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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:	
	:	**Administrative Proceeding**
ZPR INVESTMENT MANAGEMENT, INC., and MAX E. ZAVANELLI,	:	**File No. 3-15263**
	:	
Respondents.	:	

RESPONDENTS' REPLY TO DIVISION OF ENFORCEMENT'S OPPOSITION TO MOTION FOR STAY

Respondents, ZPR INVESTMENT MANAGEMENT, INC. ("ZPRIM") and MAX E. ZAVANELLI ("ZAVANELLI"), moved for a stay of the sanctions imposed by the Commission in the Order Imposing Remedial Sanctions dated October 30, 2015 (the "Opinion') and the Order Denying Respondents' Motion for Reconsideration dated June 9, 2016 (the "Order"). The Division of Enforcement has filed a response in opposition to the Motion to Stay ("Motion") and Respondents reply to the opposition as follows[1]:

1. The Motion to Stay was made pursuant to SEC Rule 401(c), 17 C.F.R. §201.401(c) (2006) by the Respondents who are aggrieved by the Opinion and the Order and are entitled to review in the federal courts.

2. The Commission currently has jurisdiction of this matter.

[1] Citations to the transcript are noted as TR-__ and to the Initial Decision as ID-___. Citations to the exhibits offered by the Division of Enforcement ("Division") and the Respondents are noted as DX-__and RX-__, respectively.

3. The Respondents have the burden of establishing that a stay is justified under the circumstances [2].

4. The standards for determining if a stay is warranted are:

- Likelihood of success on the merits;
- Whether Respondents will suffer irreparable injury if the stay is not granted;
- Whether any person will suffer substantial harm if the stay is granted; and
- Whether the stay will serve the public interest [3].

5. The first two standards (likelihood of success and irreparable injury) are generally dispositive of whether a stay will be issued [4].

6. Respondents have also filed a Motion to Adduce Additional Evidence, which is incorporated into the Motion to Stay.

I. LIKELIHOOD OF SUCCESS

7. The Division of Enforcement through its response contends the Respondents will be unable to demonstrate a likelihood of success on appeal. This conclusion is premised on the basis that subsequent disclosures made by the Respondents before any prospective investor became a client of the firm are irrelevant and that the "total mix" of information ZPRIM provided should not be considered in determining the issues of materiality or scienter. This rejection of the "total mix" concept is contrary to a substantial and formidable body of case law espoused by the United States Supreme Court, the federal appellate courts, and the federal district courts. *See* paragraphs 12, 13 and 14 of this Reply. In determining the likelihood of success, this body of case

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[2] *See*, e.g., Nken v. Holder, 556 U.S. 418, 433-34 (2009); Steven Altman, Exchange Act Release No. 63665, 2011 WL 52087, at *2 (Jan. 6, 2011).
[3] Nken, 556 U.S. at 434; Steven Altman, 2011 WL 52087, at *2.

[4] *See*, e.g., Winter v. NRDC, 555 U.S. 7, 22 (2008); Sherley v. Sebelius, 644 F.3d 388, 393 (D.C. Cir 2011); Katz v. Georgetown Univ., 246 F.3d 685, 688 (D.C. Cir 2001); Wisconsin Gas Co. v. FERC, 758 F.2d 669, 674 (D.C. Cir. 1985); Blankenship v. Boyle, 447 F.2d 1280, 1280 (D.C. Cir. 1971) (per curiam); Monica J. Lindeen, Securities Act Release No. 9808, 2015 WL 3747254, at *3 (June 16, 2015).

law cannot be ignored. The Order Instituting Administrative and Cease-and-Desist Proceedings ("OIP") charged Respondents with publishing misleading advertisements. There was no finding by the Commission in the Opinion, however, that performance numbers used in any of these advertisements were inaccurate or false. Paragraph 5 of the OIP alleged that **"[w]hen ZPR stated these advertisements were GIPS compliant, it became obligated to speak fully about any material facts on that subject whose absence would make the advertisements misleading. In this instance, by not disclosing the period-to-date returns in these advertisements, as required by the GIPS advertising guidelines, ZPR was able to conceal the fact it was underperforming the market."** (Emphasis Added). The OIP, contrary to the conclusions stated in the Opinion and the Order suggested the "total mix" was the relevant test in determining materiality.

