UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

ORIGINAL

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

BRIEF IN SUPPORT OF APPELLANT-RESPONDENTS, ZPR INVESTMENT MANAGEMENT, INC. AND MAX E. ZAVANELLI, APPEAL OF INITIAL DECISION

PHILIP J. SNYDERBURN, ESQUIRE
Florida Bar No. 0202592
E-Mail: psnyderburn@srslaw.net
K. MICHAEL SWANN, ESQUIRE
Florida Bar No. 0442410
E-Mail: mswann@srslaw.net
SNYDERBURN, RISHOI & SWANN, LLP
2250 Lucien Way, Suite 140
Maitland, Florida 32751
Telephone: 407-647-2005
Facsimile: 407-647-1522

Attorneys for Respondents

TABLE OF CONTENTS

TABLE OF AUTHORITIES

I. INTRODUCTION[1]

The Respondents, ZPRIM INVESTMENT MANAGEMENT, INC. ("ZPRIM") and MAX E. ZAVANELLI ("Zavanelli") (collectively referred to as the "Respondents"), seek reversal or modification of the May 27, 2014, Initial Decision ("ID") of the Administrative Law Judge ("ALJ") that embodies findings and conclusions of material fact that are clearly erroneous; conclusions of law that are erroneous; and a decision of law or policy that is important in the regulation of investment advisers. The Respondents timely filed a Petition for Review, which was granted on July 22, 2014. The order granting the petition states that the Securities and Exchange Commission ("Commission" or "SEC") will determine what sanctions, if any, are appropriate.

Since 1994, when ZPRIM became registered as an investment advisor[2], Zavanelli has successfully created and managed investment portfolios for clients of the firm. While managed by Zavanelli between June 30, 2004 and June 30, 2014, the ZPRIM Global Equity composite has been rated five stars by *Morningstar, Inc.* ("*Morningstar*") and achieved a compounded return during this period of over 450%. RX-Supplement 49; the ZPRIM All Asian composite he has managed since its inception on January 3, 2007 has received a four star rating from *Morningstar* and through June 30, 2014, achieved a compounded return of over 250%. RX-Supplement 50; and the ZPRIM Fundamental Small Cap Value ("SCV") composite he has managed realized a compounded return of over 425% between June 30, 2004 and June 30, 2014 and received a four star rating from *Morningstar*. *See* RX-Supplement 51.

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[1] Citations to the transcript are noted as TR-__. Citations to the exhibits offered by the Division of Enforcement ("Division") and the Respondents are noted as DX-__ and RX-__, respectively. Respondents' supplemental exhibits are noted as RX-Supplement __.

[2] DX-89 at 21, 22.

Despite Zavanelli's substantial success as a portfolio manager, the ID concluded, in substantial part, that a claim made by ZPRIM in a few select magazine advertisements and investment newsletters misrepresented that it was in compliance with the Global Investment Performance Standards ("GIPS")[3], violated certain sections of the Investment Advisers Act of 1940 ("Adviser's Act") and warranted a censure, a cease and desist order and civil penalties of $250,000 as to ZPRIM and a permanent associational bar, a cease and desist and civil penalties of $660,000 against Zavanelli. ID, page 1. As the brief will discuss in greater detail the sanctions and civil penalties set forth in the ID are far too severe and draconian for technical violations of the GIPS Advertising Guidelines[4] especially when the Respondents disclosed accurate performance results to prospective clients through the ZPRIM website and in direct written materials before clients invested. *See* RX-8 through RX-11; RX-14, 16 and 18. The evidence did not demonstrate any knowing or intentional misconduct by the Respondents yet the ID essentially found that any departure from the requirements of the GIPS Advertising Guidelines should result in strict liability under the Adviser's Act.

The magazine ads at issue in this proceeding contained two sentences, in a small-type footnote, referring to GIPS. An example of one of these ads, which appeared in the October 2008[5] edition of *SmartMoney* magazine, appears on the following page:

[3] GIPS is a voluntary set of standards relating to the calculation and presentation of investment results that were created and administered by the CFA institute. *See* RX-3. The goal of GIPS is to achieve full disclosure and fair representation of investment performance by firms claiming compliance with GIPS. *Id.* at page 2, ¶D.10.g.

[4] The GIPS Advertising Guidelines should be followed by firms that claim compliance with GIPS in advertisements that show investment performance results. RX-3, pages 34, 35.

[5] The October 2008 *Smart Money* advertisement reprinted above was introduced into evidence during the final hearing as RX-5. The other magazine ads appeared in the November and December 2008 editions of *SmartMoney*, *see* RX-6 and RX-7; the February and May 2011 editions of *SmartMoney*, *see* RX 15 and RX-17; and the March 2011 edition of *Barron's*, *see* RX-19.

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* Results are based on fully discretionary accounts categorized as domestic small cap value equity including those accounts no longer with the firm. The composite return is calculated on a size adjusted basis. The returns in this composite are net of fees. Fees are described in the firm's ADV part II. Management fees are deducted in the first month of each quarter when they are paid. New accounts will pay initial management fee in advance which could be in a different month. Past performance does not guarantee future results. Trade date, not settlement date, is used for all valuations. Exchange & NASDAQ listed stocks are valued at the closing (last trade) price for each month. Non-national market issues are valued at the closing bid. Dividends and interest are reported with a one month lag. Incurred commission costs are included in all unrealized gains. ZPR Investment Management, Inc.'s compliance with the Global Investment Performance Standards (GIPS®) has been verified firm-wide by Ashland Partners & Company LLP from December 31, 2000 through March 31, 2008. In addition, a performance examination was conducted on the Fundamental Small Cap Value Composite beginning 12/31/2000. ZPR Investment Management, Inc. is a registered investment adviser managing separate accounts that are fully discretionary. ZPR Investment Management, Inc. claims compliance with the Global Investment Performance Standards (GIPS®). Complete description of the policies and procedures for this composite and a list and description of all firm composites are available upon request.

