UNITED STATES OF AMERICA
Before the
SECURITIES EXCHANGE COMMISSION

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In the Matter of

MICHAEL R. PELOSI,

Respondent.

Administrative Proceeding
File No. 3-14194

POST-HEARING REPLY BRIEF OF MICHAEL R. PELOSI

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Introduction

The Division of Enforcement's ("Division") Post-Hearing Brief ("Brief") fails to provide any support for their claim that Mr. Pelosi violated Section 206 (1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act"). As will be addressed in detail below, the Fact section and the accompanying Proposed Findings of Fact contain factual misstatements and mischaracterizations of testimony that when closely analyzed evidence the Division's failure to establish a cohesive fact pattern that would support their claims. This failure does not provide support for their legal analysis and their conclusions. As a result, the Division has failed to meet their burden of proof, and this matter must be dismissed in its entirety

Analysis of Division's Fact Section and Proposed Findings of Fact

The Fact Section of the Division's Brief and their Proposed Findings of Fact are replete with factual misstatements and mischaracterizations of Mr. Pelosi's testimony and, in all, provide no factual support for the Division's claim that Mr. Pelosi violated Section 206 (1) and 206(2) of the Advisers Act.[1]

Sections 2 and 3

In Sections 2 and 3 of the Facts section, the Division maintains that Halsey had an "established practice" for reporting client portfolio information that included Client Letters containing quarterly or twelve month returns using computer-generated, time weighted return calculations and references to the S&P 500 and the Lehman Aggregate Bond indices. In addition, the Division contends that Mr. Zoldy and Mr. Julian "instructed" Mr. Pelosi on the communication of account performance results in Client Letters and that, "as a Rule", the TWR Reports should be used for communicating quarterly and annual performance results.

In reality, Halsey, while required to have established procedures for such disclosure under Advisers Act Rule 206(4)-7, had no written procedures and, in fact, there is no evidence whatsoever that it had any guidance, informal or formal, for its client communications. Further, the alleged "instruction" consisted of two brief discussions with Mr. Pelosi. When questioned about this "instruction", Mr. Zoldy testified:

> Q And you can explain how Mr. Pelosi was trained on how to communicate account performance to clients?
>
> A Mike was shown past letters that other clients had received. I can recall standing with Mike, Looking over his shoulder working on the first couple of letters that he was responsible for, going through the package of information supplied by our administrative assistants.[2]

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1 The Division's Brief continually refers to their Proposed Findings of Fact as support for their factual claims. As such, this brief and its analysis is directed both at the Division's Brief and its Proposed Findings of Fact as referenced therein.

2 Zoldy 207:17-25.

Mr. Julian stated:

Q When Mr. Pelosi joined Halsey, was he trained on the practices of the firm in terms of preparing the quarterly client communications?

A Well, training not in a formal sense. There was no class. We are a small firm and a lot of what we do to teach each other is just done by one person stepping into the other person's office.

And I do recall I entered Mike's office one day with a letter and a sample of the information we just discussed. Told him it was a typical package and I told him that the discounted cash flow method was there really as a check, but that the time-weighted returns were the returns that we used in reporting performance to our clients.[3]

No other training, annual compliance instruction, annual reviews or other firm continuing education ever addressed this most important topic. In fact, Halsey did not conduct any such training for any compliance requirement. This haphazard approach to its client communications left Mr. Pelosi with no specific guidance on their content and certainly could not remotely be characterized as an "established practice".

The Division later states that Mr. Pelosi had "16 years" of experience at his previous employment of providing his clients with computer generated performance results. This is clearly misleading as neither Mr. Zoldy nor Mr. Julian ever even inquired about his experience. Had they, they would have learned that he had none. At his prior employment, the drafting of letters such as client correspondence and performance reports were generated by another division.[4]

Further, neither Mr. Zoldy nor Mr. Julian, after the brief discussion noted above, ever reviewed any Pelosi client letters for conformance with their alleged "practices" and certainly not for compliance purposes. In fact, they failed to offer any further thoughts or guidance on Client Letters for the remainder of Mr. Pelosi's employment.[5] Thus, the Division has no basis whatsoever for maintaining that Halsey had any "business practice" for their Client Letters.

In terms of material that Halsey regularly provided to Mr. Pelosi for the Client Letters on a monthly basis, the Division now admits that Halsey provided DCF reports to Mr. Pelosi. In its Pre Hearing Brief at p. 4, it claimed that Halsey did not provide this. Mr. Pelosi has correctly maintained throughout that he regularly received this report. However, aside from providing each portfolio manager certain account information including the TWR and DCF reports, throughout the entire period of Mr. Pelosi's employment, Halsey had no established "business practice" or procedure, informal or informal, for the structure or content of its Client Letters including the use of the TWR and DCF reports.

3 Julian 484:1-14.
4 Julian 566:22-567:1 and Zoldy 322:9-16.
5 Zoldy 325:20-326:3 and Julian 569:9-12.

Sections 5 to 7

In Sections 5 to 7, the Division argues that Mr. Pelosi's alleged deception was discovered by two Halsey assistants and that his actions when later confronted with this further evidence his violations. Two long time Halsey employees first discovered Mr. Pelosi's adjustments when they were working on his client communications sometime in late 2007 and early 2008. Each separately discovered that Mr. Pelosi was making such changes and each separately questioned about it.

In these discussions, the Division admits that Mr. Pelosi responded by stating that: "I calculate these figures in a different way" and "I have to take other things into consideration" Mr. Pelosi's adjustments then were discovered well before August 2008, and, at that time, Mr. Pelosi offered a clear and definitive explanation for them. This explanation was completely consistent with his actions then and later. His use of the data from the DCF report and his use of the Deitz calculations are certainly "calculate[ions of] these figures in a different way" and his dividend adjustments would certainly be characterized as "other things" that he took into consideration.[6]

At that time, did he delete these letters? Was he surprised, bewildered or incredulous during these discussions? Did he immediately stop and/or alter his practices? No. He merely explained his actions and continued making appropriate adjustments. The Division has continually claimed at the hearing and in its Brief that Mr. Pelosi has made up a story in the aftermath to address his conduct. Actually, months before the August 2008 confrontation, Mr. Pelosi had clearly and forthrightly addressed the changes that he was making and the reason for them.

Ms. Rourke and Ms. Rynne continued to observe this practice and later informed Mr. Zoldy of it. However, Ms. Rourke testified that she reported this to Mr. Zoldy because she didn't want to get blamed for any mistakes-not because she believed there was some fraudulent conduct.[7]

Why did Mr. Pelosi react in the manner that he did when confronted in August 2008? The main reason was that Mr. Zoldy and Mr. Julian's reacted disproportionately to this situation. As Halsey had no compliance procedures in place, no directives existed as to the content of the Client Letters, and no Client Letters were ever reviewed for compliance purposes. By August 2008, neither Mr. Zoldy nor Mr. Julian had spoken to Mr. Pelosi about the content of his Client Letters for three years. In sum, under Mr. Zoldy and Mr. Julian, Halsey had utterly disregarded its compliance responsibilities for the Client Letters for years, and, as such, their sudden interest in them would have been unanticipated and a surprise.

Under normal circumstances, if a partner in such a small firm was diverting from an established practice, it could be anticipated that this would be informally discussed and resolved between the partners. However, Mr. Zoldy and Mr. Julian, while having no previous

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6 Rourke 39:1-3.
7 Rourke 39:14-20.

reason to be concerned about this issue, did not provide Mr. Pelosi with this opportunity. Instead, they actually conducted a secret, internal review that included a consultation with an attorney, and then "confronted" Mr. Pelosi with their "findings". The challenging tone of this meeting assumed a harshness that went beyond anything that Mr. Pelosi could have anticipated. Experiencing this hostility, Mr. Pelosi, as would anyone, was genuinely surprised and incredulous and, as a result, reacted negatively.

Under such circumstances, mistakes are often made and Mr. Pelosi made several. He was not forthright about his adjustments. A mistake that the Division exploits unrelentingly, making it appear to be a deception that was somehow part of an ongoing scheme. Actually, Mr. Pelosi corrected this mistake by informing Mr. Julian the next day. (Mr Zoldy was gone on a business trip.) He also bungled the letter review. Here, once again, the Division places great emphasis on this, attempting to link it into some fraudulent design. In reality, Mr. Pelosi was openly conducting his letter review immediately after the meeting with the complete knowledge of Mr. Zoldy and Mr. Julian. If the deletion were by design, it would mean that it was done in front of the entire firm at the peak of the business day when every Firm member was reviewing these exact documents.[8] Further, everyone at Halsey knew that there were backup tapes for the Client Letters, including Mr. Pelosi.

It was also Mr. Pelosi who informed Ms. Frois of this problem, and she immediately proceeded with Mr. Julian to replace the files within a short time.[9] In fact, a Halsey employee, Ms. Rourke, verified this situation by testifying that Mr. Pelosi initiated the discussion with Ms. Frois.

Q And were you aware of any discussions between Ms. Frois and Mr. Pelosi regarding that?

A I believe -- my understanding is, as well as I can recall, that Mike asked -- Mr. Pelosi asked Sue Frois to help him retrieve some of those files.

Q And was that right at this time frame?

A Yes, right about the same time.

Q So, in fact, Mr. Pelosi had asked Ms. Frois to retrieve that information?

A Uh-huh.

Q And that's what led to this discussion?

A Uh-huh. [10]

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8 One genuine question was how Mr. Pelosi managed this deletion when there was a notice screen on the system that had to be overridden to do this. The answer is that anyone who has used these confounding systems has been guilty of such a blunder at one point or another. Mr Pelosi's was badly timed.

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

10 Rouke 91:16-92:3.

The Division also makes a major point about certain documents that were supposedly missing from Mr. Julian's credenza. Mr. Julian maintains that these were copies of client letters that were copied and being reviewed by him. Allegedly, when he came to the office the following morning, some were missing. Mr. Pelosi, it appears, was in the office earlier than Mr. Julian. Mr. Julian maintains that Ms. Frois secured these documents for him and on that next day confirmed that some were missing. However, Ms. Frois denied that she knew anything about this in her testimony. If Mr. Julian's story were true, it would mean that Mr. Pelosi once again would have forgotten about the backup tapes and that Ms. Frois was lying under oath. Ms. Frois has over 25 years of business experience as a portfolio assistant and an impeccable reputation. Are we to believe Ms. Frois or Mr. Julian, the CCO that drafted and signed a false filing with the regulatory authorities concealing this very situation?

In his testimony, Mr. Julian also concocted another story about paragraphs that were then also missing from some of Mr. Pelosi's Client Letters in Halsey's system. Unfortunately, Mr. Julian somehow failed, as Halsey has throughout all of this, to retain these letters. Otherwise, there is no evidence whatsoever to substantiate this testimony. Mr. Julian also claims that Mr. Pelosi presented him with a written explanation to use in discussing these adjustments with his clients. These was actually rough notes taken by Mr. Pelosi of a telephone conversation with his brother regarding, among other things, the possible errors that could result for the use of templates. He responded to a Division question regarding his allegedly providing this note to Mr. Julian as follows:

> Q So you wrote out an excuse for why the letters might be different from the Advent reports. Right?
>
> A I wrote out what he was telling me about Word. The bottom part of this secondly were notes I wrote to myself after that conversation. This was nothing that I ever intended to give to anyone, let alone Ken. Under these circumstances, why on earth would I provide him with a torn, tattered, incomplete memo, incomplete sentences, crude abbreviations, and it certainly, it certainly was not something that I was proposing as an example of what we could explain to my clients with. That is – that's a mischaracterization of these handwritten notes. [11]

The Division then revisits the Pelosi e-mail and memorandum that Mr. Pelosi drafted. Mr. Pelosi wrote this e-mail and the memorandum as 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

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[11] Pelosi 748: 17-751:17.