8. The Opinion acknowledged that after the six (6) magazine advertisements at issue were published, ZPRIM "[D]id send prospective investors its GIPs-compliant presentation [but], it did not do so until investors received contracts to retain ZPRIM. It would have been important to potential investors to receive the information at issue to be able to compare performance numbers before they reached this advanced stage with ZPRIM." *Id* at pg.20. **This is actually a concession by the Commission that the "total mix" is relevant to determine the issue of materiality.** *See also* RX-10. ZPRIM's GIPS-compliant presentation contained performance information that was required by the GIPS Advertising Guidelines **and which had been omitted from the advertisements.** This performance information also showed that the firm was underperforming its benchmarks in 2008. *See* RX-10, (June 30, 2008 ZPR Small Cap -26.04% vs Russell 2000 -16.20%).

9. Evidence was also introduced by the Respondents and unrebutted that in addition to its GIPS compliant presentations, the Respondents sent marketing information packages to any prospective investor who responded to an advertisement. *See* testimony of David Sappir ("Sappir"), TR-1192, 1193 and RX-11, 16, 18, and 20, which represent these marketing packages. The marketing packages were sent **before** the client contracts and GIPS-compliant presentations were provided by ZPRIM to the prospective investors, and contained the performance data that was required by the Advertising Guidelines. The performance information that was included in each marketing package also showed that ZPRIM was underperforming its benchmarks in 2008. *See* RX-11, 1Q 2008, ZPR Small Cap -22.08% versus Russell 2000 -13.01%. The Opinion, however, ignores and makes no reference to these material disclosures that were provided by ZPRIM to prospective clients who responded to the advertisements and which the firm was obligated to disclose according to the charges contained in the OIP. In addition, each advertisement at issue disclosed the firm's website, which could be freely accessed since passwords or registration were not required. *See* RX-5, 6, 7, 15, 17 and 19. The website also contained all of the performance information that was required by the voluntary GIPS Advertising Guidelines. *See* RX-8.

10. Therefore, this unrebutted evidence demonstrates that prospective clients who responded to the magazine advertisements and requested more information from ZPRIM received a constant flow of performance data that was required by the Advertising Guidelines and showed ZPRIM's SCV Composite was clearly underperforming its benchmarks in 2008. More importantly, the marketing packages[5] that preceded a final package of information that contained

[5] *See e.g.* RX-11.

contracts and the GIPS-compliant presentation, were delivered[6] by ZPRIM to prospective investors immediately following an inquiry and not at an "advanced stage" in the decision to become a client of the firm. *See* testimony of Sappir, TR-1192, 1193. In further support of this fact, Respondents have filed a Motion to Adduce Additional Evidence in the form of a summary prepared by ZPRIM that spans a period from February 9, 2007 to June 20, 2013 (the "Summary"). The Summary identifies the name of each prospective client; the date the prospective client contacted the firm; the source of the reference, such as an advertisement, that the prospective client was responding to; and the date the marketing package was sent by ZPRIM to each prospective client. A copy of the Summary was attached to the Motion to Stay contrary to the assertion by the Division of Enforcement. The Summary also shows that any prospective client was sent a marketing package within days after that person contacted the firm. The recent Order of the Commission denying Respondents' Motion for Reconsideration concluded that there was "scant support" for the assertion that the marketing packages were sent "immediately". The Summary proves just the opposite and that the marketing information was sent to prospective investors "immediately". In addition, the Commission concluded that "the record does not substantiate these assertions" (Order at pg. 10) but the Summary provides additional evidence to negate that finding. However, and even without the Summary, ZPRIM's marketing representative's phone number in New York was included in each of the six (6) advertisements at issue. He testified that if anyone contacted him about an advertisement, he collected their information, forwarded it to the firm, **"and they [ZPRIM] would send out the package."** TR-1193. Respondents introduced into evidence an email dated August 12, 2008, which included a marketing package that was sent to a prospective client. Information included in this marketing package clearly demonstrated that the

[6] *See* RX-10.