The ID did not and could not find that the ads claim of GIPS compliance was false since ZPRIM's compliance with GIPS had been verified firm wide by Ashland Partners & Company, LLP ("Ashland")[6] and by Alpha Performance Verification Services ("Alpha"). Nor is there any dispute that the performance information reported in the ads was entirely accurate. ID, pages 48, 49.

Instead, the ID accepted the Staff's contention that the ads were materially false or misleading because the 13th and 16th sentences in the footnote contained in the above ad technically failed to comply with the GIPS Advertising Guidelines. It is also undisputed that ZPRIM did not attract any new clients as a result of placing these advertisements and therefore, did not financially benefit. ID, page 27.

Accordingly, and as the brief will detail, the use of a footnote in six (6) advertisements by ZPRIM to make a claim of GIPS compliance; mistakenly referring to the GIPS standards by ZPRIM in two investment newsletters; and neglecting to modify certain language in two *Morningstar* reports do not warrant a lifetime bar against Zavanelli or the imposition of any Second Tier civil penalties against the Respondents. These sanctions, as set forth in the ID, are clearly punitive in nature and should be vacated by the Commission who should either dismiss the case in its entirety or at a minimum impose lesser sanctions.

II. FINDINGS OF FACT

A. BACKGROUND FACTS REGARDING RESPONDENTS

ZPRIM is a Florida corporation and since 1994 has been registered as an investment advisor. DX-89, pages 21, 22. Since its formation and until October, 2011, Respondent, Max E.

[6] Ashland verified ZPRIM for GIPS compliance between December 31, 2000 and December 31, 2009 . RX-14. Alpha verified ZPRIM for GIPS compliance from December 31, 2009 to December 31, 2013. RX-22, 29; RX-Supplement 52.

Zavanelli ("Zavanelli") has served as the President, Chief Operating Officer and sole shareholder of ZPRIM. RX-1, page 2, ¶B.2. Between May 2009 and October 2011, Zavanelli also served as the Chief Compliance Officer for ZPR[7]. DX-79, ¶9. TR page 1298, lines 11-14.

ZPRIM allocates client assets in equities amongst several proprietary strategies that include its Fundamental Small Cap Value composite ("SCV"). RX-1, page 2. ZPRIM manages its composites using a theory of stock prices known as the Growth Rate Arbitrage Price Equilibrium System ("GRAPES") and has a proprietary data base that was started in 1980 and expanded in 1994 to cover thousands of U.S. and international stocks. TR page 1380, lines 3-13.

Zavanelli is 68 years old and has been a portfolio manager for over 30 years. After graduating from high school, Zavanelli worked as a computer operator with Continental Can in New York City. TR page 1335, lines 9-12. In 1965, he enlisted in the Army and served for approximately three and half years. TR page 1356, lines 2-6. In 1969, Zavanelli was honorably discharged with a rank of first lieutenant.[8] *Id.* at lines 7-11. After his military service ended, Zavanelli returned to Continental Can as a chief computer scheduler. *Id.* at 20-25. He also attended college during this time at Bernard Baruch College and received a degree in business administration. TR page 1357, lines 1-12. Zavanelli continued his education at Columbia University and spent four (4) years there in a Ph.D. program where he studied finance and economics but for financial reasons, he did not earn a doctorate degree from that institution. TR page 1357, 1358.

[7] On October 1, 2011, Zavanelli voluntarily resigned as the President and Chief Compliance Officer for ZPRIM and his son, Mark D. Zavanelli took over those positions. TR page 1298, lines 11-14. When Mark D. Zavanelli joined ZPR, he received a 25% ownership of ZPR. On or about October 2013, Mark D. Zavanelli received 100% of the ownership for ZPR. TR page. 761, lines 8-21. In June 2014, Zavanelli voluntarily resigned as ZPRIM's Treasurer and as a member of ZPRIM's Board of Directors and no longer serves as an officer or director for the firm. RX-Supplement 53.

[8] During his military service, Zavanelli received a top secret crypto security classification because of his position as a nuclear weapons officer. *Id.* at lines 12-15.

Zavanelli then worked at Mellon Bank as a senior financial analyst and in 1977, joined American National Bank as a stock market theoretician. Soon after joining American National Bank, he became one of two investment strategists for the bank. TR page 1358, lines 18-22; TR page 1359, lines 3-12.

In 1982, Zavanelli registered Zavanelli Portfolio Research as an investment advisor with the SEC to manage money for institutional clients. TR page 1361, lines 12-22. Prior to this time, this company also sold research to institutional clients and money managers and was formed after Zavanelli left American National Bank. TR page 1361, lines 6-8.

In 1988, Zavanelli and his firm, Zavanelli Portfolio Research, were censured by the Commission and prohibited from soliciting new advisory clients for a period of six months. *See* RX-32. Other than this event, 26 years ago, Zavanelli and his firm have had no regulatory issues.

