INITIAL DECISION RELEASE NO. 448
ADMINISTRATIVE PROCEEDING
FILE NO. 3-14194

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of	:	
	:	INITIAL DECISION
MICHAEL R. PELOSI	:	January 5, 2012
	:	

APPEARANCES: Richard M. Harper II and John J. Kaleba, Esqs., representing the Division of Enforcement, Securities and Exchange Commission

John R. Hewitt, Esq., McCarter & English LLP, representing Respondent Michael R. Pelosi

BEFORE: Cameron Elliot, Administrative Law Judge

SUMMARY

This Initial Decision finds that Respondent Michael R. Pelosi (Pelosi) violated Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (Advisers Act) by misrepresenting client performance results, bars Pelosi from associating with an investment adviser or investment company, imposes a civil penalty of $60,000, and orders Pelosi to cease and desist from further violations of the Advisers Act.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission) issued its Order Instituting Cease-and-Desist Proceedings (OIP) on January 14, 2011, pursuant to Sections 203(f) and 203(k) of the Advisers Act and Section 9(b) of the Investment Company Act of 1940 (Investment Company Act). Pelosi filed his Answer on February 24, 2011.

The parties filed their prehearing briefs by May 31, 2011. A hearing was held from June 20 through June 27, 2011, in Bridgeport, Connecticut. The admitted exhibits are listed in the Record Index issued by the Secretary of the Commission on October 14, 2011. The Division of

Enforcement (Division) and Pelosi thereafter filed post-hearing briefs and post-hearing reply briefs.[1]

B. Summary of Allegations

The instant proceeding concerns alleged misrepresentations of account performance returns by Pelosi, then a vice president and portfolio manager (PM) at Halsey Associates, Inc. (Halsey), a registered investment adviser located in New Haven, Connecticut. OIP 1. The OIP alleges that Pelosi violated Sections 206(1) and 206(2) of the Advisers Act from 2005 through August of 2008, by knowingly or recklessly misreporting account performance returns to his investment-advisory clients. OIP 1, 6. The Division seeks a cease-and-desist order, industry bar, and civil penalty.

Pelosi denies most of the key allegations. Answer 2. Pelosi also contends that any differences in reported performance returns were not material, considering the total mix of information available to the clients. Answer 3. Finally, Pelosi argues that any differences in performance results were justified. Resp. Br. 8; Tr. 621-22.

II. FINDINGS OF FACT

The findings and conclusions herein are based on the entire record. I applied preponderance of the evidence as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 102 (1981). I have considered and rejected all arguments, proposed findings, and conclusions that are inconsistent with this Initial Decision.

A. Background

Halsey is a registered investment adviser firm. OIP 1; Tr. 16, 467. James Zoldy (Zoldy) is Halsey's chairman and treasurer. Tr. 174. Kenneth Julian (Julian) is Halsey's president and chief compliance officer. Tr. 466-67. Halsey's clients are mostly individuals and families, but include institutions, mainly non-profit organizations. Tr. 469. Halsey currently has seven employees. Tr. 17. At the end of 2004, Halsey had four PMs – Zoldy, Julian, William Curran (Curran), and Grayson Murphy (Murphy). Tr. 19, 178, 619. The latter two were members of Halsey's first generation of PMs, while the former two were younger PMs. Tr. 177-78, 1030-31.

Toward the end of 2004, Halsey sought to hire a new PM, as Curran and Murphy were reaching retirement. Tr. 196, 470. Halsey had approximately $700 million under management, and its 2004 billings were over $2.5 million, 14.5% more than in 2003. Tr. 178, 195-96; Div. Ex. 8. Halsey sought a candidate with a proven track record, who could do research and help

[1] Citations to the transcript of the hearing are noted as "Tr. ___.". Citations to Pelosi's Answer are noted as "Answer ___.". Citations to exhibits offered by the Division and Pelosi are noted as "Div. Ex. ___." and "Resp. Ex. ___.", respectively. The Division's and Pelosi's post-hearing briefs are noted as "Div. Br. ___." and "Resp. Br. ___.", respectively. The Division's and Pelosi's post-hearing reply briefs are noted as "Div. Reply Br. ___." and "Resp. Reply Br. ___.", respectively.

manage the firm, but Halsey did not require the candidate to have an existing book of business. Tr. 196-97, 199.

Julian met Pelosi while they both worked at the Bank of Boston, in the 1990s.[2] In 2005, Julian invited Pelosi to interview and then offered him the PM position. Div. Ex. 7; Tr. 471-73, 618-19. Upon Pelosi's acceptance, he and Halsey signed a Memorandum of Understanding (MOU), providing Pelosi with an annual salary of $120,000, plus fees generated from his clients after becoming "self-sustaining," which was when the fees a PM generated covered his salary and proportionate share of the overhead. Div. Ex. 7; Tr. 201-202. Pelosi achieved this in 2007. Tr. 212. Pelosi brought in 15 of the 36 clients Halsey added in 2005. Tr. 206-07, 1038; Div. Ex. 9. Upon Curran's retirement at the end of 2006, Pelosi was assigned some of Curran's clients. Tr. 203. Overall, Pelosi brought in between 25 and 30 clients to Halsey, worth approximately $65 million at the time of his departure in 2008. Tr. 251.

During the hiring process, Pelosi and the PMs discussed hiring an additional PM, and other methods of improving Halsey, some of which were eventually implemented. Tr. 246-48. Pelosi and the PMs also discussed Halsey's collaborative approach and its monthly stock-selection meetings. Tr. 249. Pelosi suggested adding another portfolio assistant (PA), and the firm eventually hired Susan Frois (Frois). Tr. 91, 488.

B. <u>Pricing</u>

Halsey priced its investor portfolios at the end of every month. Tr. 103, 833. The PAs would create a "price file" in Axys, Halsey's record-keeping and reporting system,[3] and populated it with portfolio pricing information from Charles Schwab (Schwab), the custodian of most of Halsey's clients. Tr. 103-04, 144, 183-84. Schwab's price file was in a different format, which the PMs changed before it could be uploaded to Axys.[4] Tr. 184, 401-02. Next, the PAs obtained and entered price information for any remaining un-priced assets and reports of corporate actions (e.g., dividends, stock-splits) from Interactive Data Corp (IDC), an outside pricing service. Tr. 50-52, 104, 144, 184-85, 833. The PAs then manually entered – using brokerage statements – other pricing information not already in the system. Tr. 49-50, 839, 852-53.

Next, Zoldy manually priced certain bonds. Tr. 144-45, 184-86. Without a centralized bond exchange, bond prices were obtained either through pricing services, which set prices based on bond characteristics, or from brokers who provided prices at which bonds actually traded. Tr. 186. Zoldy received bond trading quotes from Robert Sharkey (Sharkey) at RBC Dain Rauscher,

[2] Pelosi graduated from the University of Connecticut with a major in finance and a minor in economics, and later earned an MBA in finance, also from the University of Connecticut. Tr. 1006-07. He also earned a chartered financial analyst (CFA) certificate. Tr. 1007.

[3] The Axys system is made by a company called Advent. Tr. 182-83.

[4] Schwab used different prefixes, which Halsey changed using "find and replace." Tr. 184, 401-02.

a broker-dealer who occasionally sold bonds to Halsey. Tr. 144-45, 184-87. At times, Zoldy changed the bond price in Axys to reflect this broker-supplied price. Tr. 144-45, 184-87. Zoldy had sole discretion over the bond pricing adjustments and no one reviewed the prices after him. Tr. 256-57, 559. However, if Julian asked to look at the bond prices, Zoldy would allow him. Tr. 560. Ultimately, all Halsey pricing came through Zoldy. Tr. 261-62. Halsey did not conduct an additional, formal review of pricing for compliance purposes. Tr. 559.

After the Axys pricing file was complete, the PAs reconciled it against the Schwab statements to check for any missing transactions, such as client withdrawals. Tr. 22, 104-05, 188. Changes to Axys were rarely made after the pricing and reconciliation process was completed. Tr. 191.

C. Client Letters

In 2005, Halsey PMs wrote and sent quarterly and annual client letters, reporting clients' portfolio performance. Tr. 19-20, 101-02, 475-76. Halsey staggered the letters, so that each month a PM sent letters to one third of his clients. Tr. 20-22.

The performance numbers in the letters were based on performance reports generated by Axys. Tr. 180-81. Axys generated four reports for each account: (1) Account Summary, which provided a basic summary of the account; (2) Portfolio Appraisal, which listed the account's securities positions; (3) Performance History by Asset Class, which calculated the account's time-weighted return (TWR); and (4) Discounted Cash Flow (DCF), which calculated the account's return, taking cash flows into account. Div Exs. 2, 5. Halsey's practice was to use the TWR report, not the DCF, for annual and quarterly returns numbers. Tr. 180-81, 189-90, 483. DCF reports only helped the PMs determine cash flows in and out of client accounts. Tr. 30-31, 482.

After pricing and reconciling the portfolio, the PAs generated the above three (or four[5]) reports and gave them to the PMs to use in the client letters. Tr. 24, 29, 105, 114; Div. Ex. 2. Using these reports, the PMs included quarterly returns, recent (three-month) activity, and annual performance information in the client letters. Tr. 141, 179-82. After the PMs drafted the letters, the PAs printed them, had the PMs sign them, and sent the letters to clients together with the first two reports. Tr. 30, 114-16. There was no additional supervisory review of the letters. Tr. 52-54, 134, 326.