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 to his clients. While there was every reason to provide Mr. Pelosi with this opportunity, he was never given it.[12]

As it has no other viable evidence to establish its case, the Division in the above sections has compiled an aggressive ad hominem attack on Mr. Pelosi in an attempt to erode his credibility. However, when properly explained, this commentary is found to be replete with inconsistencies, mischaracterizations and inaccuracies and thus is wholly ineffective.

Section 10-Division's Record Evidence of Pelosi's Letters

In Section 10ii, the Division attempts to establish the materiality of the variance between Mr. Pelosi's adjustments and the TWR reports. In so doing, they state:

> *ii. Range of Inflation Shows Many Instances Well Above Rounding Errors.* In comparing Pelosi's account reporting to TWR Reports, the Division also presented evidence summarizing the sizes of Pelosi's inflation of performance. This analysis displayed the number of instances of inflation according to ranges of basis point size. For Pelosi's reporting of annual account results, this analysis showed there were 50 instances of inflation greater than or equal to 100 basis points, 67 instances of inflation between 50 and 99 basis points, 48 instances of inflation between 25 and 49 basis points, 44 instances of inflation between 10 and 24 basis points, and 39 instances of inflation between 1 and 9 basis points. SoF, ¶ 107.
>
> For Pelosi's reporting of quarterly account results, the analysis showed there were 40 instances of inflation greater than or equal to 100 basis points, 39 instances of inflation between 50 and 99 basis points, 44 instances of inflation between 25 and 49 basis points, 53 instances of inflation between 10 and 24 basis points, and 38 instances of inflation between 1 and 9 basis points. SoF, ¶ 108.

Mr. Pelosi has asserted in Section C of his Post Trial Brief that the above claims by the Division lack materiality based on standards established in the cited case law including quantitative standards. However, in order to secure a more complete understanding of this materiality issue, it is also helpful here to review it from another perspective. The US Securities & Exchange Commission ("Commission" or "SEC") Staff Accounting Bulletin ("SAB") No. 99 states that "the use of percentage as a numerical threshold, such as 5% may provide the basis for preliminary assumption that.. . a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material."

A significant decision in this area, Ganino v. Citizens Utilities Co., 228 F. 3d 154 (2d Cir 2000), held that, while bright line numerical tests for materiality are inappropriate, SAB 99 "constitute(s) a body of experience and informed judgment," Skidmore v. Swift & Co., 323 U.S. 134, 140, 89 L. Ed. 124, 65 S. Ct. 161 (1944). Further, SAB No. 99 is thoroughly reasoned and consistent with existing law and its non-exhaustive list of factors is simply an application of

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

the well-established *Basic* analysis to misrepresentations of financial results. It was therefore found to be persuasive guidance for evaluating the materiality of an alleged misrepresentation." Id at 163.

In a recent case, ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co., 553 F.3d 187 (2d Cir 2009), the court held that it could not reasonably infer that there was a substantial likelihood that Defendants' reporting of the transactions as loans rather than as trades would have been viewed by a reasonable investor as having significantly altered the total mix of information made available. It noted that "While Ganino held that bright-line numerical tests for materiality are inappropriate, it did not exclude analysis based on, or even emphasis of, quantitative considerations. Ganino, 228 F.3d at 164. According to Ganino, an alleged misrepresentation relating to less than two percent of defendant's assets, when taken in context, could be immaterial as a matter of law. Id.; see also Parnes v. Gateway 2000, Inc., 122 F.3d 539, 547 (8th Cir. 1997) (finding alleged misrepresentations with regard to two percent of total assets were immaterial as a matter of law); In re Westinghouse Sec. Litig., 90 F.3d 696, 715 (3d Cir. 1996) (stating that a misstatement was immaterial where only one percent of assets was allegedly misclassified). And as the SEC stated in SAB No. 99, "[t]he use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that . . . a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material." SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. at 45,151.

Here, the SEC itself has, in its SAB 99, established 5% as a long recognized standard for materiality. Thus, a five percent numerical threshold is a foundation for assessing the materiality of the alleged misstatements. In this case, the overwhelming majority of the alleged misrepresentations do not remotely approach that threshold. Therefore, by any relevant standard, including the SEC's own standard, the variances in the above cited percentages by the Division are immaterial.

This lack of materiality is heightened by a review of the data in the Client Letters that were made available to Mr. Pelosi by the Division and were included in his Exhibits 4 to 6. The Division failed to address these in its exhibits. In this review, Mr. Pelosi has determined that there are some 100 references to client's returns that were available in the Halsey production but yet were not addressed by the Division. Among those omissions, there are at least 22 instances in which the returns quoted in Pelosi's Client Letters understate the returns reflected on the recently produced Advent performance reports.[13] Moreover, the Division failed to address an additional 62 instances in which the returns quoted in Pelosi's letter agree with those reflected on the Advent reports. Combined, this represents 84 instances that the Division failed to address including those in which the returns quoted in Pelosi's letter understate or are consistent with the returns reflected on current Advent reports. This is even further evidence of the lack of materiality of the Division's claims. These omissions are in addition to the more than two hundred letters that remain missing in this matter.[14]

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[13] For convenience of review, the Respondent has compiled these in Attachment A. However, each one of these is contained in the same order as in Respondents Exhibit 4.

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

Section 11-Alleged Overstatement of Total Amount, Individual Asset Class and Combined Asset Class performance Results

In Section 11, the Division initially claims that Mr. Zoldy testified that he reviewed the Division's Exhibits 17 to 24 and that the client correspondence relied on by the Division "constituted the firm's record of what Pelosi sent to his clients from 2005 to August 2008". This statement, on its face, appears to establish that the subject correspondence was all the letters generated by Mr. Pelosi while he was at Halsey. However, a close review of Mr. Zoldy's testimony and Exhibit 25, the "Declaration of James S. Zoldy, Jr. Certifying Records of Regulary Conducted Business Activities" reveals something quite different.

Mr. Zoldy when asked about Halsey's document production of Mr. Pelosi's records stated:

> "We also were asked whether we could supply any other electronic documents that we had and we had our computer technician come in and through archival methods get a snapshot of what existed on Mr. Pelosi's computer as of August 13th, the day before we confronted Mr. Pelosi about the issue, but unfortunately e-mail correspondence was not part of that."[15]

In paragraph 2 of Exhibit 25, Mr. Zoldy certifies that the notebooks designated as Volumes 1-8 and marked as Exhibits 17 to 24 in this matter are true and correct copies of the documents produced by Halsey to the Division, and, in paragraph 3, certifies that the first documents contained in each tab of these notebooks are true and accurate copies from Halsey's database of letters from Mr. Pelosi to Halsey customers. It then states that these are "letters either scanned copies of signed letters (through early to mid-2008) or unsigned electronic copies of letters (after early-to mid-2008)."

Reading this information in its entirety evidences that once again the Division is attempting to assert a fact that is not in the record. Namely, that Halsey has produced all the records of Mr. Pelosi when, in fact, this production was incomplete and consisted only of a limited amount of records that were then on Halsey's systems. The certification clearly states that Mr. Zoldy only verified the authenticity of a small number of 2008 Client Letters. Thus, at least the 2005, 2006 and 2007 records that were used by the Division in its Exhibits 26 and 30, and were the basis for its Exhibits 27-29 and 31-33, were never verified. Further, Halsey clearly failed to retain and provide all the appropriate Client Letters.[16] This failure is fatal to the Division's claims as the absence of these documents, as noted in Section IIC of Mr. Pelosi's Post Trial Brief, prevents the Division from properly establishing its claims.

Section 11A-Alleged Evidence of Overstatement

In Section 11A, the Division attempts to show specific examples of Mr. Pelosi's overstatement of total account returns. Once again, this information when properly analyzed is

15 Zoldy 236:14-21.
16 Section III of the Respondent's Post trial Brief.

actually evidence of Mr. Pelosi's good faith practice of attempting to ensure that his client's have an accurate reflection of their portfolio performance.[17]

Lonergan: The Division alleges that Mr. Pelosi reports to Lonergan that, for the period 6/30/05 through 10/31/05, her IRA portfolio gained 2.1%, claiming that it "beat the return of the S&P 500." The TWR report shows a gain of 1.3%, or a difference of 0.8.

Consistent with its practice of misstatements, the Division asserts that Mr. Pelosi claimed that the IRA 'beat the return of the S&P 500. The letter (Bates # 004672) makes no such claim. Further, the corresponding TWR report for this period is littered with ?s and provides no value. (Bates #004867) As such, it is impossible to make any appropriate assessment of this information. Interestingly, the Division does not mention that the same letter understates the return on her taxable portfolio relative to the quarterly DCF report by 1.2%, or an amount greater than the alleged overstatement (1% quoted, vs. 2.2% on Advent).

Due to the inaccuracy of Halsey's records, Mr. Pelosi testified that he was required to base his assessments on the information in Schwab's systems. However, Halsey failed to provide any Schwab statements for any clients for the month of October, 2005. Without this data and the account transactions for this period, no analysis can be made of both the alleged overstatement in her IRA or the understatement in her taxable account.

Lonergan IRA and Taxable Portfolio: The Division claims that for the period 7/31/05-7/31/06 Mr. Pelosi quoted that Ms Lonergan's IRA as gaining 5.2%. The TWR, however, shows a gain of 4.1%. This account was funded during May of '05, and Mr Pelosi worked from a report at the time of preparing the letter that was from the inception date through 7/31/06 (Mr. Pelosi often provided results from inception for periods shortly after an account was funded). The reconciliation for this is as follows: $663,382 market value on May 31, 2005, compared to a 7/31/06 market value of $697,897 (Bates # eo7539). A simple calculation of percent change between these values yields 5.2%, exactly the return quoted. As this is an IRA, Ms. Lonergan was not taking distributions during this time period. Therefore, there was no need for any adjustments for external cash flow.

George: For the period ending 7/31/2006, the Division noted that Mr. Pelosi reported that this portfolio gained 10.7%, while TWR report showed a gain of 6.8% or a difference of 388 basis points. The first paragraph of this letter (Bates 004709) specifically references the start of when Halsey began managing this portfolio (June of 2005). The last sentence of the second paragraph states "the market value of your portfolio increased accordingly, from $1,145,569 on June 30 2005 to $1,268,740 on July 31 2006". The difference between these two values is 10.7%, exactly the return quoted in his letter. This issue was addressed by Mr. Pelosi at the hearing on this matter.[18]

Connecticut Hypodermics: This Division asserts that this letter addressed the annual period ending 9/30/06, and Pelosi reports that the plan gained 9.6%, although the TWR report showed a gain of 7.02%, or a difference of 258 basis points. In this situation, Mr. Pelosi

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[17] The documents cited herein are contained in the Division's Exhibits 17 to 24.

[18] See Pelosi 1173.

was again viewing the performance report from the portfolio's inception through 9/30/06. This was the sole portfolio that, since it was a profit-sharing plan, Pelosi asked Ms. Rynne if a continuous history from the prior custodian to Halsey could be provided. This would show an uninterrupted view of the portfolio's behavior to plan participants. When Halsey began reporting these results, Mr. Pelosi showed the results from that inception (June '05).

