UNITED STATES OF AMERICA
Before the
SECURITIES EXCHANGE COMMISSION

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

BRIEF IN SUPPORT OF APPELLANT-RESPONDENT MICHAEL R. PELOSI'S APPEAL OF INITIAL DECISION

JOHN R. HEWITT
Of Counsel and On the Brief

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

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I. INTRODUCTION

The Respondent, Michael R. Pelosi ("Pelosi") maintains that the January 5, 2012 Initial Decision of the Administrative Law Judge ("Decision") in this matter embodies findings and conclusions of material fact that are clearly erroneous and conclusions of law that are erroneous. Pursuant to this, Pelosi filed a Petition For Appeal of Initial Decision on January 27, 2012 which petition was granted on March 8, 2012. In the order granting the petition, the U. S. Securities and Exchange Commission ("SEC" or "Commission"), on its own initiative, determined to review what sanctions, if any, are appropriate in this matter.

In support of his appeal, Pelosi presents this brief which provides detailed support for his petition including an analysis of all material factual errors and those errors in the Decision's Conclusions of Law. The brief concludes that the Commission should vacate the bar sanction in the Initial Decision and impose a lesser sanction on Mr. Pelosi.

II. FINDINGS OF FACT

A. Personal and Professional Background

Michael R. Pelosi is a life-time resident of Waterbury, Connecticut, who graduated *magna cum laude* from the University Of Connecticut with a B.S. in Finance, with a minor in Economics. He obtained an MBA from the University of Connecticut, also *magna cum laude*, in 1991, and a CFA in 1994.

Upon graduation in 1986, Mr. Pelosi accepted a full time position with Bank of Boston as a credit analyst. He was made a portfolio manager in 1988, managing approximately $100 million in assets for approximately 80 clients. He advanced to Senior Vice President of Bank of Boston in the late 1990s, managing over $350 million. When Bank of Boston was acquired by Fleet Bank in 1999, Mr. Pelosi was also made co-head of a large-cap equity team. When Bank

of America acquired Fleet in 2003, Mr. Pelosi continued in these roles and his team was asked to manage one of the bank's largest equity funds, the National Strategic Growth Fund. At this point, Mr. Pelosi was managing over $2 billion.

Mr. Pelosi was repeatedly asked by Fleet and later Bank of America to relocate to New York or Boston, and to relinquish his individual advisory work so as to focus more on his other responsibilities. Mr. Pelosi did not desire to move, or to give up his individual advisory relationships, and eventually looked for other opportunities in central Connecticut.[1]

Mr. Pelosi accepted a portfolio management position with Halsey Associates, Inc. ("Halsey") in April 2005.[2] Halsey, an investment advisory firm in New Haven, had primarily high net worth and small institutional clients with assets of $750,000,000. Halsey was seeking new portfolio managers and new business. Mr. Pelosi brought in 15 of the 36 clients Halsey added in 2005,[3] and eventually brought in 30 clients with assets under management of approximately $65 million.[4]

After leaving Halsey, Mr. Pelosi was a Senior Portfolio Manager with YHB Investment Advisers, Inc. ("YHB") in West Hartford, Connecticut from 2009 to 2012, where he managed portfolios for approximately 30 high net worth and institutional clients.

B. Halsey Employment-2005 to 2008

1. Halsey Compliance Failures

In Pelosi's discussions prior to his employment, Zoldy and Julian expressed great interest

1 Throughout this brief, the Respondent will cite the witness testimony at the hearing on this matter by noting the individual witness and then the specific page(s) in the transcript. Pelosi 605 to 606 and 1006 to 1035. The Exhibits in this case will be cited as Div. Exh __ and Resp. Exh. __. The Decision citations will be cited as Dec. at

2 Pelosi 1035:1-7, Zoldy 179:2-3 and Julian 470:11-16.

3 Div. Ex. 9

4 Dec. at 3.

in implementing a model portfolio at Halsey, and also agreed on Pelosi's suggestion to add new research tools for its analytical use. Zoldy and Julian also described their monthly portfolio management investment meetings where they would work jointly on research initiatives. Upon assuming his position at Halsey, Pelosi soon discovered that its daily business operation was considerably different than what he had anticipated. Contrary to his understanding, Zoldy and Julian each conducted their own separate research and exhibited little interest in a collaborative approach. Pelosi's efforts to initiate the use of a model portfolio, to hold weekly meetings, secure new analytical software or add to the PM staff also received little attention. He also learned that a great deal of time was devoted to the drafting of quarterly client letters.[5]

Additionally, Pelosi was not informed of any Halsey compliance or supervisory policies and procedures, written or otherwise. The Firm did not conduct any e-mail, correspondence, order or pricing reviews including a supervisory review of their client letters. and did not have a record retention policy.[6] The Decision confirms these compliance failures, noting that Julian, the CCO, admitted that Halsey had inadequate compliance procedures during Pelosi's tenure[7], that Pelosi was not formally trained[8], that it failed to have a compliance procedure addressing performance calculations[9], that it did not review pricing for compliance purposes[10], that Halsey did not conduct a supervisory review of client letters[11] and that Halsey violated Investment Adviser's Act Rule 206(4)-7 for its failure to conduct annual reviews.[12] The Decision also noted that Halsey's 2009 compliance manual didn't address reconciliation, but stated that this was

[5] Pelosi 1035:8-1038:10, 1043:19-24.
[6] Rynne 134: 14-25;17-25, Rourke 52:18-53:5; 53:2-5, Zoldy 243:23-244:9; 322:18-324:17 and Julian 528:8-18; 567:2-21.
[7] Dec. at 8.
[8] Dec. at 5.
[9] Dec. at 9.
[10] Dec. at 4.
[11] Ibid.
[12] Ibid.

"because it was not an operations manual' and that, while Halsey's compliance manual did not have anything on reconciliations nor much on pricing, it had "formal operations practices". No explanation is provided for the latter two statements. In fact, the Investment Adviser's Act and its guidelines (discussed below) do not discuss "formal operations practices" nor provide any explanation justifying the failure to have reconciliation procedures "because it was not an operations manual".

The Decision also fails to explain why it references the 2009 manual that was implemented after Pelosi had left the firm in August 2008 and fails to note that Halsey had a 9 page manual during Pelosi's tenure that failed to address the above noted rule requirements and many, many others.[13] Further, the "Halsey Compliance" Section on page 8 discusses only a few of the above discussed failures and is well after the principle discussion of the alleged disclosure violations. Taken as a whole, Halsey's compliance failures evidence a complete breakdown in its compliance responsibilities. However, the Decision discusses them at isolated points over eight pages and fails to address the significance of this breakdown on Halsey's client communications.

Investment Adviser's Act Rule 206(4)-7, Compliance Procedures and Practices, establishes Halsey's compliance requirements and the SEC's guidance on Rule 206(4)-7 notes that an investment adviser's procedures must provide for the accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements and that these procedures must provide for the accurate creation of required records and their maintenance in a manner that Secures them from unauthorized alteration or use and protects them from untimely

[13] Resp. Exh. 2. See also the applicable compliance requirements as discussed below.

destruction.[14] These requirements are fundamental and establish the necessary framework for an investment adviser to develop proper disclosure and retention policies for their client communications. Zoldy and Julian ignored these guidelines,[15] despite the fact that they had been senior officers at major financial institutions with such policies and procedures.[16]

The absence of such procedures at Halsey was not simply a rule violation, but a delinquency that, as will be detailed below, resulted in inconsistencies and inaccuracies in Halsey's client communications and a failure to create and maintain its most basic records. As to training, Zoldy and Julian testified that they offered "instructions" to Pelosi, but these consisted of two brief conversations with Pelosi, when he first joined Halsey.[17] Further, neither Zoldy nor Julian ever even inquired about Pelosi's experience in drafting client communications. Had they, they would have learned that he had none.[18] For the remainder of Pelosi's employment or over three years, the record is completely devoid of any evidence of further training, annual compliance instruction, annual reviews or other firm continuing education addressing these most important topics. In fact, neither Zoldy nor Julian ever offered any further thoughts or guidance on client letters ("Client Letters") for the remainder of Pelosi's employment.[19] Zoldy and Julian's completely irresponsible and haphazard approach to client communications left Pelosi with no specific guidance on their content and certainly could not remotely be characterized as "formal operations practices", even if this were an accepted procedure.

As a result, Halsey failed to establish a proper standard and the required compliance structure under the Advisors Act for its client communications. As no standard existed, an

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

[15] Rynne 134:17-25, Rourke 53:2-5, Zoldy 243:23-244:9 and Julian 528:8-18.

[16] Julian had been a colleague of Pelosi at BA and Zoldy had worked at Cititrust. Zoldy 175:19-176:1 and Julian 469:24-470:1.

[17] Julian 484:1-14; 566:22-567:1 and Zoldy 322:9-16..

[18] Pelosi 606:5-25.

[19] Zoldy 325:20-326:3 and Julian 569:9-12.

evaluation of Pelosi's Client Letters must be based on existing recognized performance standards pursuant to the Advisors Act. Of note, the Division never proved, and indeed never even tried to prove, that Mr. Pelosi's performance calculations were outside the range of performance figures that could have been produced under accepted standards for calculating such figures. All the Division tried to prove, and all the Decision found is that Mr. Pelosi's numbers did not match the numbers in Halsey's reports. But the Halsey reports were themselves inaccurate. In light of these problems with the Halsey data, the Division should have been required to prove its claims of fraud based on an accurate calculation of performance results.

2. Halsey Record Keeping Failures

Halsey also failed to properly maintain and retain its records under Investment Adviser's Act Rule 204-2(a)-7, Books and Records to Be Maintained by Investment Advisers Rule, and violated Investment Adviser's Act Rule 204-2(a)(16) that states, in pertinent part, that Halsey must retain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts. Rule 204-2(g)(3) requires advisers that maintain records in electronic format "to maintain and preserve the records, so as to reasonably safeguard them from loss, alteration, or destruction." Halsey failed to have any procedures in place to address these requirements and also failed to maintain many of these required records.