firm's SCV Composite was underperforming its benchmarks in 2008. RX-11. Finally, in footnote 51 of the Order relating to Respondents' assertion that each prospective client received full and fair disclosure of all material facts including ZPRIM's prior investment performance, the Commission stated that "Respondents do not explain, or cite to anything in the record to demonstrate, how they can be sure that no prospective clients decided to select ZPRIM on the basis of its false advertisements." This statement ignores the fact every prospective client was provided with a GIPS compliant presentation **before becoming an actual client of the firm.** The GIPS expert witness called by the Division who was also the GIPS verifier for ZPRIM, testified that any mistake in the advertisements would be rectified through the delivery of a GIPS compliant presentation and this would satisfy the GIPS requirements. TR-1057, 1064. When the 2011 advertisements were published, the firm was outperforming its benchmarks in 2010. *See* RX–22; Verifier's Report: Global Equity 46% vs MSCI EAFE Index 8%; All-Asian 71% vs MSCI EAFE Index 8% as of 12/31/2010. Any prospective client would have received the GIPS compliant presentation in 2011, which showed that these Composites were crushing their benchmarks. RX–22. In the Order Denying Respondents' Motion For Reconsideration, the Commission stated that **"We think it appropriate to look to the content of the advertisement in determining materiality and to exclude subsequent communications delivered only to those individuals who respond."** Order, pg.9, Emphasis Added. However, this interpretation totally contradicts language in the Commission's OIP that **"When ZPR stated that these advertisements were GIPS compliant, it became obligated to speak fully about any material facts on that subject whose absence would make the advertisements misleading."** OIP, paragraph 5. ZPR satisfied this obligation by providing all material facts concerning its investment performance in the "total mix" of information, and the Summary supports this assertion. For example, the Summary

confirms that no prospective client who responded to advertisements placed by ZPRIM in the October, November or December 2008 issues of *Smart Money* magazine ever elected to become a client of the firm. In addition, the Summary also confirms that no prospective client who responded to the advertisements placed by ZPRIM in the February or May 2011 issues of *Smart Money* or the advertisement placed in the March 21, 2011 issue of *Barron's* magazine ever elected to become a client of the firm. Finally, the Summary reveals that no prospective client ever contacted ZPRIM as a result of receiving the April 2009 or the December 2009 investment newsletter. Therefore, and contrary to the Order's conclusion, Respondents can be and are sure that "no prospective clients decided to select ZPRIM on the basis of its false advertisements." *See* Order, pg.10, footnote 51.

12. The Commission is required to show that if there were misrepresentations or omissions, the statements or omitted facts were material. SEC v. Mannion, 789 F. Supp. 2d 1321, 1340 (N.D. Ga. 2011). The standard required under Section 206 of the Advisor's Act is whether or not a reasonable investor would have considered the information important in deciding whether or not to invest or in this case, become a client of ZPRIM. *See* SEC v. Steadman, 967 F.2d 636, 643 (D.C. Cir. 1992).

13. Decisions of the United States Supreme Court have repeatedly emphasized that materiality is to be viewed by examining the "total mix" of information both for omissions and misrepresentations of facts. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449, 96 S. Ct. 2126, 48 L. Ed 2d 757 (1976), *accord, e.g.,* Amgen, Inc. v. Conn. Ret. Plans & Trust Funds, ___ U.S. ____, 133 S. Ct. 1184, 185 L. Ed 308 (2013) *(dissenting opinion n. 5)*; Matrixx Initiatives, Inc. v. Siracusano, ___ U.S. ___, 131 S. Ct. 1309, 179 L. Ed 398 (2011); Basic, Inc. v. Levinson, 485 U.S. 224, 231-32, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988). This is the same standard followed

in the OIP when it charged the Respondents with an obligation "to speak fully about any material facts on that subject. . ." Notwithstanding this case law, the Commission would view the advertisements in isolation while ignoring the "total mix" of information as argued in the opposition response.

14. If one elects to disclose material facts but the disclosures are incomplete, the federal securities laws "implicate a duty to disclose whatever additional information is necessary to rectify the misleading statements." *See* Rowe v. Maremont Corp., 650 F.Supp 1091 (N.D. Ill. 1986); Schlifke v. Seafirst Corp., 866 F.2d 935 (7th Cir. 1989) and the recent Opinion of the Commission issued In the Matter of: David F. Bandimere, Securities Act of 1933 Release No. 9972; Securities Exchange Act of 1934 Release No. 76308, Oct. 29, 2015 at pg.16.

15. When applying this legal principle, it is clear that the "total mix" of information provided by ZPRIM gave a prospective client all material facts about the investment performance of the firm, both good and bad, which were required by the Advertising Guidelines. Assuming the omission of performance data in the advertisements and newsletters required by the Guidelines was material, it was, nevertheless, made available to prospective investors in subsequent "immediate" and subsequent disclosures but clearly before an investment decision was reached as required by controlling case law to correct any omission or misrepresentation of a material fact **and as charged by the OIP.** It is also important to note that performance data was provided by ZPRIM to prospective clients and was not hidden or made difficult to locate. Prospective clients of ZPRIM, unlike their Morgan Keegan & Co., Inc.[7] counterparts, did not have to search for the performance data that corrected and supplemented information contained in the 2008 *Smart Money*

[7] SEC v. Morgan Keegan & Co., Inc., 678 F.3d 1233 (11th Cir. 2012).

advertisements. Clearly, ZPRIM drew prospective clients' attention to this information by providing it directly to them.