In 1991, Zavanelli relocated his investment advisory and research business to Orange City, Florida, in order to accept a teaching position at Stetson University as the first Roland George Professor and Chair of Applied Investments and Research. TR page 1369, lines 6-24. Zavanelli stopped teaching in 1994 in order to devote his full time to his businesses and divided Zavanelli Portfolio Research into three (3) separate corporate divisions.[9]

The ID erroneously found that ZPRIM's composites "have had good years and some bad years"[10] and overlooked Exhibits DX-56[11] and RX-8[12] that showed 2008 to be the only bad year ZPRIM experienced.

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[9] These corporate divisions were operated as ZPR Investment Management, Inc. ("ZPRIM"), ZPR Investment Research, Inc. and ZPR International, Inc. TR pages 741, 742.

[10] ID, page 6.

B. BACKGROUND AND OVERVIEW OF GIPS

Historically, the measurement of performance, reporting of performance results and other investment management practices varied significantly on a global scale, which limited the comparability of performance results between investment firms on a global basis. RX-3, page 1. The CFA Institute recognized the need for a global set of performance presentation standards and adopted the initial GIPS standards in February 1999 which were later amended and became effective on January 1, 2006 ("2005 GIPS Standards"). RX-3, page 3, ¶13. One of the objectives of GIPS is to:

> Insure accurate and consistent investment performance data for reporting, record keeping, marketing and presentations. *Id.* at page 1, ¶C.7.

In addition, investment firms must apply the GIPS standards:

> [W]ith the goal of full disclosure and fair representation of investment performance. *Id.* at page 2, ¶D.10.g.

It is important to note that GIPS standards are voluntary in nature and investment firms are not required to follow them. TR page 904, lines 9-11.

The 2005 GIPS standards addressed a number of categories that included composite construction, calculation, methodology, compliance and also contained guidelines regarding a firm's election to advertise. RX-3, "Table of Contents". The 2005 GIPS Advertising Guidelines provided a checklist of requirements that firms who made a claim of GIPS

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[11] Exhibit DX-56 is a quarterly performance sheet for the ZPRIM Small Cap Value ("SCV") composite with quarterly and annual performance returns. In 2009, the SCV composite had an annual return of 43.77%. In 2008, the composite had a negative annual return of (40.11%). From 2001 through 2007, the annual performance returns ranged from a high of 55.36% to a low of 3.35%. Since 2001 through 2009, the composite has realized a positive annual return of 17.28%.

[12] Exhibit RX-8 showed returns for the ZPRIM Global Equity composite. In 2009, this composite, like the SCV composite, had an annual return in 2009 of 69.44%. In 2008, the Global Equity composite had a negative annual return of (50.85%). Between 2001 and 2007, the annual performance returns for this composite ranged from a high of 49.37% to a low of 9.28%. Since 2001 through 2009, this composite has realized a positive annual return of 19.19%.

compliance and advertised their performance results were to follow that included the types of performance results that advertisements were to include. RX-3, page 34.

The GIPS standards were later amended in 2010 and became effective on January 1, 2011. RX-4, page 3. Section B.5. of the 2005 GIPS Advertising Guidelines was also amended to eliminate the requirement by firms to include "period to date" performance results in advertising. RX-4, page 30.

The ID erroneously found that firms who do not meet all of the GIPS requirements cannot represent they are in compliance with GIPS. ID, pages 8, 9. This conclusion was based on the testimony of Nikola Felix[13] ("Feliz"), a senior manager with Ashland, who stated that "a firm claiming compliance within an advertisement must follow all of the guidelines within the [GIPS] advertising guidelines." TR-930. Feliz, however, also testified as follows [Emphasis Added]:

Question: If you meet every single – if you meet item 5 [of the GIPS Advertising Guidelines] but you don't meet the other ones, is that complying with the [GIPS] Advertising Guidelines.

Answer: No. *See* TR-1090.

This testimony explicitly related only to the GIPS Advertising Guidelines requirements and was not to a firm's overall claim of GIPS compliance.

The ID's findings also did not consider an Error Correction Policy established by GIPS, which allows firms to correct compliance errors that are made without jeopardizing an overall claim of GIPS compliance. *See* RX-40; RX-41. Feliz testified that if a firm made a mistake in an advertisement and provided GIPS compliant supplemental information to prospective clients

[13] The ID also cites Div Ex 25 at 16 to support its finding but this page of the 2005 GIPS Manual discussed recommendations for Presentation and Reporting and Real Estate and is unrelated to the GIPS Advertising Guidelines or a firm's overall claim of GIPS compliance.

that corrected the mistake, the GIPS Advertising Guidelines would be satisfied. TR-1064. She also testified that when a firm took corrective action to address mistakes that appear in its advertisements, the prior mistakes or errors made do not jeopardize an overall claim of GIPS compliance by the firm. TR-1029, TR-1069. Thus, the very same witness the ID relies on for its conclusion that the ads violated GIPS actually testified to the contrary.[14]

C. ZPRIM BEGINS ITS CLAIM OF GIPS COMPLIANCE

ZPRIM retained Ashland in 2006 to conduct an initial verification of the firm's compliance with GIPS regarding its composite construction and to ensure that ZPRIM had policies and procedures in place to properly calculate performance results. DX-37, pages 1, 2; DX-40. The initial verification by Ashland covered a five year period from December 31, 2000 through December 31, 2005 and ZPRIM first claimed compliance with GIPS on or about March 23, 2006. TR page 918, lines 16-20, DX-40. Thereafter, ZPRIM continued to provide Ashland with information that was required to verify its claim of GIPS compliance on a firm wide basis and examine the performance of ZPRIM's SCV and Global Equity composites for each quarterly period that included marketing materials sent by Theodore A. Bauchle ("Bauchle").[15] TR page 919, 1019.

