UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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

DIVISION OF ENFORCEMENT'S BRIEF IN OPPOSITION TO RESPONDENT MICHAEL R. PELOSI'S PETITION FOR REVIEW OF INITIAL DECISION

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PRELIMINARY STATEMENT

Respondent Michael Pelosi ("Pelosi") appeals from the Initial Decision finding him liable for violations of sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") and, based on those violations, imposing a bar from association with an investment adviser or an investment company, a civil penalty of $60,000, and an order to cease-and-desist from violations of sections 206(1) and 206(2) of the Advisers Act. In the Order Instituting Proceedings, the Division alleged that, for a three-year period from 2005 through August 2008, Pelosi knowingly or recklessly provided his clients with inflated investment returns, exaggerating gains and minimizing losses. After a one-week hearing in June 2011, the Law Judge determined that Pelosi had knowingly or recklessly provided his clients with overstated investment returns in violation of Sections 206(1) and 206(2). Although Pelosi tried to justify his overstatements with a variety excuses, the Law Judge determined that these justifications were "unpersuasive, inconsistent, ad hoc, ex post facto, and, at times, incoherent."

In this Petition for Review, Pelosi tries the same excuses again. As will be shown below, the Law Judge correctly found that the factual record establishes that Pelosi violated Sections 206(1) and 206(2). The Law Judge also correctly found that Pelosi's proffered excuses are after-the-fact fabrications that have no credibility and do nothing to explain the inflated numbers that he sent to his clients.

Finally, the Law Judge also imposed appropriate sanctions. Pelosi, a fiduciary investment adviser, knowingly and egregiously breached the duty owed to his clients by providing them with falsely inflated investment returns, month after month, for a period of three years. The evidence also shows that Pelosi lied to his business partners, destroyed evidence, suggested further lies to be given to firm clients, provided fabricated excuses in sworn testimony, and, currently, defiantly denies that he provided his clients any falsely overstated returns while

simultaneously expressing an intent to return to the role of fiduciary investment adviser. Although the Division contends that the civil penalty should be $195,000 rather than $60,000, the Law Judge imposed the most appropriate basic set of sanctions for this egregious misconduct: an industry bar, civil penalty, and order to cease and desist.

STANDARD OF REVIEW

The Commission's review of this administrative proceeding is *de novo*. Gary M. Kornman, 2009 SEC LEXIS 367, *35 n.44 (Feb. 13, 2009), *petition denied*, 592 F.3d 173 (D.C. Cir. 2010). The standard of proof required to establish Pelosi's liability for violations of 206(1) and 206(2) is the preponderance-of-the-evidence standard. Steadman v. SEC, 450 U.S. 91, 74-79 (1981). In weighing the record evidence, the Law Judge's credibility findings from the proceeding below "are entitled to considerable weight because they are based on hearing the witnesses' testimony and observing their demeanor." Steven Altman, 2010 SEC LEXIS 3762, *11 n.9 (Nov. 10, 2010).

STATEMENT OF FACTS

I. Background—Halsey Associates, Inc. and Pelosi

Halsey Associates, Inc. ("Halsey") is an investment adviser located in New Haven, Connecticut. James Zoldy ("Zoldy") is the firm's Chairman and Treasurer. Kenneth Julian ("Julian") is the firm's President and Chief Compliance Officer. SoF, ¶¶8-9.[1] In late 2004, the Halsey firm had approximately four full-time portfolio managers who were also owners of the firm. Zoldy and Julian were younger members of the firm's second generation, who had joined the firm in the 1990s. Id. Toward the end of 2004, Halsey was looking to add a new portfolio manager to expand the firm's second generation as its first generation was moving closer toward retirement. In interviewing potential candidates, Halsey was looking for an experienced investment adviser who would follow the firm's investment philosophy and business practices. Id. ¶11.

In 2004, Respondent Michael Pelosi was an investment adviser with Columbia Management Group, a division of Bank of America, where he had provided investment advisory services for approximately 16 years. **SoF**, ¶6. At the time, Pelosi began looking to leave Columbia Management in order to avoid a company request to relocate to New York or Boston. Some years earlier, in the early 1990s, Pelosi and Julian had worked together at Bank of Boston. In late 2004, Pelosi called Julian and informed him that he was leaving Columbia Management Group. Julian inquired whether Pelosi would like to join Halsey. After an interview process, Pelosi joined the firm as portfolio manager and investment adviser on April 25, 2005. Id. ¶¶8-15; *see also* APTr.653:23; 613:15-19; ID at 22 n.29.

[1] References to "SoF" refer to the Division's Statement of Facts. References to "APTr." refer to the transcript of the June 2011 administrative hearing before the Law Judge. References to "DE" and "RE" refer to the Division's Exhibits and Respondent's Exhibits, respectively, that are part of the record. References to "ID" refer to the Law Judge's Initial Decision. "PB" refers to Pelosi's Brief in Support of His Petition for Review.

A. Halsey's Business Practice for Reporting Client Account Performance.

At the time Pelosi joined the firm, Halsey had an established practice for reporting client portfolio account performance. Each portfolio manager was responsible for sending clients letters on a quarterly basis that reported their account's periodic performance in the body of the client letter. The firm staggered the letters so that each month, each portfolio manager would send out letters to one third of his client accounts. **SoF**, ¶16.

Within each client letter, Halsey portfolio managers reported the quarterly or twelve-month returns for the client's accounts, using a computer-generated, time-weighted return (TWR) calculation. The letter also provided asset class returns for the quarter or twelve-month period, again using the computer-generated, TWR calculation. **SoF**, ¶17.

All of the information necessary to report TWR performance in client letters came from paper reports generated by Halsey's portfolio management software program, Advent. Each month, Halsey's administrative assistants used this program to print out, for each client, a package of Advent reports. These included: (1) an Account Summary, (2) a Portfolio Appraisal, (3) a Performance History By Asset Class Report ("Performance History" or "TWR" Report); and (4) a quarterly Discounted Cash Flow ("DCF") report. The Account Summary and Portfolio Appraisal reports show a snapshot of the account's current holdings, with detail on cost basis, market value and income. The Performance History or TWR Report calculates a percent return for each investment class and the total account over the time period covered by the report. The Performance History report calculates the periodic return using a TWR calculation. **SoF**, ¶¶18, 24.

In preparing the periodic client letters, Halsey portfolio managers used the TWR report for the purpose of reporting client portfolio account performance. **SoF**, ¶27. They used the quarterly Discounted Cash Flow or DCF report for the purpose of reviewing additional account

detail for the previous three months. They did not use the quarterly DCF report to report account performance. Id. ¶29. After drafting the letters, the portfolio managers would enclose the Account Summary and Portfolio Appraisal, but not the TWR report or the quarterly DCF report. Id.¶25.

B. Pelosi's Guidance.

Upon Pelosi's arrival at Halsey, Zoldy and Julian instructed Pelosi on Halsey business practices, including the communication of account performance results to clients by letter. Zoldy and Julian also instructed Pelosi that, as a rule, he should use the Performance History or TWR Report for communicating quarterly and annual performance results in client letters. Pelosi never asked Zoldy or Julian any questions concerning the use of the TWR Report. Pelosi never expressed any concern that the firm was using an inappropriate or improper calculation methodology. Pelosi knew that Halsey expected him to report the computer-generated performance results to firm clients. **SoF**, ¶¶30-33.

The practice of providing clients with computer-generated performance results was familiar to Pelosi. For the previous 16 years as an investment adviser at Bank of America/Columbia Management Group, Pelosi had provided his clients with computer-generated performance results. As a result of this experience, Pelosi knew that it was wrong to provide his clients with anything other than the computer-generated performance returns. **SoF**, ¶34.

II. Discovery of Pelosi's Misconduct.

In the spring of 2008, a change in Halsey administrative procedure caused two Halsey administrative assistants, Kathleen Rourke ("Rourke") and Maureen Rynne ("Rynne"), to discover that Pelosi was overstating investment performance in his client letters. Before the spring of 2008, the administrative staff provided each portfolio manager with the Advent reports necessary for writing the client letters. In 2008, however, Halsey went through a system upgrade

that cut down on the monthly administrative procedures necessary for maintaining Halsey's client accounts. As a result, the portfolio managers had the administrative assistants become more involved in the client letter writing process by creating the first draft of quarterly client letters. This draft letter writing included inserting investment performance figures in the letters. Every administrative assistant employed by Halsey used the TWR Report for the purpose of inputting the investment returns in these letters. After inputting the TWR performance calculations into the letters, the administrators gave the draft letters to the portfolio managers along with the package of Advent reports. **SoF**, ¶¶16-23, 37-41.

As Rourke and Rynne began to receive draft letters back from Pelosi, they noticed that Pelosi would change the performance returns from the numbers reported in the TWR report. Rourke and Rynne prepared letters for other Halsey portfolio managers, but they did not see such changes being made by any of them. Rourke and Rynne asked Pelosi why he changed the figures, and Pelosi responded either "I calculate those figures in a different way," or "I have to take other things into consideration." Over time, Rourke and Rynne became concerned about Pelosi's changes because they were happening "more frequently" and "repeatedly." **SoF**, ¶¶49-52.

A. Business Partners Observe Pattern of Inflation.

In August, 2008, Rourke and Rynne informed Zoldy that they had observed Pelosi sending out client letters with performance numbers different than the computer-generated reports. Zoldy appeared shocked and upset. Zoldy informed Julian, and they decided to review a sampling of Pelosi's client correspondence. Zoldy and Julian collected between 20 and 40 of Pelosi's client letters and compared the performance reported in the letters to the Advent-generated TWR reports. The comparison showed that Pelosi's letters overstated performance

results. More specifically, his letters over-stated positive returns and under-reporting negative returns at both the total account and the individual asset class levels. **SoF**, ¶¶53-56.

B. Pelosi Attempts To Mislead Business Partners.

After observing this pattern of overstating performance, Zoldy and Julian decided they would approach Pelosi and ask for an explanation. On August 14, 2008, Zoldy and Julian called Pelosi into a conference room at Halsey. They showed Pelosi copies of his client letters and corresponding Advent reports. Zoldy asked Pelosi to explain why the numbers were different. Pelosi acted "surprised," "bewildered," and "incredulous." He denied that he had made any adjustments. Pelosi did not admit or acknowledge that he had intentionally sent his clients altered performance results. Instead, he claimed that the differences were attributable to "system's errors or mistakes by [Halsey's] assistants." The meeting ended with Zoldy and Julian informing Pelosi that they would pursue a more exhaustive review of Pelosi's correspondence. **SoF**, ¶¶57-64.

After the meeting, Zoldy and Julian asked the administrative staff to print out Pelosi's client correspondence. Shortly after the collection process started, Rourke noticed that Pelosi's correspondence was "disappearing" off of the firm's computer system. It appeared from Halsey's computer system that a group of Pelosi client letters, within a particular range of the alphabet, had been deleted off the system. Zoldy and Julian confronted Pelosi in his office. Pelosi admitted to deleting the letters, but claimed it was an accident. **SoF**, ¶¶65-66.