The results can be reconciled in two ways:

1)Deitz:
$2,292,379 ending 9/30/06 market value plus accrued interest per 9/30/06 DCF. (Bates #eo7821)
$2,033,445 beginning 6/30/05 market value per 6/30/05 DCF (Bates #eo6943)
$62,989 net inflow ($179,547-$116,558) per 9/30/06 DCF (Bates #eo7821)
0.5 - assume cash flows occurred mid-year

$$= \frac{2,292,379 - 2,033,445 - 62,989}{2,033,445 - .5(62,989)}$$

$$= \frac{\$195,945}{2,064,940}$$

= 9.5%

2) Advent reports:
6/30/05 through 9/30/05 return from TWR report (Bates # eo4159, DCF report not available) = 2.12%
9/30/05 through 9/30/06 return from TWR, DCF, SEC brief = 7.0%
Linking those two periods = 1.0212 x 1.07 = 9.3%

Lonergan: For the period ending 1/31/08, the Division alleges that Ms. Lonergan's taxable portfolio declined 4.2%, while the TWR report showed a decline of 5.77%. Mr. Pelosi testified that, in drafting Client Letters, Halsey would often use a template to draft a series of letters as a time saver. Howeve this often lead to errors and this is an instance of such a template error. The Lonergan letter (Bates # 004662 was created using the Dr. George letter (Bates #004701) for the same period and dated a day earlier. The language and format of both are very similar, with the Lonergan letter being modified to add information concerning her IRA. As a result, both total returns and asset class returns are identical

Morganti: For the year ended 7/31/06, the Division claims that Mr. Pelosi overstated results by reporting a 6.2% gain for the period, while the TWR report showed a 4.17% gain. Yet, the DCF report showed a return that exactly matched the one quoted in my letter, 6.2%.[19]

Belowsky: For the period ending 1/31/07, the Division alleges that Mr. Pelosi inflated results without basis, comparing the 8.1% result quoted in the letter to a 4.7% TWR result. However, Mr. Pelosi believes that the quoted result was actually from 1/1/06-1/31/07, rather than 1/31/06-1/31/07, as verified by the following reconciliation:

[19] Pelosi 786.

MV on 1/1/06 (as opposed to 1/31/06) = $97,279
MV on 1/31/07 = $104,341
.Fees paid during period (to reconcile to *gross* return that would have been on the Advent report) = $748

$$\text{Deitz: } \frac{104{,}341 - 97{,}279 - (-748)}{97{,}279 + .5(-748)}$$

$$= \frac{7{,}810}{96{,}903}$$

$$= 8.1\%$$

This issue addressed by Mr. Pelosi in detail at the hearing:

> Q Okay. So it's from your memory, that letter reported 12-month results?
>
> A Yes, it did.
>
> Q Okay. And the 12-month result that it reported was 8.1 percent?
>
> A Yes.
>
> Q And your testimony is that the -- that number was higher than the 12-month DCF report. Right? Because on your spreadsheet for Mr. Belowsky at Row 480, the actual return on the DCF report was statement 4.7.
>
> A My -- the 8.1 is greater than the 4.7.
>
> Q Right. And it's also higher than the 12-month return from the time-weighted return. Right?
>
> A Yes.
>
> Q Each month you were given a 12-month time-weighted return report?
>
> A Each month I should have been given a 12-month time-weighted return report. My point is -- and I know that this happens -- it is a function of keying in the correct date with each and every report. And it's very easy to type in 1/1/07 as opposed to 1/31/07. I don't know if that's what happened here. But I don't think it is a coincidence if you take the market value on January 1st and compare it to the market value of January 31st of '07, it matches exactly the number quoted in the letter.[20]

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20 Pelosi 1193:18-1194:22.

<u>Section 11B-Alleged Examples of Pelosi's Overstatement of Individual Asset Class Returns</u>

In Section 11B, the Division provides examples of instances where they allege Mr. Pelosi overstated individual asset class returns. Here, again, this information, when properly analyzed, is actually evidence of Mr. Pelosi's good faith practice of attempting to ensure that his client's had an accurate reflection of their portfolio performance.

<u>Dexter Davenport</u>: The Division alleges that Mr. Pelosi reported to Mr. Davenport that, in the most recent quarter as of September 30, 1997 [*sic*] the common stocks grew "in line with the 2% advance in the S&P 500". They then compare this to a TWR report that shows a loss of 1.15%.

This is a good example of an immaterial adjustment. It is interesting to note that the Division does not note that Mr. Pelosi understated the returns of both bonds and preferred stocks in that same letter (Bates #004272). Mr. Pelosi also quoted a return on taxable bonds of 1.2%, compared to a TWR report (Bates #eo4078) showing 3.6% for the same period. The letter further reports a -1.0 loss on preferreds, while the TWR report posts a smaller 0.6% loss.

<u>Lonergan</u>: For the quarter ending 1/31/08, Mr. Pelosi reports a 7.5% loss on common stocks, compared to TWR loss of 8.5%, which the Division claims is "much closer to the 10.6% loss in the S&P 500." However, this is the same template issue cited above, in which this Lonergan letter was created from the George letter, using it as a template, and not adjusting all the figures. Like the total return quoted in Lonergan's letter, the common stock return is identical to that in the George letter.

<u>Honey Florian</u>: For the quarter ended 2/29/08, the Division alleges that Mr. Pelosi reports a decline of 0.4% in her taxable bonds, while Advent shows a loss of 1.33%. Based on a reviewl of Honey's portfolio (Bates eo1892 through eo1899) Honey also held positions in 2 taxable bond funds, which were categorized separate and apart from her other taxable bonds and would have impacted the return of this asset class.

<u>Section 11C-Alleged Examples of Pelosi's Overstatement of Combined Asset Class Returns</u>

The Division in Section 11C addresses examples of Pelosi's alleged overstatement of combined asset class returns and a close scrutiny of them actually establishes further support foe Mr. Pelosi.

<u>Lonergan</u>: For the period 6/30/05-10/31/05, the Division states that the letter quoted 'equities" in her IRA gaining 3.1%, compared to a TWR report that shows common stocks up 2.27% and 'other' up 1.73%. In order to make an appropriate assessment of his adjustments, Mr. Pelosi required an accurate report of the appropriate account data. Here, as Halsey did not maintain all the required account records, Mr. Pelosi would have relied on the Schwab statements for this account. However, Halsey failed to provide any Schwab statements for any clients for the month of October, 2005. Without access to this data including the account transactions for this period, Mr. Pelosi could not make an appropriate assessment of this equity return.

Robert George: For the period ending 7/31/06, the Division alleges that Mr. Pelosi quoted 'equities' gaining 12.1%, while the annual TWR result for common stocks and preferreds was 8.41% and 9.87% respectively. As explained above, the first paragraph of this letter (Bates 004709) specifically references the beginning of Halsey managing this portfolio (June of 2005). The last sentence of the second paragraph states "the market value of your portfolio increased accordingly, from $1,145,569 on June 30 2005 to $1,268,740 on July 31 2006". The difference between these two values is 10.7%, exactly the return quoted in his letter.

TWR report (#E00791) Common stock return 6/30/05-7/31/05 = 3.3%
TWR report (#E00872) Common stock return 7/31/05-7/31/06 = 8.4%
Total common stock return for period = 11.7%

TWR report (#E00791) "other" return 6/30/05-7/31/05 =5.4%
TWR report (#E00872) 'other" return 7/31/05-7/31/06 =9.9%
Total "other" return for period =15.3%

'Other' represents 21% of equities, and common stocks 79%. Applying these weights to returns above results in a 12.4% 'equity' return vs a 12.1% quoted.

Connecticut Hypodermics: For the period ending 9/30/06, Pelosi reported that "equities returned 14.1%, while the TWR report showed common stocks increased 'only' 8.44% and mutual funds gained 'only' 13.31%". The Division referenced this same letter above with respect to "total account differences" Again, Pelosi was clearly looking at a performance report that was from the portfolio's inception through 9/30/06. This is the sole portfolio that, since it was a profit-sharing plan, Mr. Pelosi requested Ms. Rynne to provide a continuous history from the prior custodian to Halsey in order for plan participants to have an uninterrupted view of the portfolio's behavior. When reporting results in the periods shortly after the account began being managed by Halsey, Mr. Pelosi intended to show results from that inception (June '05). *In several other reporting periods before and after this*, the 14.1 % equity result referenced in the letter is consistent with the equity result for the period Pelosi was quoting:

TWR report (#E04159) Common stock return 6/30/05-9/30/05 = 3.5%
TWR report (#E003963, div. exhibit 19) Common stock return 9/30/05-9/30/06 = 8.4%
Total common stock return for period = 11.9%

TWR report (#E004159) "other" return 6/30/05-9/30/05 = 8.9%
TWR report (#E003963, div. exhibit 19) 'other" return 9/30/05-9/30/06 = 13.3%
Total "other" return for period =22.2%

'Other' represents 28% of equities, and common stocks 72%. Applying these weights to returns above results in a 14.7% 'equity' return vs 14.1 quoted.

The above analysis, when viewed with the appropriate detail and perspective, unquestionably establishes that the Division's claims are without merit.

Section 12A-Division's Allegations re Use of the DCF Reports

The Division alleges that Mr. Pelosi specifically denied using the DCF reports for annual returns, and references his investigation testimony where he is asked if DCF would not have been relevant to 12 month figure. Mr. Pelosi responds "that is correct".

Here, the Division is taking a statement out of context and claiming that it results in an inconsistency. In this situation, it is important to review the complete testimony, as, in this, Mr. Pelosi is asked to respond to a question about a specific difference in a client's annual return on a TWR report and the one in the client letter. When the Staff asks if the DCF report would be relevant to the 12 month figure (e.g., this particular difference), Pelosi appropriately responds "no" because the standard DCF report included only 3 months of information on it.

This is not a denial of using DCF reports for annual returns. Mr. Pelosi says "that is correct" to the Staff because the Halsey assistants did not typically run a DCF report for a 12 month period in the package supplied to the PMs. Mr. Pelosi may generate a 12 month DCF report himself if the situation warranted it. In fact, the time period of that report could sometimes be irrelevant because it was the information contained within that report that was used, not necessarily the return stated on the report itself.

In this particular reference by the Division, it is critical to note that Pelosi is describing the reports (that it contains three month information), not describing what he used for performance. Clearly, a DCF report could be run for any time period by a PM.

The SEC has not pointed to one instance in the investigative testimony from June 2009 in which Pelosi specifically stated that he did not use a DCF report for periods other than one quarter. In fact, Pelosi has given a clear and consistent explanation of his use of the DCF reports in the administrative hearing in 2011.

> However, I often myself called up a DCF report to look at it for the year. I preferred a discounted cash flow format primarily because it afforded greater transparency. You could reconcile individual asset class returns on a DCF report by following the beginning balance, the cash flows into and out of that asset class, realized gain and loss, unrealized gain and loss, income from that asset class and reconcile to the return for that asset class at the bottom line. That was of interest to me. You cannot do that from a TWR report. As you can see, the only information on this TWR report is the number. There are instances in which I wanted a greater understanding of that number.[21]

As is the case with virtually all these claims, the Division's allegations are then a complete mischaracterization of Mr. Pelosi's testimony.

[21] Pelosi 623:11-25

The Division then claims that contrary to Halsey practice Mr. Pelosi testified that he used a quarterly DCF report for the purpose of reporting quarterly client account returns in his letters. As established above, Halsey did not and cannot now claim that it had any "established practices" regarding its Client Letters. Further, both Julian and Zoldy testified that the DCF report was given monthly and state this report "showed any additions or subtractions into the account, so it just gave it gave additional detail " (Zoldy 209:10-12) and that it was "helpful to the portfolio manager to look at both reports to look for any differences in performance numbers that would normally be a reflection of a substantial inflow or outflow of cash during a three-month period" (Julian 482:20-25).

The Division alleges in the second paragraph of p. 22 that Pelosi claimed to use the DCF report for reporting annual returns because "there was never a distinction made between", the TWR and DCF. In the actual testimony, Pelosi never finishes this sentence and the SEC conveniently inserts the words TWR and DCF after the quote and finishes the sentence for him. Nowhere in his testimony does Pelosi say that he used the DCF report for reporting annual returns because there was never a distinction made between TWR and DCF reports. Here, again, the Division is distorting the actual testimony for its own purposes.