In his testimony, Zoldy stated that he reviewed the Div. Exhs. 17 to 24 that contained the client correspondence used by the Division and it "constituted the firm's record of what Pelosi sent to his clients from 2005 to August 2008". This statement, on its face, appears to include all the letters generated by Pelosi while he was at Halsey. However, a close review of Exhibit 25, the "Declaration of James S. Zoldy, Jr. Certifying Records of Regularly Conducted Business

Activities" reveals something quite different. In its paragraph 2, Zoldy certifies that the notebooks designated as Volumes 1-8 and marked as Div. Exhs. 17 to 24 in this matter are true and correct copies of 240 letters produced by Halsey to the Division. In paragraph 3, Zoldy certifies 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).

Div. Exhs. 26 and 30 are spreadsheet chronological listings of the 240 client letters contained in Div. Exhs 17 to 24 that the Division utilized to establish its case in this matter. However, even a cursory review of these exhibits evidences significant time gaps in these Client Letters. There are only fifteen letters for 2005, and no consistency in time or client order for the 2005 to 2008 period, as many individuals appear only once a year, while others appear more frequently. This explains Zoldy's vague reference in Exhibit 25 to letters "through early to mid-2008", as many Halsey records were not included in this production. Zoldy's vague verification and testimony regarding these records are the only basis for their admission into evidence.[20] The Division did nothing else to validate them as the basis for their claims. The Decision bases its findings on the Division's Exhibits, and, as their underlying documents have not been properly verified, its findings lack a proper basis. Halsey's failure to maintain these records is another example of its total compliance breakdown, and yet another rule violation, i.e., Investment Adviser's Act Rule 204-2(a)-7. Equally as important is that it prevented Pelosi from properly analyzing all the actual records that were generated by him during his Halsey employment.

To further compound this problem, Pelosi found strong evidence of an additional 80 and possibly many more letters. Pelosi made a detailed analysis of the Halsey Client Letters that were provided to him by the Staff as part of the Rule 230 production. He actually reviewed each record in this production and initially compiled a manual spreadsheet of the Client Letters (Resp.

20 Zoldy 235:24-238:3

Exh. 9) that was then transcribed into an electronic spreadsheet (Resp. Exh. 4).[21] In so doing, he discovered evidence of some 80 more Client Letters and provides this evidence in these exhibits. Additionally, Pelosi's computations, based on his knowledge of the issuance of these letters, established that there were some 500 Client Letters in total sent by him from 2005 to 2008.[22] When questioned about these missing letters, neither Zoldy nor Julian were able to offer any insight into this, although they verified that record keeping was the Firm's and not Pelosi's responsibility.[23]

The Decision notes that Pelosi's allegation about the Division's records being incomplete was unsubstantiated, and that neither party introduced documentary evidence to establish the missing letters.[24] This completely ignores the detailed and extensive information that Pelosi provided in his summary exhibits-Resp. Exhibits 4-9-and his testimony regarding them. Pelosi's presentation of a summary chart representing the actual existing Client Letters is fully consistent with all evidentiary requirements. In a case such as this, where documentary evidence is so voluminous that its production in the courtroom would be inconvenient, Fed. R. Evid. 1006 provides for its presentation in the form of a chart or summary, provided that, as here, the underlying documents are available for the other party's inspection at a reasonable time and place. "The convenience of trials demands that other evidence be allowed to be offered, in the shape of the testimony of a competent witness who has perused the entire mass and will state summarily the net result. *Such a practice is well established to be proper.*" John Henry Wigmore, Evidence (James H. Chadbourn, Ed., 1972) § 1230 (emphasis added). As long as all counsel have access to the material being summarized as was the situation here, then the

21 Pelosi 756:22-757:10 and 1134:14-24.
22 Pelosi 1139:9-1141:9 and 1151:5-1153:21
23 Zoldy 330:1-10, 245:16-246:2 and Julian 569:13-571:25.
24 Dec at 12.

summary is "admissible, competent evidence." *Miami Natn'l Bank v. Penn. Ins. Co.*, 314 F. Supp. 858, 865 (S.D. Fla. 1970). See also *Gross v. U.S.*, 201 F. 2d 780, 787 (9th Cir. 1953). Resp. Exh. 4 to 6 were well within the parameters FRE 1006 contemplates.

The Decision also errs in its discussion of the Division's 240 letters, as it notes that these did not include unsigned letters. As noted above, Zoldy, in his flawed verification of these letters, clearly notes that they included "unsigned electronic copies."[25] Compounding this problem, the Decision attributes the source of these records to Pelosi's counsel instead of Halsey.[26] It is apparent that the Decision is based on evidence, i.e., the Division's Exhs. 17 to 24 and 26 to 30, that has not been properly verified and is incomplete, and that it has confused their origin and content in several key respects. Further, the Division's Summary Witness, Mr. Jacques, testified that he was unaware of any other letters, and that his computations would likely change if there were any additional letters.[27] These computations are the primary basis for the Decision making several significant findings regarding Pelosi's performance including a conclusion that "a substantial majority of the discrepancies (in the 240 Client Letters) are performance overstatements".[28] Certainly, an additional 80, and possibly 250, letters could have a substantial effect on these computations. Therefore, the data and information contained in Division's Exhibits 26 to 30 and the Decision are based on improperly verified records that have been irreparably confused. As a result, these records should be excluded from the Division's evidence in this matter.

3. Halsey's Operational Failures

In addition to Halsey's procedural failures, it also had serious operational problems.

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25 Div. Exh. 25.
26 Dec. at 10, Fn.12.
27 Jacques 462:6-463:16.
28 Dec. at 10.

Proper pricing of portfolios is a requirement under the Federal Securities laws, and, at Pelosi's prior firms, this was done daily through automated means by a separate department.[29] As noted above, Halsey had no written procedures for establishing security prices, for ensuring a uniform approach to portfolio pricing or for providing its clients with a uniform portfolio valuation in their Client Letters.[30] Halsey's portfolio pricing occurred just once a month, was done manually and only those accounts that were to be reviewed that month or roughly one third were reconciled.[31] Zoldy manually priced Halsey's fixed income securities on a monthly basis and used three sources for this-Schwab, a price list from IDC (a pricing service) and one compiled by one broker, who also executed many of Halsey's fixed income orders.[32] The latter was an obvious and undisclosed conflict that Zoldy admitted in testimony.[33] Further, while various automated pricing services were readily available, Zoldy, by himself behind closed doors, reviewed all pricing and, at his discretion, made changes where he deemed appropriate. None of this was reviewed by anyone else at the Firm.[34] Pelosi was quite uncomfortable with this situation and discussed it with Julian, the CCO, who expressed concern but did nothing to address it.[35]

Halsey's manual reconciliation of its client accounts on a monthly basis was another issue. Pelosi's prior experience was that reconciliations were done daily through the bank's automated systems. At Halsey, upon the completion of the pricing process, the portfolio assistants manually reconciled those accounts to be reviewed that month with the firm's system ,

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29 Investment Advisers Act Rule 206(4)-7 and Pelosi 611:15-18 and 1051:13-21.
30 Dec. at 4.
31 Dec. at 3.
32 Zoldy 413:12-414:16, Julian 560:4-561:8, Frois 833:4-838:6 and Pelosi 670:10-673:9.
33 Dec. at 4; Zoldy 187:7-15, 261:18-22.
34 Dec. at 4.
35 Pelosi 761:5-9.

and this often resulted in erroneous entires.[36] Manual pricing for equities was eliminated in March 2008 by the employment of a newer Advent system, although fixed income pricing was still done manually behind closed doors by Zoldy. [37]

The Commission also found Halsey's reconciliation and portfolio management procedures to be problematic. Halsey was examined by the SEC's Office of Compliance and Inspections from October 19, 2009 to January 29, 2011 regarding the period when Pelosi was at Halsey.[38] By this time, which was over a year after Pelosi was terminated, Halsey had finally developed a second written set of procedures.[39] Despite this, the SEC still found their systems to be in violation of Rule 206(4)-7 in the exact areas that Pelosi had registered concern. It noted that "Halsey also lacks standard operating procedures in two areas; reconciliation and portfolio management. The staff believes that the firm should adopt written procedures documenting its processes of reconciling client account assets with custodial records as reflected in the firm's Advent system. The staff also believes that the firm should adopt written procedures documenting client reviews, meetings, and changes to client guidelines. Finally, it notes that "Failure to know and follow adopted policies and procedures, and failure to adopt policies and procedures that reflect all critical elements of the advisory business is inconsistent with the requirements of Rule 206(4)-7".[40]

Halsey's procedural failures in this area, its antiquated systems, internal pricing of fixed income, pricing without review and manual entries (which often lead to errors) resulted in serious Rule 206(4)-7 violations and were then justifiably a serious concern to Pelosi. They also justified Pelosi developing his own structure and performance evaluation for his Client Letters.

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36 Halsey's system was an old Advent system.
37 Dec. at 4.
38 Dec. at 8.
39 Resp. Exh. 3.
40 Dec. at 8 and Resp. Exh. 18 at 6.

4. Pelosi Client Letters

As Halsey failed to establish any standards for the content of its Client Letters, the Decision must establish that Pelosi's Client Letters otherwise violated the Advisors Act. In fact, Pelosi made a determined effort to ensure that his Client Letters conformed to all applicable standards including those cited by the Division. Pelosi had no prior experience in drafting Client Letters and was provided only a brief review by Zoldy and Julian on writing them.[41] In so doing, no particular emphasis was placed on their composition or required content nor was the use of the TWR report emphasized.[42] Certainly, there was also nothing stated at any time in the next three years that would have lead Pelosi to understand that its use was mandatory.[43] Halsey never produced any internal memos, policy statements, e-mail or any other document addressing the content of Client Letters or the required use of the TWR Report.

As a result, Pelosi requested and used the information and reports that Zoldy, the Firm's senior principal, utilized in drafting his letters, believing that this would contain all the appropriate information necessary to draft them, including the quarterly DCF Report and the annual TWR Report.[44] The Client Letters contained a general discussion of the portfolio's performance over the last quarter, accompanied by separate reports of the actual quarterly and annual performance categorized by security and a detailed portfolio appraisal. Clients also received monthly statements from the independent custodian (Schwab), and could view their portfolio and its activity anytime in real-time at Schwab on-line.