D. ASHLAND ASSISTED ZPRIM TO CREATE AN ADVERTISEMENT FORMAT

In 2006, Bauchle testified that Ashland helped ZPRIM create a template that could be used to place advertisements that complied with the GIPS Advertising Guidelines. TR page 187.

[14] Feliz's testimony is also consistent with information provided by the GIPS Helpdesk that "typically, the identification of an error does not require the firm from ceasing its claim of compliance with the [GIPS] Standards." *See* RX-34.

[15] Bauchle served as the Operations Manager for ZPRIM in 2006 and was subsequently appointed to serve as its Vice President. TR page 145, lines 3-7. At the time Ashland was retained by ZPRIM, Bauchle was listed by Ashland as the main contact for GIPS matters. DX-40. In addition, Bauchle had primary responsibility for GIPS compliance issues. TR page 186.

Zavanelli testified that Ashland also prepared footnote disclosures that were part of the advertisement template. TR page 1397.

The advertisement format that Ashland helped to create and footnote disclosures it prepared were used by ZPRIM to place advertisements in 2007 and from January to April of 2008. TR page 1394 through page 1397; DX-21, ZPR Advertise 00001 – 00004.

In April 2008, Ashland instructed Bauchle to remove the word "audit" from language contained in the footnote. DX-64. Ashland also suggested that additional changes to the footnote disclosure language be made by ZPRIM to include a statement regarding Ashland's performance examination of the ZPRIM composite being advertised. RX-47. As a result of these instructions, ZPRIM removed the word "audit" from the footnote and made other corrections as well. *See* DX-21, pages 00005-00021.

This evidence clearly refutes the ID's erroneous finding that it was unlikely Ashland advised ZPRIM how to craft the footnote. ID, page 14, footnote 11. Although Feliz testified that Ashland did not participate in drafting the footnotes, this documentary evidence establishes that she was mistaken on this point. TR-1070-1072. The Staff also elected not to introduce Feliz's notes to corroborate her testimony.

E. ZPRIM WAS NOT INFORMED BY ASHLAND THAT ITS ADVERTISEMENTS WERE NOT GIPS COMPLIANT

The ID erroneously found that Feliz and Hoxmeier, another member of Ashland's GIPS verification team, spoke with Bauchle about missing information required by the GIPS Advertising Guidelines within a ZPRIM advertisement he had provided to Hoxmeier in January 2008. ID, page 15.

During the final hearing, Feliz testified that after Bauchle sent the January 2008 ad (DX-21, "ZPR Advertise" No. 00002), she and Hoxmeier called him to provide feedback on certain GIPS compliance issues relating to the ad. TR page 927. According to Feliz, she and Hoxmeier told Bauchle that the January 2008 ad did not disclose the currency used for the returns and did not disclose how a prospective client could receive a GIPS compliant presentation and a list of composites for the firm.[16] TR page 928. In addition, Feliz claimed to have told Bauchle that the word "audit" should not be used in the ad. *Id.* She testified that the conversation with Bauchle occurred mid-year 2008 even though Bauchle had sent the January 2008 ad to Ashland on January 11, 2008, months before this alleged conversation took place.[17] Feliz also provided testimony that Bauchle listened to these suggestions and either during the same call or in another call Feliz had with him later that month, he indicated that ZPRIM had no intention of placing any future magazine ads. TR page 934, lines 8-25.

Feliz's recollection of these conversations is not credible for a number of reasons. First, it is inconsistent with Bauchle's testimony that no one from Ashland ever contacted him to discuss the advertisement he sent to Ashland on January 11, 2008. TR page 290, 291. There is also no written evidence to support Feliz's testimony about these conversations with Bauchle. She testified that she did not follow up the 2008 conversation with any e-mail or other correspondence to Bauchle. TR page 1020. Feliz was also unaware if Hoxmeier had followed up with Bauchle in writing on the GIPS compliance items or if she instructed Hoxmeier to do so. *Id.* Feliz also testified that the working papers maintained by Ashland that she had reviewed in preparation for her testimony at the final hearing did not contain any reference or entry

[16] The OIP does not charge the Respondents regarding these items under the GIPS Advertising Guidelines. *See* RX-1.

[17] Compare TR page 933 - page 934 with DX-55 "January 2008 e-mail from ZPRIM to Hoxmeier."

concerning any conversations Feliz had with Bauchle about the ad (January 2008). TR pages 1020, 1021. Again, these notes taken by Feliz were not introduced by the Staff.[18]

The testimony that Feliz gave during the final hearing about the mid-year 2008 call with Bauchle was also inconsistent with investigative testimony she had previously provided to the SEC on February 22, 2011. At that time, Feliz stated that prior to her first conversation with Zavanelli in early 2010 concerning the ZPRIM December 2009 client newsletter, no Ashland verifier had expressed any concerns about Max [Zavanelli], Ruth [Ann Fay] or Ted's [Bauchle] noncompliance with GIPS in marketing materials, presentation materials, advertisements or newsletters. DX-88, "Testimony of Nikola Feliz", page 36 through 37. During her testimony at the final hearing, Feliz admitted that the testimony she had previously given during the SEC investigation was truthful and that prior to 2010, there were no GIPS compliance issues for ZPRIM. TR page 1028, 1029. Despite this testimony, Feliz affirmed her statement about the conversation she had with Bauchle in 2008 regarding a ZPRIM advertisement. *Id.*