In March 2008, Halsey updated its system (to Data Exchange), allowing it to electronically link to custodians and automatically update asset prices daily. Tr. 32-33, 46, 117-18, 190-91, 479-80, 848-49. The PAs no longer had to manually reconcile prices and, because they had more time, began drafting the client letters. Tr. 32-33, 118, 479-80. Both Rynne and Kathleen Rourke (Rourke), Halsey PAs, included TWR quarterly and annual performance

[5] Mary Rynne (Rynne), one of the PAs, testified that she generated the first three reports for all PMs and, at one point, the DCF for Zoldy only. She could not recall if she generated the DCF for Pelosi as well. Tr. 115-16, 139-40.

numbers in all the client letters. Tr. 35-36, 119, 121. The PMs then edited the writing, reviewed numbers, and returned the letters to the PAs to mail. Tr. 122, 480.

D. Pelosi's Client Letters

Halsey did not formally train Pelosi to write client letters. Tr. 322. He was given old client letters to use as templates and current Axys reports. Tr. 207. Those reports included the Summary, Appraisal, TWR, and, for a period of time, the DCF report. Tr. 208. Zoldy explained the reports to Pelosi and supervised Pelosi in drafting his first few letters. Tr. 207, 1046. Julian told Pelosi to use the performance numbers in the TWR report, and that the DCF reports were used only as a check and for additional detail. Tr. 208-09, 484. Pelosi testified that Julian did not tell him this. Tr. 636.

E. Discrepancies

After Rourke and Rynne started preparing the client letters in 2008, they noticed that the letters Pelosi returned to them for mailing had different performance numbers than those in the corresponding Axys reports. Tr. 38, 125. The client letters from the other PMs did not contain such discrepancies. Tr. 39, 125-26. The PAs questioned Pelosi about this, and he responded that he was calculating performance differently. Tr. 39, 124-26. He did not tell them to keep the discrepancies quiet. Tr. 60, 135. Because he was a partner, the PAs chose not to press the issue with Pelosi. Tr. 38, 135, 171-72. The PAs did not report the discrepancies to the other PMs because they feared termination and wanted to gather more evidence. Tr. 575.

Over time, the discrepancies continued. Finally, in August 2008, the PAs told Zoldy and showed him evidence. Tr. 40-41, 126-28, 218-19, 353. On August 7, 2008, Zoldy told Julian. Tr. 491. Soon after, they both reviewed between twenty to forty of Pelosi's letters and compared them to the corresponding Axys reports. Tr. 220, 359, 581. They discovered substantial discrepancies, and a pattern of mostly over-reporting positive returns and under-reporting losses. Tr. 221, 492.

F. Confrontation

On August 14, 2008, Julian and Zoldy confronted Pelosi about the discrepancies. Tr. 222, 493. Zoldy showed Pelosi his client letters and corresponding reports and asked why the performance numbers were different. Tr. 493, 708. Pelosi said it must be either a system or PA error; he did not have a reason for the discrepancies, and asked to see more evidence. Tr. 222, 494. The meeting ended with everyone indicating they would conduct a more exhaustive review of the letters. Tr. 223, 495, 1232-33.

Pelosi testified that he often manually calculated returns for legitimate purposes.[6] Tr. 703. During his investigative testimony, Pelosi stated that he did not mention his justified manual adjustments at the meeting. Tr. 704-06; Div. Ex. 38 at 163-65. During the hearing, he testified inconsistently; first he denied lying about his manual adjustments, and later he admitted

[6] Pelosi's specific justifications for the adjustments are described below.

to lying about them, and to being sorry for lying. Tr. 704, 1221. I find that Pelosi was not completely forthcoming and that he did not mention the specific justifications for his adjustments. Tr. 707, 709, 712. Pelosi assumed Julian and Zoldy did not want to discuss his problems with Axys in detail, especially after Julian said "we're not going to throw our system under the bus for this." Tr. 1099-1101, 1232-33.[7] Pelosi thought that without supporting data, raising his justifications would only harm his cause. Tr. 1107.

The next morning, Julian thought that Pelosi might be to blame for missing client letters, so he asked Pelosi to leave the office. Tr. 496-500, 728. Before Pelosi left, Julian asked him if he spoke to his wife, and Pelosi said he "couldn't bring himself to do it." Tr. 501, 729. Julian told him there was no way to go further unless Pelosi was completely truthful. Tr. 501. Pelosi understood this to mean that if he capitulated, they would give him time to explain the discrepancies. Tr. 1109. Minutes later, Pelosi called Julian outside and said, "I did it," that he did not realize it was that widespread, and when confronted with the letters the day before, he "freaked out."[8] Tr. 501-02. Julian encouraged Pelosi to justify the inflated returns, but Pelosi did not. Tr. 503, 731-32. Pelosi was remorseful and sorry and promised it would never happen again. Tr. 505.

Later that day, Pelosi e-mailed Julian stating that "beyond being embarrassed and ashamed over the matter at hand, I'm deeply ashamed I didn't just tell you yesterday in the conference room." Tr. 507; Div. Ex. 34. Pelosi testified that "I didn't just tell you yesterday in the conference room" meant that at the meeting, he said he made adjustments in only a few cases, while, in fact, it was more than that. Tr. 708. Pelosi also testified that "the matter at hand" does not refer to the performance values discrepancies, although he did not explain what it does refer to. Tr. 742-43; Div. Ex. 34. Finally, Pelosi testified that the purpose of the e-mail was to apologize for lying in the meeting and not acknowledging his manual changes.[9] Tr. 1221-23.

On Monday, August 18, Pelosi handed Julian a typed note stating, "[a] night of no sleep and actually feeling the whole [sic] in my stomach getting bigger made me waffle again, until later in the morning . . . . I'm embarrassed and ashamed by the performance issue, but I cringe at my behavior after the meeting." Tr. 509-10; Ex. 35. Pelosi testified that he remains "ashamed by the performance issue."[10] Tr. 745. He testified that his purpose in writing the note was

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[7] Pelosi first mentioned this statement by Julian at the hearing; he did not mention this statement in his investigative testimony. Tr. 1219.

[8] Pelosi testified that he said, "I did make changes." Tr. 730-31. Pelosi also testified that he said this to Julian because he had not said this at the Thursday meeting. Tr. 731. This contradicts his earlier testimony that during that meeting he told Zoldy and Julian that he made a few manual adjustments. Tr. 706.

[9] This, too, is inconsistent with Pelosi's testimony that he did acknowledge a few manual adjustments at the meeting. See Tr. 706.

[10] This is inconsistent with Pelosi's testimony regarding "the matter at hand," that he was not embarrassed over the performance issue.

twofold: to ensure a more thorough review and to gain time to seek alternative employment. Tr. 1224-26. He also admits that both the note and the e-mail do not refer to his "legitimate" reasons for his numbers. Tr. 744, 747. Despite his admission that the purpose of the e-mail was to apologize for lying in the meeting and not acknowledging his manual changes, Pelosi testified that in the note he was merely trying to apologize for being defensive during Thursday's meeting. Tr. 1110, 1112. This is not plausible; I find that Pelosi's testimony on this point is not credible, and that his note was intended at least as an apology for changing his performance results.

During this period, Zoldy and Julian conducted a review of Pelosi's client letters, which consisted of comparing all Pelosi's client letters to the corresponding Axys reports. Tr. 367. Although they did not tabulate the results, they found a clear trend of inflation. Id. Because they did not want to ruin Pelosi's career, they decided not to report him to the regulators. Tr. 228-29.

Julian and Zoldy never met with Pelosi to discuss the results of their review of Pelosi's letters. Zoldy and Julian testified that during this period, from the confrontation on August 14, 2008, until his termination on August 27, 2008, Pelosi never requested a formal meeting. Tr. 366. Rather, he apologized to them, but never mentioned specific justifications for his different performance numbers. Tr. 226-27 (Zoldy), 511 (Julian). Pelosi, however, alleges he asked for a meeting more than six times, but Julian and Zoldy were either not in the office together or said they had not completed their review. Tr. 1109, 1128-29. In view of his many inconsistent statements about these events, I do not credit this testimony.

Despite his alleged justifications, Pelosi admits that he knew it was wrong to use performance numbers not in Axys. Tr. 643. He knew, based on prior experience, not to manually adjust the computer-generated results. Tr. 760. Pelosi concedes that he did not manually adjust computer-generated performance numbers at Bank of America, nor does he at his current job at YHB Advisors. Tr. 613. He acknowledges that Halsey expected him to report computer-generated returns in his letters. Tr. 616. He testified that he generally faithfully reported results based on Axys, though sometimes his results differed from the TWR and DCF reports. Tr. 617. As explained in detail below, this testimony is inaccurate and not credible.

G. Termination Meeting and Departure

On August 26, 2008, Zoldy and Julian notified Pelosi of their decision to fire him. Tr. 1130. Pelosi offered to explain the performance discrepancies to his clients, but Zoldy and Julian ended the meeting. Tr. 1130-31.

On the following day, August 27, Zoldy and Julian gave Pelosi a MOU detailing the terms of his termination. Tr. 589; Div. Ex. 12. They told him they would not report him to the regulators if he signed it. Tr. 589. Pelosi asked for more time, but Zoldy and Julian refused. Tr. 378. Nor did they give Pelosi an opportunity to consult with counsel. Tr. 590, 1133. Julian insisted Pelosi sign the MOU on that day or they would call the authorities. Tr. 1132-33.

Pelosi thought Julian and Zoldy were bluffing about not reporting him to the regulators, and that if there were really something to report, they would. Tr. 735-36. Pelosi knew that using

a return value not from an automatically generated report "is an exception" to the general practice, but he did not think it was a "reportable event." Tr. 737-38. Yet, he did not refuse to sign the MOU, because he was looking to buy time in the weak economy. Tr. 738.

H. Reporting Pelosi's Departure

After Pelosi's departure, Halsey wrote to its clients, notifying them of Pelosi's departure and that some performance results were inaccurate, and provided them with new, accurate results. Tr. 232-33; Div. Ex.13.

On or about 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 the false declaration that Pelosi had not resigned from Halsey after allegations were made that accused him of violating investment-related laws or industry standards of conduct. Tr. 517-18; Div. Ex. 15.