Pelosi, upon first compiling his Client Letters, discovered Halsey's problems with valuation and reconciliation, its antiquated systems and its manual entry practices. This lead him

[41] Julian 566:22-567:1 and Zoldy 322:9-16.
[42] Dec. at 5. Pelosi 1045:4-1046:24
[43] Pelosi 622:24-623:10; Zoldy 404:14-19 and Julian 484:1-14
[44] Dec. at 4. Pelosi 631:13-632:8.

to a detailed evaluation of the performance information provided to him.[45] These revealed such problems as errors in asset class totals, returns quoted in reports for the wrong period, differences in asset value between the Schwab statements and the Advent reports, failure to enter any price in the reports, errors in the tables for the Client Letters and account balances entered in the Halsey reports prior to the account opening.[46] Initially, Pelosi attempted to secure the assistance of Zoldy to correct these problems, but Zoldy exhibited little interest, replying once that "I can't explain it. It is what it is. This is the system." Pelosi had little alternative but to take corrective action himself.[47] Pelosi then made revisions to Client Letter content so as to ensure that his clients received timely and accurate performance information. This unquestionably resulted in certain performance differences from the Advent reports, although they were more accurate with usually small variants.[48]

However, each adjustment was fully consistent with the Association for Investment Manager and Research ("AIMR") guidelines, which the Division recognized in its Exhibits 11 and 46. It included adjustments to data inaccuracies, preferred stock pricing, inclusion of cash flows based on Deitz calculations, combining certain reporting categories and the use of the DCF Report and its data. The Pelosi expert, Audley, verified this in his report.[49] Further, his calculations did not change the Advent system, any security market price or the value of any portfolio. Further, each Client Letter was accompanied by a detailed portfolio appraisal that included the quantity of securities held in the account, the cost per unit, total value, units held and income for each holding. Clients also received the monthly Schwab statement, and could

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

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

47 Dec. at 13 and Zoldy at 1205-06.

48 Pelosi 702:25-703:18 and Exhibits 4-6

49 Resp. Exh. 29.

view their portfolio anytime at Schwab on-line.[50] Pelosi then made appropriate adjustments to the performance data in the Client Letters that was in full conformance with the Advisors Act.

5. Office Relationship

Pelosi testified that, over time, his relationship with Julian and Zoldy deteriorated, due to his persistent requests to update Halsey's systems and operations.[51] This reached a turning point in 2008, when Halsey hired a marketing person to attract new clients to fill Pelosi's excess capacity. Pelosi disapproved of this, and disagreed on his excess capacity. At this point, the other PMs excluded Pelosi from conversations, and their weekly meetings declined in frequency.[52] Frois also testified that the relationship had deteriorated and noted, as an example, an instance in 2008 where Julian came to her office, which involved actually walking past Pelosi's office, to tell her to inform Pelosi that a meeting cancellation.[53] However, the Decision finds Frois's testimony as unreliable for, among other reasons, "her unusual demeanor" and "evident bias".[54] (Despite this, the Decision finds her testimony credible on three other occasions in support of its position on other issues.) According to the other Halsey employees, Pelosi had a cordial and professional relationship with everyone.[55] The existence of such a cordial relationship however is contradicted by the actions of Zoldy and Julian in August 2008.

6. Discussions with Rourke and Rynne Regarding Performance Adjustments

Rourke and Rynne, the other Halsey PAs, each had separate conversation with Pelosi in 2007-2008 regarding his performance adjustments in his Client Letters and/or PowerPoints. In

50 Resp. Exh. 27.
51 Dec. at 9.
52 Ibid.
53 Frois 892-93
54 Dec. at 9.
55 Dec. at 9.

these, the assistant was preparing client PowerPoints and noticed that some figures that Pelosi was using were different than those in the Halsey system. In late 2007 or early 2008, Rourke inquired with Pelosi about this, who responded that he had a different way of calculating the performance figures.[56] Rynne also noticed this when she was preparing a Pelosi PowerPoint and, in response to her inquiry, he responded that "he used a different calculation".[57]

In these discussions, Pelosi did not hesitate nor direct Rourke or Rynne to conceal his actions or to refrain from speaking about it. For a substantial period before he was confronted by Zoldy and Julian (see below), Pelosi openly discussed his performance adjustments and readily discussing them. This unquestionably evidences that Pelosi's intention in these adjustments was to provide a more timely and accurate understanding of a client's performance.

7. Confrontation

Although Pelosi continued with his adjustments, it wasn't until early August 2008 that Rourke and Rynne met with Zoldy to discuss these.[58] The delay allegedly resulted from their hesitancy to report a senior person at the Firm and that Rourke and Rynne did not press the issue as they "feared termination". However, this fear did not originate with Pelosi.[59] Another reason cited by Rourke for this meeting was to ensure that she was not blamed if any mistakes were made.[60] In this meeting, Zoldy registered concern and initiated a review of Pelosi's Client Letters. This review allegedly lead to a discussion with Julian on or about August 7, 2008.[61]

From August 7 to 13, 2008, Zoldy and Julian conducted a review of Pelosi's client letters and the supporting data. In this, Zoldy claimed that 20 letters were reviewed, while Julian

56 Dec. at 5. Rourke 39:1-3.
57 Dec. at 5. Rynne 124:17-21.
58 Zoldy 218:17-219:7, Rynne 126:15-25 and Rourke 40:6-41:7.
59 Dec. at 5. Pelosi 1092:10-15, 1093:21-24 and Rourke 38:23-25, 60:12-14.
60 Rourke 38-40.6.
61 Zoldy 219:8-25 and Julian 574:7-21.

testified that 40 had been evaluated.[62] The review allegedly revealed 'substantial discrepancies" and over-reporting positive returns and under-reporting losses.[63] However, this review was not documented in any way and, ultimately, no spreadsheet analysis, memoranda, notes or other documentation was created to substantiate it. However, Zoldy and Julian consulted with counsel about this situation on 3 or 4 occasions in this period. Zoldy and Julian determined to meet with Pelosi, and, on August 14, they had an unannounced meeting with Pelosi, confronting him with copies of several Client Letters whose results varied with those in the Advent System.[64] When questioned, Pelosi did not acknowledge these changes, as he was genuinely confused by the extent of them. As a result, he wanted an opportunity to review the letters before further discussion of them. The meeting was recessed after only a few minutes with the parties each agreeing to a more detailed review.[65]

Zoldy left on a business trip on August 15, and, on that day, Julian spoke briefly with Pelosi in his office. Based on Julian's commentary, Pelosi believed that the way to resolve the situation was to admit that he had made these changes. In a phone call and a later meeting that day outside the office, Pelosi admitted to Julian that he had made certain changes in the Client Letters.[66] In the next day, Pelosi, based on Julian's comments, wrote an e-mail to Julian and a memo to both Julian and Zoldy apologizing for his conduct at the first meeting. In the e-mail, Pelosi states that "Beyond being embarrassed and ashamed of the matter at hand, I'm deeply ashamed I didn't tell you yesterday in the conference room" and further that he had "truly deluded himself into believing it had happened in isolated instances but when I saw for myself I lost it." In the memo, Pelosi apologizes for his "initial reaction" at the meeting in the conference

62 Dec. at 5. Zoldy 355:20-23, 359:24-360:1, 362:10-16 and Julian 581:3-12

63 Dec. at 5.

64 Dec. at 5. Zoldy 366:22-370:11 and Julian 492:1-493:6.

65 Dec. at 5 and 7. Zoldy 222:2-223:22, Julian 493:6-495:15 and Pelosi 1099:9-1102:10.

66 Dec. at 6.

room, states that he is "embarrassed and ashamed by the performance issue" and that he 'cringes" at his behavior after the meeting. He noted that he is "overwhelmed with regret" and that "it was a very dumb thing to do, but it was a mistake".[67] The Decision notes in its discussion of this period that Pelosi "was remorseful" and apologetic for his conduct.[68]

One reason that Pelosi reacted in this manner was that he had been encouraged by Julian to accept the responsibility and that, if he did, he would have the opportunity to make an appropriate analysis and to explain it to his clients. He was capitulating so as to secure more time to properly communicate with his clients and to find another job.[69] 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 his use of these performance figures. It is not an admission that he was attempting to deceive his clients. Rather, he was asking for an opportunity to explain it to Zoldy, Julian and his clients. While there was every reason to provide Pelosi with this opportunity, he was never given it.[70]

Julian and Zoldy allegedly conducted a further review of the Pelosi Client Letters after the August 14 meeting, although there is no record of any such analysis, or their consulting with any expert for assistance in this. In the period from August 14 to 27, 208, Zoldy never sought to meet again with Pelosi on this subject although in this period, Zoldy and Julian, as noted, consulted with counsel 3 or 4 times on this situation.[71] On August 26, 2008, Zoldy and Julian met again with Pelosi without notice and informed him that he would be terminated. At this meeting, Pelosi offered to explain the performance differences to his clients, but Zoldy ended the

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67 Dec. at 6
68 Dec. at 6 and 7.
69 Pelosi 1222:12-1225:14
70 Dec. at 6 and 7. Pelosi 707:9-708:11, 744:20-746:2, 1221:22-1230:9, Zoldy 366:7-20 and Julian 506:11-507:21.
71 Julian 442:20-24, 577:15-25

meeting without permitting this.[72] On August 27, 2008, Julian and Zoldy, again without prior notice, confronted Pelosi with a Memorandum of Understanding which, among other things, provided for his resignation and for a release of all claims against Halsey and its officers. It also required Pelosi not to make any disparaging commentary about Halsey. It further stated that "As long as this expectation is met, Halsey will not report the events leading up to and including this separation to the proper regulatory authorities".[73]

As noted, Zoldy and Julian had conferred with an attorney at least 3 or 4 times on this situation and knew the matter needed to be reported to the regulators. However, Zoldy and Julian in the Memorandum agreed that they would not report this, if Pelosi would cooperate with them. Pelosi, while expressing regret at making the revisions in the Client Letters without discussing them with Julian or Zoldy, did not believe that he had done anything wrong and consistently expressed his desire to explain his reasoning for them. Now, without the benefit of counsel, he was being coerced to resign without establishing his position. Though he had significant concerns about the legality of the document, Pelosi was led to believe that it had been drafted by an attorney. Left with no alternative, Pelosi signed the memorandum.[74] Julian and Zoldy then filed a false Form U-5 with FINRA which failed to reveal the circumstances surrounding Pelosi's termination.[75]