During her investigative testimony before the SEC, Feliz also reviewed the same January 2008 ad Bauchle had sent to Ashland and claimed she did not recall ever having reviewed it. DX-88, "Testimony of Nikola Feliz", pages 146, 147. Feliz went on to state that this ad did not inform someone how to get a full GIPS disclosure presentation from the firm and did not identify the currency used for performance. *Id.* at pages 147, 148. Feliz also pointed out that the ad used the word "audit." *Id.* at page 148, lines 21-25 through page 149, lines 1-3. These were the same

[18] Evidence was also presented during the final hearing that Hoxmeier had previously provided guidance through an e-mail to Bauchle concerning a marketing material ZPRIM sent to Ashland for the 2007 fourth quarter verification period. This correspondence was dated April 3, 2008, and addressed, among other issues, the use of the word "audited"[18] by ZPRIM in a Flash Report for its SCV and Global Equity composites. *See* DX-64. There are no e-mails, however, from Hoxmeier or anyone else from Ashland concerning the January 2008 ad that Bauchle sent and it was the practice of Hoxmeier to send e-mails and give written instructions on GIPS compliance issues to Ashland clients. TR page 1023, 1024.

identical issues Feliz claims she spoke to Bauchle about in mid-year 2008, but during her investigative testimony, she never mentioned the supposed conversation with Bauchle and could not recall if she had ever reviewed the January 2008 ad that Bauchle sent. *See* DX-88.

In the ID, the ALJ resolved the conflicting testimony between Bauchle and Feliz by finding that "[Feliz] convincingly explained that she had not reviewed her notes on ZPRIM prior to her investigative testimony because she had no prior notice of what the testimony would be about and she only remembered the telephone call with Hoxmeier and Bauchle when her memory was refreshed by reviewing the advertisement and her notes." ID, page 15, footnote 12.

This finding, however, overlooks the testimony of Feliz provided during the SEC's investigation of ZPRIM that revealed she had reviewed Ashland's history with ZPRIM [notes maintained] before her testimony and had no recollection of ever having reviewed the ZPRIM January 2008 advertisement. *See* DX-88, page 25; 146. She also reviewed the January 2008 advertisement and claimed she had no recollection of ever seeing it before. *Id.* pages 146, 147. As previously discussed, she also testified during the final hearing that the ZPRIM notes she reviewed did not contain any reference or entry concerning the alleged call with Bauchle. TR-1020, 1021. There were also no Ashland notes or working papers admitted into evidence that reflected any telephone calls between Feliz and Bauchle regarding the January 2008 ad. Therefore, no evidence existed that Feliz could have reviewed or refreshed her recollection about the call(s) and the evidence that was introduced during the final hearing did not support the ID's findings about a telephone call Feliz claims to have had with Bauchle about the January 2008

ZPRIM advertisement. There is simply no competent evidence to suggest that ZPRIM through Bauchle was advised of GIPS deficiencies by Ashland in the January 2008 advertisement.[19]

F. ZPRIM ADVERTISEMENTS DISCLOSED HOW AN INTERESTED PARTY COULD RECEIVE A GIPS COMPLIANT PRESENTATION

The only possible deficiency that Ashland ever pointed out to ZPRIM regarding its advertisements related to the use of the word "audit" which Hoxmeier advised Bauchle of in April 2008. DX-64; TR pages 291, 294, 1396, 1397. After April 2008, ZPRIM removed the word "audit" from all future magazine advertisements it placed. DX-21; DX-64. Feliz testified at the final hearing that the use of the word "audit" by ZPRIM in certain advertisements was not material and did not adversely affect ZPRIM's overall claim of GIPS compliance. TR-1068, 1069.

As noted, the evidence presented during the final hearing refutes Feliz's testimony that she told Bauchle in mid-2008 that a ZPRIM January 2008 advertisement was deficient because it did not identify the currency used to express returns[20] and did not inform an interested party how to obtain a GIPS[21] disclosure presentation as required by the GIPS Advertising Guidelines. RX-3; page 34, ¶ B, items 2 and 8. Bauchle testified that no one from Ashland ever informed him that there was anything wrong with the January 2008 advertisement he sent to Hoxmeier. TR page 291; DX-55.

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[19] If Feliz had actually instructed Bauchle to identify the type of currency used to calculate performance returns shown in advertisements and describe in the advertisement how a prospective client could obtain a GIPS compliant presentation, he certainly would have made those corrections in addition to removing "audit" from the footnote.

[20] In each advertisement it placed, ZPRIM included a dollar sign next to the minimum investment required to be made, which would have disclosed to prospective clients that the performance results being shown were depicted in United States currency. *See e.g.,* DX-21.

[21] The advertisement did provide information about how an interested party could obtain a list or description of ZPRIM's composites. DX-21, ZPR Advertise 00001; RX 3, page 34, ¶ B, item 2.