Several facts show that Pelosi's deletion of these letters was not an accident. First, Pelosi deleted an entire range of the alphabet, at a time when he claims to have been looking at individual letters and Advent reports. Second, Halsey used Microsoft Word, which requires a confirmation before deleting electronic documents. Although Pelosi admits that he confirmed

deletion of these letters, he "can't explain how [he] got past that." Third, Pelosi confessed, in a sense; in the days following the meeting, Pelosi sent Zoldy and Julian a typewritten apology in which he stated that he "cringe[d] at [his] behavior after the meeting." During the July 2011 hearing in this matter, Pelosi admitted that intentional deletion of his client correspondence would have been the only "cringe-worthy" event to happen after the August 14 meeting with Zoldy and Julian. **SoF**, ¶67.

After Pelosi deleted his client letters, Zoldy and Julian asked him to leave the Halsey office, which Pelosi did. Later that day, Zoldy was able to retrieve the deleted letters from a Halsey back-up system. At the end of the day, Susan Frois, a Halsey administrative assistant, handed Julian a stack of Pelosi client correspondence about an inch and a half thick. Julian placed this stack of letters on his credenza in his unlocked office and left for the evening. **SoF**, ¶¶68-69.

When Julian arrived at the Halsey office the next day, on August 15, he observed that Pelosi was already in the office. Julian also noticed that the stack of letters on his credenza was "noticeably smaller" than the evening before. Julian asked Frois if the pile looked smaller than the evening before. Frois confirmed that it did. Julian did a cursory examination of the Pelosi client letters on Halsey's computer system, and saw that some of the electronic copies of Pelosi client correspondence were missing paragraphs. **SoF**, ¶¶70-72.

After discovering the missing letters and deleted information, Julian asked Pelosi to leave the office. Before Pelosi left the office, however, Julian encouraged Pelosi to tell the truth about what he had done. Pelosi then left the office. **SoF**, ¶¶73-74.

C. Pelosi Admits Misconduct, But Suggests Misleading Clients.

Approximately ten minutes after leaving the office on August 15, Pelosi called Julian and asked Julian to meet him outside the office. Julian agreed. Upon meeting outside the office, Pelosi told Julian, "I did it." Julian and Pelosi then walked together and talked for approximately twenty minutes. During this conversation, Julian encouraged Pelosi to provide a reason why he sent out altered performance results. Pelosi never did. Instead of justifying the figures he sent to his clients, Pelosi apologized, stated that he very much wanted to stay with Halsey, and claimed that it would never happen again. **SoF**, ¶¶75-78.

Later that same day, Pelosi sent Julian an email. In the email, Pelosi expressed embarrassment and shame for sending out adjusted performance results to his clients. Pelosi also expressed deep shame for not admitting to his conduct in the August 14th meeting with Julian and Zoldy. **SoF**, ¶79; DE34.

On Monday, August 18, 2008, Pelosi returned to the office and provided Julian with two copies of a type-written note. Pelosi's note again expressed embarrassment and shame for sending out adjusted performance results to his clients. **SoF**, ¶¶80-81; DE35.

Between August 18 and August 27, Pelosi made additional pleas to remain employed at Halsey. Pelosi came to Julian's office a couple of times and talked about ways he could make it right with his clients and remain at Halsey. During this time period, Pelosi handed Julian a handwritten note about editing tables in Halsey's word processing system. Pelosi handed the note to Julian and suggested it as a possible excuse to explain to clients why Pelosi sent performance results that did not match the computer-generated reports. **SoF**, ¶¶82-83; DE36.

D. Pelosi's Termination And The Agreement To Withhold Regulatory Reporting.

On August 27, 2008, Zoldy and Julian decided Halsey needed to disassociate itself from Pelosi. They prepared a separation agreement for Pelosi. Under the terms of the agreement, Pelosi would resign from his position on the firm's board of directors, but would remain on paid leave and would receive his share of net revenues through September 30, 2008. The agreement further provided that, so long as Pelosi not disparage Halsey or its employees, the firm would not report Pelosi to proper regulatory authorities. **SoF**, ¶¶84-90. Zoldy and Julian presented Pelosi with the separation agreement on the afternoon of August 27. They told Pelosi that if he did not sign the agreement, they would report his conduct to regulatory authorities. Pelosi signed the agreement. **SoF**, ¶90.

On October 1, 2008, Julian submitted a Form U5, Uniform Termination Notice for Securities Industry Registration to FINRA and the State of Connecticut, reporting Pelosi's separation from Halsey on September 30, 2008. This form contained a false declaration that Pelosi had not resigned from the firm after allegations were made that accused him of violating investment-related statutes, regulations, rules, or industry standards of conduct. **SoF**, ¶¶93-94.

In March or April of 2009, a Halsey client questioned Zoldy and Julian about the appropriateness of the firm's decision not to report Pelosi's conduct. Following this questioning, Zoldy and Julian decided to correct the Form U5 to reflect the truth of Pelosi's resignation. On June 12, 2009, Julian submitted a second Form U5 reporting that Pelosi had resigned from the firm after allegations were made that accused him of violating investment-related statutes, regulations, rules, or industry standards of conduct. **SoF**, ¶¶95-97.

III. Documentary Evidence Confirms Pelosi Inflated Performance for Three Years.

The Division's evidence in this case includes a set of binders containing Halsey's record of Pelosi client correspondence and, matched with each letter, the corresponding TWR and DCF

reports from the Halsey Advent system. APTr. 235:24-238:21; DE17-24. In addition to this documentary evidence, the Division presented the testimony of a forensic accountant employed by the Commission who compared the performance returns reported in Pelosi's client letters to the returns reflected in Halsey computer-generated reports. From this comparison, the accountant prepared a set of summary exhibits, which were also admitted into evidence, showing the differences between Pelosi's reported returns and those in the TWR and DCF reports. APTr.417:6-461:3; DE 26-33. The Division's comparison of Pelosi letters to the Halsey TWR reports confirms Zoldy's and Julian's personal observations: Pelosi sent his clients inflated returns.

A. Comparison of Pelosi Letters to TWR Reports.

The Division first compiled the number of times Pelosi reported account returns that inflated, deflated or matched the applicable TWR report, which are set forth in the following table.

	Accounts	Inflated	Deflated	Equal
Pelosi letters annual/YTD results compared to Halsey TWR Reports	297	248 84%	36 12%	13 6%
Pelosi letters quarterly results compared to Halsey TWR Reports	261	214 82%	31 12%	16 6%

See APTr. 418:19-438:10; DE 26-27. In 297 instances of reporting annual or year-to-date returns, Pelosi inflated those returns 248 times, or 84% of the time. In 261 instances of reporting quarterly returns, Pelosi inflated them 214 times or 82% of the time. Comparing instances of inflation to deflation, Pelosi inflated both categories of returns more than five times as often as he deflated performance.

B. Accounting For Possibility of Rounding.

Within client letters, Pelosi typically reported performance to the nearest tenth of a percent or within ten basis points. *See* DE26 (summarizing Pelosi client letter returns in

Columns A and B); APTr.421:4-424:6. To account for the possibility of rounding, the Division next performed the same comparison, but counted differences of less than 10 basis points as "equal" or matching the TWR Report. APTr.437:13-438:10; DE27. When accounting for rounding, the comparison of Pelosi client reporting to TWR Reports showed an even starker pattern of inflation because Pelosi's instances of deflation dropped dramatically. The results were as follows:

	Accounts	Inflated	Deflated	Equal
Pelosi letters annual/YTD results compared to Halsey TWR Reports	297	209 70%	18 6%	70 24%
Pelosi letters quarterly results compared to Halsey TWR Reports	261	176 67%	8 3%	77 30%

See APTr.437:13-438:10; DE27. Here, accounting for rounding causes Pelosi's instances of deflation to decrease by 50 to 75 percent. By contrast, even when accounting for rounding, Pelosi still inflated annual account performance in 209 instances, or 70% of the time, and quarterly account performance in 176 instances, or 67% of the time. As a result, when comparing inflation to deflation, it becomes clear that when Pelosi inflated performance beyond the possibility of a rounding error, he inflated annual performance 10 times more often than he deflated it, and he inflated quarterly performance 20 times more often than he deflated it. **SoF**, ¶106.

C. Inflation Range Shows Most Instances Well Above Rounding Errors.

The Division also presented evidence summarizing the sizes of Pelosi's inflation of performance. *See* APTr.440:13-443:14; DE29. This analysis broke down Pelosi's instances of inflation according to their basis point size as follows:

INFLATION OF PERFORMANCE RESULTS (BASIS POINTS)

	≥100	50-99	25-49	10-24	1-9	Sub-Total
TWR Reports: Annual/Year-to-Date	50	67	48	44	39	248
TWR Reports: Quarterly	40	39	44	53	38	214
TOTAL	90	106	92	97	77	462

See APTr.440:13-443:14; DE29. According to this analysis, Pelosi inflated account performance (either annual/year-to-date or quarterly) a total of 462 times. Of those 462 times, in 385 instances of inflation, or 83% of the time, Pelosi's inflation was greater than 9 basis points, or beyond the possibility of rounding errors. Moreover, the analysis shows that in 90 instances, or approximately 20% of the time, Pelosi's inflation was over 100 basis points or more than a whole percentage point above the account's true performance.

D. Individual Letter Comparisons.

The Division's summary and comparison exhibits are based upon Pelosi's individual client letters and the corresponding performance reports from Halsey's Advent system, all of which are contained within Division Exhibits 17 through 24. APTr. 235:24-238:21, 418:19-420:15; DE17-24. Within these binders, the individual tabs collect each client letter and its corresponding Advent reports. A review of this compilation shows the specific instances in which Pelosi overstated performance results for total accounts and individual asset classes. The following tables provide examples.[2]

1. Examples of Overstatement of Total Account Returns.

Client	Account	Ltr Date	Period	Pelosi	TWR	Diff.	Cite
S.L.	IRA	11/7/2005	6/30/2005 to 10/31/2005	2.1%	1.30%	80bp	**SoF**, ¶110
S.L.	IRA	8/9/2006	7/31/2005 to 7/31/2006	5.2%	4.05%	115bp	**SoF**, ¶111
R.G.	IRA	8/10/2006	12 months as/of 7/31/2006	10.7%	6.82%	388bp	**SoF**, ¶112
S.T.	Profit Sharing Plan	10/17/2006	12 months as/of 9/30/2006	9.6%	7.02%	258bp	**SoF**, ¶113
S.L.	Taxable	8/13/2007	12 months as/of 7/31/2007	11.6%	10.93%	67bp	**SoF**, ¶114

[2] The columns within each of the following two tables provide: client identity by initials, the account reported in Pelosi's letter, the date of the letter, the period reported, Pelosi's stated return, the return from the applicable TWR report, the difference between the two returns, and then a citation to the Division's Statement of Facts. The second table of individual asset class returns includes a column identifying the asset class reported.