Why did Pelosi react as he did in August 2008 when he had readily addressed the same situation earlier with the Halsey PAs? The main reason was Zoldy and Julian's disproportionate reaction to this situation. By August 2008, neither Zoldy nor Julian had spoken to Pelosi about

72 Dec. at 7.

73 Dec. at 7 and 8. Resp. Exh. 13

74 Resp. Exh. 13. Dec. at 7 and 8. Zoldy 370:1-378:20, Julian 586:5-590:9 and Pelosi 1131:9-1133:5.

75 Resp. Exh. 10; Dec. at 8; Zoldy 382:4-18 and Julian 517:-518:12

his Client Letters for three years.[76] As such, their sudden and accusatory confrontation was unanticipated and a surprise. Normally, it could be anticipated that, if a partner in a small firm with a "cordial" relationship with his partners was diverting from an established firm practice, this would be informally discussed and resolved between the partners. However, Zoldy and Julian, while having no previous reason to be concerned about this issue, did not provide this opportunity to Pelosi. Instead, they actually conducted a secret, internal review that included consultations with an attorney, and then "confronted" Pelosi with their "findings". The challenging tone of this meeting assumed a harshness that went beyond anything that Pelosi could have anticipated. Experiencing this hostility, Pelosi, as would anyone, was genuinely surprised and reacted negatively. Under such circumstances, mistakes are often made and Pelosi's mistake was not being forthright about his adjustments. However, he corrected this mistake by informing Julian the next day. As is seen from the analysis by both the Division and Pelosi, any true assessment of these adjustments would have led to the conclusion that they were minor and merited only informal, internal corrective action. Instead, Zoldy and Julian used this opportunity to terminate Pelosi, who had then become a problem for them.

C. Zoldy and Julian-Credibility

1. SEC Examination

The Decision has done little to address the credibility of Zoldy and Julian in this case, despite the fact that the SEC Staff in its examination found many serious problems at their firm including client disclosures containing inconsistencies, a lack of reconciliation and portfolio management procedures and no policies regarding reconciliation and documenting client reviews. The Decision stated that Staff's letter noted that "Halsey disclosed that it calculated performance

[76] Zoldy 326:4-327; Julian 568:11-369:4.

consistent with the Association for Investment and Research, but these standards are now called Global Investment Performance Standards (GIPS)" and that "(o)verall, the Staff did not find that, outside of Pelosi's misconduct, Halsey misreported performance information." Actually, the Staff's comments differed substantially from this, as Pelosi was not mentioned in the letter and in addressing the GIPS issue, the letter stated that Halsey's "Compliance Manual states and management confirmed to the staff that the firm is not GIPS compliant" and that as to its client communications an "inaccurate claim of GIPS compliance may constitute a false and misleading statement under Rule 206(4)-1(a)(5)."

2. The Two Form U-5s

When Zoldy and Julian filed their false Form U-5 regarding Pelosi's departure, they claimed as a basis that they did not want to ruin Pelosi's reputation. However, immediately after Pelosi left Halsey, Julian and Zoldy sent letters to Pelosi's clients informing them that he had left under questionable circumstances. Thus, it is obvious that Zoldy and Julian had no real concern for Pelosi's reputation. They would fear however that an accurate Form U-5 disclosure would likely result in an SEC investigation, which involved a genuine regulatory risk to Halsey, Zoldy and Julian. In March/April of 2009, a Halsey client's consultant questioned their decision not to report Pelosi's conduct to the regulators.[77] Zoldy and Julian, therefore, decided to correct the Form U5 to reflect the truth of Pelosi's termination.[78] On or about June 12, 2009, Julian submitted a Second Form U5, reporting that Pelosi had resigned after allegations accusing him of violating investment-related regulations.[79] The investigation of this matter ensued.

3. Zoldy Pricing Adjustments

77 Zoldy 229-31
78 Julian 229-31, 519-20??
79 Zoldy 519-20; Resp. Exh. 11

As noted, after Pelosi left the Halsey firm, Zoldy and Julian sent Pelosi's clients a letter explaining his departure and noting that some performance results previously provided may have been inaccurate or incomplete and included performance figures that purported to be accurate. Frois initially draft these letters for their review. In at least two instances, these letters were given to Zoldy who struck certain of the performance figures and substituted lower figures. When Frois questioned Zoldy on these changes, he said that the system was wrong and to use these figures. In one instance, the performance was lowered from 26.3 to 12.2%. The revised letters were then sent out to clients.[80]

The above described conduct of Zoldy and Julian evidences ethical failures of the first order and seriously erodes their credibility in this case.

III. PERFORMANCE ADJUSTMENTS IN PELOSI CLIENT LETTERS

Pelosi had determined early in his employment that he would need to adjust the performance information in his Client Letters, and he continued in this practice even after Rynne and Rourke questioned him on it. The Decision notes that his letters inflated annual results in 84% of his letters, inflated quarterly results in 82% of his letters and, even assuming Pelosi rounded his numbers below 10 basis points, his results were still inflated in 70% of his annual letters and in 67% of his quarterly letters.

As noted, Pelosi's performance numbers would vary from the TWR and DCF reports, if Pelosi made the adjustments that he has maintained. However, Pelosi testified that the use of the modified DCF Report performance figures and most of his Client Letter adjustments should not have resulted in significant changes.[81] Therefore, a true analysis of the accuracy of Pelosi's performance numbers would not be simply be of inflated figures, but the amount of variance

[80] Zoldy 392:7-397:4 and Frois 909:11-913:8, Div. Ex. 16.
[81] Pelosi 645:6-650:4

from all the Halsey performance numbers. This analysis was done in Pelosi's Exhibit 5 which contains a histogram or a complete listing of all his performance numbers charted in terms of their variance from the DCF and TWR Reports.[82]

Exhibit 5 establishes that 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 performance numbers 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. Further, of the more than 300 total quarterly performance numbers available, more than half the differences fall between -0.2 and 0.2, regardless of whether those differences are measured relative to a DCF report or a TWR report. Nearly 75% of the differences fall between -0.4 and 0.4. More than 40% of the returns quoted in the available Pelosi letters either exhibit no difference relative to Advent reports or understate client returns relative to those reports.

Clearly, there is no intent to mislead clients here because there is no pattern of overstating results. In fact, there are nearly as many instances of no differences or understatements as there are instances of overstatements. These numbers support Pelosi's position that he was making adjustments that were designed to ensure greater accuracy in his client communications and not to ensure that his returns were consistently favorable. Yet another point is noteworthy here. If Pelosi were intent on deceiving his customers, why were his changes so small and why did he make negative adjustments?

The Decision does not discuss in any detail Pelosi's exhibits addressing the performance

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82 Resp. Exh. 5.

data including Exhibit 4, which is clearly the most comprehensive analysis of the Client Letters. In fact, the Decision mischaracterizes Pelosi's testimony by stating he "did not, however, explain most of the specific discrepancies. Pelosi concedes as much, but claims he did not have sufficient time to find an explanation for each discrepancy". Actually, Respondent's Exhibit 4 in Column B addresses in great detail numerous issues that were detected in Pelosi's extended analysis of the Client Letters, and much of this was also addressed in considerable detail in his testimony.[83]

The Decision's conclusion then regarding the alleged discrepancies is not based on an accurate analysis of all the relevant data. A proper assessment of this information such as that in Exh. 5 evidences that the data is consistent with Pelosi's contentions.

A. Data Inaccuracies

1. Pricing and Reconciliation

The Decision stated that "Pelosi never complained to anyone at Halsey" about these problems.[84] However, the Decision also stated three paragraphs above this on the same page that: "Therefore, he (Pelosi) reviewed the Axys performance numbers, finding what he perceived as certain inaccuracies in the reports' performance numbers, which he manually corrected. Id. For example, while writing his first few client letters, Pelosi testified that he found illogically large performance numbers; Pelosi went to Zoldy who said 'I can't explain it. It is what it is. This is the system.'"[85]. Pelosi then clearly registered concern with Zoldy about this problem. In response, Zoldy did nothing. Halsey's procedural failures in this area, its antiquated systems, internal pricing of fixed income, pricing without review and manual entries (which often lead to errors) resulted in

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83 Pelosi 1139:4-1150:1.
84 Dec. at 13.
85 Zoldy 1205-06

serious Rule 206(4)-7 violations and were then a serious concern to Pelosi. Many of these actual errors are addressed in detail below. They also provided justification for Pelosi to develop his own structure and performance evaluation for his Client Letters.

2. Question Marks

The Decision states that "Certain performance reports contained question marks in place of values, which Pelosi views as proof of the report's inaccuracy. Rynne and Rourke provided several reasons for the question marks, but none of these definitively addressed the problem.[86] Frois testified that a question mark means that there is something wrong with the particular line item and that the performance numbers on that report are not valid.[87] Rourke admitted that inaccurate data in the Advent system led to question marks appearing on the Advent reports which were included in Halsey's documents.[88] As a general rule, if a report generated at the end of a month had a question mark, it would be investigated and corrected.

However, in spite of the Halsey justifications and alleged solutions for these problems, there remains one basic fact - Halsey provided the Division with the discussed reports in 2009, and they were Halsey records for the years 2005 to 2007.[89] These reports were obviously a part of Halsey's records in 2009, yet they still had question marks on them from the preceding years. This means that the records were never corrected or were later changed. As a result, Halsey, even in 2009, had a serious record keeping problem.