Also, in that portion of the testimony, Pelosi goes on to repeat what he has continually maintained: that he used the DCF report because it provided him with the information necessary to investigate questionable returns (which is just as Julian testified and cited above 482:8 – 25)

The Division claims that Mr. Pelosi, on cross examination, wavered on whether he used the DCF report for reporting annual returns. The Division's citation is as follows:

A I don't believe so.

Q You were only given time-weighted return report for annual results. Right?

A Yes.

This citation conveniently doesn't include the question, which combined with the answer is as follows:

Q You were never given the annual DCF report by the portfolio administrators at Halsey. Right?

A I don't believe so.

Q You were only given time-weighted return report for annual results. Right?

A Yes.[22]

[22] Pelosi 1217:11-18

This is clearly a different question than "did you ever use a DCF report for annual return", and is again a distortion of the record.

Pelosi <u>never denied in his testimony that he used a DCF report for annual returns</u>. He acknowledges that he was not given the 12 month DCF reports by Halsey in the package but that he would often call up a 12 month DCF to gain more information or to use as a cross check. In Pelosi testimony, the Division does not ask if he used the DCF report, but whether he was given the DCF report. These are two entirely different questions that obviously have different answers.

Pelosi has never claimed that Halsey provided him with 12 month DCF reports. A reading of his actual testimony supports this.

> Q Now, you now say that you used the discounted cash flow report for reporting annual returns to clients. Correct?
>
> A No. I said -- I -- there were instances in which I called up 12-month DCF report to gain a better understanding of what was being given to me on the time-weighted report as a cross check. And also, if you looked at both reports, I think you would agree that there's greater transparency on the DCF report than there is on the TWR report.
>
> Q So you are saying you didn't use DCF report for reporting annual returns?
>
> A I'm saying that I called it up, and there may have been times when I used the DCF report. It was five years ago. I --
>
> Q So you can't recall today whether you did or you didn't?
>
> A I believe more often -- most often I used the time-weighted return for 12 months.
>
> Q You were never given the annual DCF report by the portfolio administrators at Halsey. Right?
>
> A I don't believe so.
>
> Q You were only given time-weighted return report for annual results. Right?
>
> A Yes.[23]

At page 22 paragraph 2, the Division alleged that "On cross examination, however, Pelosi wavered on whether he used the DCF report for reporting annual returns. First Pelosi denied that he had" SoF 139 pg 1217:14-18 Then it states that 'there may have been times

[23] Pelosi 1216: 14 – 1217:18

that he used the DCF report pg 1217:2-6. However, the relevant testimony again demonstrates that the Division is resorting to distortion to evidence its point.

Q Now, you now say that you used the discounted cash flow report for reporting annual returns to clients. Correct?

A No. I said -- I -- there were instances in which I called up 12-month DCF report to gain a better understanding of what was being given to me on the time-weighted report as a cross check. And also, if you looked at both reports, I think you would agree that there's greater transparency on the DCF report than there is on the TWR report.

Q So you are saying you didn't use DCF report for reporting annual returns?

A I'm saying that I called it up, and there may have been times when I used the DCF report. It was five years ago. I --

Q So you can't recall today whether you did or you didn't?

A I believe more often -- most often I used the time-weighted return for 12 months.[24]

Here, Mr. Pelosi is readily acknowledging that he customarily relied on the TWR report for annual data. The above testimony also dispels the Division's claim that "On further cross examination, Pelosi admitted that the Halsey administrative staff had never given him annual DCF report…..".

In all of the above, Mr. Pelosi's testimony is honest and forthright. In his Halsey tenure, he composed over 500 Client Letters for periods extending back six years in an environment of no policies, procedures or methods of review and control. His actions were based on his desire to ensure that his clients received accurate and timely portfolio information and were always consistent with any legal standard under the Advisers Act.

Section 12B-Division's Allegations Re the Dietz Calculations

Section 12B of the Division's brief asserts that Mr. Pelosi's claimed use of the Modified Dietz Calculation was incredible. The Division claims that Pelosi contradicted himself and claimed 1) that he used the Modified Dietz method for some other purpose than adjusting for cash flows, 2) that he used the Modified Dietz calculation to calculate annual performance, and 3) that, when asked to identify the specific basis for using the calculation for a reason other than adjusting for cash flows, Pelosi could not identify one.

Mr. Pelosi never claimed that he used a modified Dietz calculation for any reason other than to account for the distortions cash flows can create in various performance methodologies. These distortions are readily acknowledged by investment literature, the Advent

[24] Pelosi 1216:14-1217:10.

help function and Mr. Julian and Zoldy, themselves.[25] Mr. Pelosi has consistently testified that when he saw significant cash flows, he would use a Dietz methodology because of the Halsey system's apparent insensitivity to those cash flows. In addition, he said that he might run a Dietz calculation when returns presented to him looked illogical as a check on the reasonableness of it. If the Dietz calculation and the Advent return did not agree and large external cash flows were not to blame, he would run a security by asset class report as an attempt to identify the issue (Pelosi 1213-1216.

Q Now, you say that the modified Deitz calculations is the performance calculation you used to adjust for cash flows that you saw. Right?

A It was one of the reasonable -- checks for reasonableness I used when I saw something that looked illogical to me, yes.

Q It was to adjust for cash flows?

A No, I didn't say that. I said it was one of the things that I used to check for reasonableness. For example, when I --

Q Isn't it the point to modify these calculations to adjust for cash flows? Wasn't that the reason why you were using it?

A It is. But the cash flow issue was not the only reason why I was running the modified Deitz calculations.

Q Isn't it true that you did not make a change to 12-month or annual performance based on cash flows so that it would not affect 12-month returns?

A Cash flows -- 12 months -- longer periods of times would be less sensitive to cash flows.

Q For that reason, you didn't use the modified calculations calculation for annual performance returns. Is that right?

A Not as a result of cash flow issues. But I may have done a modified Deitz calculation if I had gone into the -- if something looks strange on one of the reports and as a result it caused me to go into the performance by security which reported gives me return for each security held in the portfolio and if those returns didn't look inconsistent with the return on -- that I was given on the report, yeah, I could have run --

Q So there was just some other wild reason why you might have done it, other than cash flows?

A I don't think it was wild. I think I talked about it -- I think I mentioned it the first time I met with the Commission.

25 See discussion in Sections E2 and E4 of the Pelosi Post Hearing Brief.

Q Okay. What was the other basis for doing modified Deitz calculation?

A I just explained, if something --

Q Not something. What is the specific thing?

A If I was given a performance report that seemed incongruous with what I understood the behavior of past three months to be or the past year to be.

Q In what respect?

A If the number was up when the market was down.

Q Would it be cash, equity, dividend, what?

A All of it. All of it. It would cause me to look more closely. And as I just testified, everything about what my experience was in 2005 caused me to want to look more closely. One of the checks I used to look more closely was to review a performance by security report within Advent.[26]

The second claim is that Mr. Pelosi "used the Dietz calculation to calculate annual performance". The Division consistently generalizes about time periods in every discussion regarding performance, referring only to quarterly and annual periods. However, Mr. Pelosi provided results for periods other than that as well. As discussed above in the Division's Sections 11A to 11C, in the first year after an account was funded, results were generally provided for the period since inception, e.g., not a quarter and not yet a year. Cash flows would certainly impact these early periods as the accounts became funded (which usually does not occur in one transfer). Mr. Pelosi readily and consistently acknowledged that cash flows have less of an impact the longer the period under review. However, he also felt it important to convey that sometimes during the first year following an accounts initial funding, this calculation was performed for something other than one quarter.

As to the third point, "when asked to provide the basis for using the modified Dietz calculation for a reason other than adjusting for cash flows, Pelosi could not identify one." Again, Pelosi never <u>used</u> the result of a Dietz calculation for anything other than to account for the performance impact of large external cash flows. However he was very clear about why he might <u>run</u> the calculation: it was a means to cross check a suspicious result. If further investigation was warranted based on that result, he would do so, as noted above, by running a performance by security report to see what he could learn from that report.

Further, Mr. Pelosi consistently testified that the Dietz calculation was used selectively to adjust for cash flows:

[26] Pelosi 1214:22-1216:13

Q Now, what is it that you claimed to have done in the calculation of performance to adjust for the system capture of cash flows?

A Simply a Deitz calculation.

Q Now, how many -- while you were at Halsey, how often did you use the modified Deitz calculation to adjust for the cash flow issue?

A I don't know how many, but I would say I used it at least -- I used it for every single period, you know, usually -- at least once.

Q Okay. I want to make sure we are clear on this. So by every period, do you mean every cycle, so every month you would use the modified Deitz calculation at least once?

A No, no, no, no.

A In 2005, it would have been more than 2006 or 2007 because more of those clients were new and had the cash flow issue that I'm referring to.

Q Did you do it in every account in 2005?

A No. No. It would not have been every account because we adjusted --

Q Did you do it only when the account got funded?

A No. Because in some cases, there were cash flows after the account got funded.

Q How often did that happen?

A My clients added money to their portfolios, my clients took money out of their portfolios.

Q But in your experience, I mean, how often did you have to use the modified Deitz calculation in order to adjust the performance results you were sending to your clients?

MR. HEWITT: Asked and answered aboutsix times, Your Honor.

JUDGE ELLIOT: Overruled.

A I'm really not comfortable putting a number on it. I'm telling you I don't think there's a year that went by when I didn't use it. It certainly didn't happen every month.

BY MR. HARPER:

Q You can't give us any way to gauge how many times you did this?

A After 2005 I would say -- again, I don't have a ton of confidence in this, but I would say it was fewer than ten times a year.

Q That's the best you can do?

A I'm afraid it is.[27]

The Division further states on page 26 "as Pelosi's expert Dr. Audley admitted on cross examination, Advents TWR calculation methodology is compliant w/GIPS because it calculates its time weighted return by linking together internal rates of return using the modified Dietz method".

However, the basis for this is Division's Exhibit 11, which is an extract from the help function of the version of Advent that Halsey currently uses. It assumes daily pricing but Halsey did not price daily until May 2008 and only reconciled accounts quarterly. This situation is therefore inapplicable to those discussed by Mr. Pelosi relating to his use of the Dietz calculation. Page one of Exhibit 11, About Performance Calculations, states:

> With Axys (the version of Advent that Halsey upgraded to in May 2008), you can run two types of performance reports. Performance reports that calculate an Internal Rate of Return (the DCF report), and the Performance History reports that calculate a TWR. The following sections briefly explain the formulas that Axys uses in reports. Performance measurement in Axys is designed to comply with GIPS standards.

Reciting from the Advent's Axys help function, the Division states:

> Q Dr. Audley, isn't it true that because the time weighted return calculation on Advent minimizes the effect of cash flows on the portfolio it's the only calculation on Advent that fairly compares the performance of one money manager to another manager or an index?[28]

While Audley agreed, the question was irrelevant as the issue in this case does not involve a comparison of money managers, and the question does not distinguish between Halsey's practices prior to their upgrade and those after.

Here, the Division is attempting to selectively combine pieces of testimony and exhibits to establish their claims, but, when addressed in appropriate detail, they offer no actual

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27 Pelosi 664:15-18; 665:23-666:9; 667:16-19 and 667:24-669:4.

28 Audley 1367:4-10.

support. Division's Exhibit 11 addresses the TWR methodology's sensitivity to cash flows noting:

> 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.
>
> 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.

There is no evidence that such calculations were ever made at Halsey.[29] Thus, Mr. Pelosi was using his Dietz computations to address this problem.