S.L.	IRA	8/13/2007	12 months as of 7/31/2007	13.1%	12.53%	57bp	**SoF**, ¶115
P.C.	Personal	12/13/2007	Qtr as of 11/30/2007	1.1%	(0.55%)	165bp	**SoF**, ¶116
S.L.	Taxable	2/8/2008	Qtr as of 1/31/2008	(4.2%)	(5.77%)	157bp	**SoF**, ¶117
W.D.	WC Ass'n	2/11/2008	Qtr as of 1/31/2008	(4.1%)	(5.92%)	182bp	**SoF**, ¶118.

2. Examples of Overstatement of Individual Asset Class Returns.

Client	Account	Ltr Date	Asset	Period	Pelosi	TWR	Diff.	Cite
D.D.	IRA	10/18/2007	common stock	Qtr as of 9/30/2007	2%	(1.15%)	315bp	**SoF**, ¶125
S.L.	Taxable	2/8/2008	common stock	Qtr as of 1/31/2008	(7.5%)	(8.52%)	102bp	**SoF**, ¶126
W.D.	WC Ass'n	2/11/2008	common stock	Qtr as of 1/31/2008	(7.7%)	(8.88%)	118bp	**SoF**, ¶127
D.F.	H.F. Taxable	3/11/2008	taxable bonds	Qtr as of 2/29/2008	(0.4%)	(1.33%)	93bp	**SoF**, ¶128
P.C.	Personal	3/12/2008	common stock	Qtr as of 2/29/2008	(6.8%)	(11.45%)	465bp	**SoF**, ¶129

IV. The Fabricated Excuses of Intentional Adjustment.

Pelosi has twice attempted to explain the overstated performance returns in his client correspondence: during the Division's investigation in July 2009; and a second time during the administrative proceeding in June 2011. During this testimony, Pelosi denied inflating performance. Instead, Pelosi claimed he *intentionally* reported returns different than Halsey's TWR reports. According to Pelosi, (1) he sometimes used Halsey's DCF Report instead of the TWR Report, (2) he sometimes used a Modified Dietz Calculation to adjust Advent's computer-generated results; (3) and he sometimes added back declared, but unpaid, dividend for preferred stocks that went "x-dividend" just prior to end of a client's reporting period. **SoF**, ¶¶133-147, 148-154, 158-163. As explained below, however, these excuses are nothing more than after-the-fact fabrications that fail to do anything explain Pelosi's inflated numbers.

A. Intentional Adjustments Never Mentioned During Internal Investigation.

The first indication of fabrication is that Pelosi never mentioned any of these supposed intentional acts during Halsey's internal investigation. When Zoldy and Julian confronted Pelosi in August 2008, Pelosi denied making any intentional changes and blamed the differences on system errors or administrative mistakes. **SoF**, ¶¶60-61. On the following day, August 15, Pelosi changed course and admitted to Julian that he "did it." Id. ¶¶70-77. Julian asked Pelosi to provide reasons for his conduct. Id. ¶77. Pelosi did not offer any. Id. During the approximate two-week period before Pelosi's departure from Halsey, from August 14 to August 27, Pelosi sent Julian two typewritten documents expressing shame and remorse for his misconduct and for not admitting to what he had done. Id. ¶79-80, DE34, DE35. He apologized directly to Julian and Zoldy multiple times for his misconduct, and offered Julian a handwritten note suggesting word processing errors as a possible explanation to clients. **SoF**, ¶82-83, DE36. Not once, in all of these communications, did Pelosi mention the supposed intentional use of DCF Reports, Modified Deitz calculations, or the x-dividend adjustments. **SoF**, ¶¶58-83.

During the July 2011 hearing, Pelosi attempted to offer a fabricated memory that, during his initial meeting with Zoldy and Julian on August 14, he had told them that he had been making purposeful changes to the computer-generated returns. APTr.703:19-704:13. Pelosi claimed that, during discovery, he read a chronology that reminded him of this fact. Id. This testimony was the opposite of his investigation testimony, in which he admitted lying to Zoldy and Julian by denying that he had made the changes. DE38, 163:9-165:1.

During hearing cross-examination, Pelosi was forced to admit that this remembered testimony was false. When cross-examined about his meeting with Julian outside of Halsey's offices on the next day, August 15, Pelosi testified that he started the conversation by admitting

to Julian that he had made manual changes to the Advent performance figures. APTr.730:15-731:4 ("I told him I did make changes. That's the first thing I said to him, I said, I did make changes."). At this point, Pelosi was caught in irreconcilable testimony. The reason he admitted to Julian on August 15 that he had made changes to the Advent-generated performance results was that he had previously denied it on August 14. Pelosi then conceded he had never told Julian and Zoldy that he had intentionally made manual changes before making his admission to Julian outside of Halsey's offices on August 15. *See* APTr.731:1-16. Later during cross-examination, Pelosi confirmed that he abandoned the fabricated memory and admitted that, during the first meeting with Julian and Zoldy in August 2008, he did not tell them that he had made his own manual calculations. APTr.799:14-800:8.[3]

Pelosi's willingness to offer fabricated memories casts serious doubt on the credibility of his entire testimony. In the absence of corroborating evidence, Pelosi's testimony should not be credited at all.

B. The Supposed Use of DCF Reports.

Pelosi's specific claim that he used Halsey DCF Reports is incredible for a number of additional reasons. First, Pelosi's testimony about his supposed use of DCF Reports has been irreconcilably (and unbelievably) inconsistent. Second, Pelosi's claim to have used the DCF Reports is contradictory to every other Halsey employee who testified in these proceedings. Third, even if Pelosi were to be believed, the Division performed a comparison of Pelosi client letters to Halsey DCF reports and the result was the same: a distinct picture of inflation.

[3] This version is consistent with Ken Julian, APTr.494:1-4, as well as Pelosi's post-meeting email to Julian, *see* DE34 ("Beyond being embarrassed and ashamed over the matter at hand, I am deeply ashamed that I didn't just tell you yesterday in the conference room."), and Pelosi's own investigation testimony. RE19, 163:14-165:1.

1. Irreconcilably Inconsistent Testimony.

As part of the investigation in July 2009, the Division asked Pelosi several times to state his practice in using Advent reports for reporting client account performance. In response to these questions, Pelosi testified he used the TWR report for reporting annual returns and the quarterly DCF report for reporting quarterly returns. **SoF**, ¶ 134. Pelosi provided his rationale for using these two different reports. First, Pelosi testified that three Halsey staff members, specifically Rynne, Julian and Zoldy, told him to use the TWR Report for 12-month reporting and the DCF Report for quarterly reporting. **SoF**, ¶¶ 134-35, 137. Pelosi further insisted that he followed this guidance because he did not know the substance of the TWR calculation method and, therefore, had "no basis" to choose one method of performance calculation over the other. **SoF**, ¶¶ 136-37. Based on this explanation, Pelosi told that Division staff that the DCF Report would not have been relevant to him for reporting 12-month returns. DE38, 155:20-22.

During the administrative hearing in June 2011, however, Pelosi testified to a completely different practice. Pelosi claimed that he used the DCF report for reporting 12-month returns because "there was never a distinction made between" the TWR and DCF reports given to him by the Halsey staff. APTr.618:24-623:6. Pelosi further testified that he preferred the DCF report for reporting annual returns because "it afforded greater transparency." Id. 622:24-623:25.

Both of these stories cannot be true. In fact, based on the testimony of everyone else who worked at Halsey and the record evidence, the more likely answer is that neither story is true.

2. Everyone Else Understood TWR Reports Were Used for Client Reporting.

Every other Halsey employee who testified at the hearing, two portfolio managers and three administrative assistants, knew and understood that Halsey's practice was to use the TWR Report for reporting all client account returns. **SoF**, ¶141. Indeed, the administrative assistants

who prepared client letters for Pelosi after the system upgrade in early 2008 used TWR reports to insert the client performance numbers. Id. ¶¶37-40. It was Pelosi's manual adjustments of these letters that was noticed by the administrative staff and caused his misconduct to be detected. Id. ¶¶49-53. At no time in 2008, either when the administrative staff questioned Pelosi or during the August internal investigation, did Pelosi tell the administrative staff, Zoldy or Julian that he was using Advent's DCF report. Id. ¶¶42, 61-62, 77-83.

3. Comparison of Pelosi Reporting to DCF Reports: Same Inflation.

Even if the Commission were to credit Pelosi's incredible testimony that he used DCF reports, the record evidence shows that Pelosi's client reporting was similarly inflated as compared to these reports. At hearing before the Law Judge, the Division presented evidence comparing Pelosi's client letters to the applicable DCF reports. APTr.444:25-461:3; DE30-33. This comparison shows the same picture of inflation. In 298 instances of reporting annual or year-to-date returns, Pelosi inflated those returns 222 times, or 74% of the time. APTr.444:25-454:8; DE31. In 261 instances of reporting quarterly returns, Pelosi inflated them 214 times or 82% of the time. Id. Pelosi inflated annual/year-to-date client account performance more than three times as often as he deflated performance. Id. He inflated quarterly account performance more than six times as often as he deflated it. Id.

The ranges of inflation were also well above the possibility of rounding errors. Pelosi inflated account performance (either annual/year-to-date or quarterly) performance a total of 436 times. *See* Tr. 456:18-461:3; DE 33. Of those 436, in 372 instances of inflation, or 85% of the time, Pelosi's inflation was greater than 9 basis points, or beyond the possibility of rounding errors. Id. Moreover, in 101 instances or approximately 23% of the time, Pelosi's inflation was

over 100 basis points, or more than a whole percentage point above the account's true performance. Id.

B. The Supposed Use of Modified Deitz Calculation.

Pelosi's claim that his inflated returns can be explained by the use of a Modified Dietz calculation suffers from a similar lack of credibility and evidentiary support.

1. *Irreconcilably Inconsistent Testimony.*

During the Division's investigation in July 2009, Pelosi testified that he sometimes used a "Modified Dietz" calculation to adjust *quarterly* performance returns for total account or asset class performance. **SoF**, ¶148. When asked to explain his rationale, Pelosi testified that he based his decision on the existence of account cash flows affecting the particular return. **SoF**, ¶149. According to Pelosi: "[T]he Deitz calculation *was only performed* when there were cash flow issues, significant cash flows." **SoF**, ¶150 (emphasis added).

During the same investigation testimony, the Division twice asked Pelosi if he used the Modified Deitz calculation to adjust annual returns, and twice Pelosi said he did not. **SoF**, ¶151. Pelosi explained that he would not have adjusted annual performance based on cash flows because a "performance system is more sensitive to . . . cash flows over a shorter period of time. I don't believe it would have affected a 12-month period as much as they could affect a three month period. So I don't recall making a change to the 12-month results on that basis." Id. ¶152.

At the hearing before the Law Judge, Pelosi testified to the opposite. He claimed that he used the Modified Dietz calculation to adjust annual performance. Id. ¶154. He also claimed that he used the Modified Dietz calculation for some other purpose than adjusting for cash flows.

Id. When asked to identify the specific basis for using the Modified Deitz calculation for a reason other than adjusting for cash flows, Pelosi could not identify one. Id.