In March or April of 2009, a Halsey client's consultant questioned Halsey's decision not to report Pelosi's conduct to the regulators. Tr. 229-31. Zoldy and Julian, therefore, decided to correct the Form U5 to reflect the truth of Pelosi's termination. Tr. 229-31, 519-20. On or about June 12, 2009, Julian submitted a second Form U5, reporting the termination of Pelosi and that Pelosi had resigned after allegations were made accusing him of violating investment-related statutes, regulations, rules, or industry standards of conduct. Tr. 519-20; Div. Ex. 16.

I. Commission Exam

Starting in October 2009, the Commission staff (Staff) conducted a review of Halsey. Resp. Ex. 18. The review pertained to a time when Pelosi was employed at Halsey. Tr. 563. The Staff stated its findings in an August 18, 2010, letter to Halsey. Id. The Staff found that Halsey's client disclosures contained inconsistencies. Tr. 312-13; Resp. Ex. 18. The Staff also found that Halsey lacked standard operating procedures in reconciliation and portfolio management. Tr. 316, 563-64; Resp. Ex. 18. The letter also suggested that Halsey adopt written policies regarding reconciliation and documenting client reviews. Tr. 317. Zoldy testified that such policies were in place, only not written. Id.

The Staff also noted that Halsey disclosed that it calculated performance consistent with the Association for Investment and Research, but these standards are now called Global Investment Performance Standards (GIPS). Resp. Ex. 18; Tr. 314. Overall, the Staff did not find that, outside of Pelosi's misconduct, Halsey misreported performance information. Tr. 312; Resp. Ex. 18.

J. Halsey Compliance

Julian was Halsey's compliance officer since 2003. Tr. 244, 469, 523. He admits that, in hindsight, Halsey's compliance practices from 2003 through 2009 were inadequate. Tr. 525-26. Adviser's Act Rule 206(4)-7 requires annual review of policies, procedures, and operations – which Halsey did not conduct. Tr. 315-16, 525-26. Halsey's compliance manual did not have a

section addressing performance calculation. Tr. 244-246; Resp. Ex. 2. As of June 2009, Halsey's compliance manual did not have a provision relating to reconciliation of pricing because it was not an operations manual. Tr. 307-08; Resp. Ex 3. However, while Halsey's written compliance manual did not have anything on reconciliations nor much on pricing, Julian testified Halsey still had formal operations practices. Tr. 527-28.

K. Office Relationship

Pelosi testified that his relationship with Julian and Zoldy deteriorated over time. Tr. 721. Specifically, Pelosi's persistent requests to update Halsey's systems and operations irritated Julian and Zoldy. Resp. Br. 37-38: Tr. 721. Their relationship reached a turning point in 2008, when Halsey hired a marketing person to attract new clients to fill Pelosi's excess capacity. Tr. 216-18, 489-90, 722, 892-93, 1083, 1088. Pelosi disapproved, and did not feel like he had any excess capacity to fill. Tr. 726-27. At this point, according to Pelosi, the other PMs excluded him from conversations, and the weekly meetings declined in frequency. Tr. 892-93.

Pelosi alleges that Zoldy and Julian wanted to poach Pelosi's clients and this motivated their accusations, the manner in which they handled the investigation, and his eventual firing. Resp. Br. 37-38. He claims this also explains his panic after the confrontation, because he realized this was the vehicle for them to end the partnership. Tr. 721.

According to the other Halsey employees,[11] however, Pelosi had a cordial and professional relationship with everyone. Tr. 212 (Zoldy), 534, 572-3 (Julian), 47 (Rourke), 129-30 (Rynne). Zoldy testified that Halsey's purpose was not to take Pelosi's $65 million of client assets. Tr. 382-83. Pelosi admits that Zoldy and Julian were making over one million dollars annually, and Zoldy said he was sated. Tr. 723. Finally, Pelosi took many of his clients with him to YHB Advisors, including some of his Bank of America clients. Tr. 605, 1113; Resp. Br. 33. Therefore, I find that Julian and Zoldy credibly testified that they did not falsely accuse Pelosi in order to poach his clients. Moreover, since it is undisputed that Pelosi acted alone, Julian's and Zoldy's motives are irrelevant.

L. The Discrepancies

At the hearing, the Division compared Pelosi's client letters with the applicable Axys TWR and DCF reports to demonstrate Pelosi's pattern of inflating returns. Tr. 417-461; Div. Exs. 26-33. Matthew Jacques (Jacques), a forensic accountant with the Commission, reviewed

[11] Besides Frois, who testified otherwise. See Tr. 892-93. To the extent Frois' testimony is inconsistent with these Findings of Fact, I do not credit it, based on her unusual demeanor and her evident bias. She laughed inappropriately, she occasionally used a tone of voice suggesting that she did not take the proceedings seriously, she made unusual facial expressions, most often under cross-examination, and she sometimes looked at me questioningly after answering, as if she wanted to know whether I approved of her answer. She was clearly biased toward Pelosi; he helped her secure employment first at Halsey and then at YHB Advisors, and she provided substantial unpaid assistance to Pelosi in preparing for the hearing. See Tr. 920, 981-82, 991.

243 of Pelosi's client letters and reported the results in spreadsheets and charts.[12] Tr. 418-24; Div. Exs. 17-24, 26-33. Specifically, he compared the performance returns in Pelosi's letters to those in Halsey's reports, noting any discrepancies. Tr. 421-24. He calculated and summarized the variances for each of the client letters and the corresponding TWR reports. Tr. 421-28, 435; Div. Exs. 26-33.

A substantial majority of the discrepancies are performance overstatements. Div. Ex. 27. Compared to the TWR reports, Pelosi inflated annual results in 84% of his letters and inflated quarterly results in 82% of his letters. Tr. 436; Div. Exs. 27, 28. Even assuming Pelosi rounded his numbers below 10 basis points, his results were still inflated in 70% of his annual letters and in 67% of his quarterly letters. Tr. 437-38; Div. Ex. 27. The remaining letters either accurately reported or underreported performance results. Div. Exs. 27, 28. Additionally, Pelosi's overstatements were greater than 100 basis points 50 times (16.8% of the time) for the annual reports and 40 times (15.3%) for the quarterly reports; the inflation was 50 to 99 basis points 67 times (22.6%) for the annual reports and 39 times (14.9%) for the quarterly reports. Tr. 440-42; Div. Ex. 29.

Jacques conducted the same analysis comparing Pelosi's letters to Halsey's DCF reports, with similar results. Tr. 446-660; Div. Exs. 30-33. Specifically, 74% of Pelosi's annual results were greater than those in the applicable DCF reports, as were 82% of his quarterly results. Div. Ex. 31. The number of letters with overstatements in the 50-99 and 100+ basis point ranges were similarly significant. Div. Ex. 33.

In addition to the summary evidence, the Division introduced numerous individual Pelosi letters that overstated total account performance,[13] that overstated combined asset class performance,[14] and that overstated individual asset class performance.[15] Div. Br. 15-20. While Pelosi explained (albeit unsatisfactorily) several of these discrepancies, as discussed below, he did not even attempt to explain them all. See Resp. Reply Br. 8-13; Tr. 796.

Pelosi also gathered and summarized the performance values in his letters, those in both the TWR and DCF reports, and the discrepancies between them. Tr. 1134; Resp. Exs. 4, 5, 6. He did not, however, explain most of the specific discrepancies. Pelosi concedes as much, but claims he did not have sufficient time to find an explanation for each discrepancy. Tr. 797. Instead, Pelosi provided several general justifications for his different numbers, which are summarize and addressed below.

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[12] The letters were provided to Jacques by the Division attorney, who received them from Pelosi's counsel. Tr. 462.

[13] Div. Exs. 17 (Tab 9), 18 (Tabs 47, 49), 19 (Tab 69), 21 (Tab 146), 22 (Tab 183), 23 (Tab 194, 195).

[14] Div. Exs. 17 (Tab 9), 18 (Tab 49), 19 (Tab 62, 63), 20 (100).

[15] Div. Exs. 21 (Tab 166), 23 (Tab 194, 195, 206, 207).

M. Expert Testimony

Pelosi called David Audley (Audley), an expert in asset management and financial technology, to testify.[16] Tr. 1259; Resp. Exs. 28, 29. In his expert report, Audley opined that Axys was incapable of: (1) handling corporate actions; (2) handling preferred stock; and (3) reconstructing past account performance, due to its "cancel and correct" feature. Resp. Ex. 29 at 2-4. Halsey PAs testified that they manually entered the corporate actions. Tr. 50-52, 104, 144, 184-85, 833, 1342-45. Audley also clarified that his report was regarding Advent's systems in general, but he possessed no specific knowledge about Halsey's Axys system. Tr. 1348.

Audley's report also stated that the "SEC's letter underscores Halsey's serious procedural and recordkeeping problems." Resp. Ex. 29 at 4. However, on cross-examination, Audley admitted that the Commission Staff did not actually find any recordkeeping deficiencies.[17] Tr. 1353-54.

Finally, the report stated that only returns from the DCF report or calculated through a Dietz calculation comply with the CFA Institute[18] standards (also known as GIPS). Resp. Ex. 29 at 4-5. However, on cross, Audley admitted that he is not a CFA or member of the CFA Institute. Tr. 1354-55. He also conceded that adoption of GIPS standards is not required for all investment advisers. Tr. 1356. Most importantly, Audley testified that at the time he wrote his report, he thought Halsey used TWR without making capital flow adjustments. Tr. 1360-61. However, after reviewing the Axys help instructions, he realized that this assumption was incorrect. Tr. 1362. Accordingly, he conceded that, in using TWR reports, Halsey was indeed GIPS compliant. Tr. 1363. Finally, as discussed below, it is irrelevant which of the calculation methods – DCF, TWR, or Dietz – is most accurate, because Pelosi's returns do not match any of them.