The Division then attempts to claim that the use of the Dietz formula was not discussed at the hearing, but it was addressed in great detail in Mr. Pelosi's testimony. This use is also addressed above in Sections 11A to 11C above. Mr. Pelosi's testified on this subject in his review of Respondent Exhibit 25:

> Q Uh-huh. All right. Let's take a look at these letters here. And first one is a May 9th, 2005, letter to Mr. Bosco. Okay?
>
> A Yes.
>
> Q And it's a two-pager, E04775. And looking at the second paragraph, the sentence or two at the bottom of that, can you take a look at that, please, and tell us what's going on here? What are you describing and why?
>
> A In that second paragraph, I'm describing this client's investment activity for the period July 31st through February 28th of 2005. So it would have been right around the time the assets were first transferred to the bank -- I'm sorry --to Halsey. This is actually an interesting example. The first letter here is -- and the second letter are for the same client, and the same issue struck me. I describe a beginning market value here on July 31st of $2,323,000. The market value described on this kind of cash flow report in this production was $2,366,000. The market value on the Schwab statement reflecting the total funding, which actually occurred in August, not July, was $2,341,000. The point

29 This entire subject is addressed in depth in Respondent's Post Trial Brief at Sections E2 and E4.

is: Neither of them -- all three don't agree. However, if you used the Schwab market value of the amount coming in during July, in other words, that $2,341,000, compared to the $2,273,000 on February 28th, you arrived at exactly a 3.7 percent return.

Q All right.

A It's my belief that the market value on that DCF at the time that I was preparing this letter was, in fact, $2,323,000.

Q All right. And the figures you just recited for us, you have a definitive recall of those?

A They are all in Concordance.

Q All right.

Q Let's look at the next letter, and the Bosco letter on June 16th of 2006.

A Yes.

Q Is the same situation here true here?

A Absolutely. If you apply a Deitz formula to the figures in that last paragraph, you arrive at a -- a return as calculated by that Deitz formula of roughly 3.9 percent, higher than the 3.1 percent reflected in this letter. However, if you applied the Schwab market value, that reflects the actual funding during the month of August that 2,341,300 and something. You actually arrive at exactly 3.1 percent.

Q All right. So again, that's your personal recall? You have no problems at all in terms of that being exact?

A No. That is absolutely exact.

Q That letter is E04777 and 4778.

Q Okay. Let's go the next letter, the Drubner letter of November 2006 --

A Yes.

Q -- 4557, 4558?

A So the second paragraph, again, which is where you'll customarily find, at least, the beginning of investment results describes a two-and-a-half percent total return for the period. The last two sentences of that paragraph reference a beginning market value on June 30th of 10,000,311 compared to an ending market value of October 31st of the number you see there, a reference total cash flows and then break down those cash flows according to the purpose of them. And again, here you would use a Deitz calculation and using a -- or accepting the market value use on this letter, which I confirmed in Schwab, you arrive at a two point -- I believe it was 2.5 percent change quoted in the second sentence.[30]

Section 12C-Division's Allegations re Preferred Stock

The Division states at page 28, 2nd paragraph that "During this investigative testimony, Pelosi claimed that he added the dividend income to adjust performance because his clients had a "common question" about "fixed income returns". Once again, this claim has no relevant basis as this comment had no connection whatsoever to preferreds. The relevant testimony actually reads:

> since I began managing portfolios for individuals, the only common question had to do with how this industry accounts for fixed income returns and the client's viewpoint that this investment return is going over its lifetime equal the yield on the security. That's how they think about things.[31]

Nothing here or anywhere else suggests that Mr. Pelosi accrued for income on preferred because of this "common question". The "common question" that Mr. Pelosi is referring to related to fixed income securities that his clients actually did invest in. The Division has demonstrated a lack of understanding of fixed income securities as here it attempts to create the appearance of contradictions in Pelosi's testimony because they confuse the meaning of fixed income securities, bonds and preferred stocks:

Q How was it that you learned about the income issue with these bonds?

A The market value of the portfolio wasn't reconciling with the Schwab.

Q And when you joined the firm, you didn't have any experience with these particular bonds. Right?

A No, we did. The portfolio was funded with these securities.

Q I thought you said you didn't have any experience with fixed income securities when you came to the firm?

A No. I said I never had any experience with preferred securities when I came to the firm.[32]

The Division then alleges that "When questioned at the June hearing, however, Pelosi initially denied that his clients had questions about investment performance....I don't

30 Pelosi 1051:22-1054:8 and 1070:7-1071:1.
31 Pelosi Investigative Testimony 103:18-23.
32 Pelosi 691:10-24.

recall having a conversation with any of my clients regarding investment performance" Again, this is an extraction that is inconsistent with the actual testimony. Here, Mr. Pelosi stated:

> Q You knew how they looked at their portfolios. Right?
>
> A My clients look at market values in their portfolios, yes.
>
> Q And you believed that they would care about the difference in performance that would result if added -- if the X-dividend was not added back in. Right?
>
> A I was trying to capture the economic impact of that fixed income security.
>
> Q Because you knew they care about it?
>
> A My clients -- I can't answer that. I can tell you, I have never had -- I don't recall having a conversation with any of my clients regarding investment performance. No one has ever come up to me and said, Michael, why was the return this quarter, why was it this that quarter. I never recall having that conversation.[33]

Mr. Pelosi was explaining that he never had a conversation with a client on this subject. However, Pelosi offered in his testimony in 2009 that he had been asked many times since he started managing money for individuals about how the industry accounts for fixed income returns. In fact, the Division themselves cited that testimony and it was:

> since I began managing portfolios for individuals, the only common question had to do with how this industry accounts for fixed income returns and the client's viewpoint that this investment return is going over its lifetime equal the yield on the security. That's how they think about things.[34]

Pelosi then clearly never <u>denied</u> discussing the accounting for fixed income returns with clients, but he has consistently said that no client has ever asked about portfolio returns, including in his investigative testimony in 2009:

> The other point is that none of this was ever done to compensate for any performance issue that my, compensate for any performance concern that my clients had—performance was never even discussed. There was never a conversation about why this asset class performed above or below a certain benchmark. As I said, my clients are concerned about asset values. They have complimented me not only on the growth of those asset values but the relative lack of volatility when they have complimented me on the growth of their portfolios in good markets, I tell them to judge me when the market is not good. And they have, and they are still with me[35]

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33 Pelosi 692:20-693:15.

34 Pelosi Investigative Testimony 103:18-23.

35 Pelosi Investigative Testimony 90:6-18.

On page 28, the Division then continues to mischaracterize by stating that "instead, Pelosi claimed that adding back income had to do with questions about "market value" Upon further cross-examination at the June 2011 hearing, after much combativeness, Pelosi eventually conceded that his purported x-dividend adjustment had to do with changing investment performance, not market values in his client letters." This testimony is actually as follows:

> Q The justification you gave about adding back in the X-dividend to the preferred stock was because you knew your clients would notice the decrease in price. Right?
>
> A Yes.
>
> Q And you believed that they would care about the difference in performance?
>
> A I don't think I referenced performance. I think the market value was what I was referring to.
>
> Q And when you say you added back the X-dividend for the purpose of market value -- is that what you are saying?
>
> A I'm saying -- I'm trying to capture the economic effect or -- the economic value of that security. And it doesn't seem to me that capturing the decline in the market value of that security without capturing the offsetting income that caused that decline is capturing the economic effect. I was trying to put the preferred returns on the same footing as the fixed income returns that my clients had always been quoted, that is, accruing the income for the preferred the same way that income is accrued for bonds.
>
> Q Right. And so you did this adding back in of the income to the dividends so that the performance would reflect it. Right?
>
> A Yes. Yes.[36]

The "combativeness" that the Division references is the result again of their lack of understanding of the fixed income market and preferreds in particular. Unlike bonds, which carry accrued income with them, preferreds trade flat, so that when the preferred goes ex-dividend, the value of the preferred goes down by an amount approximating the dividend. Therefore, you cannot talk about making an adjustment to accrue for the income (i.e., performance) without talking about market value because that is the reason you are making the adjustment- the value of the security declines without having yet received the corresponding income payment. They are interrelated and must be discussed together although the Division doesn't appear to understand this.

Pelosi did not accrue for preferred dividends because his clients had a 'common question" about fixed income returns. This contention makes little sense, and Mr. Pelosi

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36 Pelosi 693:16-694:1 and 694:14-695:7

explains several times why he did it, including below (a portion of which is repeated from just above):

> Q And when you say you added back the X-dividend for the purpose of market value -- is that what you are saying?
>
> A I'm saying -- I'm trying to capture the economic effect or -- the economic value of that security. And it doesn't seem to me that capturing the decline in the market value of that security without capturing the offsetting income that caused that decline is capturing the economic effect. I was trying to put the preferred returns on the same footing as the fixed income returns that my clients had always been quoted, that is, accruing the income for the preferred the same way that income is accrued for bonds. Right. And so you did this adding back in of the income to the dividends so that the performance would reflect it. Right?
>
> A Yes. Yes.
>
> Q And you sent your clients letters that had their account performance listed in the body of the letter?
>
> A Yes.
>
> Q And you knew that when your clients read the letter that they would want to know what the performance of their fixed income securities were and they would notice a decline in price -- or, excuse me, in performance?
>
> A It wasn't -- it wasn't about what the number was in that letter. I did it because I want -- I wanted to show the consistency, the return over a longer period of time that accurately captures the return of that asset. It wasn't because I wanted to show a higher return for preferreds, it's because I didn't want to show a big negative return in one quarter and a large positive return in the next quarter. It was a way of smoothing those results which coincided with the economic value of the security.[37]

Division's Exhibit 46 recites certain reporting standards that are applicable to ex-dividends 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 was then completely consistent with GIPS standards in these adjustments.

On Page 29, 2nd paragraph, the Division claims that Mr. Pelosi made adjustments each quarter. However, he never said this, and, in fact, went to great length to explain that this adjustment was most often applicable to the calendar quarters.

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37 Pelosi 694:14-696:2.

Q How often did you do that while you were at Halsey?

A Often.

Q And so how many times per cycle would you adjust preferred stocks to add back X-dividends?

A Preferreds tend to pay dividends at similar points in the year, very often at the end of calendar quarters. So it would have occurred or the adjustment would have been made probably most often for the cycle periods that ended in a calendar period. How many times that occurred, I -- I -- I don't know. It would be -- it would be a function of which preferreds were held and how many of those preferreds were held in a client's portfolios that were coming up for review that cycle.

Q But in your experience, how often did it happen taking all that into account?

A There was -- in the periods where it mattered, I would say it occurred across most of the portfolios being reviewed for that period, because most of those portfolios would have held the same preferred stocks.

Q How often did you change the performance in account letters, account performance reporting letters because of the change in preferred stocks?

A I can give you a proportion. If 20 letters were coming up for review for the period reflecting the calendar quarter, I would say this issue would have affected, you know, 15 or 16.

Q So we can take that percentage and just apply it across the total then. Right?

A No. Because not every letter was coming up for review on a calendar quarter. That doesn't help us. Could you please tell us how many times --

A I cannot.

Q -- you remember doing it?

A How many times I remember doing it?

Q Yeah.

A No, I can't. I can't.

Q So you can't tell us how many times you added back the X-dividend to preferreds in 2005?

A I can only tell you that in relation to 2006 and later periods, it would have been less because these portfolios held far fewer preferreds because they came in with none of them.

Q By August of 2008, what's your best estimate as to how many times you had done it?

A I would apply the proportion I gave you earlier to the total number of letters that I wrote and that's my –[38]

The Division continues by stating that "Even though Pelosi claims to have made adjustments each quarter and made inverse adjustments the next quarter, he asserts that he kept no records tracking this repetitive and recurring adjustment. Pelosi's claims that he did this adjustment on a regular basis by adding figures one quarter and backing them out the next quarter, without any journal or record-keeping to facilitate accurateness and efficiency, is unbelievable.

In fact, this is readably believable and is recommended by GIPS. As noted above, 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 were then a recognized and appropriate reporting adjustment, were in accordance with GIPS standards and were fully consistent with his reporting responsibilities to his clients.