2. Lack of Corroborating Proof

There is also no proof to support Pelosi's incredible claims. At the June 2011 hearing, Pelosi provided the Commission with a spreadsheet in which he purports to identify client letters in which his inflation is supposedly the result of using the Modified Dietz calculation. *See* RE4. This identification consists only of adding the words "Dietz calculation" to the "Account Name" column of his spreadsheet. *See, e.g., id.* at Rows 514, 1085, 1097 ; *see also* APTr.1242:24-1244:6. Pelosi never substantiated any of these assertions with evidence demonstrating how he used specific data and a Deitz calculation to arrive at any of his inflated returns. *See* APTr.763:6-773:6 (admitting that Respondent Exhibits do not contain any proof of calculations).

According to Pelosi, the Deitz calculation is a "simple" calculation. *See* RE38 at 109:12-15. Pelosi testified that during discovery he had the necessary data and "ran Deitz calculations to see if that was the issue." APTr.767:9-768:10. Yet, Pelosi did not corroborate his purported justification by providing the Commission with evidence of a single instance demonstrating how he used data and the Modified Deitz calculation to reach any of the numbers he provided his clients. The only logical inference from these facts is that the data does not support his testimony.

D. The Supposed Adding Back of Unpaid "x-Dividends" to Preferred Stock.

Pelosi also claimed that his overstatements of performance can be explained by an inclusion of declared, but unpaid, dividends for preferred stocks. This explanation suffers from similar incredible testimony and lack of evidentiary support.

1. Inconsistent and Incredible Testimony.

During the Division's investigation, Pelosi claimed that he added back x-dividend income to adjust performance because his clients had a "common question" about "fixed income returns." **SoF**, ¶160. When questioned about x-dividends during the June 2011 hearing, however, Pelosi initially denied that his clients had questions about investment performance. Id. ¶161. In Pelosi's words at the hearing, "I can tell you, I have never had – I don't recall having conversation with any of my clients regarding investment performance." Id. Instead, Pelosi claimed that adding back income had to do with questions about "market value." Id. Upon further cross-examination at the June 2011 hearing, Pelosi was eventually forced to concede that he had offered his purported x-dividend excuse to explain changing the reported investment performance, not market values, in his client letters. APTr.694:14-696:20.

Pelosi's claim that he adjusted preferred stock by adding back x-dividends is incredible for the additional reason that he claims to have diverted from a known firm practice without informing anyone, in an area in which he had no experience, and in which he knew that Zoldy, the firm's Chairman, was the expert. Pelosi never had any experience with preferred securities prior to arriving at Halsey. **SoF**, ¶164. Pelosi knew that Zoldy was the Halsey officer in charge of pricing fixed income securities. Id. Pelosi was also aware that Halsey, as a business practice, did not accrue x-dividends in reporting account performance. Id. Yet, Pelosi claims he made income adjustments to securities with which he was not familiar, going against firm practice, without ever discussing the adjustment with any of the other portfolio managers. Id. Under this set of facts, Pelosi's claim is unbelievable.

Furthermore, Pelosi kept no written record of his purported adjustments. Pelosi claims that he not only added back x-dividends, but also during the following reporting period for the

same account he would go back and make the inverse adjustment "so that the next quarter's results were not inflated." **SoF**, ¶165. Even though Pelosi claims to have made adjustments each quarter and made inverse adjustments the next quarter, he asserts that he kept no records tracking this repetitive and recurring adjustment. Id. Pelosi's claim that he did this adjustment on a regular basis by adding figures one quarter (within three different cycles) and backing them out the next quarter, without any journal or record-keeping to facilitate accurateness and efficiency, is unbelievable.

Pelosi's claim that he adjusted performance returns by adding back x-dividends is incredible for the additional reason that his purported conduct in making an "inverse adjustment" during the following period is illogical and unbelievable. Pelosi testified on cross-examination that, in first adjusting performance figures to add x-dividend income, he did not make any changes to the Advent system, nor did he ask the administrative staff to do that. **SoF**, ¶166. Therefore, when Advent recorded the paid dividend during the following quarter, the account performance would be accurate, not inflated. Pelosi's claim to have made a subsequent inverse adjustment to correct inflation that did not exist is illogical and unbelievable.

2. Lack of Corroborating Proof.

Despite ample opportunity, Pelosi has not shown one example of a performance calculation in his client letters that reflected his purported x-dividend adjustment. Pelosi first claimed to have made this x-dividend adjustment during investigation testimony in July 2009. **SoF**, ¶167. Since the institution of these proceedings, Pelosi had access to his client correspondence and the opportunity to go back and show examples of his purported adjustments. During the July 2011 hearing, Pelosi acknowledged that he could have gone back and looked "at when each preferred went x-dividend" in order to substantiate his purported adjustments. Id.

Despite knowing the issues and the availability of the data, Pelosi did not offer proof of any declared x-dividend he used to reach a performance figures that he reported to his clients. Id.; *see* APTr.763:6-773:6 (admitting that Respondent Exhibits do not contain any proof of Modified Dietz or x-dividend calculations). As with the supposed Modified Deitz adjustment, Pelosi claims he had the data and information but chose not to present it to the Commission. The only logical inference is that the objective data does not support his incredible testimony.

V. The Bogus "Reporting Period" and "Template" Excuses.

Pelosi has also advanced three excuses for his inflated returns that lack any logical or credible support. First, he claims that he sometimes reported annual returns that were really returns for a longer time period dating back to the account's alleged inception. PB at 31. Pelosi has no proof of this claim other than his word, which suffers from a severe lack of credibility. This argument is also a *non sequitur.* Even if Pelosi reported a higher 15-month or 16-month return, his letters misrepresented those higher returns as a 12-month return.[4] ID at 18. Inflating returns by misrepresenting the time period reported is still a misrepresentation of the reported return.

Second, Pelosi claims his misrepresentations can be explained because he sometimes substituted performance returns with a simple calculation of market value changes from beginning to end of the reporting period. APTr.651:12:652:16. But the Division's analysis excluded instances where Pelosi actually informed clients that he was providing them with a percentage change in market value. Pelosi's first client letters did provide clients with changes

[4] A good example of this excuse is Pelosi's 10/17/2006 letter to S.T., reporting the annual return of a profit sharing plan. **SoF**, ¶113. Pelosi's letter reports an annual return ending 9/30/2006 of 9.6%. The TWR report shows an annual return of only 7.02%. Id. Pelosi claims, based on his word alone, that this difference is attributable to the fact that he reported a return from June of 2005, the alleged inception of the account, through 9/30/2006, a period of 15 or 16 months. *See* Pelosi Post-Hearing Reply Brief at 9-10. The letter, however, explicitly reports an annual return. DE19 at Tab 63. Even if we assume the truth of Pelosi's explanation, he still misrepresented the reported annual return in his letter by 258 basis points. *See* ID at 18.

in market values, but these letters explicitly informed them of this fact. APTr.651:12-655:1(Pelosi); DE17 at Tab 2. For this reason, the Division did not include these reported figures as discrepancies with performance returns. *Compare, e.g.*, DE17 at Tab 2 (providing percentage increase in market value) *to* DE26 at Row 2, Columns A-B (no entry for Pelosi return). Interestingly, these same early letters also told clients that, in the future, Pelosi would be reporting "investment returns," which Pelosi would obtain form the Advent, computer-generated reports. APTr.651:12-655:1(Pelosi); DE17 at Tab 2. As these initial letters indicate, Pelosi knew there was a material difference between reporting change in market values and the TWR performance return calculation. Accordingly, to the extent Pelosi now claims that subsequent letters that reported returns are really simple changes in market values, he knowingly misrepresented the performance return. And, the Division's evidence appropriately holds Pelosi accountable only when he knowingly misrepresented those changes of market value as return calculations.

Finally, Pelosi contends that his letters can be explained by the fact that he carelessly cut and pasted client letters in word processing, resulting in clients receiving erroneous results. PB at 33. As the Law Judge noted, this excuse is "highly suspect" because Pelosi's examples of template errors actually contain adjustments to make the letter accurately report returns for certain portions of the recipient's account. ID at 21. In addition, the record shows that Pelosi suggested this phony excuse to Julian in August 2008, days after Pelosi admitted his misconduct. *See* APTr.511:21-513:3(Julian); DE36 (referring to "pasting" data in letters). As Julian testified, Pelosi offered this excuse as a misrepresentation to give to Halsey's clients, not as a legitimate explanation for the figures in his letters. Id.

VI. The "Combined Equity Reporting" Excuse Merely Led To More Proof of Inflation.

Pelosi has also claimed that his letters could be explained by the fact that he sometimes provided a "weighted average return" of common stock and mutual fund returns, in order to give "a view of the total equity picture." *See* DE38, 92:5-22. The Division's examination of this excuse, however, simply produced more evidence of Pelosi's misconduct. As set forth below, his letters also overstated combined "equity" returns above what the TWR Reports calculated for both individual asset classes.[5]

Client	Account	Ltr Date	Period	Pelosi *Equities*	TWR *Common Stock*	TWR *Mutual Funds*	Diff.	Cite
S.L.	IRA	11/7/2005	6/30/2005 to 10/31/2005	3.1%	2.27%	1.73%	>83bp	**SoF**, ¶120
R.G.	IRA	8/10/2006	12 months as of 7/31/2006	12.1%	8.41%	9.87%	>223bp	**SoF**, ¶121
D.D.	IRA	10/10/2006	4/30/2006 to 9/30/2006	1.8%	(0.19%)	None Held	199bp	**SoF**, ¶122
S.T.	Profit Sharing Plan	10/17/2006	12 months as of 9/30/2006	14.1%	8.44%	13.31%	>79bp	**SoF**, ¶123
P.L.	VBL 1991 Irrevocable Trust	3/7/2007	12 months as of 2/28/2007	12.6%	6.27%	11.09%	>151bp	**SoF**, ¶124

Having a combined "equity" return higher than the both the individual asset class returns in the TWR Report is a mathematically impossible result for an accurate combined return. Weighted averaging of the asset class returns could never bring the combined return above those of the individual asset classes. Moreover, because of the comparative size of these asset classes, the actual performance of a combined "equity" class was sometimes much closer to the worst performing asset. For example, on September 30, 2006, the Profit Sharing Plan reported to S.T. above had common stock holdings twice as large as its mutual fund holdings. The combined

[5] This table includes columns identifying Pelosi's "equities" returns, the TWR report's common stock returns, the TWR report's mutual fund returns, and a "difference" column that shows the approximate number of basis points by which Pelosi's combined return exceeded the two TWR report returns. The precise basis point inflation would depend on the relative sizes of the individual asset classes.

weighted return would have been much closer to the lower common stock return of 8.44% than the higher mutual fund return, and therefore, even further away from Pelosi's reported return of 14.1 percent. **SoF**, ¶123; *see also* **SoF**, ¶124 (noting same effect).

ARGUMENT

Pelosi's brief in support of this Petition for Review challenges the Initial Decision in three areas: (1) the factual record; (2) the legal conclusion, based on that record, that Pelosi violated the Advisers Act; and (3) the appropriateness of the sanction awarded. Contrary to Pelosi's arguments, however, the factual record evidencing his misconduct is solid and supported by mutually confirming testimony and documentary evidence. In addition, based on this factual foundation, the Law Judge correctly concluded that Pelosi's conduct violated sections 206(1) and 206(2) of the Advisers Act and that these willful violations warranted an industry bar, a cease-and-desist order, and a civil penalty.