N. Client Testimony

Several of Pelosi's clients testified. Some of the clients would have wanted to know that Pelosi calculated performance returns differently than everyone else at Halsey. Tr. 279-80 (Belowsky), 298-99 (Davenport), 552 (Burrows). Most would have accept Pelosi's method of calculating returns, if it were correct. Tr. 286 (Belowsky), 558 (Burrows), 1429-30 (Bosco), 1443 (Florian), 1456-57 (Platano). Two clients testified that performance differences of even less than 1% matter to them. Tr. 296 (Davenport), 550 (Burrows). Nearly all testified that unsubstantiated performance results are a misrepresentation of value or that it is not acceptable

[16] Audley holds a Ph.D. from Johns Hopkins University (1972). He is currently the Executive Director of graduate programs in Financial Engineering/Mathematics at Johns Hopkins University. Resp. Ex. 28, 29. He served in the U.S. Air Force for sixteen years. He was also a "portfolio manager, proprietary trader, and Chief Investment Officer." Resp. Ex. 29.

[17] However, the Commission Staff did find that Halsey lacked standard operating procedures regarding reconciliation and portfolio management. See Resp. Ex. 18 at 6.

[18] Previously, the AIMR (Association for Investment Management and Research).

for an investment adviser to lie about performance results.[19] Tr. 286 (Belowsky), 299 (Davenport), 558 (Burrows), 1429-30 (Bosco), 1448 (Florian), 1483 (Lenkowski).

III. DISCUSSION AND ANALYSIS

A. Missing Letters

Pelosi alleges that, during his time at Halsey, he sent approximately 500 client letters, but the Division only used approximately 240 letters to conduct its analysis and, thus, the Division's conclusions are inaccurate. Resp. Br. 21-22; Resp. Reply Br. 7-8. Specifically, Pelosi argues, the Division's assertion that a certain percentage of Pelosi's client letters contained inflated returns is inaccurate, given the overall number of letters the Division used. Id., Tr. 463.

Neither party introduced documentary evidence of the missing letters. Tr. 1139-41, 1151-53. Additionally, Pelosi would not send letters if he physically met with clients. Tr. 116, 407, 571. Thus, while Pelosi may have been at the firm for a sufficient duration in which to send 500 client letters, the number of letters he actually sent was smaller, given his many client meetings. Tr. 571. Additionally, the Division did not include in its analysis Pelosi's unsigned letters. Tr. 1152.

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[19] The only exception was Louis Scianna. Mr. Scianna testified on cross-examination, in pertinent part, as follows:

> Q And you would expect that Mr. Pelosi, as your investment advisor, would be honest with you about how [your investments] are performing. Right?
> A. Correct.
>
> . . .
>
> Q. If the court determines that Mr. Pelosi committed fraud by lying to his clients about the performance of their investments, will you continue to trust him with your entire retirement fund?
> A. Are you Mr. Harper?
> Q. Yes.
> A. Well, when you called me on the phone and asked me that question, I said to you I would think about it. And subsequent to that, I have thought about it. I had the discussion with my wife, also. And my answer is yes, I would continue with him.

Tr. 1408, 1411. Mr. Scianna, a demonstrably successful businessman, testified that he expected Pelosi to be honest about how his entire retirement fund is performing, and only a few minutes later testified, after considerable deliberation, that he would continue to trust his entire retirement fund to Pelosi even after Pelosi was determined to be a fraudfeasor. I do not credit such patently inconsistent and insincere testimony.

Finally, in its analysis, the Division relied upon Pelosi's client letters and Halsey's TWR and DCF reports. Tr. 237-238. Div. Ex. 25. Comparing the two clearly demonstrates numerous discrepancies. Even if other letters existed, and the returns in those letters are all perfectly accurate, that only affects the ratio or percentage of inflated-to-accurate letters. It does not, however, refute the existence of numerous overstatements (and understatements) in the letters on record. Therefore, I find Pelosi's allegation that the Division's conclusions are inaccurate to be unsubstantiated, and even if correct, only marginally relevant.

B. Pelosi Justifications

Pelosi alleges that he was justified in using different performance numbers than those reported in the Axys reports. Tr. 621-22. Pelosi perceived Halsey as possessing subpar valuation procedures and antiquated systems, and engaging in inaccurate manual pricing. Resp. Br. 8. Therefore, he reviewed the Axys performance numbers, finding what he perceived as certain inaccuracies in the reports' performance numbers, which he manually corrected. Id. For example, while writing his first few client letters, Pelosi testified that he found illogically large performance numbers; Pelosi went to Zoldy who said "I can't explain it. It is what it is. This is the system." Tr. 1205-06. While Zoldy never told him to manually calculate performance, Pelosi realized he needed to take more ownership of performance results. Tr. 1208.

Pelosi justifies his adjustments to the performance values as: (1) correcting data inaccuracies in Axys; (2) based on the DCF reports; (3) accounting for Axys' inability to accurately capture cash flows; (4) used when reporting for atypical reporting periods; (5) calculating for preferred stocks going ex-dividend; (6) the result of aggregating returns for similar asset classes; (7) correcting for broker-supplied bond prices, and (8) the result of erroneous use of letter templates. Tr. 645-49, 652-54; Resp. Reply Br. 8-14. According to Pelosi, where the performance numbers in his client letters differ from those in the Axys reports, his numbers are, in fact, typically more accurate. Id.; Resp. Br. 14.

1. Data Inaccuracies

As a general matter, Pelosi contends that Axys contained inaccurate and incomplete data, largely because of the manual steps in Halsey's pricing process. Div. Ex. 45 at 4. Because of the inaccurate underlying data, the TWR and DCF reports were incomplete or inaccurate. Resp. Br. 15. This caused him to manually calculate his clients' returns.

a. Pricing & Reconciliation

Both Rourke and Rynne, who performed Halsey's pricing, testified that Halsey's pricing was mostly automated and accurate. Tr. 26, 109-11. Also, Pelosi never complained to anyone at Halsey about the accuracy of the Axys data or its reports. Tr. 47-48, 111-113, 130, 143-44. Halsey's reconciliation of prices was generally accurate and consistent with the custodial

statements.[20] Tr. 107, 938. PMs typically found errors infrequently, and PAs then regenerated new reports based on corrected numbers. Tr. 108-09. Pelosi also admits that if he saw a questionable number in a report, he did the same. Tr. 638-640. Pelosi understood this to be Halsey's procedure. Tr. 643.

b. Question Marks

Certain performance reports contained question marks in place of values, which Pelosi views as proof of the reports' inaccuracy. Halsey's employees, however, provided several reasons for the question marks. First, because Halsey priced its assets at the end of the month, reports generated before the end of the month contained question marks. Tr. 62, 149-50, 334. Second, accounts with a negative balance received question marks. Tr. 66, 151, 333, 336. Third, Bank of America was the prior custodian of many of Pelosi's clients' accounts, and that bank was slow in transferring the securities to Schwab, the new custodian. Tr. 68. Question marks reflect the time before a previous custodian transferred the securities to the current custodian.[21] Tr. 68-69, 153-54. Finally, if a report was generated for the wrong cycle, for example, for a two-month period, or if a PM was meeting a client, there would be question marks. Tr. 152, 157. As a general rule, if a report generated at the end of a month had a question mark, it would be investigated. Tr. 149. PAs generally came across question marks first and notified the PMs. Tr. 336-37.

c. "N/A" and "0" Entries

Pelosi points to instances of conflicting numbers and "N/A" and "0" entries, all of which Halsey employees explained. Pelosi introduced two versions of Axys reports with conflicting performance numbers, and he introduced reports that conflicted with Schwab's numbers. Tr. 77-86; Resp. Ex. 27. As to the first, Rourke (without having the portfolio appraisal report) explained that the initial source of the numbers was probably incorrect and was later corrected. Tr. 77-79. Rourke did not have sufficient documentation to definitively reconcile Axys and Schwab, but suggested that the discrepancy had to do with the late transfer of securities from Bank of America to Schwab. Tr. 83-87.

Zoldy explained "N/A" entries as indicating a return that is out of the bounds of reason. Tr. 337-38; Resp. Exs. 26 & 27. Additionally, if they could not determine the reason for a question mark in the "short-term investments" column, they would enter a zero. Tr. 339.

[20] Even Frois recalled only two instances where, even after reconciliation, the statements were not consistent. Tr. 938-41. She also testified that any pricing difference was primarily with bonds, which had particular pricing issues, and only rarely with equities. Tr. 933-34.

[21] Even if the new custodian did not receive the securities until later, Pelosi tried to get the portfolio data from the previous custodian to show continuity of performance. Tr. 155, 164, 166.

d. Replaces Old Data

Pelosi testified that Axys is not a record-keeping system that stores old data. If one updates data in Axys, the new data replaces the old. Tr. 59-60; Resp. Br. 22. Different data would result in different performance reports (for the same period). Tr. 1156-67. The possibility that this occurred, Pelosi alleges, prevents the Division from properly assessing Halsey's data and returns. Resp. Br. 22-23. This also prevents ascertaining the exact report Pelosi was given. Tr. 1159.

I do not find Pelosi's allegation persuasive. First, Pelosi provided no evidence of such data updates and changes occurring. Second, Zoldy, Julian, Rourke, and Rynne all personally observed the performance discrepancies in real time. Rourke and Rynne reviewed Pelosi's client letters and the applicable Advent reports as they were sent out. Zoldy and Julian conducted a substantial review of the same in August of 2008. Additionally, Axys reports that have not been subject to post-reconciliation changes "would be perfectly okay to use for an examination of historical performance." Tr. 1349.

e. Summary

I find that Halsey's pricing and reconciliation were, for the most part, accurate. Halsey employees, all of whom were credible witnesses, testified to that accuracy. Tr. 26 (Rourke), 107 (Rynne), 191 (Zoldy), 598-99 (Julian), 938 (Frois); see also 1345-46 (Audley). Halsey employees satisfactorily explained the handful of irregularities Pelosi introduced. These few instances did not represent a systemic issue; rather, they were isolated results of particular and infrequent circumstances. The Staff's 2009 finding that Halsey lacked written reconciliation procedures does not imply a general lack of procedure, which Halsey employees testified Halsey possessed. Tr. 101, 527-28. Nor did the Staff find that Halsey's reports generated incorrect performance returns. Resp. Ex 18 at 6; Tr. 1353-54. Therefore, I find that Halsey's price information and performance results contained in the reports was generally accurate.