The adjustment necessary to accrue for preferred income, if one was made, was largely the same for each portfolio each quarter that it came up for review. Mr. Pelosi did not invest in variable rate preferreds on behalf of his clients. Instead, the preferred income payments were of fixed amounts and occurred at fixed intervals. Once the preferred securities that had gone x just prior to the close of the quarter had been identified, the adjustment was the same across any portfolio being reviewed that quarter that held the security. The only factor that varied was the proportionate weight of that security in that particular portfolio and any intra-quarter trading in preffereds. As to maintaining records, these were simple routine adjustments and there was no requirement to maintain such records.

At page 29 par 3, the Division claimed that "Pelosi's claim that he adjusted performance returns by adding back x-dividends is incredible for the additional reason that his purported conduct in making an "inverse adjustment" during the following period is illogical and unbelievable. Pelosi testified on cross-examination that, in first adjusting performance figures to add x-dividend income, he did not make any changes to the Advent system, nor did he ask the administrative staff to do that. Therefore, when Advent recorded the paid dividend during the

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[38] Pelosi 681:21-683:23.

following quarter, the account performance would be accurate, not inflated. Pelosi's claim to have made a subsequent inverse adjustment to correct inflation that did not exists is illogical and unbelievable"

Actually, the Division's point here lacks logic and credibility. Pelosi consistently testified that no calculation made by him ever affected any data on Advent; not the Dietz calculations, not combining like asset classes, and not accruing for the preferred dividend including its reversal to avoid double counting the payment when it is received (investigative testimony 107:4-7):

> nothing I've ever done had any affect at all on pricing or market value. It wasn't even performance on the system. It was that we were explaining to our clients. It had no system affect at all ...[39]

As the Division itself states, Mr. Pelosi "in first adjusting performance figures to add x dividend income, did not make any changes to the Advent system" The accruing for the dividend payment when the security went x was reflected in the Client Letter, not the Advent system. Many preferred stocks do not pay quarterly, but rather semi-annually, including preffereds held in Pelosi's client portfolios. Therefore, if Mr. Pelosi did not reflect in his Client Letters the corresponding and offsetting adjustment to the return reported in the subsequent period when that income was paid finally reflected in Advent, he would be double counting that payment in his client correspondence. The irony is that Mr. Pelosi made this adjustment to avoid inflating what was reported in his client correspondence.

At Page 30 Par. 1-2, the Division states: "Despite ample opportunity, Pelosi has not shown one example...."; "Since the institution of these proceedings, Pelosi had access to his client correspondence and the opportunity to go back and show examples of his purported adjustments.....;"Pelosi had this data and information and chose not to present it to the court...."; "Despite knowing the issues and the availability of the data..." and " his claim was to do a systematic showing of the data and calculations that were used to arrive at the client-reported results"

This also is without merit as the information necessary to systematically and accurately recreate these calculations is not in that correspondence but in the Advent back office (the data portion of the system). This information includes each client's transaction history of preferred securities during the period, which would also provide a record of any securities that were called during the period and when those proceeds were booked into Advent. No transaction histories for any client or any time period are now available in Halsey's records as they have failed to properly maintain them.

While Mr. Pelosi believed that he could find when each preferred went x – dividend (see below), this would require the use of these external sources not within Halsey's available records. Therefore, while the Division claims that Pelosi's testimony regarding the preferred stock adjustments is unbelievable, they provided no record of preferred stock returns

39 Pelosi Investigative Testimony 107:4-7

quoted in these letters compared to any type of Advent performance report upon which to base that claim.

The Division at p. 29-30 claims that Mr. Pelosi's testimony cannot be trusted as it was inconsistent regarding his informing Mr. Julian about making the adjustments. Mr. Pelosi has admitted throughout this matter that he failed to inform Mr. Zoldy and Mr. Julian at the August 14, 2008 meeting about these adjustments.

The Division Has Failed To Meet Its Burden of Proof

Steadman v. SEC, 450 U.S. 91 (1981), established that "in a disciplinary proceeding before the Commission violations of the antifraud provisions of the securities laws may be established by a preponderance of the evidence." Id. at 95. Steadman, like this matter, involved a violation of the Advisers Act in which the Commission sought to bar the respondent from future association with an investment adviser. The case's influence has been widely felt, because the Court, in determining the proper standard of proof to apply, looked to the legislative history of the Administrative Procedures Act. Consequently, Steadman is both generally relevant to any administrative proceeding, and specifically relevant to this matter.

The Steadman court, in determining Congress's intent with respect to establishment of a standard of proof, took into consideration both the quality and the quantity of the information necessary for a sanction. "Congress was primarily concerned with the elimination of agency decisionmaking [*sic*] premised on evidence which was of poor quality -- irrelevant, immaterial, unreliable, and nonprobative -- and of insufficient quantity -- less than a preponderance." Id. at 102. To put it simply, there must be enough quality evidence to support a sanction; neither a small amount of good evidence nor a great amount of weak evidence will meet the burden. As the Steadman court observed, "[t]he phrase 'in accordance with. . .substantial evidence' thus requires that a decision be based on a certain quantity of evidence. Petitioner's contention that the phrase 'reliable, probative, and substantial evidence' sets merely a standard of *quality* of evidence is, therefore, unpersuasive" (emphasis in original). Id. at 98.

Here, the Division has failed to meet both the quantity and the quality standards. The Division's case is premised on its analysis of a incomplete collection of 240 of the approximately 500 letters Pelosi generated during his time at Halsey. A case built on approximately half the available evidence is one that is "of insufficient quantity -- less than a preponderance." Id. at 102. The introduction of the missing letters could alter the Division's own conclusions as to Pelosi's alleged pattern of misrepresenting his clients' results. This very scenario -- one in which consideration of a limited amount of evidence results in distorted facts and false conclusions -- is the one the preponderance standard was intended to prevent.

Beyond its insufficient quantity, the evidence the Division has provided is of insufficient quality. The Division makes much of the fact that some of Pelosi's letters presented superior results. But even to the extent that Pelosi adjusted returns up, those adjustments were so slight as to be immaterial. Once scrutinized, Pelosi's letters -- even the limited number presented here -- do not support the conclusion that he deliberately misled his clients.

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%. 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.

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.

Even in its own analysis of Pelosi's client letters, the Division fails to prove that Pelosi intentionally and meaningfully inflated his reported results. The Division asserts that, "[f]or Pelosi's reporting of annual account results, this analysis showed there were 50 instances of inflation greater than or equal to 100 basis points, 67 instances of inflation between 50 and 99 basis points, 48 instances of inflation between 25 and 49 basis points, 44 instances of inflation between 10 and 24 basis points, and 39 instances of inflation between 1 and 9 basis points." Keeping in mind that a basis point equals one one hundredth of a percentage point, the Division alleges here that Pelosi exaggerated results by, at most, 1%. Such an exaggeration, even if true, is immaterial.

The Division's claims as to Pelosi's reporting of quarterly account results are similarly unavailing. The Division alleges that, "there were 40 instances of inflation greater than or equal to 100 basis points, 39 instances of inflation between 50 and 99 basis points, 44 instances of inflation between 25 and 49 basis points, 53 instances of inflation between 10 and 24 basis points, and 38 instances of inflation between 1 and 9 basis points." Once again, each instance of alleged inflation of results is within the immaterial range of .01%-1%.

A judgment according to the preponderance of the evidence standard must be "a conscientious and rational judgment on the whole record in accordance with the proofs adduced." Id. at 101 (internal citations omitted). Any decision that is consistent with this dictum cannot favor the Division's position.

Pelosi's Conduct Does Not Merit Any Penalty Under the Adviser Act

The Division is seeking to bar Mr. Pelosi for acting as an investment adviser, a second tier penalty of $195,000 and a cease and desist order. None of these are justified in this situation.

Bar

The revocation of registration or bar is the most severe sanction that the SEC is authorized under Section 203(f) of the Advisers Act. 2 Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers § 10.04[A] (2nd ed. 2005). A bar requires not only misconduct, but also the SEC's determination that the misconduct is so severe that revocation is necessary "for the protection of the public." Id. (citing Robert F. Lynch, Adv-481 (1975)). In short, revocation – or a bar from association with any investment firm – is the gravest sanction and is, accordingly, reserved for the gravest misconduct.

Mr. Pelosi's conduct, even if examined in the harshest and least favorable light, does not approach the level of misconduct shown to warrant revocation. As will be illustrated further, *infra*, revocation is appropriate only in the most outrageous of cases. In In re Soliman, 52 S.E.C. 227 (1995), an RIA's registration was revoked, and he was barred from association with any investment firm, because he both defrauded the IRS and, by his own admission, maintained no records related to his advisory service. As the SEC noted, his "penchant for untruthfulness about material matters [wa]s egregious." Id. at 231. Both in terms of Mr. Pelosi's intentions and the impact of his actions, the current allegations, even if construed against Mr. Pelosi, do not call for revocation.

In In re Stone, 41 S.E.C. 717 (1963), Stone, a Registered Investment Adviser ("RIA"), prepared "a weekly investment advisory service" based upon a mathematical formula he developed. Stone and a public relations agent together marketed this service; as a result of their efforts, several newspapers published articles praising the service. Those articles relied upon Stone's misrepresentations as to his academic credentials; the actual, market-tested results of his formula; and the original subscriber base for the service. For instance, Stone represented that he was a graduate of Cornell and had been a graduate student at NYU. In fact, he did not finish his Cornell degree and took only extension courses at NYU. Despite advertising a "background in mathematics," Stone had taken only "courses concerning the application of mathematics to music." Id. at 722. Likewise, research about the formula's effectiveness that he presented as "exhaustive" in fact was not "representative of general market action." Finally, although he claimed to have previously sold the formula to "a selected clientele of institutional investors," "no institution and only one individual" had subscribed. Id. at 719. For these reasons, the SEC concluded that revocation of Stone's registration was "in the public interest." Id. at 724. See also In re Shortline Reports, 1971 SEC LEXIS 437 (1971) (revoking registration of RIA and imposing six month suspension of its president for, inter alia, disseminating investment advice without examining its reliability and worth).

Marketlines v. SEC, 384 F.2d 264 (2nd Cir. 1967) concerned the publication of "misleading advertisements soliciting subscriptions to its market letters" by an RIA. In the proceeding appealed here, the SEC found that those advertisements "violate[d] specific SEC rules" and were "designed to whet the appetite of the unsophisticated." Id. at 266. The court agreed. Perhaps more troubling, the RIA failed to disclose that its president, treasurer, and sole stockholder "failed to pass an examination to qualify as an investment adviser in Illinois and. . .was found guilty of various serious crimes and was disbarred in New York." Id. at 267. The court, upholding the SEC, found that neither Marketlines nor its president should "continue as an investment adviser – an occupation which can cause havoc unless engaged in by those with appropriate background and standards." Id.[40]

Marketlines, Stone and Solimon all address blatant disregard for the requirements of the Advisers Act and serious fraudulent conduct that far surpasses any actions of Mr. Pelosi even if viewed in their most unfavorable light.

In In re Brainard, 41 S.E.C. 991 (1983), an RIA sold to investors security interests in a corporation's accounts receivable. This corporation purported to sell various products to large chain retailers. Id. at 992-93. However, the corporation was "a complete fraud. . .none of the money [invested by the RIA's clients] was used to finance. . .[the] alleged operations" of the corporation. Id. Eventually, the State of North Carolina enjoined the sale of these Securities because they were unregistered, but by then, the RIA had sold to investors "at least $4,375,000" worth of the Securities. The RIA represented to his salespersons that he "had checked [the corporation] out" and told a customer that this investment "entailed 'absolutely no risk.'" Id. at 995. Among a number of similar instances, the RIA "recommended to a husband and wife that they withdraw $30,000. from their retirement fund" for this investment. Id. at 996.