I. Pelosi's Evidentiary Challenges Lack Merit

Pelosi makes essentially three challenges to the factual record. He claims (1) that Halsey's lack of a robust compliance manual prevented Pelosi from knowing that Halsey used the TWR for reporting client account returns (PB at 5-6, 12); (2) that Halsey's record of Pelosi client correspondence is incomplete (PB at 6-9); and (3) that Halsey's Advent records are unreliable (PB at 21-29).[6] None of these challenges are supported by the evidence.

[6] Pelosi also attempts to make much of the SEC's October 2009 examination, which occurred after Halsey's disclosure of Pelosi's misconduct earlier that year. PB at 11. In the Exam Staff's deficiency letter, it recommended that Halsey adopt written procedures "documenting its processes" of reconciliation. *See* RE18 at p.6. As the letter tacitly acknowledges and as Halsey witnesses testified, however, the firm had an existing reconciliation process. It was just not documented. APTr. APTr.22:7-24:22(Rourke); 102:18-24(Rynne). The letter does not find any record-keeping deficiencies. APTr.1352:13-1354:19(Audley).

A. Pelosi Did Not Need Compliance Manual To Understand Reporting Standard.

Pelosi now contends that Halsey's lack of a robust compliance manual prevented him from knowing that Halsey used the TWR report for reporting client account returns. He claims not to have understood there was any standard at all. This claim is simply not credible.

Both Halsey officers, Zoldy and Julian, testified that they trained Pelosi to use the TWR Report for reporting client account returns. APTr.207:13-210:11(Zoldy);484:1-14(Julian). After this training, Pelosi never questioned them concerning the use of the TWR report for this purpose. APTr.210:12-16(Zoldy);484:23-485:24(Julian).

All four Halsey witnesses called by the Division, two portfolio managers and two administrative assistants, testified that they understood that Halsey's practice was to use the TWR report for reporting client returns. **SoF**, ¶141. Susan Frois, the only Halsey employee Pelosi called at the June 2011 hearing, also testified that she used the TWR report for inputting returns in client letters. APTr.951:21-953:13. This unanimous understanding, by professional advisers as well as lay staff, seriously undercuts Pelosi's claim of ignorance.

Pelosi's claim is also inconsistent with what he said in the investigation. During the investigation, Pelosi claimed that he used the TWR Report for 12-month returns and the DCF Report for quarterly returns because it was what three Halsey officials (specifically Rynne, Zoldy and Julian) told him to do. RE19, 81:21-82:10; *see also* **SoF**, ¶134. He has now abandoned this specific explanation, which no longer holds much validity in light of the Division's evidence showing the same inflation in Pelosi's letters as compared to either set Advent reports.

Finally, Pelosi's claim that Halsey's client reporting was standard-less is further undermined by his own conduct in August 2008. When Zoldy and Julian confronted Pelosi about the discrepancies in his client letters, Pelosi did not claim that he was entitled to use any

standard he wanted. He first lied and denied that he made any changes, blaming the differences on the system errors or administrative staff mistakes. The following day, Pelosi admitted he violated Halsey's standards and promised it would not happen again. These actions are not consistent with Pelosi's current position that he could make up any standard he wanted. Instead, these actions instead suggest that Pelosi knew Halsey's computer-generated TWR Report standard, but lied about, and then was remorseful for, reporting something else on his own.

B. Halsey Kept, and Attested to, Record of Pelosi Client Correspondence.

Pelosi argues that Halsey did not keep a record of client correspondence and, further, that the record evidence of his client correspondence is somehow incomplete. These arguments are also unsupported by the record.

Halsey followed a record-keeping policy for maintaining client correspondence. Halsey's written record-keeping policy, dated in 2004, provides that "all client correspondence is kept in files which are stored in [Halsey's] office." *See* RE2 at Section V.1; APTr.244:16-246:2(Zoldy). Consistent with this written policy, the firm kept hard-copies of client letters in client correspondence files through the time of the Advent system upgrade in 2008. APTr.44:24-45:20(Rourke); 114:10-115:2(Rynne). After the system upgrade, Halsey changed its practice to keep electronic copies of client correspondence on the firm's computer system. APTr.44:24-45:20; 114:10-115:2.

The Division also laid an adequate evidentiary foundation for the admission of Halsey's record of Pelosi's client correspondence. During the June 2011 hearing, Zoldy identified the Pelosi letters within Division Exhibits 17-24 and then confirmed that these letters represent Halsey's record of what Pelosi sent to his clients. APTr.237:1-238:7. Pelosi made no objection to the admission of these exhibits either before or during the administrative hearing.

1. There Is No Credible Proof of Missing Letters.

Pelosi claims that there are some 250 "missing letters," *see* APTr.1140:24-1141:9, but the only evidence in the record on this subject is that he did not write these letters. To make this claim, Pelosi relies on his spreadsheet marked as Respondent Exhibit 4. APTr.1139:9-1141:9, RE4. According to Pelosi, he reviewed the Halsey documents in the investigation file and marked his spreadsheet "no letter provided" whenever he did not find a client letter for a particular cycle. APTr.1140:24-1141:9. Pelosi uses this marker to suggest that all of these letters are "missing." The fundamental flaw of this approach is that Pelosi did not write client letters to every client, every cycle. As two Halsey portfolio administrators testified at the hearing, Pelosi frequently did not provide client letters when he visited with clients or met with them in the Halsey office. APTr.32:6-18(Rourke); 116:25-117:12(Rynne). Pelosi's identification of "no letter provided" does nothing to establish whether these letters are missing or were just never written. The only evidence in the record on this subject is that Pelosi had a regular practice of not providing client letters. In the absence of proof that Pelosi actually wrote and sent client letters that are not in Halsey's records, the only logical conclusion is that letters do not exist for every client, for every cycle because Pelosi did not provide them to every client, every cycle.[7]

2. There Is No Credible Proof of Additional Letters or Cherry-Picking.

Pelosi also claims that he "discovered" in the Halsey document production some 80 more letters that are not included in the Division's compilation exhibits of his client correspondence.

[7] Pelosi suggests that missing letters are indicated by the fact that Halsey's record of his correspondence has only 15 letters for 2005. PB at 7. Pelosi, however, fails to mention (1) that he did not join Halsey until April 25, 2005, and (2) that when he joined, he did not bring any clients with him. APTr.653:22-23; id. 651:12-20. His former clients did not join him at Halsey until some "period of time" after his arrival. Id. 651:12-20. Many of these clients did not join Halsey until 2006 or 2007. *See* DE 13 (Halsey letters showing account inception dates).

APTr.1139:9-13; PB at 8. Based on these alleged 80 additional client letters, Pelosi argues that the Division cherry picked evidence supporting its case. PB at 43-45.

First, Pelosi's claim of Division cherry picking is completely unfounded. Halsey's Chairman, James Zoldy, established the record of Pelosi correspondence. He and the Halsey staff reviewed Division Exhibits 17 through 24. APTr.236:22-238:7. Based on this review, Zoldy testified under oath that the letters contained in these exhibits are the firm's record of Pelosi's correspondence. Id. Whatever disagreements Pelosi might have about which letters constitute that collection, his dispute is with Halsey, not the Division.

Second, as it exists today, the record suggests that Pelosi's 80 "additional letters" are merely unsigned duplicates of his signed letters. As Halsey witnesses testified, the firm's record of official correspondence includes (1) signed copies of correspondence until the Spring of 2008, and then (2) unsigned electronic copies after the Spring of 2008. APTr.44:24-45:20(Rourke); 114:10-115:2(Rynne); 233:14-234:6(Zoldy). Importantly, during the Division's investigation in 2009 through 2010, Halsey produced an electronic copy of Pelosi's hard-drive, which included electronic copies of draft letters he kept on his computer. APTr.239:12-240:25(Zoldy), 857:12-858:2(Frois). At the June 2011 hearing, Pelosi testified that the 80 letters he discovered were "unsigned." Id. 1151:21-1152:18(Pelosi).[8] To the extent that Pelosi's hard-drive contained electronic copies of draft letters from prior to the Spring of 2008, Halsey would not have included any those unsigned letters in its official record of correspondence. The logical inference is that the 80 unsigned letters allegedly discovered by Pelosi are simply duplicate copies of unsigned letters from prior to 2008, when the firm retained signed copies. This

[8] Pelosi faults the Initial Decision's finding that "the Division did not include in its analysis Pelosi's unsigned letters." *See* PB at 9; ID at 12. As indicated by the subject heading in the Decision, however, the discussion of "unsigned letters" relates to Pelosi's claim of "missing letters." ID at 12. The citation following the Decision's sentence cites to Pelosi's hearing testimony that the alleged "missing letters" were unsigned. *See* id.; APTr. 1151:21-11:52:18. There is no dispute that the Division's analysis did not rely on any missing, unsigned letters.

inference is actually confirmed by Respondent Exhibit 8, which is a summary of Pelosi's notes from reviewing the Halsey documents in the investigation file. APTr.765:19-766:13; 754:14-756:2. In this review, Pelosi identifies numerous "draft" letters. *See, e.g.,* RE8 at p.10, Item eo 6408 ("draft/typos"); at p.12, Item eo 6232 ("dated 10/12/07 draft"); at p.18, Item eo 5800 ("2/28/06 draft")' at p.20, Item eo 5653 ("draft letter").

Furthermore, Pelosi suggests these additional letters are helpful to his case, but he offered no proof of them or their contents. He did not submit them into evidence or identify them in summary exhibits. He didn't even show them to Zoldy to inquire whether these letters were or should have been part of the firm's official record. Pelosi's calculated decision to withhold these alleged letters and argue their absence suggests that they are irrelevant.

Finally, even if these letters existed, they would not eliminate "the substantial number" of client letters in the record containing material performance overstatements. ID at 24-25.

C. Advent Reports Are Accurate and Reliable Confirmation Evidence.

Pelosi contends that the Advent reports (TWR and DCF Reports) in Division Exhibits 17 through 24 are unreliable for two reasons. First, Pelosi claims that, because of pricing and reconciliation errors, Halsey employees altered the Advent system data after he wrote his letters and therefore the Advent performance reports are different than when he wrote is letters. PB at 23-27. Second, Pelosi contends that these manual "updates" caused Advent reports to contain unexplainable question marks and "N/A" or "0" entries.[9] Id. at 24-25. Both of these points are refuted by the record. Moreover, even if Pelosi's argument had merit, Halsey witnesses observed Pelosi's overstatement of client account performance in real time, before any changes would have been made to the Advent system.

[9] If Halsey portfolio managers saw any indications of error in Advent reports after reconciliation, the reports would be corrected and reprinted before being used for letter writing. APTr.108:1-109:14. Pelosi confirmed this fact. Id. 637:12-640:13.