3. NA and 0 Entries

The Decision states that Pelosi established that Halsey reports had "N/A" and "0" entries,

86 Dec. at 14.
87 Frois 847-848
88 Rourke 69: 2-9
89 Resp. Exh. 26.

and that the Halsey employees explained them.[90] Rourke testified that an N/A or 0 would mean that data was incorrect and would later be corrected.[91] Zoldy confirmed that certain system errors occurred, and that an "N/A" would suggest a return that is "out of the bounds of reasonable".[92] Numerous Advent reports containing "N/A" and "0" were included in the Halsey production to the Division in 2009 and ultimately were included in the Division's analysis (Div. Exhibit 28 and 30). If the N/A or 0 means the data is incorrect, it then should have been corrected. However, here again, N/A and 0 appears in documents in Halsey's 2009 production that relate back to earlier periods such as 2005. This evidences the very point that Pelosi makes, i.e. that Halsey did not correct inaccuracies in its records or that these records were later affected by manual updates to the Advent system. This clearly evidences that the manual entries into the Halsey's system lead to continual changes in its reports over time

This, among other things, led Pelosi to question the accuracy of the system and to make adjustments as appropriate. Finally, it is data that the Division used in its Exhibits to establish their case, and that the Decision used in its findings. The only conclusion to reach is that the Decision is based on questionable data.

4. Old Data Replaced With New Data

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

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[90] Resp. Exh. 27.
[91] Royce 77-79.
[92] Zoldy 337-338.

Frois testified, "not a record keeping system".[93] While it is capable of maintaining client account portfolio records on an ongoing basis, any new entry updating this account information automatically eliminates the data that it replaces.[94] The Decision notes that Pelosi presented no evidence of this problem[95], but Pelosi, Zoldy, Rourke, Frois and Rynne all were questioned on Resp. Exh. 27 that contained specific examples of this problem. In the latter part of this exhibit, there are two copies of supposedly identical reports each of which had been provided by Halsey to the SEC on different dates. In the interim, certain new entries had to have been made in these reports, as they should have been identical but they actually had different data.[96] Zoldy testified that documents with the same date should have the same market value but could not explain why there was a difference.[97]

The Decision notes that this was not an issue as Zoldy, Julian, Rynne and Rourke saw the problem in "real time". This denies the reality of the situation, however, as any such documents reviewed by them in 2008 would have had the same problem as those noted above, i.e. they would be comparing 2008 Advent data that likely had their performance numbers altered by later entries. This problem would have originated from the time the Advent system was employed at Halsey in 2004.

At Halsey, new data was entered into the TWR and DCF Reports on a monthly basis. In this case, Rule 204-2(a)(16) would require Halsey to maintain a separate record of each DCF and TWR report that existed at the time the Client Letters were being composed. Not surprisingly,

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93 Frois 847:21-23. The Decision at p. 15 erroneously attributed this statement to Pelosi.

94 Frois 847:25-848:10, 877:7-18, 899:3-7, Expert Report, Audley 1279:8-1280:2.

95 Dec. at 15.

96 For example, Bates No. 100147 and 100193 and others in Resp. Exh. 27. Pelosi 1157:2-17, Rourke 76:24-84:25; 84: 18-85:3 and Rynne 158:3-160:2; 159:22-162:16.

97 Zoldy 344:20 – 346:7

Halsey failed in this record keeping responsibility as no such records were ever maintained.[98] This is not simply a rule violation but a delinquency that prevents the adviser, as well as the SEC and the Respondent, from properly assessing the data in the relevant TWR and DCF Reports. Additionally, the evidence of this problem is, by its very nature, eliminated when the change is made. In other words, unless an earlier copy of the document exists as occurred in the above instances, there would be no means to evidence the record keeping failure. Finally, without the actual earlier report, no proper analysis can be made to determine the basis for the performance information used in the Client Letters.

5. Start Dates

Halsey's practice was to use a start as of the first of the month following initial funding because of Advents cash flow issues that occurred because daily pricing and reconciliations were not performed. Yet the reports Halsey provided in the production of documents often use a start date that is the first of the month in which initial funding occurred, so that the cash flow problem is present in these reports. [99] Consequently, it is impossible make a determination on alleged performance discrepancies at all in the 'from inception" results in Pelosi's letters compared to Advent because Halsey didn't provide "from inception" results using the correct and actual "from inception" date. Examples of these problems are seen in Resp's Exhibit 27.

6. Summary

The Decision found that Halsey's pricing and reconciliation were, for the most part, accurate, and that Halsey employees satisfactorily explained the handful of irregularities Pelosi introduced.[100] Contrary to this conclusion, the Halsey record keeping failures noted above are one of

98 Frois 879:8-21, Rynne 122:16-19, 169:7-170:9, Rourke 36:23-37:1, 44:24-45:4, Zoldy 233 :19-234 :2.
99 Pelosi 1178:21 – 1181:1
100 Dec. at 15

the most significant issues in this case and are not explained at all by Halsey's employees. They resulted in an inability to correctly determine what Halsey records were the originals and/or whether their information had been later changed in the system. These reports were, of course, used by the Division to compile their Exhibits 28 to 30, and are the foundation of their case and are also used to establish many of the findings in the Decision. As a result, it is very likely that the compilations and conclusions in the Exhibits and the Decision are inaccurate. Further, contrary to the contention in the Decision, that there are only a "handful" of these documents, the documents presented in Resp. Exhs. 26 and 27 were only examples. A description of all such problems that Pelosi detected are noted in Column B of Exh. 4, and Resp. Exh. 26 and 27 and this reveals that 50 such issues occurred in the 320 some letters.

These Halsey record keeping problems were a significant issue that still had not been resolved by 2009. They also represent very serious issues that were not properly recognized and/or addressed in the Decision. They were certainly a sound reason for Pelosi to have serious concerns about Halsey's records and to take the corrective action that he did. It is a further reason to seriously consider reducing Pelosi's sanctions in this matter.

B. <u>DCF Reports</u>

As noted above, Pelosi requested and used the information and reports that Zoldy utilized in drafting his letters and quickly discovered Halsey's problems with valuation and reconciliation, its antiquated systems and its manual entry practices. This lead him to conduct a detailed evaluation each month of the performance information provided to him,[101] and, if necessary, to make revisions to the content of the Client Letters to ensure greater information

[101] Pelosi 640:20-642:14; 761:5-9; 1050 :19-1051:21

accuracy.[102] However, each adjustment was fully consistent with the AIMR guidelines, and included adjustments to preferred stock pricing, inclusion of cash flows based on Deitz calculations, combining certain reporting categories and, of course, the use of the DCF Report and its data. The Decision, in fn 22, asserts that Pelosi gave inconsistent testimony about using the DCF reports for his annual letters. This is inaccurate, as Pelosi was actually responding to a question pertaining to quarterly information that contained three months of information.[103] This was not a denial of using annual DCF reports, as Pelosi could have generate a 12 month DCF report himself if the situation warranted it. The Decision notes that Pelosi concedes that the performance values he included in his client letters do not match the values contained in DCF reports.[104] This is not a concession, but the very point that Pelosi has made throughout this case. The Decision concludes that "Pelosi did not include portfolio returns from the dcf reports" in his clients letters. Essentially, this denies the existence of the Respondent's Exhibits 4 to 6 which were admitted into evidence and provide extensive data relating to the DCF reports. It also fails to acknowledge his extensive testimony on this issue.[105]

C. Cash Flow & Dietz

Pelosi often found discrepancies in Halsey's reports with accounts that had significant recent cash flows or 10% or more of the portfolio value. This adjustment was consistent with his use of the DCF Report that Julian described as being helpful in determining "a substantial inflow or outflow of cash during a three month period".[106] His adjustments were made using a modified Deitz calculation, a well-recognized performance calculation in this area that identifies and

[102] Pelosi 702:25-703:18 and Exhibits 4-6
[103] Pelosi 1215:24-1218:16.
[104] Dec. at 16.
[105] Pelosi 1215:24-1218:16.
[106] Julian 482:14-25.

accounts for the timing of all random cash flows.[107] The Decision states that "Finally, and most importantly, there is no record of actual Deitz calculations". In testimony, Pelosi reviewed a series of instances in Resp. Exh. 25, where he had employed this calculation,[108] the Expert Report also addressed the use of this calculation.[109]

Further, while the Decision concludes on the top of p. 18 that the "performance values contained in Pelosi's client letters were not the result of Dietz calculations, it states in fn. 26 at the bottom of the same page that two cited Pelosi Client Letters are "examples of Dietz calculation." There is no question that Pelosi was utilizing Dietz calculations in a manner that was appropriate and that Pelosi's testimony and exhibits and the Decision, itself, confirm this. The proper accounting for cash flow was also addressed in the Advent Help Guidance, as was the modified Dietz approach.[110]

Pelosi's concern about cash flow originated with the fact that Halsey's systems were incapable of performing a cash flow calculation so Pelosi utilized the Deitz calculation. The Decision contends that Pelosi's allegation that the TWR reports did not take cash flows into account is contradicted by his own expert. Actually, Pelosi repeatedly testified to the opposite – that the TWR report was extremely sensitive to cash flows because Halsey didn't price or reconcile daily.[111] Julian also acknowledged this.[112] Without daily pricing and reconciliations, the TWR report was prone to inaccuracies as a result of cash flows.

During the period at issue, none of Haley's TWR based reporting complied with GIPS

107 Pelsoi 642:10-14, 1050:24-1050:24-1051:21.
108 Pelosi 1046:22.
109 Resp. Exh. 29 at p. 4.
110 Div. Exh. 11
111 Pelosi 622:24-623-25.
112 Zoldy 482: 20-25.

requirements in this area. The TWR instructions cited in Division Exhibit 11 that Halsey provided were from the help function of a version of Advent that they subscribed to in 2009, not the version in place during Pelosi's employment at Halsey (its dated 2009 at the bottom of the page). Further, Advent, even in 2009, could not perform the calculations described in that document because Halsey didn't price daily before the upgrade and only reconciled quarterly after it. The basis for Audleys supposed "admission" that TWR takes cash flows into account, and that it is GIPs compliant is Division's Exhibit 11, which is an extract from the 2009 Advent help function later used by Halsey.