In his defense, the RIA asserted that he "reasonably relied upon the information supplied to him" by representatives of the corporation, an assertion the SEC found to be "totally lacking in merit." Id. at 996. The SEC further noted that the RIA "disregarded obvious warning signals with respect to the alleged collateral for. . .[the] Securities." Id. at 998. The SEC concluded that the RIA engaged in a massive fraud. . .manifest[ing] a blatant indifference to the obligation of fair dealing borne by those in the Securities business." Id. at 1001-02. For his "callous disregard of the Securities laws," the RIA's registration was revoked. See also In re Suter, 47 S.E.C. 951 (1983) (revoking registration, and barring from association with any investment adviser, RIA who defrauded those subscribers to his newsletter who paid by credit card); In re Investment Registry of America, 21 S.E.C. 218 (1946) (revoking registration of RIA who "overcharged for services and took Secret profits by. . .adding expenses which in fact did not exist into gross cost to consumers").

Mr. Pelosi's conduct, which involved the use of information that he believed to be valuable to his client's understanding of their investments, does not remotely approach those of the individuals and entities noted above and cannot, even if viewed in its harshest light, justify a revocation or bar.

Financial Penalty

[40] See also In re Anne Caseley Robin, 41 S.E.C. 634 (1963), in which an RIA failed to disclose in her application to become an RIA that her husband, who was not an RIA, exercised a "controlling influence" over her. Id. at 635. Together, the two published "investment advice consisting of entirely unverified rumor." Id. at 637. See also, generally, SEC v. Bolla, 401 F. Supp. 2d 43 (D.D.C. 2005), vacated on other grounds, 550 F. Supp. 2d 54 (D.D.C. 2008) (barring an RIA who created an investment firm so that his associate, who was previously barred from associating with an investment firm, could manage it from behind the scenes).

Civil penalties under the Advisers Act are divided into three tiers. In the first tier, the amount imposed for each violation "shall not exceed the greater of (i) $ 6,500 for a natural person or $ 65,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation." 15 U.S.C. § 80b-9(e)(2)(A). The second tier imposes higher penalties per violation, but may only be invoked if the violation "involved fraud, deceit, manipulation, or a deliberate or reckless disregard of a regulatory requirement." 15 U.S.C. § 80b-9(e)(2)(B). The third tier imposes highest penalties, but only applies if the violation satisfies all the requirements for the second tier and, in addition, the court concludes that the "violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons." 15 U.S.C. § 80b-9(e)(2)(C).

Court's Discretion: Facts and Circumstances

The purpose of a civil penalty is to punish the individual violator as well as deter future violations. Kenton Capital, 69 F. Supp. at 17. The court has jurisdiction to impose "a civil penalty to be paid by the person who committed [a] violation" of "any provision of [the Advisers Act]." 15 U.S.C. § 80b-9(e)(1).

The court also has discretion to determine the appropriate amount of civil penalties "in light of the facts and circumstances" of the particular case. 15 U.S.C. § 78u(d)(3); SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 17 (Dist. D.C. 1998). In determining whether civil penalties should be imposed and the amount of the fine, courts look to a number of factors, such as (1) the egregiousness of the defendant's conduct; (2) the degree of the defendant's scienter; (3) whether the defendant's conduct created substantial losses or the risk of substantial losses to other persons; (4) whether the defendant's conduct was isolated or recurrent; and (5) whether the penalty should be reduced due to the defendant's demonstrated current and future financial condition. SEC v. Haligiannis, 470 F. Supp. 2d 373 (S.D.N.Y. 2007); SEC v. Coates, 137 F. Supp. 2d 413, 429 (S.D.N.Y. 2001).

For example, "some courts have considered a defendant's ability to pay when determining the amount of civil penalties to impose or whether to waive civil penalties." SEC v. Druffner, 517 F. Supp. 2d 502 (Dist. Mass. 2007) (citing SEC v. Rubin, 1993 U.S. Dist. LEXIS 13301 (S.D.N.Y. Sept. 24, 1993) (ordering disgorgement of profits and SECs earned on improper trades but taking into account defendants' financial situations when calculating civil penalties)). In SEC v. Druffner, even though the court found that the defendant violated provisions of the Securities Act and the Exchange Act and ordered a disgorgement of $732,281, the court denied to impose any civil penalties because the defendant did not have any means to pay them. Id.

Requirement for the Second Tier of Civil Penalty

If civil penalties are warranted, the court determines which level of civil penalties is appropriate by examining whether an evidence of "fraud, deceit, manipulation or deliberate or reckless disregard of regulatory requirement" exists. SEC v. Barr Financial Group, Inc., 1999 U.S. Dist. LEXIS 11352, *15 (Dist. Fla. May 5, 1999). Such evidence is required for defendants to be liable for the civil penalties of the second tier. Id. In SEC v. Barr, the court only imposed a first tier civil penalty of $5,000 because the actions of the defendant, an investment advisor who

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failed to maintain and provide true and accurate records identifying each of the clients as prescribed by the regulations (a violation of §204 of the Advisors Act), was not in fraudulent, deceitful, or reckless disregard of regulatory requirement. The court found that although the defendant showed a blatant disregard for the statutory authority of the SEC by refusing to comply with statutory requirements to disclose information to the SEC, there was no evidence of fraud, deceit, or manipulation on the defendant's part. Id.

Similarly, in SEC v. Slocum, Gordon, & Co., the court denied the SEC's demand for application of the third tier to the defendants' violations of the Advisers Act and only imposed a first tier civil penalty. SEC v. Slocum, Gordon, & Co., 334 F. Supp. 2d 144 (Dist. R.I. 2004). The court in this case found that the Second or third tier penalties were inappropriate because the SEC failed to demonstrate any losses and also because the defendants' commingling of the client and firm funds in violation of the Advisers Act was not intentional or deliberate. Id. at 186. Since the court has "discretion to arrive at a figure within the proscribed limitations 'in light of the facts and circumstances' presented," the court only imposed a $3,000 civil penalty. Id. at 187.

The court's discretion in finding the appropriate civil penalty is not only between each tiers but also within them. In SEC v. Moran, a case against a broker who was found to be in violation of §206 (2), 204, and 207 of the Advisers Act, the court lowered the total civil penalty to $25,000, even though the defendant could have been liable for total of $300,000 (6 second tier violations). SEC v. Moran, 944 F. Supp. 286 (S.D.N.Y. 1996). After considering facts and circumstances of the defendant such as personal suffering that the defendant has incurred, the disgorgement the court imposed in the same case, and the nature of the defendant's violations, the court found that a lower amount was more appropriate. Id.

Rules Applied to Mr. Pelosi

Taking into consideration (1) the egregiousness of the defendant's conduct, (2) the degree of the defendant's scienter, (3) whether the defendant's conduct created substantial losses or the risk of substantial losses to other persons, and (4) whether the defendant's conduct was isolated or recurrent, the SEC's demand for the second tier's maximum civil penalty of $195,000 is wholly inappropriate.

First, Mr. Pelosi's adjustment to the performance information was not egregious. His adjustments were relatively minor and were made in the honest belief that his calculations were a fairer representation of the portfolios.

Second, Mr. Pelosi did not have a required scienter to be eligible for the statute's fraud requirement. For the second tier of civil penalty to be imposed, the statute requires evidence of fraudulent, deceitful, or reckless disregard of regulatory requirement. 15 U.S.C. § 80b-9(e)(2)(B). There is no evidence of intentional or deliberate fraud by Mr. Pelosi, as his revisions in the Client Letters was to ensure that his clients would have a clearer understanding of their portfolios and not to deceive or defraud them. His actions were open and known to his assistants and his explanation for them then is completely consistent with his current position on this matter.

In SEC v. Barr, even though the defendant blatantly disregarded the regulatory requirements, because there was no fraud or malicious intent for his actions, the court denied the second tier civil penalty. SEC v. Barr Financial Group, Inc., 1999 U.S. Dist. LEXIS 11352 at *15. Similarly, in our case, there is no evidence of Mr. Pelosi's deliberate intention to deceive Halsey or its clients. Although he failed to inform his supervisors of the changes, he did not hide or conceal them. He spoke openly with his assistants about his revisions, continued to make these revisions thereafter and, at no time, attempted to destroy the Client Letters.

Third, Mr. Pelosi's actions did not create any loss or even risk of substantial loss to his clients or his firm but rather generated a substantial profit for them. In fact, Mr. Pelosi is not aware of one client complaining to him or Halsey about the investment performance of his portfolios.

Lastly, Mr. Pelosi's actions were isolated. Mr. Pelosi adjusted the numbers in the Halsey client letters because his 20 years of experience at other established companies indicated to him that Halsey's system of assessing and reporting the portfolios was inadequate. Mr. Pelosi's diligence combined with his instinct and experience helped him to achieve frequent promotions at Bank of Boston, while it went through numerous changes (Bank of Boston was acquired by Fleet; Fleet was acquired by Bank of America). Through such changes in the corporation and throughout his lengthy career, not once was he accused of any irregular activity. These sanctions then are not appropriate for Mr. Pelosi.

Cease and Desist

Section 203(k) of the Advisers Act authorizes the Commission to impose a cease and desist order upon any person who is violating or has violated the Advisers Act. A cease and desist order prevents further harm to the investing public. Moreover, a cease and desist order draws investors' attention to questionable or illegal professional conduct. Consequently, "[t]he existence of a cease and desist order. . .is clearly relevant to a reasonable investor, who is naturally interested in whether management is following the law. . ." SEC v. Merchant Capital, 483 F. 3d 747, 771 (11th Cir. 2007). See also SEC v. Paro, 468 F. Supp. 635, 646 (N.D.N.Y. 1979) (finding that investors would have been "especially dubious" of investment offer "if they had been apprised of the cease and desist order and injunctions which had been issued against" the offeror). As noted, a significant number of Pelosi's clients followed him from Halsey to his current firm, and have remained with him even when he was faced with these accusations. Thus, a cease and desist order is unwarranted not only because Pelosi's conduct is not itself unlawful but also because, as the behavior of Pelosi's clients demonstrates, information about Pelosi's conduct would not affect their investment decisions.

Further, Pelosi's conduct, even if examined in the harshest light, is not comparable to other conduct deemed to warrant a cease and desist order. In one recent decision, In re Lyniuk, File No. 3-14304, 2011 WL 2705695 (Jul. 13, 2011), the respondent "engaged in egregious self-dealing by obtaining undisclosed compensation of at least $400,000, including rebates on brokerage commissions that were generated through the Fund's trading, and a referral fee of $40,000 in connection with his investment of $500,000 of the Fund's assets in a start-up venture that offered limited liquidity." Following that fund's "disastrous" losses, respondent failed to redeem investors' shares and, instead, made "unauthorized payments to himself and his friends." Soon thereafter, respondent went about seeking investors for another, new fund, using "false and misleading information concerning the history, assets under management, and performance of the [new] fund." Id. at *1-*2. By contrast, there is no indication that Pelosi deliberately misled investors or engaged in self-dealing. And perhaps most importantly, for purposes of a cease and desist order, there is no indication that Pelosi intends to engage in any future wrongdoing. See also, e.g., In re Stratum Wealth Mgmt. and Charles B. Ganz, Administrative Proceeding File No. 3-13633, 2009 WL 3100573 (2009) (imposing cease and desist order against respondent who, inter alia, misappropriated client funds); In re Seavey, Administrative Proceeding File No. 3-10336, 2001 WL 981151 (2001) (respondent, the adviser to a fund, arranged for wire transfer of fund monies to an account he secretly controlled). Pelosi's conduct is of neither the quantity nor the quality to warrant a cease and desist order, making that sanction inappropriate here.