1. *Advent Account Records Are Reliable.*

Each month, the Halsey administrative staff reconciled client accounts in Advent to the custodian statements prior to the printing of Advent reports for client letter writing. APTr.22:7-24:22(Rourke); 102:18-24(Rynne). Rourke, a portfolio administrator who had worked at Halsey for over twenty-eight years and conducted thousands of account reconciliations, recalled only "maybe one" post-reconciliation change made to a client account. APTr.24:23-25:13. Rynne, a 20-year veteran Halsey portfolio administrator, testified that account changes after reconciliation happened maybe twice a year and were corrected before letters were sent. Id. 107:12-109:14. Zoldy, the firm's Chairman and officer in charge of pricing, said that such changes happened only in "very rare" circumstances. Id. 191:9-22. These witnesses were consistent. Changes to account records after the completion of account reconciliation were rarely made.

To make his argument of pricing and reconciliation errors, Pelosi relies on the dubious testimony of his current administrative assistant, Susan Frois. At the June 2011 hearing, Frois testified that during each reconciliation there were "ten pages of rejects," which she had to investigate extensively, as well as incorrect classification of securities, pricing issues, and "corporate actions." APTr.851:7-854:13. According to Frois' hearing testimony, these errors occurred "all the time" because most of the securities held in the accounts required adjustment. Id. 854:3-13. The first problem with this testimony is that it is inconsistent with that of the other three Halsey witnesses described above. The second and more troubling problem is that it is inconsistent with Frois' own investigation testimony given twenty months earlier in October 2009. During investigation testimony, Frois's explanation of the reconciliation process failed to describe any of these supposed errors or their supposed frequency. RE20(Frois IT), 16:24-18:10. Frois testified that she reconciled client accounts to cash by looking for account distributions, contributions or gifts, and possibly foreign tax. Id. To the extent there were any differences, it

was a "small difference" and "it was normally bond pricing that was the difference." Id. There is not even a hint of the pricing issues, corporate actions, or the other litany of errors she rattled off at the June 2011 hearing.

There is more. Toward the end of investigation testimony, the Staff asked Frois to identify any other concerns with Halsey's electronic record-keeping system, including the Advent system. RE20(Frois IT), 71:23-72:13. This invitation to describe any other problems elicited a comment about "email." Id. That is it. There is not even a suggestion of the supposed catalogue of "mistakes" that occurred "all the time."

Frois' investigation testimony from October 2009 is strikingly consistent with Jim Zoldy's June 2011 hearing testimony. At the hearing in July 2011, Zoldy testified that post-reconciliation errors occurred "very rare[ly]" and, when they did, they usually pertained to gifts of securities in client accounts. APTr.191:9-22. This explanation is consistent with Frois' investigation testimony of 2009, when she testified that her reconciliation process consisted of manually inputting transactions that were not securities "buys or sells," but rather gifts, or contributions or distributions from the client accounts. RE20(Frois IT) at 16:24-17:18. This consistency shows that the hearing testimony of Zoldy, Rourke and Rynne is the accurate portrayal of the Halsey system and its records.

Frois has a personal stake in these proceedings. In the last twenty years, Frois has followed Pelosi from Bank of America to Halsey, and now to YHB Advisors. RE20(Frois IT), 8:6-9:22, 63:4-13; 65:18-66:21. After the commencement of administrative proceedings, Frois worked on Pelosi's hearing exhibits at YHB during work hours and during her personal time after hours, at her own house, and at Pelosi's house. APTr.981:10-25(Frois); 1240:10-

1241:5(Pelosi). Frois received professional legal representation from Respondent's counsel at no cost to her. Respondent's counsel represented her during investigation testimony at a discounted rate of $500 per hour, but Frois had yet (as of the June 2011 hearing, twenty months later) to receive a bill for these services. APTr.992:18-993:2.

Moreover, Frois's conduct at the hearing led the Law Judge to find that she was not a credible witness. He found that Frois exhibited an "evident bias" in favor of Pelosi and an unusual demeanor throughout her testimony. ID at 9 n.11. In resolving any conflicting witness testimony on the subject of the Advent system, the Commission should therefore rely on the consistent and credible testimony of Rourke, Rynne, and Zoldy.

2. Advent Reports In Division Exhibits Remain Unchallenged.

Prior to the June 2011 hearing, Zoldy and his staff reviewed the Pelosi letters and Advent reports in Division Exhibits 17 through 24. APTr.236:22-238:7(Zoldy). Zoldy attested to the Advent reports as true and accurate copies of Halsey's electronic business records by way of a business record certification, which was admitted as Division Exhibit 25. Id. 238:13-21(Zoldy); DE25. At the hearing, Zoldy testified that the letters Division Exhibits 17 through 24 represented Halsey's record of what Pelosi sent to his clients and that the TWR and DCF reports had been correctly matched with the letters. APTr.237:24-238:7. Pelosi did not challenge any of this testimony or these exhibits.

Instead of addressing the Division's evidence, Pelosi offered two separate packages of Advent reports that he pulled from the investigation record and asked witnesses about question marks and "N/A" or "0" entries in these documents. *See* RE26 & RE27. The Halsey witnesses explained most of Pelosi's alleged discrepancies on the spot. For example, Pelosi's sample reports covering a time period ending before month-end have question marks because Halsey

created Advent price files on a month-end basis. The Advent system therefore could not generate reports other than for month-end periods. *Compare* RE26 at Halsey 004912 *with* APTr.62:9-23(Rourke); 149:2-150:12(Rynne); 334:6-20(Zoldy). Question marks appear in the "short term investments" column where there are debit balances caused by a client's trading on margin. *Compare* RE26 at Halsey E01302, E00112, E0025, E00589 *with* APTr.65:19-68:5(Rourke); 150:25-151:17(Rynne); 334:21-336:18(Zoldy). The starting account value of zero may have been caused by the transfer of funds to a separate account for a client who had more than one account. APTr.85:14-86:3(Rourke). Even if Pelosi had raised an unanswered question concerning the Advent records in his two exhibits, however, he never demonstrated how these reports affected the performance calculations in the Division's exhibits or any other document.

3. Advent Reports Confirm Real-Time Observations.

Even if Pelosi's indirect challenges to the Advent reports in the Division's exhibits had merit, Pelosi cannot avoid the personal observations of Zoldy and Julian, in real time, back in August 2008.

As conceded by Pelosi's expert, Advent reports that have not been the subject of post-reconciliation changes "would be perfectly okay to use for an examination of historical performance." APTr.1349:11-16(Audley). In early August 2008, Zoldy and Julian conducted their initial review by pulling and comparing approximately 20 to 40 Pelosi client letters and corresponding Advent reports. In that review, they personally observed that Pelosi's letters showed a pattern of overstating the Advent performance results. More specifically, Julian observed over-reporting of positive returns and under-reporting of negative returns at the account level and at the individual asset class levels. **SoF**, ¶¶53-56. On August 14, Zoldy and Julian showed a sample of these letters to Pelosi, and Pelosi observed that they were "recent letters."

APTr.1127:8-19, 1250:4-11(Pelosi). Thus, Zoldy and Julian compared Pelosi's recent correspondence to Advent reports at a time before any of the alleged changes would have been made to the Advent system. Their review independently establishes the picture confirmed by the Advent data in the record: Pelosi was sending his clients letters that overstated investment performance, at both the account and asset class levels.

II. Pelosi Violated Sections 206(1) and 206(2) of the Advisers Act.

Sections 206(1) and (2) of the Investment Advisers Act of 1940 make it unlawful for an investment adviser "to employ any device, scheme, or artifice to defraud any client or prospective client, or to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6(1) & (2). As an investment adviser, Pelosi is a fiduciary of his clients and owes them "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading'" them. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963) (internal citations omitted). Contrary to the command of this duty, Pelosi violated his clients' trust by knowingly misleading them about their investments' performance. Each quarter within each year, for a period of three years, Pelosi intentionally sent his clients performance returns that were overstated without any justifiable basis.

A. Pelosi Acted With Intent to Deceive His Clients.

To establish a violation of Section 206(1), the Division must prove that Pelosi acted with scienter, SEC v. Steadman, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992), which courts have defined as a "mental state embracing the intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); Aaron v. SEC, 446 U.S. 680, 686 n.5, 695-97

(1980). A finding of recklessness is sufficient to satisfy the scienter element. David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997); *see also* Steadman, 967 F.2d at 641-42. In the context of securities fraud, recklessness means conduct that is "highly unreasonable' and . . . 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.'" Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978) (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)). A violation of Section 206(2), on the other hand, does not require any proof of scienter. Capital Gains Research Bureau, 375 U.S. at 195.

Here, the record is filled with evidence demonstrating Pelosi's intent to deceive his clients. First, there is the distinct pattern of inflated returns. In a review of 297 accounts for which Pelosi provided annual performance returns during his three years at Halsey, Pelosi overstated performance in 248 instances (or 84% of the time). In a review of 261 accounts for which Pelosi provided quarterly performance returns, Pelosi overstated performance in 214 instances (or 82% of the time). In reporting both annual and quarterly returns, Pelosi provided overstated annual performance more than five times as often as he deflated performance. **SoF**, ¶104-05. This evidence gets stronger when the possibility for rounding errors is removed. When accounting for rounding, by removing differences below 10 basis points, the comparison of Pelosi's client letters to Advent TWR reports shows that Pelosi overstated annual performance 10 times more often than he deflated it, and that he overstated quarterly performance 20 times more often than he deflated it. **SoF**, ¶106. This distinct pattern of overstating performance returns paints a stark and unmistakable intent: Pelosi was boosting performance returns to mislead his clients into believing that their investments' performance was better than their actual returns.

Pelosi's scienter is also shown by the size and degree of inflation he provided to his clients. Pelosi admitted that performance adjustments of 150 basis points or greater, or those that change a negative return to a positive return, would be material to an informed investor. *See* DE38 at 95:6-11. As reviewed above, there are several examples of Pelosi providing his clients with overstatements above 150 basis points. *See*, *supra*, Facts, III.D.1-2. There are also examples where Pelosi changed a negative return to a positive return. *See* **SoF**, ¶116 (reporting account had a quarterly gain of 1.1%, but the applicable TWR report showed a loss of 0.55%); id. ¶125 (reporting common stock return of 2%, but the applicable TWR report showed a loss of 1.15%). Thus, even according to Pelosi's view of materiality, formed by his personal experiences with clients, he intentionally sent his clients overstatements of investment performance that he knew would be material to them.

Pelosi's intent to deceive his clients is also demonstrated by his attempts in 2008 to conceal his misconduct. When Zoldy and Julian first confronted Pelosi about the differences between his client letters and Advent reports on August 14, 2008, Pelosi denied knowledge of how this happened and claimed that differences were attributable to "system's errors or mistakes by Halsey's assistants." **SoF**, ¶¶58-61. These statements were obvious fabrications because, until this confrontation with other professional investment advisers, Pelosi had been acknowledging to Halsey's administrative staff that he had been changing performance returns for his own purposes. Id. ¶¶49-52. When Pelosi learned that Zoldy and Julian would be digging further into his correspondence, Pelosi went back to his office and deliberately deleted a range of letters from the Halsey computer system. Id. ¶¶64-67. In addition, although Pelosi denies it, the credible evidence suggests that he is also responsible for the disappearance of his letters from Julian's credenza and the portions of letters from Halsey computer system. Id. ¶¶69-73. These acts of

deceit and concealment are powerful evidence that Pelosi's conduct in overstating performance results was not innocent, but rather done with an intent to deceive his clients about their investments' performance. *See* Monetta Financial Svcs., 2000 SEC LEXIS 574, *63 (2000) (noting lack of candor and attempt to hide misconduct supports finding of intent to deceive); *see also* G. Bradley Taylor, 2002 SEC LEXIS 2429, *35 (2002) (noting efforts to conceal conduct demonstrate consciousness of guilt and support finding an intent to deceive).