D. Atypical Periods

When the period that Pelosi was reporting was slightly shorter or slightly longer than a year since inception, Pelosi would have received, or would have asked for, results since inception on the TWR report, believing that this was the information that a client desired to see.[113] Every client letter is created from a form letter for that period, and consequently each letter already contained a reference to the quarterly and annual periods. In the process of writing many letters each month, Pelosi did not adjust that language in every instance, but did include beginning and ending market values and cash flows for the period to which he was referring. This is actually a higher level of disclosure and transparency than simply reporting a percent return alone, and is certainly not indicative of an intent to mislead. Moreover, since the returns quoted do align with a Dietz calculation for the atypical period, it is clear that either such a calculation was performed, and it was done with the intent to provide a more complete time period, or that the actual performance report provided to Pelosi at the time did in fact reflect the time period that Pelosi was referring to.

113 Pelosi 1158:16-1160:10

The Decision concludes that Pelosi's odd period reporting was not valid because they were not TWR based. However, none of Halsey's TWR based reporting were appropriately time weighted or complied with GIPS requirements, as none were priced daily or even monthly.[114] Further, Halsey has provided no actual performance reports that were provided to Pelosi at the time he was preparing his letters. As the information contained in Advent changed over time, Pelosi, as noted above, did not have the original performance reports, and, as such, it was impossible to confirm what information Pelosi had available to him at the time he was preparing the letters.

E. Preferred Stock Dividend

Pelosi reported performance of preferred stocks by accrual accounting vs. cash accounting which is a recognized and appropriate reporting adjustment in accordance with AIMR (later CFA Institute) Standards and GIPS standards and was fully consistent to his reporting responsibilities.[115] Pelosi testified that was not able to provide reconciliations for these adjustments, as the information necessary to perform such calculations should be in the data portion of the Advent system and, as noted above, Halsey did not maintain transaction histories for any client or any time period. While the Division had claimed that Pelosi's adjustments were unbelievable, they provided no record of preferred stock returns quoted in Pelosi letters compared to any type of Advent performance report upon which to base their claim.

F. Combining Assets

Combining like asset returns in order to provide a complete asset class has no bearing on the total portfolio returns. Pelosi explained such combinations in response to a question from the

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114 Pelosi 1037:18-1038:3.
115 Resp. Exh. 29

Division: "this is not, I suppose an actual adjustment of performance, but I did make calculations to aggregate the returns of similar asset classes".[116] In support of this, Frois testified in the Division's investigation that she created an excel spreadsheet for Pelosi to perform these calculations[117]. The Decision states: "However, like Pelosi's other justifications, I find this one unsubstantiated". The Decision notes that we only provided one specific example of combining like asset class results. The Florian explanation was in response to a specific example cited in the Division's post hearing brief, and was not intended or represented as the only example available of such a combination. Performance fields are customized on Advent, so that the user can determine what specific asset classes it wants captured in each performance category.

G. Template Errors

The Decision finds that Pelosi's evidence regarding a specific example of a template error is not credible because he updated some, but not all, the data in the chart in his example of a 1/31/08 letter to Lonergan.[118] The fact that not all of the data was updated is the very point that Pelosi is demonstrating: that existing letters were used as templates for others and mistakes were made when typing over numbers. Some, but not all, of the correct data would be entered. It is evident in his example that some, but not all of the data was changed as the matching data in the chart is located in the exact same position in the charts of the two letters. In fact, some of the template errors in Respondent's Exhibit 25 demonstrate errors in which entire charts were copied. The template errors were then made in the course of using a form letter that was sent to various Halsey clients.

IV. CONCLUSIONS OF LAW

116 Pelosi 647:11-15
117 Footnote 25 in Pelosi Wells Submission.
118 Div. Exh 33.

A. Misrepresentation

The Decision finds that Pelosi misrepresented his performance results to his clients as the Division introduced extensive evidence establishing the disparity between his performance figures and the Division's. Price disparity alone however is not a sufficient basis for establishing misrepresentation in this case. This case demands the careful weighing and assessment of a series of factors before a misrepresentation claim can be established, and the Decision has not done this. Pelosi has readily admitted that he made changes to address Halsey's internal pricing and reconciliation problems and to address such things as data errors, pricing problems, cash flow, preferred pricing and other problems in an account. As a result, Pelosi's performance numbers were different than Halsey's, but this difference can be justified.

Both Pelosi and the SEC found significant problems in Halsey's pricing and reconciliation, and these were confirmed in the testimony of Zoldy, Frois, Rynne and Rouke and Resp. Exh. 4 to 6, 25, 26 and 27. While the Decision found little merit in the data inaccuracies such as the question marks, N/As and 0s reported in Halsey documents years after they were supposedly corrected, they are clear evidence of the problems that Pelosi encountered. Another was the complete failure of Zoldy and Julian to comply with the most basic of their compliance requirements. Zoldy is quoted in the Decision as saying that the system "is what it is" and refused to act to correct this problem. For the entire period of Pelosi's employment, Halsey had no compliance procedures including retention procedures in place to address these concerns. The SEC examination confirmed Halsey's failures, and the end result of all of this was that it did not have accurate records of its customer's portfolios from one month to the next. As a result, the records provided to the Division in 2009 were incomplete, inaccurate, conflicting, and, in essence, incapable of proving anything except Halsey's ineptness and total disregard for the law.

They were certainly wholly incapable of supporting the Division's contentions or the Decision's findings.

Pelosi, who had worked at much larger firms, was not accustomed to such negligence and diligently attempted to address these problems. In so doing, his approach was consistent with all recognized guidelines in his use of the DCF report, his Dietz calculations, etc. While it is entirely possible that Pelosi could have erred in certain of his calculations or his interpretations, his intent was to ensure that his clients received the most accurate and timely information regarding their accounts.

Further, Pelosi knew that his clients would receive a detailed appraisal report with the Client Letter and the Schwab monthly account statement. They would also have access to real-time, on-line Schwab account information. If his intention was deception, he should have acted to prevent his clients from receiving this information or created substitutes for them, as other true fraudsters have done.[119] He didn't. Rourke and Rynne questioned him on this practice months before the confrontation. He routinely responded and continued in his work. The performance numbers used by Pelosi were consistently within a few basis points of the Advent reports and therefore would not be materially.[120] As such, Pelosi was acting in good faith and developed performance information that he believed were accurate assessments of his client's portfolio's values.

Before and after his Halsey employment, Pelosi's career has been exemplary. This can be contrasted with Zoldy and Julian, who the SEC found to have violated the very provisions that Pelosi detected and to have deceived their clients with an improper GIPS claim. It was Zoldy and Julian who filed the false Form U-5, who consulted with counsel before firing Pelosi while

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119 *In re Enrique F. Villalba*, Investment Advisers Act Release No. 3130 (Dec. 29, 2010); *In re Bernard L. Madoff*, Investment Advisers Act Release No. 2892 (June 16, 2009).
120 Resp. Exh. 4 to 9.

not permitting him the same opportunity and who altered the numbers in their Client Letters.

Pelosi conduct does not remotely approach those cases cited in the Decision for its misrepresentation argument that are either factually distinguishable from Pelosi's circumstances, or which are premised on legal positions or arguments different from those Pelosi advances. For example, in *SEC v. Blavin*, 760 F. 2d 706, 711 (6th Cir. 1985), the defendant did "not deny that his newsletters contained false and misleading statements," but rather argued that any inaccuracies were not material or that they did not induce reliance. Pelosi has never conceded that his letters contained false and misleading statements, and a case premised on such a concession is not relevant. Likewise, in *SEC v. Simpson Capital Mgmt.*, 586 F. Supp. 2d 196, 201 (S.D.N.Y. 2008), the SEC alleged that the defendant "conducted a fraudulent scheme involving unlawful 'late trading' in shares of mutual funds." The allegations against Pelosi, even if viewed in the light most favorable to the Division, do not rise to the level of a "fraudulent scheme" or involve any trading.

SEC v. Rana Research, 8 F. 3d 1358, 1362-63 (9th Cir. 1993) involved defendants who issued press releases containing false information regarding stock value and the existence of a firm deal with a recognized investment bank as a transaction partner. The defendants then issued a "series of purportedly 'curative' statements" which, they argued, neutralized their earlier false statements. *Rana Research* is not relevant to this matter, as neither the Schwab statements, the real-time online information and the Advent Reports was issued after Pelosi's letters. Because all of this information was available simultaneously, it could not have been intended to "cure" any of Pelosi's representations. Pelosi's conduct in this case does not remotely approach that which is addressed in the Decision's cited cases and therefore they have no genuine relevance to this matter.

B. Scienter

In his Client Letters, Pelosi's sole intention was to ensure that his clients had a clear and accurate understanding of their portfolio's performance. His adjustments were designed to enhance this understanding and do not establish the requisite scienter, recklessness or negligence that is required for a violation of Sections 206(1) or 206(2). Even if this information was inaccurate, it is important to understand that the publication of inaccurate information is not a basis for a scienter claim *SEC v. Seghers*, 298 Fed. Appx. at 331 (5th Cir. 2008) (quoting *Lovelace v. Software Spectrum*, 78 F.3d 1015, 1020 (5th Cir. 1996)).

As noted, Pelosi's history before and after Halsey evidence an impeccable reputation. Despite receiving little guidance or instruction, Pelosi utilized the reports and information provided to him to develop a Client Letters that provided a timely and accurate assessment of his client's portfolios. Neither Zoldy nor Julian spoke to him about his Client Letters prior to August 2008, and Pelosi was wholly unaware of any concerns that Halsey or its principals had about his Client Letters until then.

While Pelosi believes that his calculations were a fairer representation of performance, he admits in hindsight that he used bad judgment in not discussing these in more detail with Zoldy and Julian. His adjustments did not alter the Advent system, the specific market price of any security or the value of any portfolio. Viewing this from a different perspective, if Pelosi was truly intent on deceiving his clients, his method was seriously flawed, as the appraisal report, the Schwab monthly account statement and the on-line Schwab account information were never altered. Practically speaking, these are the most frequently viewed sources for laymen to determine portfolio performance.

Further, if Pelosi was intent on a fraudulent design, he allowed the only evidence of this -

his Client Letters - to exist untouched in Halsey's records for years.[121] This was true even after he had the discussions with Ms. Rourke and Ms. Rynne about his use of alternative calculations. Further, his open and candid response to their questions and his continuation in this practice are further evidence of his lack of scienter.