Under the GIPS Advertising Guidelines, advertisements must disclose "How an interested party can obtain a presentation that complies with the requirements of GIPS standards and/or a list and description of all firm composites." *See* RX-3, page 34 (item 2 of the GIPS Advertising Guidelines requirements). The ID agreed with the interpretation of this requirement offered by Jean Cabot ("Cabot"), who led the SEC's examination of ZPRIM in February 2009 and Feliz, that disclosure of both a GIPS presentation and a list and description of the firm's composites was required to be included in advertisements that claimed GIPS compliance. ID, page 15, footnote 13. The interpretation followed in the ID, however, gave no effect to the term "or" as stated in item 2, which was erroneous. The definition of "and/or" means "used to join terms when either one or the other or both is indicated." *See* Merriam Webster at merriam-webster.com. If this definition is followed, the advertisements in question were GIPS compliant regarding this requirement.[22]

G. ZPRIM DID NOT DECIDE TO INTENTIONALLY STOP SENDING ADVERTISEMENTS TO ASHLAND

The ID also erroneously found that Zavanelli intentionally told Bauchle to stop sending advertisements to Ashland after January 2008. ID, page 17, footnote 14. In reaching this conclusion, the ALJ relied on the testimony of Feliz who stated that during her "2008 telephone call" with Bauchle regarding the ZPRIM January 2008 magazine advertisement, he told her that ZPRIM did not intend to place any magazine advertisements after that time. As previously discussed, Feliz's testimony about this event was not credible and is unsupported by any

[22] In addition, the evidence presented during the final hearing clearly established that as a matter of policy ZPRIM provided every prospective investor with a copy of its most recent GIPS compliant presentation. TR-1065 (testimony of Feliz). Moreover, the disclosure within advertisements about how a prospective client could receive a GIPS complaint presentation was not an issue charged by the Commission in the OIP and therefore, should not be considered.

documentary evidence. ZPRIM did inform Ashland that it was not going to run magazine advertisements but that communication was made following the SEC's on-site examination, and conveyed in February 2009 by Ruth Ann Fay ("Fay") who served as ZPRIM's Chief Compliance Officer at that time. TR-1277. Fay also sent an e-mail to Ashland asking whether ZPRIM should be sending it advertisements for review. *See* RX-13. She further testified that neither she, Zavanelli nor anyone else ever told Bauchle that ZPRIM was not going to run any more ads in 2008. TR-1275. Thus, this evidence rebuts any notion that ZPRIM intentionally withheld advertisements from Ashland.

The ID's reliance on Cabot's testimony for support is equally misplaced. During the final hearing, Cabot initially testified that Bauchle told her that Zavanelli instructed him not to send advertisements to Ashland, during the SEC's onsite examination of ZPRIM and when Bauchle was being prepped to testify as a witness for the Commission just before the commencement of the final hearing. *See* TR pages 518, 519. There was no testimony from Bauchle, however, that corroborates Cabot's testimony. TR-139 to 438. More importantly, when Cabot testified about this important conversation, Bauchle had been released as a witness and was returning to Florida. TR page 438, line 10. At the hearing, Bauchle stated that he previously testified before the Commission that he had never sent any advertisements to Ashland. TR-286. Bauchle then testified after reviewing Exhibit DX-55 that he had sent an advertisement to Ashland, in January 2008 (TR-288, 289), which Cabot also claimed to be consistent with statements Bauchle made to her during the SEC examination and during Bauchle's witness preparation by the SEC. TR-521. Based upon this evidence, there was no testimony that supported a finding that Zavanelli told Bauchle to stop sending advertisements to Ashland. Cabot's testimony on this point, which she later changed, is wholly unreliable. If, in

fact, Bauchle told this to Cabot during the SEC examination or during Bauchle's witness prep, then why didn't the Commission have Bauchle testify to this important conversation rather than have Cabot testify regarding a hearsay statement? The reason is clear as the conversation never happened. Bauchle also testified that Zavanelli never asked him to do anything wrong. TR-266. He also stated when asked why the ads were not sent to Ashland that it was ZPRIM's policy not to send advertisements.[23] TR-149.

The Respondents may not have been aware that they were to send ads to Ashland, but there is no evidence that Ashland ever instructed them to do so. Both engagement letters between ZPRIM and Ashland failed to mention advertisements or any obligation on the part of ZPRIM to submit that type of information. *See* DX-38 and DX-40. In addition, the "Representation Letter" that Feliz testified was required to be signed before Ashland could verify a firm's claim of GIPS compliance (TR page 919, lines 1-2 through page 920, lines 1-6) did not contain any representation that ZPRIM had provided advertisements to Ashland and, in fact, does not even mention the word advertisement. *See* DX-39 "ZPRIM letter to Ashland dated 4/28/09".

During the period, Ashland verified ZPRIM's claim of GIPS compliance, Feliz testified that all information Ashland requested from ZPRIM was provided by Bauchle. TR pages 1042, 1043. The evidence and testimony presented during the final hearing further demonstrates that ZPRIM would also have provided copies of magazine ads it placed if Bauchle or other members of ZPRIM's management had been instructed by Ashland to submit such information. Clearly,

[23] Ashland never requested ZPRIM to send advertisements for Ashland to review. *See e.g.* RX-13 and testimony of Ruth Ann Fay at TR-1257, 1267, 1272, and 1274. Feliz testified that to her knowledge no one at Ashland ever instructed Bauchle to provide advertisements to Ashland TR-1041. Feliz also testified that she did contact Bauchle after he sent the January 2008 advertisement to determine whether ZPRIM had placed any additional advertisements. TR-1041.

however, there was no intent by ZPRIM or Zavanelli to withheld advertisements from Ashland as the ID suggests and there is no evidence to support this finding.