Pelosi's intent to deceive is further shown by his later contrition to his business partners in 2008. On August 15, Pelosi admitted to Julian his previous denial had been a lie and apologized for his misconduct. **SoF**, ¶76-78. During this conversation, Julian encouraged Pelosi to explain his conduct, but Pelosi did not mention any excuse or justification. Id.¶77. Following this *mea culpa*, Pelosi provided Julian with three written documents: (1) a follow-up apology email on August 15, (2) a typewritten a apology note, and (3) a handwritten note in which Pelosi suggested using word processing errors as a means for explaining his overstatements. **SoF**, ¶¶79-83. Pelosi also had a couple of follow-up conversations with Julian, in which Pelosi made additional pleas to remain at Halsey and talked about ways he could make things right with his clients. Id. ¶82. Pelosi also had a final meeting with Julian and Zoldy on August 27, during which Pelosi begged for his job and offered to come clean with his clients about his conduct. Id. ¶¶90-91. At no time, during any of these communications or meetings, did Pelosi mention any of the supposed legitimate excuses or justifications he has presented to the Commission. **SoF**, ¶¶ 79, 80, 83; APTr. 504:5-7 (Julian). As the Law Judge noted, the evidence, as a whole, shows "one trying to deny and then apologize for his intentional misconduct." ID at 23.

Pelosi's intent to deceive is further illustrated by the fabricated after-the-fact excuses he has attempted to use to avoid enforcement liability. Pelosi has never provided the Commission with

a consistent explanation or credible evidence of his supposed intentional use of (1) DCF reports, (2) the Modified Deitz calculation, or (3) the preferred stock x-dividends. His other excuses have likewise failed to explain the hundreds of instances of inflation appearing in his client letters. Pelosi's failure to provide any credible evidence, despite the opportunity and claimed ability to do so, confirms that there is no such evidence. Pelosi foisted these unsupported excuses upon the Commission because, in reality, he repeatedly and deliberately sent his clients falsely overstated returns for the purpose of misleading them about the strength of their returns.

B. Pelosi's Inflation of Investment Returns Are Material.

Pelosi's hundreds of overstatements of investment performance are material. The standard of materiality in an action under Section 206 is whether or not a reasonable investor or prospective investor would have considered the information important in deciding whether or not to invest. *See* SEC v. Steadman, 967 F.2d at 643; *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 231-32, 240 (1988); TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). Materiality does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his decision, but rather whether the omitted fact would have assumed actual significance in the deliberations of the reasonable investor. TSC Industries, Inc., 426 U.S. at 449. This fact-specific determination "necessarily depends on all relevant circumstances of the particular case." Ganino v. Citizens Utilities Co., 228 F.3d 154, 162 (2d Cir. 2000). Here, all of the facts and circumstances demonstrate that Pelosi's overstatements of performance returns were material.

The nature of the performance returns indicates their materiality. As the Law Judge noted, the purpose of an investment is to generate returns. ID at 24. Periodic return calculations that investment advisers provide to clients "are an indication of a portfolio manager's

performance and, therefore, are the most important tool for an investor to evaluate their manager." Id. By its very nature, it is the type of information that would significantly alter the total mix of information available to reasonable investor.

The materiality of Pelosi's overstatements is further evidenced by Pelosi's own admissions concerning why he made these changes. Pelosi made these adjustments to the Advent performance calculations in order to meet what he believed to be the performance expectations of his clients. In Pelosi's words: "[My clients] have seen the growth in their portfolios over time. They have commented on my ability to insulate them from the market. They appreciate that. They have seen me manage their portfolios in good markets and in bad. And I was simply looking at the portfolio through their eyes." DE38, 88:13-19. Pelosi's admission that he adjusted investment performance based on the importance of investment growth in his client's eyes is very essence of materiality.

The materiality of Pelosi's overstatements is further evidenced by their size and the degree to which they inflated actual client performance. The record shows that Pelosi overstated total account performance by greater than or equal to 100 basis points, a whole percentage point, in 90 instances. These overstatements were often well over 100 basis points. *See, e.g.,* **SoF**, ¶112 (annual account performance by 388 bps); **SoF**, ¶113 (annual account performance by 258 bps); **SoF**, ¶116 (quarterly account performance by 165 bps); **SoF**, ¶118 (quarterly account performance by 182 bps); **SoF**, ¶125 (quarterly common stock performance by 315 bps); **SoF**, ¶129 (quarterly common stock performance by 465 bps). These overstatements were not only large, but they also grossly inflated the clients' actual performance. For example, in providing R.G. with a 388-basis-point overstatement of annual performance, Pelosi reported that the return was a 10.7% gain when Halsey's TWR report showed a gain of only 6.82%. **SoF**, ¶112. This

overstated return was 56.9% higher than the actual return. Similarly, in providing P.C. a 165-basis-point overstatement of quarterly performance, Pelosi reported that the return was a 1.1% gain when Halsey's TWR report showed a *loss* of 0.55%. Id. ¶116. This overstated return was 300% higher than the actual return. In providing D.D. a 315-basis-point overstatement of quarterly common stock performance, Pelosi reported that the return was 2% when Halsey's TWR report showed a *loss* of 1.15%. Id. ¶125. This overstated return was 273.9% higher than the actual return. Boosting actual returns by fifty, two hundred and seventy, and three hundred percent are material overstatements of actual performance. *See* Warwick Capital Management, Inc., 2007 SEC LEXIS 321, *42 (2007) (finding misrepresentations that "more than doubled performance" were "clearly material").

In addition, three former Pelosi clients testified at the June 2011 hearing that the variances between the performance results reported by Pelosi and the true result calculated by Halsey mattered to them. **SoF**, ¶¶178-92. One client even characterized the differences as "material," while all three clients testified that they expect their investment adviser to be honest and accurate in their dealings with them. Id., ¶¶182-87, 193. Even the six current clients called by Pelosi acknowledged that they expect their investment adviser to be honest about the performance of their accounts and that it was not acceptable for the investment adviser to lie to them. Id. ¶¶194-95. The testimony of all of these client witnesses confirmed that the false presentation of overstated returns by an investment adviser was a matter of "actual significance in the deliberations of the reasonable investor." TSC Industries, Inc., 426 U.S. at 449.

Pelosi claims that his overstatements of performance were not material because many of his clients stayed with him after his departure from Halsey. These clients, however, have never been informed that Pelosi intentionally sent them overstated performance returns. When Pelosi

departed Halsey, the firm sent a letter announcing Pelosi's departure and providing corrected performance information. APTr. 233:14-235:23(Zoldy); DE 13. These letters did not disclose the fact that Pelosi had had been overstating their returns. Id. Zoldy and Julian deliberately did not disclose this information to Pelosi's clients because they had agreed not to report Pelosi. Id. Pelosi also never informed his clients that he had intentionally sent them falsely inflated returns. *See* **SoF**, ¶196. Therefore, Pelosi has made no showing that his clients made the transition *despite* being informed that he intentionally provided them boosted investment performance returns for three years. At best, the evidence shows that Pelosi's clients automatically transitioned with the relocation of their adviser, rather than investigating the cause of the discrepancies raised in the Halsey letter.

Pelosi also claims that the hearing testimony of his six current clients demonstrates that they did not consider his overstatements of performance to be material. These witnesses, however, were unaware that Pelosi had lied to them or any other clients about investment performance. **SoF**, ¶196. As a consequence, these clients arrived at the hearing still believing in his honesty and integrity. APTr. 1464:12-1466:7(Dinto); 1452:6-18(Platano). Many of these witnesses expressed personal attachment to Pelosi or gratitude for past investment performance. *See* APTr.1464:11-1465:5(Dinto) ("I will tell you that Mike Pelosi has the – is the basis for everything I'd like to see in my son if I had a son."); 1452:8-18(Platano) ("I probably have more communication with Mike now almost as an adviser with the *other businesses* that we have . . . [W]e kind of use Mike as kind of our moral compass when addressing an issue of ethics or morality..."); 1400:20-1401:1(Scianna) (noting portfolio has performed "quite well" in Pelosi's care); 1402:25-1403:9(Scianna) (expressing gratitude that Pelosi built cash in portfolio prior to September 2008 market down turn). Pelosi carefully avoided asking these biased witnesses what

they might think about his actual misconduct. Instead, Pelosi asked these witnesses if they cared if he used a performance calculation different than one authorized by Halsey--a point which has nothing to do with the Division's claim that Pelosi falsely inflated performance. *E.g.*, APTr. 1403:10-17(Scianna), 1429:22-1430:4(Bosco), 1443:4-24(Florian), 1455:24-1457:5(Platano). On cross-examination, however, all six current clients testified that they expect their investment adviser to be honest about the performance of their investment accounts, and that it was not acceptable for their investment adviser to lie to them. **SoF**, ¶195.[10]

C. Pelosi Willfully Provided His Client's Inflated Returns.

The Division seeks sanctions pursuant to Section 9(b) of the Investment Company Act and Sections 203(f), (i) and (k) of the Advisers Act. To impose sanctions under these sections, the Commission must find that Pelosi committed willful violations. 15 U.S.C. § 80a-9(b); 15 U.S.C. § 80b-3(f) & (i); *see also* David E. Zilkha, 2011 SEC LEXIS 1326, *44 (2011). A finding of willfulness does not require intent to violate the law, but merely intent to do the act which constitutes a violation of the law. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); David E. Zilkha, 2011 SEC LEXIS 1326, *44 (2011); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976). As set forth above, Pelosi presented his clients inflated performance with the intent to deceive them about the strength of their investment returns. Pelosi's conduct was not mistaken or a matter of clerical error. As Pelosi told Halsey's administrative assistants and later admitted to Julian, he intentionally sent his clients the inflated returns. **SoF**, ¶¶49-52, 74-76.[11]

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[10] In his post-hearing brief to the Law Judge, Pelosi claimed that the testimony of Louis Scianna is "strongly supportive" of Pelosi's lack-of-materiality argument. For the reasons stated in the Division's post-hearing reply brief, Scianna's testimony is actually further indication of the materiality of Pelosi's misconduct. Division PHRB at 13-14 & n.4.

[11] Pelosi faults the Initial Decision for not articulating his motive. PB at 50. Although a finding of willfulness does not require proof of motive, Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978), Pelosi's motivation is apparent. By inflating investment performance, Pelosi was making himself appear to be more skillful in managing his clients' assets than he actually was. See In re Warwick Capital

III. Pelosi's Egregious Misconduct and Recalcitrant Attitude Call For Strong Sanctions.

The Division seeks to bar Pelosi from association with any investment adviser or investment company and to impose a cease-and-desist order and a second-tier civil penalty. In assessing the need for sanctions, the Commission considers the following public interest factors: the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations. Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979) (quoting SEC v. Blatt, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)). As the Law Judge found, all of these factors indicate that the public interest will be best served by removing Pelosi from the investment adviser and investment company industries and imposing a second-tier civil penalty and cease-and-desist order.