2. DCF Reports

Pelosi testified that, instead of TWR reports, he often used DCF quarterly reports for his quarterly client letters. Tr. 1218; Resp. Br. 13. He thought everyone at Halsey did the same. Tr. 629, 1081-83. When starting at Halsey, Pelosi asked Rynne to give him the same reports she gave Zoldy; she gave Pelosi the DCF report, which she referred to as the "quarterly report." Tr. 631-32, 1083. In discussing client letters with Pelosi, Zoldy and Julian mentioned the TWR report, but not that its use was mandatory. Resp. Br. 7. Halsey also did not have written procedures for client letters. Id. Finally, Pelosi did not fully understand the TWR reports. Tr. 634. Thus, Pelosi alleges he used the DCF report because: (1) he was told that is what Halsey used; (2) he was more familiar with it; and (3) he believed it was more transparent. Tr. 636.

Pelosi also testified that, sometimes, he used the DCF reports for reporting annual performance as well.[22] Tr. 1217. He did not think that TWR was the only report Halsey expected him to use for reporting annual performance.[23] Tr. 622-24. Although the PAs would not provide him with an annual DCF report, Pelosi retrieved it himself, in order to get cash flow information, and he "may have" sometimes used its performance returns in his annual client letters. Tr. 1217. For example, Pelosi testified that his August 18, 2006, letter to Mr. Lenten reported a 6.2% annual return based on the DCF annual report, instead of a 4.17% return reported in the TWR. Tr. 784-86; Div. Ex. 19 (Tab 54).

However, Halsey PAs and PMs all testified that Halsey's policy was not to use DCF returns in either the quarterly or annual reports. Tr. 35-36 (Rourke), 115-16 (Rynne), 209 (Zoldy), 484 (Julian), 953 (Frois). Rynne would generally not give DCF reports to the PMs, though at some point she did run DCF reports for Zoldy, and may have for Pelosi as well. Tr. 115, 139-40, 161. Zoldy testified that, for a time, the DCF was provided to show the PMs additional detail, such as recent transactions in the asset classes and capital flows. Tr. 208-09. Nonetheless, Halsey's policy was to use the portfolio returns from the TWR reports in the client letters. Tr. 209.

Everyone at Halsey, including Pelosi, knew the policy was to use return values from the TWR reports. Tr. 209-10. Pelosi never had any questions about which report to use, nor was he told to use different reports for different periods (quarter versus annual). Tr. 210. Julian told Pelosi to use TWR for performance and that DCF was only a check. Tr. 484. Pelosi never expressed concern with TWR or mentioned using DCF. Tr. 485-86. After the Axys update, when the PAs drafted client letters, Rourke, Rynne, and Frois included TWR quarterly and annual returns for Zoldy's, Julian's, and Pelosi's letters. Tr. 35-36, 119, 121, 953. Pelosi never mentioned to Rourke or Rynne that they were using the wrong report. Tr. 37-38, 123.

Most importantly, as the Division points out and Pelosi concedes, the performance values Pelosi included in his client letters do not match the values contained in the DCF reports. Div. Br. 23-24; Tr. 797. The performance numbers in Pelosi's letters are generally as inconsistent with the DCF reports as they are with the TWR reports, as noted above. Tr. 444-54, 456-61; Div. Exs. 30, 31, 33; Div. Br. 23-24. Pelosi himself introduced several spreadsheets comparing the returns he included in his client letters to the returns in the DCF (and TWR) reports. Resp. Exs. 4, 5, 6. These spreadsheets demonstrate the consistent discrepancies between the returns in Pelosi's client letters and those of both reports. Resp. Exs. 4, 5, 6.

To summarize: everyone at Halsey testified that they did not use the performance values from the DCF reports; Pelosi was told to use the TWR reports; Pelosi never expressed any

[22] Pelosi gave inconsistent testimony about using the DCF reports for his annual letters, both at the hearing, where he testified that he "often" referred to them in preparing annual letters, and during the investigation, when he testified that he used only TWR reports. See Tr. 623, 628-29, 1217-18; Resp. Ex. 19.

[23] Yet, Pelosi testified that Halsey internally referred to DCF as quarterly reports. Tr. 623.

concern with the TWR reports; Pelosi made confusing, even contradictory, statements regarding his use of the DCF reports; and, most importantly, the returns in his client letters do not match those in the DCF reports. Therefore, I find that Pelosi did not include portfolio returns from the DCF reports in his client letters.

3. Cash Flows & Dietz

Pelosi alleges that he made many of his manual performance adjustments in order to account for client deposits and withdrawals, or cash flows. Resp. Br. 11, 13; Tr. 623, 645, 664-9. Pelosi alleges that only the DCF report took cash flows into account, while the TWR reports did not. Resp. Br. 11, 13; Tr. 623, 645, 1047. Therefore, Pelosi testified, if he encountered an account with cash flows of over 10%, he manually calculated the portfolio's return using a Modified Dietz (Dietz) calculation, which is another method for calculating a portfolio's time-weighted return that takes cash flows into account. Tr. 664, 1068; Resp. Br. 12. He then used the Dietz return in his client letter instead of the computer-generated TWR return. Tr. 664, 1068.

Pelosi testified that he also calculated a Dietz result if any of the reports contained an atypical value.[24] Tr. 1214-15. Pelosi used Dietz frequently in 2005, and about ten times annually thereafter. Tr. 666-69. He generally used Dietz for quarterly returns; but, if there was an inconsistency with the annual returns, he calculated a Dietz return – only as a check – for annual returns too. Tr. 699. To conduct the calculation, he generally used market values from the DCF report, and sometimes from Schwab.[25] Tr. 1211-13. Pelosi admits he never conducted a Dietz calculation either before or after working at Halsey. Tr. 701. Pelosi does not know if one can run a performance report on Axys which would take cash flows into account. Tr. 701.

The problems with Pelosi's contentions are numerous. First, Pelosi's allegation that the TWR reports did not take capital flows into account is contradicted by Audley, his own expert witness. Tr. 1361-62. Audley admitted that, while it is true that the TWR minimized the effect of capital flows in calculating returns, TWR took capital flows into account. Id.; see Div. Ex. 11.

Second, Pelosi testified that he always used the DCF quarterly reports, which he concedes accounted for cash flows. Resp. Br. 13. As such, there would be no need to calculate a Dietz result.

Finally, and most importantly, there is no record evidence of actual Dietz calculations Pelosi performed at the time, nor does he claim to possess any hard copies of such calculations. Tr. 764-72, 798; Div. Br. 27. The extent of his evidence was conducting two Dietz calculations in his Reply Brief. Resp. Reply Br. 10-11. However: (1) the return reported in his client letter still does not match the return of the Dietz calculation; and (2) his Reply Brief Dietz calculations attempted to explain atypical period reporting (see below), rather than accounting for cash flows.

[24] He also testified, however, that Dietz is not required where there are no cash flows. Tr. 1068.

[25] In investigative testimony, however, he only mentioned DCF values. See Resp. Ex. 19; Tr. 1211-1213.

Id. Therefore, I find that the performance values contained in Pelosi's client letters were not the results of Dietz calculations.

4. Reporting for Atypical Periods

Pelosi alleges that his reporting returns for atypical periods explains several discrepancies. Resp. Reply Br. 8-14. In Pelosi's initial years at Halsey, the first annual reporting period sometimes occurred more than a year after an account was funded. In order to capture performance from the inception of the account, instead of using the TWR report for the 12-month period, Pelosi used the portfolio's beginning and end values, sometimes taken from Schwab, and performed either a simple percent-change or Dietz calculation to determine that period's return.[26] Tr. 652-54. In these instances, Pelosi claims he used Schwab's asset prices, not the prices in Axys. Tr. 675, 678-80.

Even assuming that Pelosi made these calculations at the time he drafted the client letters, these returns are still inaccurate. First, these letters clearly state that they are reporting 12-month returns. A 13- or 14-month return, even if accurate in itself, is not as accurate as a 12-month return. Second, several of Pelosi's calculations are simple percent-change calculations, which are not time-weighted. Resp. Reply Br. 9. Finally, some of Pelosi's calculations still produce numbers that are different from those contained in his client letters. Resp. Reply Br. 8-14.

When reporting for periods shorter than one year, Pelosi alleges he used Schwab's asset prices and calculated either a simple or Dietz percent change over that period.[27] Tr. 1052-54.

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[26] Letters to Sandra Lonergan (Div. Ex. 18, tab 47 at 004670) and Robert George (Div. Ex. 18, tab 49 at 004709) are examples of a simple percent change calculation. Resp. Reply 9. Letters to Steven Tutolo Jr. (Div. Ex. 19-Tab 63 at 004388) and Belowski are examples of a Dietz calculation. Resp. Reply 9-11.

