SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3805 / March 27, 2014

INVESTMENT COMPANY ACT OF 1940
Rel. No. 30997 / March 27, 2014

Admin. Proc. File No. 3-14194

In the Matter of

MICHAEL R. PELOSI

OPINION OF THE COMMISSION

INVESTMENT ADVISER PROCEEDING

INVESTMENT COMPANY PROCEEDING

CEASE-AND-DESIST PROCEEDING

Grounds for Remedial Action

Fraud

Associated person of registered investment adviser charged with providing false and misleading portfolio performance returns in quarterly and annual letters to his clients. *Held*, the proceeding is *dismissed* because the record does not support finding of liability.

APPEARANCES:

John R. Hewitt of Gibbons P.C., for Michael R. Pelosi.

Richard M. Harper II and *John J. Kaleba*, for the Division of Enforcement.

Appeal filed: January 27, 2012
Last brief received: August 16, 2013

I.

Michael R. Pelosi, a former portfolio manager, vice president, and part-owner of Halsey Associates, Inc. ("Halsey"), a registered investment adviser, appeals from a decision of an

administrative law judge finding that Pelosi violated the antifraud provisions of the Investment Advisers Act of 1940 by overstating his clients' portfolio performance returns in quarterly and annual letters between 2005 and 2008.[1] The law judge barred Pelosi from associating with an investment company or investment adviser, fined him $60,000, and ordered him to cease and desist from committing or causing further violations of the Advisers Act's antifraud provisions.

II.

This case concerns representations Pelosi made to his clients in client letters discussing the performance of their investment accounts that Pelosi managed.[2] From February 2005 to August 2008, consistent with Halsey's practice, Pelosi routinely prepared and mailed letters to his clients discussing the clients' portfolio performance for the previous period. Neither Halsey nor Pelosi informed the clients, either in such letters or by other disclosure, how their performance results were calculated.

Halsey gave its portfolio managers monthly performance reports generated from the firm's computer system (the "Halsey Reports"), with the expectation that the portfolio managers would quote the rates of return in the Halsey Reports when they drafted their client letters. In August 2008, Halsey's two principals discovered that, in many instances, the returns that Pelosi had been reporting in his client letters differed from those reflected in the Halsey Reports. The principals subsequently confronted Pelosi, who initially denied changing the firm's performance figures but the next day admitted that he used his own figures. Soon thereafter, Halsey terminated Pelosi's association with the firm. But pursuant to an agreement with Pelosi, Halsey filed a Form U5 that failed to disclose the circumstances that led to the termination as required by the form.[3]

Ten months later, prompted by questions from Halsey's largest client, the firm filed an amended Form U5 disclosing that Pelosi had been previously fired for "inaccurately reporting performance results to his clients in written communications." An ensuing Commission investigation culminated in the institution of this proceeding against Pelosi alleging that he violated Advisers Act Sections 206(1) and (2).[4]

III.

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1 *Michael R. Pelosi*, Initial Decision Rel. No. 448, 2012 WL 681582 (Jan. 5, 2012).

2 Performance is generally expressed as a percentage and measures the return realized in a portfolio by the investment manager over a specified time period.

3 Form U5, the Uniform Termination Notice for Securities Industry Registration, requires disclosure of the nature of the termination when it is not voluntary.

4 15 U.S.C. § 80b-6(1)-(2) (prohibiting investment advisers from "defraud[ing] any client or prospective client" or "engag[ing] in any . . . practice . . . which operates as a fraud or deceit").

At the administrative hearing, the Division entered into evidence 243 of Pelosi's client letters and reports for the periods covered in these letters that were recreated by Halsey from its computer system (the "Recreated Halsey Reports") in response to a 2011 production request from the Division.[5] The Division asserted that a side-by-side comparison of the letters with the Recreated Halsey Reports showed that Pelosi violated the antifraud provisions by falsely inflating his clients' portfolio performance and that he acted with scienter because his returns were materially higher than the Recreated Halsey Reports' returns in a number of instances.

On appeal, Pelosi argues that all the Division has proved in this case is that his reported performance numbers did not match the numbers in the Recreated Halsey Reports, not that his performance calculations were improper. He asserts that he used alternative methods to calculate performance and that he was justified in reporting these calculations to clients because he believed that his figures, not the firm's computer-generated performance figures, more accurately reflected his clients' account performance.

IV.

Based on our *de novo* review of the record, we have determined to dismiss the proceedings based on the Division's failure to meet its burden of proof. The Division's case rests on the premise that Pelosi's returns were false because they materially differed from the Recreated Halsey Reports, which the Division holds out as reflecting the clients' actual performance results. But the Division did not establish either that the Recreated Halsey Reports accurately reflected the reports Pelosi saw at the time of the alleged misconduct or that the Recreated Halsey Reports accurately reflected the clients' returns.