A. An Industry Bar Is Necessary To Protect The Investing Public.

Pelosi's misconduct was egregious. As an investment adviser, Pelosi is a fiduciary. He owes his clients "'an affirmative duty of utmost good faith . . . as well as an affirmative obligation to employ reasonable care to avoid misleading'" them. James C. Dawson, 2010 SEC LEXIS 2561, at *8 (July 23, 2010) (quoting Michael Batterman, 57 S.E.C. 1031, 1043 (2004)). Because of this unique relationship of trust and confidence, it is particularly egregious misconduct for an investment adviser to engage in dishonest conduct or a breach of fiduciary obligation. *See, e.g.,* id., *15-16; Warwick Capital Mgmt., Inc., 2008 SEC LEXIS 96, *34-35 (Jan. 16, 2008). Here, Pelosi did just that. Pelosi's clients depended on him to provide honest reporting of their investments' performance. Pelosi violated that trust and confidence by

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Management, Inc., 2008 SEC LEXIS 96, *27-29 (Jan. 16, 2008) (finding similar motivation for Respondent's inflation of investment performance and assets under management).

providing them with falsely inflated returns, which boosted actual returns by as much as fifty, two hundred and seventy, and three hundred percent.

The egregiousness of Pelosi's misconduct is underscored by the lengths to which he has gone to conceal and deny his wrongdoing. *See* Warwick Capital Mgmt., 2008 SEC LEXIS 96 at *35 (noting Respondent's attempts to conceal actions highlight seriousness of conduct). When first questioned by his business partners, Pelosi lied and claimed ignorance, placing blame with possible system errors or administrative staff mistakes. Pelosi then deleted letters off Halsey's computer system. After Pelosi admitted to Julian that he had intentionally sent out the returns in his letters, Pelosi suggested to Julian that they could explain the different numbers to Halsey's fiduciary clients by blaming the differences on word processing errors. Following the institution of the Division's investigation in 2009, Pelosi offered various inconsistent and incredible explanations that he never mentioned to Halsey in August 2008. The litigation of the Division's claims has now revealed that Pelosi has no credible proof of these excuses, which have done nothing to explain the inflated numbers he sent to his clients. Indeed, the "combined equity return" excuse has simply led to more proof of inflation. Pelosi made these repeated (but ultimately unsuccessful) efforts to conceal because he knows that sending his falsely inflated returns was an unacceptable breach of his clients' trust.

Pelosi's misconduct was recurrent and prolonged. Pelosi sent his clients these inflated returns several times each month over the course of three years. Over this three-year period, Pelosi boosted hundreds of returns, including annual and quarterly total account returns as well as individual asset class and combined asset class returns.

Pelosi acted with a high degree of scienter. From 2005 through Spring 2008, Pelosi's acts of sending inflated returns required him to intentionally report different returns than the

computer-generated TWR reports he was handed each month by Halsey's administrative staff. After the Advent upgrade in Spring 2008, Pelosi's acts of sending inflated returns required him to change the TWR returns the administrative assistants had already put in his draft letters. Even when the Halsey administrative assistants questioned Pelosi's activity, he continued sending out the inflated returns, deflecting the assistants' concerns with platitudes about taking other things into account. Pelosi did not actually stop sending out inflated returns until he was questioned by his business partners, who refused to accept Pelosi's false claims of ignorance and determined to get to the bottom of his conduct. Pelosi is a *magna cum laude* graduate of the University of Connecticut's undergraduate college and graduate business school, and a Chartered Financial Analyst. **SoF**, ¶7. Prior to arriving at Halsey in 2005, Pelosi had 16 years of experience as an investment adviser. Id. ¶6. Given Pelosi's education and experience, there is no doubt that he knew his fiduciary obligations, but consciously disregarded them and affirmatively provided his clients falsely inflated returns.

Pelosi has never acknowledged lying to his clients by providing them falsely inflated returns. In fact, he continues to deny it. APTr.621:22-622:2. In an attempt to side step this issue, Pelosi has offered *faux* contrition for "substitut[ing] his own calculations for firm generated data without explanation." PB at 50. The evidence in this case, however, does not show that Pelosi merely substituted different calculations. Rather the evidence shows that he inflated the reported returns without any legitimate basis.

Pelosi's failure to recognize the wrongful nature of his conduct also appears in arguments he has advanced before the Commission. Pelosi claims that he should not be liable for his overstatements of account performance because his clients received custodian account statements that provided them various types of financial information. PB at 42. Moving beyond the basic

fact that reliance is not a requirement for enforcement liability, New Allied Development Corp., 1995 SEC LEXIS 2256, *3-4 (1995), this particular argument reflects Pelosi's complete disregard for his role as an investment adviser. Pelosi owed his clients a fiduciary duty not to mislead them about their investment performance. He owed this duty of utmost good faith precisely so that his clients would not have to do the math in order to figure out whether he was providing truthful or fictitious statements of investment performance. Pelosi abused this position of trust when he lied to his clients about their investment performance. Now Pelosi argues against his enforcement liability by suggesting that the very clients to whom he owed the duty could have figured out the performance for themselves. This disregard for fiduciary obligation is exactly what led to Pelosi's misconduct and is the precise reason why the Commission should bar him from the investment adviser and investment company industries.

Similarly, Pelosi contends that his misconduct was not egregious because his clients did not suffer losses and he did not profit from it. What Pelosi fails to appreciate is that the egregiousness of his misconduct flows from his dishonesty to his fiduciary clients, not the amounts by which they potentially lost or he potentially profited. Pelosi's clients were entitled to honest reporting of their investment performance in all circumstances. *See* Dawson, 2010 SEC LEXIS 2561, at *11 (finding egregiousness based on nature of fiduciary breach, regardless of whether any loss resulted to clients).

Pelosi's desire to continue his career as an investment adviser presents a clear and present danger of opportunities for further violations. As noted in the Initial Decision, Pelosi continues to work as an investment adviser at YHB Advisors. ID at 27. Pelosi argues that this occupation does not pose a threat to investors. The Division disagrees. The evidence shows that Pelosi not only committed repetitive, egregious misconduct by lying to his clients about their investments'

performance for three years, but also that, to avoid the consequences of this misconduct, Pelosi lied to his business partners, destroyed evidence, suggested further lies to be given to Halsey's clients, provided fabricated excuses in sworn testimony to the Division and the Law Judge, and, currently, defiantly denies that he provided his clients any falsely overstated returns. This combination of egregious misconduct, efforts to conceal, and recalcitrant refusal to acknowledge the misconduct indicates that Pelosi's continued participation in the investment adviser industry presents a substantial likelihood of recurrence.

An industry bar is also particularly important for deterring future misconduct. The selection of an appropriate sanction includes an assessment of the deterrent effect it will have in upholding and enforcing the standards of conduct in the securities business. *See* Schield Mgmt. Co., 2006 SEC LEXIS 195, *35 & n.46 (Jan. 31, 2006); Arthur Lipper Corp., 46 S.E.C. 78, 100 (1975). An industry bar will show the investment adviser industry that lying to clients about investment performance, attempting to conceal this misconduct through lies, fabricating excuses, and a continued defiant refusal to accept responsibility will lead to a bar from the fiduciary role of investment adviser.

B. Pelosi Should Receive a Second-Tier Penalty of $195,000.

The Division seeks imposition of a civil monetary penalty under Section 203(i) of the Advisers Act and Section 9(d) of the Investment Company Act of 1940 ("Investment Company Act"). Under these sections, the Commission may impose a civil penalty if a respondent has willfully violated any provision of the Investment Advisers Act or the rules or regulations thereunder. *See* 15 U.S.C. §§ 80a-9(d), 80b-3(i). Where the misconduct at issue involves fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, the Commission may impose a "Second Tier" penalty of $65,000 for each act or omission occurring

between August 2005 and August 2008. Because the violations here involved fraud and deceit, and because the fraudulent and deceitful conduct occurred hundreds of times over more than three years, the Division seeks a three-time, maximum second tier penalty of $65,000, for a total penalty of $195,000.

The Law Judge imposed a three-time civil penalty for each year of misconduct, but lowered each penalty to $20,000, for a three-time total of $60,000. The Law Judge lowered the penalties based on the facts that Pelosi has no disciplinary history, that he did not profit from the fraud, and that his clients did not suffer actual losses. The Division respectfully submits that the absence of these particular aggravating factors does not justify a lower penalty amount. While Pelosi's clients may not have suffered losses, the public interest determination extends beyond consideration of particular investors to the public-at-large. Warwick Capital Mgmt., 2008 SEC LEXIS 96 at *39-40. In addition, while Pelosi may not have profited and has an otherwise clean disciplinary history, he engaged in egregiousness misconduct for three years with a high degree of scienter. After he was caught, Pelosi sought to conceal this misconduct and now defiantly refuses to accept responsibility. With the presence of these aggravating factors, the lack of profit or prior disciplinary history should matter little, if at all. *See, e.g.*, Dawson, 2010 SEC LEXIS 1561 at *19 (imposing bar despite clean disciplinary history). In view of the whole record, the public interest factors weigh in favor of a three-time, maximum second-tier penalty in addition to the bar and cease-and-desist order. If, however, the Commission believes that Pelosi should receive any amount of mitigation, the Division contends that this should be applied to reduce the amount of the civil penalty as reflected in the Initial Decision.

C. Pelosi Should Be Subject To A Cease-and-Desist Order.

The Division also seeks imposition of a cease-and-desist order. Section 203(k) of the Advisers Act authorizes the Commission to impose a cease-and-desist order upon any person who "is violating, has violated, or is about to violate any provision of" the Advisers Act or any rule or regulation thereunder. *See* 15 U.S.C. §§ 80b-3(k). Although the imposition of a cease-and-desist order requires some showing of a future risk of violations, "[a]bsent evidence to the contrary, a finding of a violation raises a sufficient risk of future violation. To put it another way, evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits . . . ordering him to cease and desist." KPMG Peat Marwick LLP, 54 SEC 1135, 1185 (2001). Here, Pelosi's egregious and repetitive misconduct in providing clients with falsely inflated returns, and his current employment as an investment adviser, presents sufficient risk of future violations to warrant imposition of a cease-and-desist order.

CONCLUSION

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

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

(ii) based on such findings, issue an order pursuant to Section 203 the Advisers Act and Section 9 of the Investment Company Act, as appropriate, (a) requiring Pelosi to cease and desist from committing or causing violations of and any future violations of Section 206 of the Investment Advisers Act, (b) requiring Pelosi to pay a second-tier civil penalty of $195,000; (c) imposing a bar prohibiting Pelosi from associating with any investment adviser or serving on a

registered investment company; and (d) imposing such other remedial relief as the Commission deems appropriate.

Respectfully submitted
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