[27] Examples of shorter period reporting include:

1. March 9, 2005, letter to Mr. Bosco, reporting a 3.7% return for the period July 31 through February 28. Pelosi testified that, although the letter referenced a starting market value of $2,323,212, he used Schwab's starting market value of $2,341,000 for calculating performance, which, using Dietz, results in the 3.7%. Tr. 1051-53; Resp. Ex. 25. However, that letter specifically referenced a different starting market value. See Resp. Ex. 25.
2. August 19, 2005, letter to Mr. and Mrs. Drubner, reporting a 4.9% return. Here, the starting market value was actually more than what was in DCF (so, Pelosi underreported), and Pelosi obtained that value from Schwab. Tr. 1054-55; Resp. Ex. 25. This return is the result of a simple percent change calculation, because there was no cash flow to warrant a Dietz calculation. See Tr. 1068.
3. August 14 and November 14, 2006, Drubner letters – Pelosi alleges the values come from Schwab and the return is the result of a Dietz calculation. Tr. 1069-71; Resp. Ex. 25. However, the numbers in the testimony and those in the exhibits do not match.

However, Pelosi failed to introduce any of the Schwab statements or Axys reports upon which he bases his explanations. Tr. 1234. Rather, he testified to these values from memory alone. Tr. 1055-56, 1234. Additionally, Pelosi did not introduce any written calculations he claims he made. Tr. 1234, 1242.

I find that Pelosi did not manually calculate portfolio returns in order to report on atypical periods. And, even if he did make manual calculations for that purpose, the returns he reported were inaccurate because they did not represent a time-weighted return for the period for which his letters stated they were reporting.

5. Preferred Stock Dividend

Pelosi also alleges he manually adjusted returns to account for declared, but unpaid, dividends for preferred stock, when the dividends were declared just prior to the end of a reporting period. Resp. Ex. 19 at 102-04; Resp. Br. 8-9. Preferred stock pays dividends at set intervals. When the dividend comes due, the market value of the stock declines by the same amount, reflecting the dividend to be paid. The owners of the stock, however, do not lose value, as they receive the dividend payment. Yet, on the day of the dividend issuance, before the stock owner receives the dividend payment, it appears that the owner suffered a decline in value. Resp. Br. 8-9. To adjust for this, Pelosi claims he added the dividend amount back to the value of the stock. Tr. 664-65. He wanted to capture the economic value of the stock and to avoid client confusion. Tr. 692, 694. After adding back the dividend amount, he manually recalculated the total performance; but, he would not make a corresponding change in Axys. Tr. 696-97. To prevent inflated results in the next quarter's letter, he made the inverse adjustment, subtracting the dividend amount from the stock's price. Tr. 697-98. Over the years, Pelosi made this adjustment many times. Tr. 682, 684.

However, adding the dividend amount to the stock's price was not Halsey's practice, and Pelosi knew as much. Div. Br. 28-29; Tr. 211, 697. Pelosi never told the others at Halsey that he did this. Tr. 211-12. Pelosi did not have any experience with preferred stock prior to joining Halsey. Tr. 691. He was also aware that Zoldy was in charge of pricing fixed income products. Tr. 671. Moreover, because Pelosi did not make these changes in Axys, the client's account in Axys would be accurate when the dividend was paid shortly after and, therefore, the return Axys generated at the end of the next quarter would be accurate and not in need of any adjustment. Div. Br. 29. Yet, Pelosi testified that he made a reverse adjustment in the following quarter to

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4. May 14, 2007, Drubner letter – Pelosi alleges something about longer/shorter periods, but it is not clear. Tr. 1071-72; Resp. Ex. 25.
5. November 9, 2005, letter to Orton Camp, reporting a 2.5% return for a 4-month period, arrived at by a Dietz calculation using the market values at the end of the paragraph. Tr. 1072; Resp. Ex. 25.
6. November 7, 2005, letter to Robert George reports a 2.9% return for the 4-month period of June 30 through October 31. Resp. Ex. 25, bates 004713; Tr. 1073. Pelosi seems to allege that he included a mutual fund position, which was added at the beginning of the period, into the starting market value. Tr. 1073. Pelosi does not clarify or demonstrate the exact impact this would have on the final return number.

avoid an inflated price. Tr. 698. Finally, as with Pelosi's other purported manual adjustments, he has not introduced a single example of a dividend calculation that he computed, nor does he claim to possess any hard copies of such calculations. Tr. 763-71, 798. Therefore, I find that Pelosi did not add dividend amounts to preferred stock prices and then manually recalculate total portfolio returns.

6. Combining Assets

Pelosi testified that another justification for the return discrepancies is that he combined returns for assets in the same asset class. Tr. 1080. When combining, for example, all equities, he weighed each individual return based on its size relative to the portfolio. Id.

The only specific example Pelosi provides of this adjustment is a March 3, 2008, letter to the Florians for the quarter ended February 29, 2008. Resp. Reply 12; Div. Ex. 25, Tab 206. In that letter, Pelosi reported a loss of 0.4% on the portfolio's taxable corporate bonds, while the TWR reported a loss of 1.33%. Div. Br. 18; Div. Ex. 25, Tab 206. Pelosi explains that the Florians held positions in "2 taxable bond funds, which were categorized separate and apart from her other taxable bonds and would have impacted the return of this asset class." Resp. Reply 12. Presumably, this means that the client's positions in the bond funds performed better than the taxable corporate bonds and, when combined, the loss was only 0.4%, not 1.33%.

However, like Pelosi's other justifications, this one is unsubstantiated and insufficiently clarified. Pelosi cites to Halsey's Florian Portfolio Appraisal for the relevant quarter, which lists the names of the funds in which the portfolio was invested, but does not report quarterly returns. Resp. Reply 12; Div. Ex. 25, Tab 206 at E01892-99. The TWR report for that period, which does report returns, does not report the returns for these two funds separately, making it impossible to confirm his calculation. Div. Ex. 25, Tab 206 at E01900. Moreover, TWR reports returns for the following categories: Short Term Investments, Tax Exempt Bonds, Taxable Bonds, Preferred Stock, Common Stock, and Other. Id. Of these categories, it is most likely that the taxable bond funds are included in the Taxable Bond category, which experienced a 1.33% loss. Id. Thus, the 1.33% loss reported in the TWR report presumably includes the taxable bond funds, and Pelosi's justification is, at best, unsubstantiated. Therefore, I find this justification not credible.

7. Bond Prices

Pelosi suggests that he used different bond prices than the ones Zoldy obtained from the broker. Resp. Br. 5; Tr. 656-59. As mentioned, Zoldy received bond trading prices from Sharkey, a broker who occasionally sold bonds to Halsey, which he used to price Halsey's bonds. Tr. 144-45, 184-87. Pelosi perceived this as a conflict of interest. Resp. Br. 5. He also thought that these broker-provided prices, being different than Schwab's prices, would confuse clients checking their portfolios on Schwab's website. Tr. 657. Pelosi alleges that, therefore, he used Schwab's prices for these bonds. Tr. 657-59, 673.

Pelosi, however, testified that he used Schwab bond prices only when reporting portfolio (and bond) values to clients, but not in reporting returns. Tr. 657-59. Therefore, his allegation, even if true, does not explain the return discrepancies.

8. Template Errors

Pelosi testified that several of the performance discrepancies resulted from template errors. Each period, Pelosi created a template letter. Tr. 1075-77. While copying the template into other letters, full paragraphs were mistakenly transposed. Tr. 1076-77. Pelosi also copied data tables to the new letters, with the intention of later correcting the data; but sometimes he did not, and the tables remained with the wrong data. Tr. 1078. He admits that "mistakes were made." Tr. 1168.

Pelosi makes this claim about a January 31, 2008, letter to Lonergan, which contains inaccurate returns. Resp. Reply 10; Div. Ex. 23, Tab 194. Pelosi claims that he used a letter to Dr. George, of the same period, as a template in drafting the Lonergan letter. Resp. Reply 10; Div. Ex. 23, Tab 192. By accident, the Dr. George performance values remained in the Lonergan letter. This allegation is highly suspect, because several of the values in the very same sentences that Pelosi claims were left unaltered were, in fact, adjusted to accurately reflect the Lonergan account. Thus, in drafting the Lonergan letter, Pelosi was clearly aware of the need to, and indeed did, adjust the copied values to accurately reflect Lonergan's portfolio. The same is true of Pelosi's other instances of alleged template errors.[28] I therefore find this explanation not credible.

D. Summary

Pelosi maintains that all of his manual adjustments were justified. Tr. 621-22. He provides a variety of possible justifications for his adjustments. Each of his justifications is individually flawed in that: (1) Pelosi provided confusing testimony regarding when he acted because of any particular justification; (2) he failed to introduce evidence demonstrating that he indeed made these alternative calculations; and, most importantly (3) the returns he included in his client letters do not match the ones resulting from the calculations he claims to have made. The Division demonstrated that Pelosi's justifications are unpersuasive, inconsistent, ad hoc, ex post facto, and, at times, incoherent.

IV. CONCLUSIONS OF LAW

Pelosi violated Sections 206(1) and 206(2) of the Advisers Act. Section 206 provides:

> It shall be unlawful for any investment adviser . . . directly or indirectly – (1) to employ any device, scheme or artifice to defraud any client nor prospective client; (2) to engage

[28] Examples include: February 5, 2007, letters to William Drakeley, Robert George, Thomas Van Lenten. Tr. 1075-78; Resp. Ex. 25 at Halsey 4612, 4613, E05546, E05547, E05925, E05892-26.

in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

To establish violations under sections 206(1) and (2) of the Advisers Act, the Division must prove that Pelosi is an investment advisor, that he engaged in fraudulent activities, and that he negligently breached his fiduciary duty by making false and misleading statements or omissions of material fact.[29] SEC v. Merrill Scott & Assc., Ltd., 505 F. Supp. 2d 1193 (D. Utah 2007); SEC v. Gotchey, No. 91-1855, 1992 WL 385284, *2 (4th Cir. Dec. 28, 1992); See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963). To establish a violation of Section 206(1), the Division must also prove that Pelosi acted with scienter. SEC v. Steadman, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992).