H. ZAVANELLI DID NOT RECEIVE OR KNOW ABOUT A LETTER SENT BY ASHLAND UNTIL AFTER IT HAD RESIGNED AS ZPRIM'S GIPS VERIFIER

For approximately 20 years, ZPRIM has prepared and distributed a monthly newsletter to the firm's clients, business associates and friends of Zavanelli. TR page 1437, 1438. Zavanelli did not consider the client newsletter to be an advertisement since it was not used to solicit new clients. TR page 1438, 1439. Zavanelli testified that the newsletter was used as a means to provide information about why the firm was making or losing money[24] and its strategies. TR page 1442. The client newsletters were uploaded onto the ZPRIM website along with ZPRIM's composite performance results and its GIPS compliant disclosure presentations.[25] TR page 1454.

Sometime in 2010, Feliz testified that she spoke with Zavanelli about the December 2009 issue of the client newsletter.[26] TR page 990, 991. She felt the ZPRIM client newsletter was an advertisement and that ZPRIM should comply with the GIPS Advertising Guidelines or attach a copy of its GIPS compliant presentation to each client newsletter. TR pages 956, 957. Zavanelli did not see the need to do that because he felt ZPRIM was complying with the GIPS requirements and providing its GIPS compliant presentation to prospective clients as required by section O.A.11 of the GIPS manual. TR page 1449; RX-3, page 8.

In March 2010, Feliz and one of Ashland's partners spoke to Zavanelli with him about the client newsletter issue. TR page 1456. After this call and his explanation about ZPRIM's

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[24] *See* DX-71, pages 13, 14 (November 2008 ZPRIM newsletter disclosing negative returns for the firm).

[25] Where a claim of GIPS compliance is made in a document that may be considered as an advertisement and contains performance results, the GIPS Advertising Guidelines can be satisfied by providing a GIPS compliant disclosure presentation. *See* DX-47, page ZPR Ashland TB Inbox 00074.

[26] Prior to this time, she testified that there had been no issues with ZPRIM regarding GIPS compliance. TR page 1028.

policy to provide all prospective clients with a copy of ZPRIM's GIPS compliant presentation, Zavanelli honestly believed the issue raised by Ashland about the client newsletter had been addressed. *Id.* at lines 14-17. An undated letter from Ashland was subsequently sent to Bauchle by Feliz that outlined certain options for ZPRIM to follow regarding GIPS compliance issues and its newsletter. DX-52. Zavanelli, however, did not see this letter until June 2011 during his investigative testimony at the SEC's office in Miami, Florida and did not discuss the letter with Bauchle. TR page 1457. There was no evidence introduced during the final hearing to contradict Zavanelli's testimony on this point and Feliz testified that she did not know if Zavanelli ever received her letter. TR-1087. Therefore, it was improper and clearly erroneous for the ALJ to discredit Zavanelli's testimony that Bauchle never told him about the Ashland letter.[27] ID, page 19, footnote 16.

The ID noted that Zavanelli believed the investment newsletters were not advertising materials and that the GIPS Advertising Guidelines did not apply (ID, page 31) a finding that negates any claim that he acted with scienter regarding the newsletters. Zavanelli also testified that ZPRIM was not attempting to mislead anyone with the investment newsletter. TR-1445; ID, page 31.

I. ALPHA PERFORMANCE VERIFICATION SERVICES ("ALPHA") PERFORMED ZPRIM'S GIPS VERIFIER AFTER ASHLAND RESIGNED

Ashland resigned as ZPRIM's GIPS verifier in July 2010 over issues relating to ZPRIM's investment newsletters and whether the GIPS Advertising Guidelines applied.[28] TR-1004; DX-

[27] Had Zavanelli been provided with the Ashland letter on a timely basis, he testified that ZPRIM would have simply removed all references to GIPS as was suggested by Ashland in the letter. TR page 1458; DX-52.

[28] Ashland's resignation did not concern Zavanelli since he was unaware of the letter Feliz had previously sent to Bauchle at that time (TR-1457) and honestly believed that the GIPS Advertising Guidelines did not apply to the client newsletters. ID, page 31.

36. Commencing in November or December 2010, ZPRIM retained Alpha as its GIPS verifier. ID, page 20. Bauchle testified that Alpha verified ZPRIM for GIPS compliance for calendar years 2010, 2011 and 2012. TR-398. In addition, Exhibit RX-29 from ZPRIM's current website was introduced stated the following on page 2:

> ZPR Investment Management, Inc.'s compliance with the Global Investment Performance Standards (GIPS) has been verified firm wide from December 31, 2000 through December 31, 2012. [Emphasis Supplied]

See also TR-1756-1759.

Contrary to findings set forth in the ID, evidence was introduced during the final hearing that Alpha verified ZPRIM's GIPS compliance for 2012. ID, page 20. Alpha continues to serve as ZPRIM's GIPS verifier. *See* RX-Supplement 52.

J. SEC CONDUCTED AN EXAMINATION OF ZPRIM IN FEBRUARY 2009

The SEC conducted an examination and an onsite inspection at ZPRIM's offices between February 3 and February 13, 2009. TR-444. The ID stated Cabot testified that she discussed certain GIPS related issues in the October, November and December 2008 *SmartMoney* ZPRIM advertisements with Zavanelli and that he was defensive. ID, page 21. Omitted from this statement, however, was Cabot's explanation that Zavanelli reacted to the issues she raised because "it is his business and he was very proud of his business." TR-490. His reaction, therefore, was perceived by Cabot as understandable.