There was also no financial motivation in these adjustments. Neither Pelosi's salary nor profit sharing was dependent on the performance numbers provided in the Client Letters, and the fees that his clients paid were never affected.[122] Finally, as Pelosi's clients had done well for decades under his investment counseling including at Halsey, there was no need for any improper alteration of their performance figures. Pelosi's conduct then was fully consistent with ensuring that his clients received accurate and timely portfolio information at all times

While recklessness may satisfy the scienter requirement and *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F. 2d 38, 47 (2nd Cir. 1977) may define recklessness as "highly unreasonable" conduct that "represents an extreme departure from the standards of ordinary care. . .to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it," the Decision errs in its conclusion that Pelosi's conduct met this recklessness standard. In *Rolf*, for example, one adviser, Stott, reassured a client that another adviser was managing the client's account in a manner consistent with the client's goals. In fact, the other adviser, with Stott's knowledge, engaged in a risky investment strategy that devastated the client's portfolio. Id. at 42-43. Therefore, the court found that Stott aided and abetted the other adviser's fraud. Id. at 48. Pelosi's conduct, even if viewed most favorably to the Division, does approach the "extreme departure from the standards of ordinary care" described in Rolf.

In *In re David Disner*, 52 S.E.C. 1217, 1222 (1997), defendants were found to have taken

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121 Halsey had no procedural requirements to retain these letters.
122 Pelosi 619:17-620:4.

"part in a scheme to charge and pay undisclosed, unfair prices which resulted in substantial profits to the Firm at the customers' expense." One defendant further argued that he "acted merely in a ministerial capacity." In fact, that defendant had significant knowledge of all transactions, supervisory authority over others, and a financial stake in the trading profits. Id. Pelosi has never misrepresented the extent or nature of his role at Halsey, and had no financial incentive to defraud customers. Pelosi was not then "reckless" in the manner that *David Disner* contemplates.

Scienter is a matter of judicial interpretation rather than statutory language. Indeed, the Division cites, *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n. 12 (1976), noting the division among the circuits as to the appropriate standard to apply. In *Aaron v. SEC*, 446 U.S. 680, 686 n. 5 (1980), the Supreme Court specifically stated, "[t]he term 'scienter' is used throughout this opinion, as it was in *Ernst & Ernst v. Hochfelder*. . .to refer to 'a mental state embracing intent to deceive, manipulate, or defraud.' *We have no occasion here to address the question, reserved in Hochfelder, ibid., whether, under some circumstances, scienter may also include reckless behavior.*" (emphasis added). See also *Hollinger v. Titan Capital Corp.*, 914 F. 2d 1564, 1568-69 (9th Cir. 1990) (noting adoption of recklessness standard among eleven circuits); cert. denied 499 U.S. 976 (1991). As a result, it is very important to compare Pelosi's conduct with the particular conduct alleged in the Decision's cited cases. As noted, these bear little relation to the particulars of Pelosi's case.

C. Materiality

Material misrepresentations and omissions accompanied by the requisite intent can violate Investment Adviser's Act Sections 206(1) and 206(2). The standard of materiality is whether or not a reasonable investor or prospective investor would have considered the

information important in deciding whether or not to invest. <u>See</u> *SEC v. Steadman*, 967 F.2d 636 at 643 (D.C. Cir. 1992) (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)); <u>see also</u> *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32, 240 (1988). Investment advisers are fiduciaries and have an affirmative duty of utmost good faith and full and fair disclosure of all material facts. <u>See</u> *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) at 191-94, 201.

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

Further, a fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision and if disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. <u>See</u> *Basic Inc.*, 485 US at 231-32 (citing *TSC Indus., Inc v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Materiality is a mixed question of law and fact. *TSC Indus.*, 426 U.S. at 40.

The adjustments made by Pelosi were not material from a standpoint of the percentage variance from the TWR Reports or from the total mix of information that was available to Halsey clients. In assessing numerical materiality, courts have looked to significant variants such as in the Trabulse matter where the variants amounted to millions of dollars.[123] Amounts "under a certain threshold" such as the adjustments in the Client Letters have frequently been viewed as

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

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

Here, the average difference between the quarterly returns quoted in the available Pelosi letters and the returns reflected in recently generated TWR reports is 0.31%. The same difference compared to the DCF methodology is 0.30%. The average difference between the annual/ytd return quoted in the available Pelosi letters and the returns reflected in recently generated TWR reports is 0.36%. The same difference compared to the DCF methodology is 0.21%. The median quarterly difference between the return expressed in the available Pelosi letters and the recently generated TWR reports is 0.2%, and 0.1% vs. the DCF reports. The median annual/ytd difference is 0.3% for both the DCF and TWR results compared to those quoted in Pelosi's letters.[124] These variants, even if we assume their accuracy, cannot be considered material as the above case law clearly demonstrates that such differences are never viewed as material. Therefore, the Decision again has failed to establish a violation of Section 206(1) and 206(2) based on the materiality standard.

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

124 See the analysis of this data in Resp. Exhs. 4 to 6.

flow of account information provided to each client from both Halsey and Schwab, its independent custodian. Each letter contained a detailed appraisal and asset allocation summary, and each client received monthly portfolio statements from Schwab. They also had continuous access to their portfolio on Schwab's web site which contained detailed and real-time account information.

There was also no financial motivation in these adjustments. Neither Pelosi's salary nor profit sharing was dependent on the performance numbers provided in the Client Letters, and the fees that his clients paid were never affected.[125] Finally, as Pelosi's clients had done well for decades including at Halsey, there was no need for any improper alteration of their performance figures.[126]

Further, the actions of Pelosi's clients after he left Halsey unquestionably establish that his adjustments were not material under Section 206(1) or Section 206(2) above. Shortly after Pelosi left Halsey, Julian and Zoldy sent letters to all of Pelosi's clients that unquestionably conveyed that his departure was under questionable circumstances.[127] This resulted, in part, by the letter stating "[i]t has come to our attention that the performance results communicated to you may not have been accurate or complete." It then provides the "correct figures". This leaves no doubt that Halsey was claiming that Pelosi had previously provided them with falsely altered performance figures. Pelosi's clients then were aware of Halsey's allegation and were even provided with the old and supposedly new performance figures. Despite this, Pelosi's clients, with very few exceptions, left Halsey and joined him at YHB within months.[128]

125 Pelosi 619:17-620:4

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

127 As discussed above, Mr. Zoldy altered the performance figures downward in two of these letters.

128 Pelosi 1094:15-17; 113:18-25.

A similar situation was addressed in the *Abraham & Sons*[129] matter. In assessing a penalty against respondents, Judge Mahoney noted that the harm caused by the deception was "best indicated" by the fact that the clients all withdrew their investments. Id. At 86. This indicator is equally applicable to the materiality issue in this matter. Here, the opposite or the lack of materiality is evidenced by Pelosi's clients leaving the Halsey firm and joining him at his new firm. In light of all the information provided to Pelosi's clients, the adjustments made by him to the performance figures in the Client Letters were not material as they could not be viewed by reasonable investors as "having significantly altered the total mix of information made available" to them in this situation.

In this analysis, it is significant to note that the Division utilized only certain of the Client Letters available to them and that the performance information in these letters are likely based on inaccurate performance information. As discussed above, Pelosi determined that approximately 50% of the Client Letters that he had created were not used by the Division in this matter and the Division chose to ignore highly relevant information available in their own files regarding some 80 other letters. By analyzing only a portion of Pelosi Client Letters that were available, the Division is, in fact, unfairly examining only the Letters that it desires in their analysis and is ignoring significant evidence that may be contrary to their claims. In effect, such omissions in the Division's examination and its limited analysis invalidate the charts and data shown in its Exhibits 17-24 and 26-33.

The Second Circuit Court as well as the New York Federal Courts disapprove of a party's devising of its own narrow and prejudicial analysis from only preferred evidence while ignoring other available evidence. The Courts view unfavorably a party that uses only evidence that is

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

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

Similarly, the Division used only half of the Letters that were sent out by Pelosi rather than making a comprehensive analysis based on all the information. Further, there was information available from 80 additional letters that could have been applied to the Division's analysis, but was ignored. Such analysis based on limited information is further invalidated by the Division's failure to show any justification, pattern or method for examining only 240 Letters, when by their own witness's admission his analysis would possibly change if all letters were taken into consideration.[130] As discussed above, the Division also failed to properly validate the 240 letters, and the data in these letters is inaccurate as it is based on improperly

[130] Jacques' Testimony at p. 462:6-463:16.

maintained records. The Division cannot use such charts and numbers derived from limited information as a basis for their claims. The Division either must take into consideration all of the available data or it cannot maintain their position based on inadequate information. The charts and data in the Division's Exhibits 17-24 and 26-33 are then limited representations of all available evidence, and therefore have no probative value.

While the Decision notes that even if all the missing records were found to contain accurate information, this would still leave those that allegedly do contain erroneous information to support the Division's claims.[131] However, the Decision places great weight on the Division's contentions regarding the high percentage of inflated results in its charts and other similar statistics and therefore cannot maintain that such additional records would not alter its findings.

D. Willful Violation

Although the SEC is correct that, under *Wonsover v. SEC*, 205 F. 3d 408, 413-15 (D.C. Cir. 2000), "willfulness" does not require a finding that the act was "done with a bad purpose," it does not necessarily follow that Pelosi "willfully overstated his clients' returns." In *Wonsover*, for example, the defendant, who sold unregistered shares in the absence of any exemption, failed to make a "searching inquiry" as to "whether the ostensible sellers may have been intermediaries for controlling persons or statutory underwriters but also whether they even existed." Id. at 415. The kind of willful ignorance at issue in *Wonsover* is not comparable to the minor differences in performance results present here. Also factually incomparable is *Arthur Lipper Corp. v. SEC*, 547 F. 2d 171, 180 (2nd Cir. 1976), which involved "a bald diversion to the manager of sums belonging to the investment company." Contrary to those noted above, Pelosi's conduct was designed to comply with all disclosure requirements and not to willfully violate them.