A. Misrepresentation

Pelosi clearly misrepresented portfolio returns to clients. The Division introduced extensive evidence demonstrating the disparity between the returns Pelosi reported to his clients and the corresponding returns generated by Axys. See Div. Exs. 26-33. Pelosi's spreadsheet summarizing and contrasting his returns to those from the Axys reports also demonstrates this disparity. Resp. Exs. 4, 5, 6.

Nevertheless, Pelosi contends he did not misrepresent performance results. First, he argues that his adjustments were justified and therefore not misrepresentations. Resp. Br. 28-29. However, as explained above in detail, his justifications are unpersuasive. In fact, in several of the few instances where Pelosi attempted to explain specific client returns, his calculations produced different returns than those in his letters.

Second, Pelosi also argues that clients received portfolio appraisals with their letters, as well as monthly statements from Schwab, and they had real-time electronic access to their Schwab accounts. Resp. Br. 29. As such, clients had accurate portfolio information and were not reliant on his client letters. However, the portfolio appraisals and Schwab monthly statements only provided clients with their portfolio's market values, not a calculation of the portfolio's return. See Div. Ex. 2; Resp. Ex. 27. Nor is there any documentary evidence of what account information Schwab reported in the online statement. Finally, the Commission is not required to prove reliance in an enforcement action and the lack of reliance is, therefore, not a defense. See e.g. SEC v. Simpson Capital Mgmt., Inc., 586 F. Supp. 2d 196, 201 (S.D.N.Y. 2008) ("Unlike private litigants, the SEC is not required to prove investor reliance . . . in an action for securities fraud."); SEC v. Rana Research, Inc., 8 F.3d 1358, 1363 & n.4 (9th Cir.1993); SEC v. Blavin, 760 F.2d 706, 711 (6th Cir.1985). Thus, Pelosi misrepresented returns to clients.

B. Scienter

Scienter is 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.

[29] It is undisputed that Pelosi was an investment adviser at all relevant times.

680, 686 n.5 (1980). A finding of recklessness satisfies the scienter requirement. David Disner, Exchange Act Release No. 38234 (Feb. 4, 1997), 52 S.E.C. 1217, 1222 & n.20; Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-9 (9th Cir. 1990), cert. denied, 499 U.S. 976 (1991) (citing eleven circuits holding that recklessness satisfies scienter in Section 10(b) and Rule 10b-5 actions). Recklessness, in the context of securities fraud, is "highly unreasonable" conduct, "which 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. 1977) (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)).

Pelosi misreported performance intentionally or, at the very least, recklessly. The extensive and distinct pattern of overstating returns demonstrates Pelosi's intent to deceive his clients. From his experience in the industry, Pelosi knew it was wrong to manually adjust computer-generated returns, and so testified. Tr. 643, 760. Yet, he did. His unsubstantiated justifications for doing so are unpersuasive. For all the overstatements the Division highlighted, Pelosi attempts to explain only a small number of them. And, even for those, most of his explanations are incredible or incomplete. At a minimum, Pelosi's conduct was a highly unreasonable departure from the ordinary standard and, thus, reckless.

Additionally, Pelosi's conduct in August 2008, taken as a whole, demonstrates scienter. When confronted by Julian and Zoldy about the misstatements, he denied making them. Even according to Pelosi's questionable testimony that he admitted to making some manual adjustments, he was not completely forthcoming about the extent of his adjustments or his supposed justifications. Tr. 706-07, 709, 712. Pelosi's explanations for his conduct changed between his investigative testimony and his hearing testimony. See e.g. Tr. 628, 681, 700, 704, 706, 713, 1211-13. A literal reading of Pelosi's e-mail stating that he was "embarrassed and ashamed over the matter at hand" and his note that he was "embarrassed and ashamed by the performance issue" are further evidence of his guilty state of mind. Finally, Pelosi's failure to mention any of his alleged justifications in his several meetings and communications with Julian and Zoldy is inexplicable and suggests that they were ad hoc recent fabrications. Tr. 222-23, 226-27, 494-95.

Thus, Pelosi's August 2008 conduct oscillated between denial and apology, but was never forthcoming. This is inconsistent with one who made justified manual adjustments to improve the accuracy of performance reporting. Rather, taken as a whole, it is evidence of one trying to first deny and then apologize for his intentional misconduct.

Pelosi argues that his underreporting client returns proves he did not intend to deceive his clients. Resp. Br. 16-17. I disagree, for several reasons. First, while the under-reporting makes the pattern of over-reporting less perfect, the vast majority of inaccurate returns were inflated, which constitutes a telling pattern. Second, the pattern of misstatements is only one of several pieces of evidence introduced, the preponderance of which support a finding that Pelosi's fraud was intentional. Third, intentional underreporting constitutes a deceitful misrepresentation as well, even if Pelosi's motive for underreporting was not adequately explained by either party. Finally, Pelosi's underreporting does not defeat, in fact it reinforces, a finding that he acted at

least recklessly. Therefore, I find Pelosi acted with scienter, that is intentionally, or, at the very least, recklessly.

C. Materiality

The Division must prove that Pelosi's misrepresentations were material. SEC v. Mannion, 789 F. Supp. 2d 1321, 1340 (N.D. Ga. 2011). The standard of materiality under Section 206 is whether or not a reasonable 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 Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Materiality does not require proof that accurate disclosure would have caused the reasonable investor to change his decision, but only that the omitted fact would have assumed actual significance in the deliberations of the reasonable investor. TSC Industries, 426 U.S. at 449.

Pelosi's misrepresentations of client returns were material. Pelosi misreported performance returns, which are the purpose of an investment and, therefore, represent perhaps the most important piece of information relating to an investment portfolio. Returns are an indication of a portfolio manager's performance and, therefore, are the most important tool for an investor to evaluate their manager. Tr. 1367. Pelosi's misreporting did not occur once or twice; it occurred most of the time. In fact, any given Pelosi client letter of record more likely than not contained an overstatement of performance results. Finally, Pelosi's overstatements, while sometimes only a few basis points, were for the most part larger than twenty-five basis points. Div. Exs. 29, 33.

1. Missing Letters

Pelosi argues that his misrepresentations were not material for several reasons. First, he argues that the Division selectively relied on evidence most favorable to its case, while ignoring approximately 250 Pelosi client letters that may include evidence favorable to Pelosi. Resp. Br. 31. Pelosi presumably reached this number by counting every Halsey reporting cycle for which the Division did not provide him with a client letter. See Tr. 1139-41, 1151-53. However, as the Rourke and Rynne testified, Pelosi did not send a client a letter for a period in which he met with the client. Tr. 32, 116-17. Thus, these letters are not missing; they were never drafted or never sent.

Pelosi also claims that he discovered 80 client letters in the Division's production that were not included in the Division's calculations. Resp. Br. 22. He argues the Division ignored these because they do not support the Division's position. Resp. Br. 31. However, Pelosi failed to offer these letters into evidence. Thus, there is no proof of the existence of such letters, let alone their contents. And, even if these letters do exist, the Division reasonably explained that they may be the unsigned duplicates of letters the Division already accounted for. Div. Reply Br. 9-10; Tr. 1151-52.

Finally, even if the 250 plus 80 letters exist, and they all contain perfectly accurate returns, that only affects the overall percent of Pelosi letters that contain misrepresentations; it

does not, however, eliminate the very substantial number of client letters, introduced into evidence, which do contain material performance overstatements. Under Pelosi's alleged circumstances, while the misrepresentations would indeed be less widespread, they would still be substantial and material.

2. 1% Threshold

Second, Pelosi argues that the amounts of his "information changes" were too small to be material. Resp. Br. 30. Pelosi cites to two unpublished District Court decisions concerning corporate disclosures to support the proposition that misrepresentations under 1% or 2% of operating revenues are immaterial as a matter of law. Resp. Br. 32, citing SEC v. Todd, 2007 U.S. Dist. LEXIS 38985 at *14 (S.D. Cal. 2007); Mathews v. Centex Telemanagement. Inc., 1994 U.S. Dist. LEXIS 7895 at *18 (N.D. Cal. June 8, 1994). Accordingly, Pelosi argues, because all his "changes" were less than 1%, and the overwhelming majority of them less than 0.5%, they were immaterial. Resp. Br. 31-32; Tr. 685-86.

As an initial matter, Basic v. Levenson, which rejected a numerical threshold for materiality, controls here. There, the Supreme Court stated: "Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive and underinclusive." Basic, 485 U.S. at 236 & n.14. The Court continued: "After much study, the Advisory Committee on Corporate Disclosure cautioned the SEC against administratively confining materiality to a rigid formula. Courts would do well to heed this advice." Id. Similarly, the Second Circuit has "consistently rejected a formulaic approach to assessing materiality of an alleged misrepresentation." Ganino v. Citizens Utilities Co., 228 F.3d 154, 162-63 (2d Cir. 2000). Therefore, I reject the 1% or 2% test Pelosi argues for, in favor of the more holistic, fact-specific approach adopted by the Supreme Court and Second Circuit.

Additionally, Pelosi is incorrect in arguing that his misstatements were less than 1%. See Tr. 685-86. First, some of Pelosi's overstatements were over 200 basis points or 2%. Div. Br. 39. Second, Pelosi himself argues that his underreporting, which are also (technically) misstatements, were often over 3% and therefore material. Resp. Br. 16. Finally, Pelosi's overstatements, even if under 100 basis points (or 1%), inflated his clients' actual returns by as much as 50, 270, and 300%.[30] These overstatements are material even under Pelosi's proposed threshold. Id.; see Warwick Capital Management, Inc., Initial Decision Release No. 327 (Feb. 15, 2007) 89 SEC Docket 3420, 3436 (finding misrepresentations that "more than doubled performance" were "clearly material").

[30] That is, while the variance between the actual and reported returns may have been less than 1%, the amount by which Pelosi's overstatements inflated returns could have been much larger. The reason is that the former, measured in basis points, is calculated with respect to the initial investment, while the latter compares (much smaller) returns to each other.