16. Thus, to conclude the advertisements, viewed in isolation, mislead prospective investors would render the "total mix" requirement a nullity and result in strict liability. Further, it renders the duty to correct an omission by providing subsequent disclosures that correct a misstatement as impermisable. This "bright line" or "litmus test" has been totally rejected by the courts. *See* Matrixx 1315 Ct. at 1318-19 (bright line rule would artificially exclude information considered significant by reasonable investor).

17. This rational has been confirmed in the recent decision of Flannery v. SEC, 810 F.3d 1 (1st Cir. 2015), where the court assumed a single slide used in a presentation was materially misleading but concluded the availability of other information made materiality of the slide marginal. While the Commission has previously rejected this argument, Respondents believe that Flannery, supra, is persuasive on the issue of materiality. The Flannery court did not suggest the "mere availability of accurate information negates an inaccurate statement" but concluded a reasonable investor would not rely exclusively on a single slide in a presentation and "would conduct due diligence when making an investment decision, the availability of actual and accurate information is relevant." Flannery, supra, footnote 8. Due to the availability of this information, the single slide had not "altered the 'total mix' of information available." (Citation Omitted), Flannery, supra, at 11. The ZPRIM advertisements in question required a $200,000 minimum investment for its SCV and All-Asian composites and a $350,000 minimum investment for its Global Equity Composite. *See* RX–5 and RX-15. It is simply not logical to assume that a reasonable investor would invest solely based upon an advertisement involving that kind of financial commitment and therefore, the subsequent disclosures made by ZPRIM become relevant.

The "misleading statement" in the magazine advertisements was contained in a lengthy footnote where the firm claimed compliance with the GIPS standards. The firm had, in fact, been verified since at least 2000 as being compliant with these GIPS standards. Anyone reading the advertisement that actually knew what GIPS entailed and required would have requested a GIPS complaint presentation, which the firm provided to both prospective and existing clients as a matter of course. Also, anyone knowledgeable about GIPS such as an institutional investor would also have recognized that the magazine advertisements and newsletters were not formatted according to the GIPS Advertising Guidelines. As noted in Flannery, "context makes a difference." More importantly, Flannery reasoned that "thin materiality" was connected to a level of scienter. As the court there stated, "If it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness [scienter] in not disclosing the fact." Flannery, supra, at 9, citing with approval City of Dearborn Heights 345 Police & Fire Ret. Sys. v. Waters Corp., supra.

18. As a result, there is a "substantial indication of probable success" for Respondents on appeal to support their request for a stay. *See* Washington Metropolitan Area Transit. Com. v. Holiday Tours, Inc., 559 F.2d 841, 843 (D.C. Cir. 1977), citing with approval Virginia Petroleum Jobbers Association v. FPC, 104 U.S. App. D.C. 106, 259 F.2d 921 (1958).

19. Turning now to a *Morningstar* report for the period ended March 31, 2011 that stated there was "No" "Pending SEC Investigation", the Opinion found that ZPRIM acted with "scienter" by making this disclosure in the report and violated Section 206(1) of the Advisors Act . Opinion, pg.35. The evidence, however, showed that if the *Morningstar* box had been checked "Yes" then the firm had to list the date and a description of the charges. At the time of this report, however, there were no charges filed by the SEC and Ted Bauchle ("Bauchle"), a ZPRIM

employee solely responsible for providing information to *Morningstar*, testified that was the reason the box was checked "No". TR-285. Evidence was also introduced at the hearing, that if there were no pending SEC charges, this *Morningstar* box should be checked "No". RX-38. During oral argument held before the Commission on October 26, 2015, Commissioner PIWOWAR focused on this exact point and questioned counsel for the Division of Enforcement how someone could answer a question about an investigation when there was no pending charge. The answers provided by counsel were not satisfactory since Commissioner PIWOWAR dissented with respect "to the finding that ZPR Investment Management, Inc., violated Section 206(1) of the Advisers Act in connection with the *Morningstar* report . . ." *See* Opinion, pg.46.

20. Since at least one of the four Commissioners concluded that ZPRIM did not act with scienter regarding this charge, then, based upon the evidence, there is a "substantial indication of probable success" on appeal regarding this issue. The Division of Enforcement does not mention or address the fact that Commissioner PIWOWAR had the same interpretation of the Morningstar question as the Respondents.