131 Dec. at 13.

V. SANCTIONS

A. The Decision's Sanction Requires the SEC's De Novo Review

The Decision in this matter would, if upheld, permanently bar Pelosi from serving as an investment adviser. But the Decision does not provide an adequate basis for that sanction, and so it cannot be affirmed on its own terms. A permanent bar is the severest of the sanctions that can be imposed under the Investment Adviser and Investment Company Acts, as it deprives the individual of his livelihood, which has devastating effects on the individual and his family. It also deprives the investing public of the services of the barred individual. Accordingly, before the SEC imposes that ultimate sanction, it must "explain why a less drastic remedy would not suffice." *Steadman v. SEC*, 603 F.2d 1126, 1139 (5th Cir. 1979). As *Steadman* explained, it is "common [] sense" that "the greater the sanction the SEC decides to impose, the greater is its burden of justification," with the result that where the SEC uses "the most potent weapon in [its] arsenal of flexible enforcement powers," it "has an obligation to explain why a less drastic remedy would not suffice." See also, e.g., *PAZ Securities, Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007) *Steadman* also noted that "[t]o say that past misconduct gives rise to an inference of future misconduct is not enough. What is required is a specific enumeration of the factors ... that merit permanent exclusion." 603 F.2d at 1140. Pelosi's unblemished record before and after his Halsey employment presents strong evidence that there is no likelihood of recidivism.

The Decision failed to provide the required explanation, or to indicate that the judge considered a lesser sanction. In fact, the Decision specifically found that Pelosi's "prior regulatory record is clean," that Pelosi did not "enrich" himself and that his clients suffered no "actual losses" from his conduct. These factors cannot justify the imposition of "the most potent

weapon" in the SEC's "arsenal." The Decision should have at least considered the possibility of a lesser sanction, as a bar may not be imposed for a punitive purpose. The Investment Advisers Act and Investment Company Act only permit a sanction when the "public interest" requires it, and it is axiomatic that the only reason to impose a bar on an adviser "is to protect the public from future harm at his or her hands." *Howard F. Rubin*, Exchange Act Release No. 25,179, 1994 WL 730446, at * 1 (Dec. 30, 1994). In short, these proceedings are "not punitive[,] but remedial": punishing misconduct has no role to play in the analysis. Id.

The Decision fails to assess the risk to the public if Pelosi were permitted to continue serving as an investment adviser, and notes only "Additionally, it is in the SEC's interest to deter others from behaving like Pelosi"[132] *McCarthy v. SEC*, 406 F.3d 179 (2d Cir. 2005) notes that the "compelling facts in the record" —the lack of harm, lack of personal gain, and clean record—"suggest the sanction may be excessive and punitive." Id. at 189–90 (2d Cir. 2005) (vacating a two-year suspension). Here, the SEC will impose a sanction only if it concludes that the sanction is warranted based on its own *de novo* review of the record. See, e.g., *Gary M. Kornman*, Advisers Act Rel. No. 2840 n.44 (Feb. 13, 2009).

132 Dec. p 27.

B. A Proper Consideration of the Steadman Public Interest Factors Requires a Lesser Sanction

In evaluating whether an administrative sanction against an investment adviser serves the public interest, the SEC considers the egregiousness of the adviser's actions, whether the infraction is isolated or recurrent, the degree of scienter involved, the sincerity of the adviser's assurances against future violations, the adviser's recognition of the wrongful nature of his or her conduct, and the likelihood that the adviser's occupation will present opportunities for future violations.[133] The SEC also considers the extent to which the sanction will have a deterrent effect. No single factor is dispositive, and the appropriate sanction depends on the facts and circumstances of each case. Careful consideration of these factors here demands a lesser sanction.

The Misstatments Here Are Isolated. Before the conduct at issue, Pelosi had an unblemished record and a distinguished career of excellence as an investment adviser as detailed above. Moreover, Pelosi proffered evidence at the hearing that he stopped making any manual adjustments to client letters immediately upon leaving Halsey. After his termination from Halsey, Pelosi was hired by YHB Investment Advisors, and the portfolio returns in his YHB Client Letters exactly matched the returns produced by the (more modern) Advent system that YHB used to calculate returns—as both the Sec Staff's examination and YHB affirmed. And nine months into his employment at YHB, when the Division initiated its inquiry, Pelosi sought and received permission from YHB to omit any statement of returns in his Client Letters and to simply attach the Advent returns reports themselves to them. In short, Pelosi's course of conduct here is an isolated incident in an otherwise sterling career as a respected and valued advisor.

[133] See *Steadman*, 603 F.2d at 1140; *James Dawson*, Advisers Act Rel. No. 3057 at 4 (July 23, 2010); *Martin Armstrong*, Advisers Act Rel. No. 2926 at 5 (Sept. 17, 2009); *Schield Management Company*, Advisers Act Rel. No. 2477 at 15 (Jan. 31, 2006).

Pelosi's Conduct Was Not Egregious. The Decision's findings cannot justify its sanction. Intentional or reckless misstatements of financial performance are wrong and deserve censure. However, the appropriate measure of conduct considered egregious is to compare it with other violations. Under that approach, Pelosi's conduct cannot fairly be said to be egregious. Eric Brown jeopardized the life savings of elderly retirees, passing risky variable annuities off as sure things—even after being banned from selling these very instruments by the state. *Eric J. Brown*, Advisers Act Rel. No. 3377 (February 27, 2012). Hector Gallardo solicited funds from foreign investors with false guarantees, invested a fraction of it but lost nearly every penny, and simply pocketed the remaining bulk of those funds. *Hector Gallardo*, S.E.C. Release No. 34-65422 (Sept. 28, 2011). David Souza lured a group of church-goers into a Ponzi scheme and spent their investment dollars on himself. *David Souza*, Advisers Act Rel. No. 3328 (December 6, 2011). James Dawson mingled his own funds with his investors', then allocated the best trades to his personal account at his investors' expense. *James Dawson*, Advisers Act Rel. No. 3057 (July 23, 2010).

Pelosi's conduct did not result in any loss to his clients, nor did he profit from it. Pelosi's customers received Schwab monthly account statements and with each Client Letter account summary and holdings reports generated by the Advent system, which also accurately captured cost basis and market values for each Security and for the portfolio as a whole, as well as other detailed information. The Decision found that the letters "understated returns, in many cases by a substantially wider margin than the letters overstating returns."[134] This evidences that Pelosi was actually performing the types of calculations that he has consistently maintained, and counter any claim of a scheme to mislead clients. This coupled with the Division findings that these "misstatements" of investment performance over three years were generally under 1% is

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[134] Dec. at 28.

less than egregious.[135]

Pelosi's Conduct was at Worst Reckless, but Not Willful. The Decision also failed to establish Pelosi's scienter. Pelosi's manual adjustments and calculations are inconsistent with a finding of willful and malicious conduct and are far more consistent with compliant behavior. Pelosi did not profit from his conduct, nor was his salary or any profit-sharing bonus dependent on these performance numbers. Nor were the fees that Halsey charged Pelosi's customers in any way dependent on those numbers. The only possible motive is a general bolstering of Pelosi's reputation. However, the existence of both overstated and understated performance numbers evidence that Pelosi's adjustments were genuinely designed to secure accurate performance information. The Division has never offered any explanation of why someone who desired to mislead his clients would understate his investment results, and the Decision offers no enlightenment on this. In fact, the Decision is devoid of any discussion of motive-a critical deficiency.

Pelosi Acknowledges His Wrongdoing. Pelosi sincerely regrets this conduct and accepts responsibility for his actions. He acknowledges that it is improper and constitutes a misstatement to substitute his own return calculations in Client Letters for firm generated data without proper explanation. The Decision's conclusion that Pelosi failed to acknowledge his wrongdoing is contradicted by the Decision itself in its Section addressing the Confrontation.[136] Pelosi also acknowledged this at the hearing.[137]

Pelosi Will Not Violate the Investment Adviser Act In the Future. Pelosi also assures the SEC that he will not violate the Investment Adviser Act or any of the Securities laws in the future. As noted, this is evidenced by his conduct at YHB after he left Halsey. For nine months

135 See Exh. 5.
136 Dec. at 6.
137 Pelosi 707-9-7-8:11

of his initial employment there, he was completely unaware of the possibility of an SEC inquiry into his earlier actions, but proceeded to act in a manner that was fully consistent with the Advisors Act. A later SEC examination of YHB confirmed this.

In addition, these proceedings have taken a heavy toll. Pelosi's misconduct has ruined his career and tarnished his reputation. He will need to work hard to repair both. And he and his family have suffered financially, both from losing his income as an adviser and from the expense of defending himself before this SEC, which they have borne personally. This is an experience he would do anything to avoid having again, and there is no basis for thinking that he would subject himself and his family to these travails a second time. On top of that, he does not dispute that it would be appropriate for the SEC to issue a cease and desist and a fine.

Pelosi's Occupation Does Not Justify a Bar. In imposing the bar, the Decision stated that "Pelosi's current occupation as an investment adviser provides him ample opportunity to repeat these violations."[138] As noted, *Steadman* explained that it is "not enough" to "say that past misconduct gives rise to an inference of future misconduct." *Steadman*, 603 F.2d at 1140. Other than the problems that Pelosi experienced at Halsey, there is nothing in his history, before or after Halsey, to even suggest the possibility of wrongdoing. All of this is a strong indication that Pelosi will not again violate the Advisors Act.

Moreover, the SEC's ultimate mandate in determining whether to impose a bar is to protect the investors from future harm. In that regard, it is highly relevant that many of Pelosi's clients continue to want him to serve as an investment adviser and willingly testified on his behalf. While the Decision was dismissive of their testimony on the issue of whether they were misled or whether they deemed the adjustments material, their testimony was not limited to those purposes. They are investors and members of the public who very much want Pelosi's services

[138] Dec. at 27.

as an investment adviser. Their testimony cannot and should not be dismissed when deciding what sanction is appropriate in the public interest.

VI. CONCLUSION

For the foregoing reasons, the Commission should vacate the bar sanction in the Initial Decision and impose a lesser sanction on Mr. Pelosi.

Respectfully submitted,
McCARTER & ENGLISH, LLP

By: ______________________
JOHN R. HEWITT
A Member of the Firm