3. Client Testimony

Pelosi argues that the fact that his clients followed him to his current firm demonstrates that they did not consider his adjustments to be material. Resp. Br. 33. However, those clients were not informed that Pelosi sent them unsubstantiated performance results. Halsey's letter announcing Pelosi's departure did not disclose that Pelosi was overstating results. Tr. 233-35; Div. Ex. 13. Nor did Pelosi disclose this to his clients. Tr. 1408-09, 1434, 1447, 1457-58, 1469-70, 1483. Thus, they were not aware that Pelosi's adjustments were unsubstantiated, and their decision to remain as clients, therefore, does not bear on materiality.

That Pelosi's clients did not care if Pelosi made performance adjustments is similarly unavailing. These clients were under the impression that Pelosi merely used a different method to calculate returns, not that his returns were completely unsubstantiated. Tr. 1408-09, 1434, 1447, 1457-58, 1469-70, 1483. Indeed, all but one admitted that lying about performance is inappropriate. Id. Additionally, the Division called two of Pelosi's former clients who testified that an inflated return of even less than 1% matters to them. Tr. 296, 550. Therefore, Pelosi's misrepresentations of client returns were material.

D. Willful Violations

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. Div. Br. 41, 44-45. To impose sanctions under these sections, Respondent's violations must be willful. 15 U.S.C. § 80a-9(b) (2010); 15 U.S.C. §§ 80b-3(f) & (i) (2010); see also David E. Zilkha, Initial Decision Release No. 415 (Apr. 13, 2011), 2011 WL 1425710, *13. 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); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976).

Pelosi willfully overstated his clients' returns. His overstatements were not the result of a mistake or clerical error. Whether his overstatements were intended to deceive his clients or merely the result of reckless behavior, they were intentionally made. See Wonsover, 205 F.3d at 413-15. As Pelosi told Halsey's PAs, and later admitted to Julian, he intentionally sent his clients the overstated performance returns. Tr. 38-39, 123-24, 502-03. Therefore, Pelosi acted willfully.

V. SANCTIONS

The Division requests that Pelosi be barred from association with any investment adviser or investment company, ordered to cease and desist from further violations of the securities laws, and required to pay a civil money penalty of $60,000. Div. Br. 42.

A. Associational Bar

Section 203(f) of the Advisers Act authorizes the Commission to bar or suspend a person from association with an investment adviser for willful violations of the Advisers Act, if it is in

the public interest. 15 U.S.C. § 80b-3(f). Section 9(b) of the Investment Company Act does the same with regard to an investment company. 15 U.S.C. § 80a-9(b)(2) (referencing willful violations of "title II of this Act"). In determining whether a sanction is in the public interest, the Commission considers the following 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. See Conrad P. Seghers, Advisers Act Release No. 2656 (Sept. 26, 2007), 91 SEC Docket 2293, 2303-04 (quoting Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979)). The Commission also considers the extent to which the sanction will have a deterrent effect. See Schield Mgmt. Co., Exchange Act Release No. 53201 (Jan. 31, 2006), 87 SEC Docket 848, 862 & n.46 (citing other cases).

Pelosi violated Advisers Act Sections 206(1) and (2), and it is in the public interest to bar him from association with investment advisers and investment companies. Pelosi is an MBA and CFA and has over fifteen years experience as an investment adviser. Div. Ex. 37; Tr. 605-06. He knew his fiduciary obligations as an investment adviser and he knew that he was violating them by providing his clients with falsely inflated returns. He committed these violations hundreds of times over three years. While some of his misstatements were understatements of returns, the vast majority were overstatements. Thus, Pelosi's violative behavior was egregious, recurrent, and performed with scienter. Pelosi insists that his adjustments were justified and provides no assurance against future violations. Finally, Pelosi's current occupation as investment adviser provides him ample opportunity to repeat these violations.

Thus, every Steadman factor weighs in favor of a permanent associational bar. Additionally, it is in the Commission's interest to deter others from behaving like Pelosi. In addition to intentionally misleading his clients, Pelosi misled his partners, provided questionable sworn testimony justifying his adjustments, and refused to accept responsibility for the abdication of his fiduciary duty to his clients. Therefore, it is in the public interest to permanently bar Pelosi from association with investment advisers and investment companies.

B. Cease-And-Desist

Advisers Act Section 203(k) authorizes the Commission to impose a cease-and-desist order for violations of the Advisers Act. See 15 U.S.C. §§ 80b-3(k). The Commission requires some likelihood of future violation before imposing a cease-and-desist order. KPMG Peat Marwick LLP, Exchange Act Release No. 43862 (Jan. 19, 2001), 54 S.E.C 1135, 1185, motion for reconsideration denied, Exchange Act Release No. 44050 (Mar. 5, 2001), 53 S.E.C. 1, petition denied, 289 F.3d 109 (D.C. Cir. 2002). However, "a finding of a [past] violation raises a sufficient risk of future violation," because "evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering him to cease and desist." Id. at 1185.

Pelosi's egregious and repetitive misconduct in providing his clients with false performance returns, and his current employment as an investment adviser, presents sufficient risk of future violations. Therefore, the imposition of a cease-and-desist order is warranted.

C. Civil Penalty

Under Section 203(i) of the Advisers Act and Section 9(d) of the Investment Company Act, the Commission may impose a civil money penalty if a respondent willfully violated any provision of the Advisers Act, and that such penalty is in the public interest. 15 U.S.C. §§ 80b-3(i), 80a-9(d).

A three-tier system establishes the maximum civil money penalty that may be imposed for each violation found. Id. Where a respondent's misconduct involves fraud, deceit, or deliberate or reckless disregard of a regulatory requirement, the Commission may impose a "Second Tier" penalty of up to $65,000 for each act or omission. Id.; 17 C.F.R. § 201.1003 (adjusting the statutory amounts for inflation). Within any particular tier, the Commission has the discretion to set the amount of the penalty. See Brendan E. Murray, Advisers Act Release No. 2809 (Nov. 21, 2008), 94 SEC Docket 11961, 11978; The Rockies Fund, Inc., Stephen G. Calandrella, Charles M. Powell, and Clifford C. Thygesen, Advisers Act Release No. 54892 (Dec. 7, 2006), 89 SEC Docket 1517, 1528.

In determining whether a penalty is in the public interest, the Commission may consider (1) whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, (2) the resulting harm to other persons, (3) any unjust enrichment and prior restitution, (4) the respondent's prior regulatory record, (5) the need to deter the respondent and other persons, and (6) such other matters as justice may require. 15 U.S.C. §§ 80b-3(i), 80a-9(d); Murray, 94 SEC Docket at 11978. The Commission has held that "dissemination of false and misleading financial information by its nature causes serious harm to investors and the marketplace." The Rockies Fund, 89 SEC Docket at 1527.

I find a second-tier penalty to be warranted and in the public interest, but certain factors militate against imposing the maximum penalty of $65,000, which the Division requests. Pelosi acted deceitfully and disregarded the law intentionally or, at least, recklessly. This factor is particularly important given the repeated nature of Pelosi's deceitful conduct. Also, the need to deter Pelosi is strong, given his continued employment in the financial sector and his failure to acknowledge the wrongfulness of his conduct. See Murray, 94 SEC Docket at 11978. Sanctions imposed on Pelosi will also deter others from engaging in the same misconduct. Id. However, Pelosi's fraud did not enrich him and, although dissemination of false financial information causes harm to investors, it did not cause his clients actual losses. See The Rockies Fund, 89 SEC Docket at 1529. Indeed, a minority of Pelosi's client letters understated returns, in many cases by a substantially wider margin than the letters overstating returns. Resp. Br. 16. Finally, Pelosi's prior regulatory record is clean. Therefore, in light of these public interest factors and the other sanctions imposed, a second-tier penalty of $20,000 is appropriate. See Id. at 1528-29. (imposing a second-tier penalty of $20,000 for conduct of similar egregiousness). Pelosi has offered no evidence regarding his ability to pay such a penalty. 15 U.S.C. §§ 80b-3(i)(4), 80a-9(d)(4).

The Division requests that the second-tier civil penalty be imposed three times, for each year of Pelosi's violations. While the statute provides that a penalty may be imposed for "each act or omission," it leaves the precise unit of violation undefined. See Colin S. Diver, The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies, 79 Colum. L. Rev. 1435, 1440-41 (1979). Although Pelosi technically violated the statute approximately 240 times, I find that one year is a reasonable and appropriate unit of violation under the circumstances.[31] Therefore, a three-time, second-tier $20,000 penalty, totaling $60,000, is warranted.

RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the Record Index issued by the Secretary of the Commission on October 14, 2011.

ORDER

IT IS ORDERED that, pursuant to Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act, Michael R. Pelosi is BARRED from association with an investment adviser and is PROHIBITED, conditionally or unconditionally, from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

IT IS FURTHER ORDERED that, pursuant to Section 203(k) of the Advisers Act, Michael R. Pelosi shall CEASE AND DESIST from committing or causing any violations or future violations of Sections 206(1) and 206(2) of the Advisers Act.

IT IS FURTHER ORDERED that, pursuant to Section 203(i) of the Advisers Act and Section 9(d) of the Investment Company Act, Michael R. Pelosi shall PAY A CIVIL MONEY PENALTY in the amount of $60,000.

Payment of the civil money penalty shall be made on the first day following the day this Initial Decision becomes final. Payment shall be made by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission. The payment, and a cover letter identifying Respondent and Administrative Proceeding No. 3-13927, shall be delivered to: Office of Financial Management, Accounts Receivable, 100 F Street, N.E., Mail Stop 6042, Washington, DC 20549. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to

[31] In fact, a 240-time, second-tier $20,000 penalty, totaling $4.8 million, would plainly be unreasonable.

that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

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Cameron Elliot
Administrative Law Judge