The only record information concerning the accuracy of the Recreated Halsey Reports in either respect is testimony from Halsey staff, primarily the portfolio assistants and one of Halsey's principals. In the initial decision, the law judge concludes that Halsey's "pricing and reconciliation" were "for the most part" "accurate," stating that the Halsey employees, "all of whom were credible witnesses, testified to that accuracy."[6] The Commission gives "considerable weight to the credibility determination of a law judge since it is based on hearing the witnesses' testimony and observing their demeanor. Such determinations can be overcome only where the record contains substantial evidence for doing so."[7]

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[5] Halsey was required to do so because it had not kept hard copies of the Halsey Reports actually given to Pelosi during the period at issue.

[6] *Pelosi*, 2012 WL 681582, at *12.

[7] *E.g.*, *Robert M. Fuller*, Securities Exchange Act Rel. No. 48406, 56 SEC 976, 2003 WL 22016309, at *7 (Aug. 25, 2003) (internal quotation marks and citation omitted), *petition denied*, 95 F. App'x 361 (D.C. Cir. 2004).

Here, the record does not provide substantial evidence to overcome the law judge's finding that the Halsey witnesses were credible. But their testimony, however credible, did not substantiate the accuracy of the Recreated Halsey Reports. Rather, the Halsey witnesses testified only generally as to the method that they would follow, and the type of information that was entered into Axys, in a typical pricing and reconciliation process at the time of the alleged misconduct. That method included the downloading of data from the custodians, manual entry of various pricing data, and one principal's manual pricing of certain bond assets, but the record includes no records showing this data. The witnesses did not provide any specific information about the method used or the data that was entered into Axys to produce the Recreated Halsey Reports adduced at the hearing. Thus, the law judge did not have a sufficient basis on which to conclude, based only on the Halsey witnesses' testimony, that the Recreated Halsey Reports either accurately reflected the Halsey Reports seen by Pelosi at the time of the alleged misconduct or accurately reflected the clients' account performance.[8] We find no basis in the record to support either conclusion.

The Division could have introduced expert testimony, or other authoritative evidence, to establish the performance of the accounts at issue. Calculation of performance of a client's individual portfolio necessarily depends on client-specific variables, such as the individual portfolio's cash flows, asset allocation, and client comparison preferences. The investment management industry has developed several different methodologies that may be used to calculate rates of return for existing clients based on their individual circumstances. While these different methodologies may yield different results, any of them, properly used, might yield results that would be considered acceptable or at least not materially false. Because of the variables affecting the calculation of an individual client's account performance, and the diverse methods deemed acceptable for factoring these variables into performance calculation, proper determination of the clients' portfolio performance is complex and would likely yield a number of potentially accurate calculations for any given client account. The Division's evidence neither established such calculations nor provided any other basis for determining the clients' actual performance results. For these reasons, we believe that the record lacks an evidentiary basis from which to determine that the returns reported by Pelosi to his clients were materially false or misleading.

Under the circumstances and based on our de novo review, we have determined to dismiss the proceeding against Pelosi because the Division failed to establish his liability by a preponderance of evidence. But we note that many aspects of this case, including practices at the firm as evidenced by the record, raise troubling questions. We emphasize that our decision is based solely on the application of the theory the Division charged and litigated to the facts

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[8] *Cf. Kevin Hall, CPA*, Exchange Act Rel. No. 61162, 2009 WL 4809215, at *9 (Dec. 14, 2009) (distinguishing between an ALJ's appropriate use of witness credibility to find, as fact, that auditors had reviewed certain documentation and the ALJ's inappropriate use of credibility to then conclude, as a matter of law, that such review was reasonable and consistent with GAAS).

developed in this record. Because there is insufficient evidence establishing that the representations at issue were materially false or misleading, we do not address the other elements of the alleged fraud.[9]

An appropriate order will issue.

By the Commission (Chair WHITE and Commissioners STEIN and PIWOWAR; Commissioners AGUILAR and GALLAGHER not participating).

Lynn M. Powalski
Deputy Secretary

[9] We deny as moot Pelosi's request to adduce additional evidence and did not consider such evidence in resolving this matter. *See, e.g., Theodore W. Urban*, Order Dismissing Proceedings, Exchange Act Rel. No. 66259, 2012 WL 1024025, at *1 n.5 (Jan. 29, 2012) (denying requests for oral argument and to adduce additional evidence as moot "'given the [Commission's] resolution of th[e] matter'" in such party's favor (quoting *D.E. Wine Invs., Inc.*, Exchange Act Rel. No. 43929, 54 SEC 1213, 2001 WL 98581, at *4 n.25 (Feb. 6, 2001))).

UNITED STATES OF AMERICA
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ORDER DISMISSING PROCEEDING

On the basis of the Commission's opinion issued this day, it is ORDERED that this proceeding is hereby dismissed.

By the Commission.

Lynn M. Powalski
Deputy Secretary