CONCLUSION

The Division's Brief fails to provide any support for their claim that Mr. Pelosi violated Section 206 (1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act"). As established above, the Fact section and the accompanying Proposed Findings of Fact contain factual misstatements and mischaracterizations of testimony that when closely analyzed evidence the Division's failure to establish a cohesive fact pattern that would support their claims. This failure does not provide support for their legal analysis and their conclusions. As a result, the Division has failed to meet their burden of proof, and, therefore, this matter must be dismissed in its entirety

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List of Divisions Omissions As Noted In Respondents Exhibit 4

Examples of Division's Omissions of Pelosi's Understatement of Client Results.

Pelosi's letter referring to the Cly-Del pension plan for the year ending12/31/07 quoted a return of 7%. The recently produced TWR report for the corresponding period reflected a return of 7.3%. The recently generated DCF report for the corresponding period was 7.3%

Pelosi's letter referring to Burrows Trust for the year ending 5/31/08 quoted a return of 4.5%. The recently produced DCF report for the corresponding period reflected a return of 5.1%

Pelosi's letter referring to Paul Kovacs for the quarter ending 4/30/08 quoted a return of 5.3%. The recently produced TWR report for the corresponding period reflected a return of 6.1%. The recently generated DCF report for the corresponding period was 6.1%

Pelosi's letter referring to McAllister for the year ending 2/29/08 quoted a return of 2.7%. The recently produced DCF report for the corresponding period reflected a return of 3.1%

Pelosi's letter referring to Roger Roby for the period quarter 4/31/07 quoted a return of 3.1. The recently produced TWR report for the corresponding period reflected a return of 3.3%. The recently generated DCF report for the corresponding period was 3.3%

Pelosi's letter referring to Joyce Shickler for the quarter ending 12/31/06 quoted a return of 1.1. The recently produced TWR report for the corresponding period reflected a return of 1.3%. The recently generated DCF report for the corresponding period was 1.3%

Pelosi's letter referring to Joyce Shickler for the year ending 3/31/08 quoted a return of 3%. The recently produced TWR report for the corresponding period reflected a return of 3.1%

Pelosi's letter referring to Shickler Trust 2 for the quarter ending 12/31/06 quoted a return of 0.8%. The recently produced TWR report for the corresponding period reflected a return of 1.0%. The recently generated DCF report for the corresponding period was 1.0%

Pelosi's letter referring to Shickler Trust 2 for the year ending 3/31/08 quoted a return of 6.4%. The recently produced TWR report for the corresponding period reflected a return of 9.7%

Pelosi's letter referring to Antoinette and Robert Lenkowski for the year ending 4/30/08 quoted a return of 1.0%. The recently produced DCF report for the corresponding period reflected a return of 1.6%

Pelosi's letter referring to Robert Lenkowski IRA for the quarter ending 4/30/08 quoted a return of 0.5. The recently produced TWR report for the corresponding period reflected a return of 2.1%.The recently generated DCF report for the corresponding period was 2.1%

Pelosi's letter referring to Robert Lenkowski IRA for the year ending 4/30/08 quoted a return of -3.5%. The recently produced TWR report for the corresponding period reflected a return of -2.0%.The recently generated DCF report for the corresponding period was -1.8%

Pelosi's letter referring to Susan Largay for the quarter ending 4/30/08 quoted a return of 3.7. The recently produced DCF report for the corresponding period reflected a return of 4.6%

Pelosi's letter referring to David Davenport for the year ending 3/31/07 quoted a return of 10.2%. The recently produced DCF report for the corresponding period reflected a return of 10.3%

Pelosi's letter referring to Elizabeth Lenkowski IRAfor the year ending 4/30/08 quoted a return of 2.7%. The recently produced DCF report for the corresponding period reflected a return of 3.1%

Examples of Division's Omissions of Pelosi's Client Letters which contained no differences.

Pelosi's letter referring to Burrows Trust for the year ending 5/31/08 quoted return of 4.5%. The recently produced TWR report for the corresponding period reflected a return of 4.5%.

Pelosi's letter referring to McAllister for the year ending 2/29/08 quoted a return of 2.7%. The recently produced TWR report for the corresponding period reflected a return of 2.7%

Pelosi's letter referring to Antoinette and Robert Lenkowski for the year ending 4/30/08 quoted a return of 1.0%. The recently produced TWR report for the corresponding period reflected a return of 1.0%

Pelosi's letter referring to Antoinette and Robert Lenkowski for the quarter ending 4/30/08 quoted a return of 1.9%. The recently produced TWR report for the corresponding period reflected a return of 1.9%

Pelosi's letter referring to Susan Largay for the quarter ending 4/30/08 quoted a return of 8.6. The recently produced DCF report for the corresponding period reflected a return of 8.6%

Pelosi's letter referring to the Cly-Del pension plan for the quarter ending12/31/06 quoted a return of 3.8%. The recently produced TWR report for the corresponding period reflected a return of 3.8%. The recently generated DCF report for the corresponding period was 3.8%

Pelosi's letter referring to the Burrows Trust for the quarter ending 5/31/07 quoted a return of 3.5%. The recently produced TWR report for the corresponding period reflected a return of 3.5%. The recently generated DCF report for the corresponding period was 3.5%
Pelosi's letter referring to Kofkoff/Fortin Managment for the quarter ending 12/31/07 quoted a return of -2.7%. The recently produced TWR report for the corresponding period reflected a return of -2.7%. The recently generated DCF report for the corresponding period was -2.7%.

Pelosi's letter referring to Robert Kovacs for the quarter ending 7/31/06 quoted a return of 1.0%. The recently produced TWR report for the corresponding period reflected a return of1.0%. The recently generated DCF report for the corresponding period was 1.0%.

Pelosi's letter referring to Robert Kovacs for the quarter ending 4/30/06 quoted a return of 1.1%. The recently produced TWR report for the corresponding period reflected a return of1.1%. The recently generated DCF report for the corresponding period was 1.1%.

Pelosi's letter referring Christopher Hughs for the quarter ending 11/30/06 quoted a return of 6.0%. The recently produced TWR report for the corresponding period reflected a return of6.0%. The recently generated DCF report for the corresponding period was 6.0%.

Pelosi's letter referring to the Camp Estate for the quarter ending 4/30/07 quoted a return of 3.1%. The recently produced TWR report for the corresponding period reflected a return of3.1%. The recently generated DCF report for the corresponding period was 3.1%.

Pelosi's letter referring to David Davenport for the quarter ending 3/31/07 quoted a return of 3.1%. The recently produced TWR report for the corresponding period reflected a return of3.1%. The recently generated DCF report for the corresponding period was 3.1%.

Pelosi's letter referring to Dexter Davenport for the quarter ending 6/30/08 quoted a return of 2.0%. The recently produced TWR report for the corresponding period reflected a return of2.0%. The recently generated DCF report for the corresponding period was 2.0%.

Pelosi's letter referring to Dexter Davenport for the year ending 6/30/08 quoted a return of 5.1%. The recently produced TWR report for the corresponding period reflected a return of5.1%.

Pelosi's letter referring to the New Haven Parks for the year ending 3/31/06 quoted a return of 15.1%. The recently produced TWR report for the corresponding period reflected a return of15.1%. The recently generated DCF report for the corresponding period was 15.1%.

Pelosi's letter referring to Jane Curran fbo William Curran for the quarter ending 9/30/07 quoted a return of 2.4%. The recently produced TWR report for the corresponding period reflected a return of2.4%. The recently generated DCF report for the corresponding period was 2.4%.

Pelosi's letter referring to Jane Curran fbo William Curran for the year ending 9/30/07 quoted a return of 15.8%. The recently produced DCF report for the corresponding period reflected a return of15.8%.

Pelosi's letter referring to Joyce Shickler for the quarter ending 3/31/08 quoted a return of 1.5%. The recently produced TWR report for the corresponding period reflected a return of1.5%. The recently generated DCF report for the corresponding period was 1.5%.
Pelosi's letter referring to Joyce Shickler IRA for the quarter ending 12/31/06 quoted a return of 1.5%. The recently produced TWR report for the corresponding period reflected a return of1.5%. The recently generated DCF report for the corresponding period was 1.5%.

Pelosi's letter referring to Antoinette Lenkowski IRA for the quarter ending 4/30/08 quoted a return of -2.7%. The recently produced TWR report for the corresponding period reflected a return of -2.7%. The recently generated DCF report for the corresponding period was -2.7%.

Pelosi's letter referring to Antoinette Lenkowski IRA for the year ending 4/30/08 quoted a return of-2.2%. The recently produced TWR report for the corresponding period reflected a return of-2.2%. The recently generated DCF report for the corresponding period was -2.2%.

Pelosi's letter referring to Robert Lenkowski IRA for the quarter ending 4/30/08 quoted a return of 0.7%. The recently produced TWR report for the corresponding period reflected a return of 0.7%. The recently generated DCF report for the corresponding period was 0.7%.

Pelosi's letter referring to Robert Lenkowski IRA for the year ending 4/30/08 quoted a return of 3.4%. The recently produced TWR report for the corresponding period reflected a return of 3.4%. The recently generated DCF report for the corresponding period was3.4%.

Pelosi's letter referring to Elizabeth Lenkowski for the quarter ending 4/30/08 quoted a return of 3.7%. The recently produced TWR report for the corresponding period reflected a return of 3.7%.

Pelosi's letter referring to Elizabeth Lenkowski for the year ending 4/30/08 quoted a return of -1.0%. The recently produced TWR report for the corresponding period reflected a return of -1.0%.

Pelosi's letter referring to Elizabeth Lenkowski IRA for the quarter ending 4/30/08 quoted a return of 2.8%. The recently produced TWR report for the corresponding period reflected a return of 2.8%.

Pelosi's letter referring to Elizabeth Lenkowski IRAfor the year ending 4/30/08 quoted a return of 2.7%. The recently produced TWR report for the corresponding period reflected a return of 2.7%.

Pelosi's letter referring to Michael Lenkowski IRA for the quarter ending 4/30/08 quoted a return of 3.9%. The recently produced TWR report for the corresponding period reflected a return of 3.9%. The recently generated DCF report for the corresponding period was 3.9%.

Pelosi's letter referring to Michael Lenkowski IRA for the year ending 4/30/08 quoted a return of 4.4%. The recently produced TWR report for the corresponding period reflected a return of 4.4%. The recently generated DCF report for the corresponding period was 4.4%.

Pelosi's letter referring to Michael Lenkowski for the quarter ending 4/30/08 quoted a return of 3.9%. The recently produced TWR report for the corresponding period reflected a return of 3.9%.

Pelosi's letter referring to Michael Lenkowski for the year ending 4/30/08 quoted a return of 1.2%. The recently produced TWR report for the corresponding period reflected a return of 1.2%. The recently generated DCF report for the corresponding period was 1.2%.

Pelosi's letter referring to Robert Bosco for the quarter ending 5/31/08 quoted a return of 4.5%. The recently produced TWR report for the corresponding period reflected a return of 4.5%. The recently generated DCF report for the corresponding period was 4.5%.

Pelosi's letter referring to Florence Bosco for the period ending 4/26/06 quoted a return of 9.5%. The recently produced TWR report for the corresponding period reflected a return of 9.5%.

Pelosi's letter referring to Brian Davis for the quarter ending 1/31/07 quoted a return of 0.9%. The recently produced TWR report for the corresponding period reflected a return of 0.9%.

Pelosi's letter referring to Brian Davis IRA for the quarter ending 6/30/08 quoted a return of 2.2%. The recently produced TWR report for the corresponding period reflected a return of 2.2%. The recently generated DCF report for the corresponding period was 2.2%.

Pelosi's letter referring to Brian Davis IRA for the year ending 6/30/08 quoted a return of 0.7%. The recently produced TWR report for the corresponding period reflected a return of 0.7%. The recently generated DCF report for the corresponding period was 0.7%.

Pelosi's letter referring to Naugatuck Valley Surgical for the quarter ending 5/31/08 quoted a return of 1.2%. The recently produced TWR report for the corresponding period reflected a return of 1.2%. The recently generated DCF report for the corresponding period was 1.2%.