Trabulse matter[94]:

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93 Jacques 462:6-463:16.

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

> 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, showed 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)).

Here, the average difference between the quarterly returns quoted in the available Pelosi letters and the returns reflected in recently generated TWR reports is 0.31%. The same difference compared to the DCF methodology is 0.30%. The average difference between the annual/ytd return quoted in the available Pelosi letters and the returns reflected in recently generated TWR reports is 0.36%. The same difference compared to the DCF methodology is 0.21%. The median quarterly difference between the return expressed in the available Pelosi letters and the recently generated TWR reports is 0.2%, and 0.1% vs. the DCF reports. The median annual/ytd difference is 0.3% for both the DCF and TWR results compared to those quoted in Pelosi's letters.

These variants, even if we assume their accuracy, cannot be considered material as the above case law clearly demonstrates that such differences are never viewed as material. Therefore, the Division again has failed to establish a violation of Section 206(1) and 206(2) based on the materiality standard.

If we address the materiality issue in the context of the "total mix" standard, the information is also not material. The subject 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.

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 Advisers Act Sections 206(1) or (2). 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. 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[95] matter. In assessing a penalty against respondents, Judge Mahoney noted that the harm caused by the deception was "best indicated" by the fact that the clients all withdrew their investments. This indicator is equally applicable to the materiality issue in this matter. Here, the lack of materiality is evidenced by Mr. Pelosi's clients leaving the Halsey firm and joining him at his new firm. They did not consider this information provided by Halsey in the above letter as material as it was not "important in deciding whether or not to invest" with Mr. Pelosi.

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[95] In re Abraham & Sons Capital, Inc., et al, SEC Initial Decisions Release No. 135, 1999 SEC LEXIS 187 (Jan. 28, 1997).

This lack of materiality is also evidenced in the testimony of his clients. Mr. Scianna in his testimony in responding to a question regarding performance reports stated:

Q And he would describe to you annual or quarterly performance of your portfolios that he had at Halsey?

A You know, I -- I didn't really pay much attention to that part of the results. You know I based most of my thought process when we met.[96]

He also testified as follows:

Q In this matter one of the concerns or allegations relates to Mr. Pelosi's use of of a portfolio method while the Halsey firm utilized another?

A Uh-huh.

Q Has that ever been a concern to you in your review of these quarterly letters?

A No.[97]

Mr. Bosco noted:

Well, you receive from YHB you receive the letter. From Olson Mobeck you receive a little bit of a letter. From UBS they e-mail you these packs of about 30 pages which I just delete I don't even look at them because it's just too much to consume. And to me it is a sales pitch that letter, that's all it is. It's a sales pitch however you want to present it.[98]

Mr. Platano noted:

Q Do you have any concern if Mr. Pelosi would utilize a different portfolio performance method than the Halsey firm in those quarterly letters?

A No concerns whatsoever. My knowledge of Mike if there was a difference I would rely more on what Mike used than what Halsey would use.

Q Why is that, sir?

A The time I've known Mike he's one of the most honest straightforward individuals you could possibly run across.[99]

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96 Sciana 1407:19-21.
97 Sciana 1403:14-17.
98 Bosco 1428:1-6.
99 Platano 1456:23-1457:9.

Mr. Florian noted:

Q. Let's focus on the Halsey firm when he was employed at the Halsey firm and the -- I believe they did issue quarterly letters. How frequently did you read those?

A Probably once every three times. I didn't study them. It was the usual comparisons and narrative. I didn't really care much what they said but I don't -- I wouldn't ask him to stop sending them. It was just part of the flow of information.

Q What was the most important document for you or documents for you in terms of reviewing your account?

A Documents?

Q Yes.

A Page one of the report.

Q The -- when you say report it's --

A It's the bottom line it's the the bottom line. How much was there last month and how much is there now.