21. In conclusion, if all material facts were provided to prospective investors by ZPRIM regarding its investment performance as required by the Guidelines, and the March 31, 2011 *Morningstar* report disclosure regarding the SEC investigation did not involve scienter, but instead mere negligence, then no Tier 2 violations were committed by the Respondents.[8] The absence of any Tier 2 violations would, therefore, dramatically decrease the civil money penalties and also preclude a permanent bar of Zavanelli.

[8] Two other violations of the Advisor's Act addressed by the Opinion relate to a Morningstar report for the period ended September 20, 2010, involved the negligence of ZPRIM and constituted Tier 1 violations.

I. IRREPARABLE HARM

22. The monetary sanctions assessed against ZPRIM of $250,000 and Zavanelli of $570,000 coupled with the bar of Zavanelli, have caused irreparable harm which will continue if not stayed during the appellate process. Since the Opinion did not focus on the effect the marketing packages had in the "total mix" of information provided to prospective investors at an earlier stage of the disclosure process, Respondents believe a strong showing has been made that they are likely to succeed on the merits based upon the absence of any material misrepresentation or omission in the advertisements and newsletters at issue and a lack of scienter regarding a *Morningstar* report that did not disclose the Commission's investigation.

23. The Respondents understand that financial detriment from the monetary penalties, standing alone, does not constitute irreparable harm. However, the permanent bar of Zavanelli coupled with the penalties could result in the demise of the firm. With Zavanelli's bar, the investment advice that has been the mainstay of the firm is no longer available and the performance that clients of the firm have enjoyed over the past 25 years will be difficult, if not impossible, to replace. In addition, with the departure of Zavanelli and the Commission's permanent bar of him, there have been client defections.

24. These defections have had a direct impact on the revenues of the firm and if these defections continue, ZPRIM may have inadequate revenues to satisfy its monthly expenses.

25. The firm is small with assets under management of $164 million and 105 clients as of December 12, 2013. *See* Initial Decision pg.5. Currently, as of June 30, 2016, ZPRIM's assets under management are approximately $116 million and it has 74 clients. *See* ZPRIM Form ADV as filed with the Commission on July 7, 2016. The reduction of clients and assets under

management have resulted directly from the bar of Zavanelli and, therefore, financial harm to ZPRIM has occurred and is not merely speculative.

26. The firm and Zavanelli are not a continuing, substantial threat to investors or the public. The record is clear that there was no financial harm to any member of the public or any client of the firm. ZPRIM has also taken significant corrective measures to ensure future compliance with the Advertising Guidelines by requiring any advertisement to be reviewed by Mark Zavanelli, the new president and CCO of the firm. Each advertisement is then sent to the firm's GIPS verifier for review and comment and then finally sent to an outside consulting firm that specializes in rendering compliance advice under the Advisers Act for its review and comment. TR-1776.

27. Respondents believe that the novel question of whether follow on disclosures provided to prospective investors through the marketing packages and GIPS-compliant presentations cured any deficiency in the magazine advertisements and newsletters at issue has substantial merit but if the sanctions are imposed the firm will continue to suffer irreparable harm.

III. INJURY TO OTHER PARTIES

28. There has been no injury to other parties interested in the proceeding since no financial harm was suffered by any client of the firm or any member of the investing public. The Division of Enforcement did not call any client or prospective client of the firm to prove that they had been injured by the advertisements during the administrative hearing.

IV. PUBLIC INTEREST

29. The clients of the firm are within the realm of protecting the public interest. The interests of these clients should also be protected and staying the penalties and bar would be in their best interests. The Division of Enforcement in opposition to the Motion to Stay argues the

public interest is being protected from the misconduct of the Respondents. However, this begs the question since no member of the public was ever harmed by the advertisements.

V. CONCLUSION

30. Respondents, once again, request the sanctions imposed by the Commission in the Order Imposing Remedial Sanctions be stayed until the latter of (i) the expiration of the period for the Respondents to file a petition for review of the final order or (ii) if Respondents file a timely petition for review, then until the court of appeals issues its mandate.

Respectfully submitted.

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing instrument was filed on this 1st day of August, 2016, via facsimile and that the original and three copies of the same was furnished by Federal Express, overnight delivery, to:

Securities and Exchange Commission
Office of the Secretary
100 F Street, N.E.
Washington, D.C. 20549-9303

and that a true and correct copy of the foregoing has been served via Federal Express, facsimile and e-mail on this date to:

Ms. Jill M. Peterson
Assistant Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable Cameron Elliot
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1545/MOTION44 REPLY RE MOTION TO STAY 8-1-16