Q In the communication that Halsey had with you on a quarterly basis Mr. Pelosi among other things utilized a particular portfolio performance report and reporting method that was different than that of Halsey. Do you have any recall --

A I'm not aware of that and I honestly don't care about that. I never compared about those comparisons of the Dow and the Standard & Poors. I looked at page one of my reports. So I really can't give you an opinion about it.[100]

Mr. Lenkowski testified:

Q If Mr. Pelosi used a different method of performance reporting in the quarterly letters that were sent by Halsey than what Halsey used, would this be a concern to you?

A No. Based on my review of the statements no.[101]

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[100] Florian 1440:5-1441:24 and 1443:14-24.

[101] Lenkowski 1479:19-24.

The following testimony of Mr. Sciana is strongly supportive of Mr. Pelosi's conduct in this matter:

> Q. If the court determines that Mr. Pelosi committed fraud by lying to his clients about the performance of their investments will you don't to trust him with your entire investment fund?
>
> A Are you Mr. Harper.
>
> Q Yes?
>
> A When you called me I said I would think about it. Subsequent I thought about it and I had the discussion with my wife also and my answer is yes I would continue with him.[102]

Mr. Pelosi's clients overall opinion of him is also very enlightening. Mr. Dinto stated:

> My judgments were based on No. 1 Mike Pelosi and how I've known him for all these years and found him to be the most honest and one of the most straight individuals I've ever seen in my entire life. I don't say that lightly because I don't come out as strong as I do on a person. I'll tell you Mike Pelosi has the basis of everything I'd like to see in my son I don't have a son. He doesn't swear he's a hardworking person he's brilliant when it comes to financials and he's got a great family and he -- he refused going to if upper echelon of the bank Boston at the time as well as Fleet because he'd have to relocate. I know for fact he didn't do that he didn't want the leave the Middlebury area because he also takes care of his mother who lives in Waterbury...As a matter of fact I'm probably going to put another half a million dollars into the YHB account I have there and I want Mike to handle it.[103]

Mr. Platano asserted:

> Mike does a great job without much input after the original direction and what kind of objectives I have. I probably have more communication with Mike now almost as an advisor with the other businesses that we have. We have varying degrees of ownership and we are trying to consolidate those businesses. And in that process there are different interests involved and we kind of use Mike as kind of our moral compass when addressing an issue of ethics or morality about how he should handle other partner shares minority interests and those kinds of things.[104]

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[102] Sciana 1411:14-25.

[103] Dinto 1464:13-1466:7.

[104] Platano 1452:6-18.

These clients were individuals who had known Mr. Pelosi for extended periods and addressed their relationship with him with candor and insight. The above testimony, Mr. Pelosi's clients moving to his new adviser with him and the extensive amount of account information continually provided to his clients establish that the adjustments made by him to the performance figures in the Client Letters were immaterial 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. Thus, this clearly establishes that Mr. Pelosi did not violate Advisers Act Sections 206(1) or (2).

D. Zoldy and Julian Credibility and Motive

A close scrutiny of the conduct of Mr. Zoldy and Mr. Julian in this matter provides a realistic explanation for this situation and a perspective on their true motives. Mr. Zoldy and Mr. Julian have testified that the working atmosphere at Halsey was at all times during Mr. Pelosi's employment congenial and that Mr. Pelosi had been progressing well up to August 2008. In terms of business, it is true that Mr. Pelosi was doing well at Halsey, as he had been successful in bringing in approximately 30 clients with assets exceeding $65,000,000, which exceeded anything brought in by Mr. Zoldy or Mr. Julian combined in this period.[105]

However, despite Mr. Pelosi's success, his relationship with Mr. Julian and Mr. Zoldy had deteriorated substantially by August 2008. This was due in large measure to 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 valuation and reconciliation process, and the lack of redundancy and controls with respect to other important firm functions. The problem escalated when Halsey hired a salesman in 2008 instead of a promised new portfolio manager. As a result, Mr. Pelosi by mid-2008 was alienated from Mr. Zoldy and Mr. Julian and was frequently excluded from their discussions and meetings.[106]

It was supposedly at this point that the Halsey assistants approached Mr. Zoldy with their concerns about Mr. Pelosi's performance reporting. This is a curiosity as they had waited for at least a half a year to convey this information.[107] At this time, neither Mr. Zoldy nor Mr. Julian had spoken to Mr. Pelosi about his Client Letters for over three years. Further, as Halsey had no compliance procedures in place, no directives existed as to the content of them, and no Client Letters were ever reviewed for compliance purposes. In sum, under Mr. Zoldy and Mr. Julian, Halsey had utterly disregarded its compliance responsibilities for years. Mr. Pelosi also had never had any client problems or complaints. Under these circumstances, it would be anticipated that, if Mr. Pelosi failed to appreciate the emphasis that Halsey wanted placed on certain performance information or had some other error, this problem would be informally discussed with him and resolved.

Instead, Mr. Zoldy and Mr. Julian actually conducted an internal review of it including a consultation with an attorney. In fact, they consulted this counsel 3 or 4 times during

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105 Pelosi 1038:22-1043:3.

106 Frois 890:17-893-19 and Pelosi 721:7-722:16.

107 In the interim, Mr. Pelosi had continued to make his performance adjustments and had never threatened or directed them not to speak to anyone about it.

the three weeks that this occurred. This reaction is clearly disproportionate and inappropriate for the situation.

The investigation, itself, made little sense. Mr. Pelosi had sent some 500 Client Letters over a three year period, but only 20 according to Mr. Zoldy, or 40 to Mr. Julian, were reviewed in their concluding that a serious problem existed. Further, if this was such an important matter, it would seem logical that the review would involve a detailed and documented analysis, expert consultation and, most importantly, extensive written findings and conclusions. None of this was done.

Regardless of fault or personal difficulties, this matter involved the termination of Mr. Pelosi's partnership, which should have been a monumental event at this three man firm. Yet, Mr. Pelosi's partnership was terminated without one serious discussion with him. (This in stark contrast to their 3 or 4 consultations with counsel.) Instead, Mr. Pelosi is brought into the second of two unannounced meetings within two weeks and given two impossible alternatives-sign the memorandum without benefit of counsel or face immediate termination without compensation. Realistically, Mr. Pelosi had no choice, and Mr. Zoldy and Mr. Julian knew that. Mr. Pelosi was effectively silenced by this agreement, as he risked losing $120,000 by talking to his clients. Of course, Mr. Zoldy and Mr. Julian immediately sent letters to them, disclosing the situation in the most favorable terms for Halsey and most unfavorable for Mr. Pelosi.

Mr. Zoldy and Mr. Julian then didn't inform the regulatory authorities, as required by law. Again, this is after a series of consultations with counsel. The claim is that they did not want to ruin Mr. Pelosi's reputation. This notwithstanding their just having sent defamatory letters to all his clients. The real reason? They knew that such a disclosure would likely result in an investigation, which involved a genuine regulatory risk to them and their Firm. They only later disclosed this situation when it appeared that a client would report them.

These facts lead only to one conclusion: Mr. Zoldy and Mr. Julian wanted to eliminate Mr. Pelosi-who was then a hindrance to their designs-while retaining his clients and their $65,000,000 in assets.

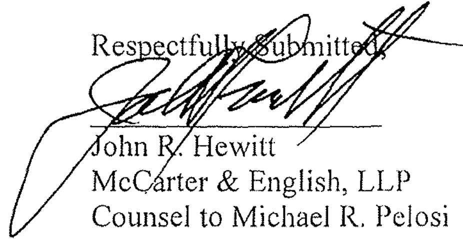
Conclusion

In contrast to Mr. Zoldy and Mr. 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 his clear intention was to ensure that his clients had a complete and clear understanding of their portfolios. Clearly, 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. These then cannot constitute violations of Sections 206(1) or 206(2) and Mr. Pelosi would then respectfully request that this matter be dismissed.

Respectfully Submitted,



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