K. SEC ISSUED A DEFICIENCY LETTER TO ZPRIM IN JANUARY 2010

Following the examination, ZPRIM received a deficiency letter in January 2010 from the SEC. DX-77. The ID erroneously implied that ZPRIM withheld this letter from Ashland when the evidence clearly demonstrated this was not the case.[29] ID, page 21, footnote 19.

L. ZPRIM RESPONSE TO THE SEC DEFICIENCY LETTER

ZPRIM responded to the SEC deficiency letter on February 26, 2010. *See* RX-78. Of relevance to the issues raised in the OIP, the SEC informed ZPRIM that a December 2008 advertisement placed in *SmartMoney* magazine contained a claim of GIPS compliance but did not include GIPS period to date composite performance results for ZPRIM's SCV composite and either a one, three and five year annualized composite returns or five years of annualized composite returns. DX-77, page 2. In addition, the SEC's examination found that ZPRIM stated its composite performance results had been audited in January and February 2008 advertisements placed in *Kiplinger's* magazine. *Id.*

Evidence demonstrated that magazine advertisements placed by ZPRIM after the date of its response to the SEC deficiency letter were not required to include period to date performance returns under the 2010 GIPS Advertising Guidelines. *See* RX-4, page 30, ¶5.a. Advertisements placed after its response to the SEC deficiency letter by ZPRIM also included one, three and five year annualized returns with the end period clearly identified. *See* DX-21, ZPR Advertise 00020 and 00021. In addition, ZPRIM removed the word "audit" from footnotes to magazine

[29] ZPRIM made Ashland aware of the SEC onsite examination that was conducted in February 2009. *See* RX-13. The evidence also demonstrated that Ashland performed GIPS verification services for ZPRIM between December 31, 2000, and December 31, 2009 and that Ashland did not perform any GIPS verification services for ZPRIM after December 31, 2009. *See* DX-36. However, since Ashland provided no verification services for ZPRIM after December 31, 2009, there was no need or obligation for ZPRIM to provide Ashland with the SEC deficiency letter, which was not issued until January 2010. DX-77.

advertisements it placed after April 2008. *Id.,* pages ZPR Advertise 00005 through 00011 and 00013 through 00021. Based upon these actions, the ID erroneously found that ZPRIM did not correct deficiencies in advertisements placed after the date of its response to the SEC deficiency letter.[30] ID, page 22.

M. ZPRIM FOLLOWED THE 2010 GIPS ADVERTISING GUIDELINES PRIOR TO THEIR ENACTMENT AS A POLICY OF BEST PRACTICES

In 2010, the GIPS Advertising Guidelines were modified to eliminate the requirement by firms to include period-to-date performance returns in advertisements. See RX-4, page 30, ¶5.a. Zavanelli also testified that in 2009 he followed the new GIPS guidelines to place advertisements prior to its effective date as a "best practices". ID, pages 29, 30. However, the ID gave no credence to this testimony since the new guidelines were not implemented until March 29, 2010 and according to the ID, "well after the November and December 2009 advertisements...." The ID further states, at page 30, footnote 26, that "Although it is theoretically possible that Max Zavanelli could have been aware in 2009 of the planned 2010 GIPS Guidelines' option to drop period-to-date returns, there is no record evidence explaining how he gained such awareness...." Admitted into evidence, however, was the ZPRIM newsletter for December 2009, which reported there were changes to GIPS standards that would be taking place in 2010 and the firm was working with its verifier (Ashland) to implement the new changes. RX-24, page 4.

[30] Bauchle was not involved in responding to the SEC deficiency letter but was primarily responsible for GIPS compliance and was the primary contact person for Ashland (TR-296, 297) while Fay was the person responsible for responding to the deficiency letter. *See* DX-78. Thus, it is clear that she had not seen or been told about a November 24, 2008, email Bauchle received from Ashland that listed GIPS Advertising Guidelines which might have applied to the ZPRIM website. DX-47. Since Fay was not aware of this correspondence, her response to the SEC's deficiency letter that questioned why Ashland did not advise the Respondents about certain GIPS issues was not disingenuous as the ID determined. ID, page 22, footnote 20.

Based upon this evidence, Zavanelli's testimony is credible that the firm was adopting "best practices" by following the new 2010 GIPS Advertising Guidelines before they went into effect.

N. THE ADVERTISEMENT FORMAT USED BY ZPRIM BETWEEN OCTOBER AND DECEMBER 2008 WAS NOT CHANGED TO AVOID PUBLICIZING POOR RETURNS

Advertisements placed by ZPRIM in the 2008 October, November and December issues of *SmartMoney* magazine did not include performance results required by the GIPS Advertising Guidelines. *See* RX-5, 6 and 7. However, all performance results that were required by the GIPS Advertising Guidelines were disclosed by ZPRIM on its website and made available to prospective clients through direct mailings between October and December 2008 when the *SmartMoney* advertisements at issue were published.[31] RX-8 -11.

In addition, the evidence demonstrated that Bauchle and others, but not Zavanelli, created the format used to place the *SmartMoney* advertisements. RX-46 and RX-48. The evidence also demonstrated that Zavanelli was not provided with copies of these advertisements prior to publication.[32] TR-1415 through 1417. The evidence also demonstrated that the format used for these *SmartMoney* advertisements was totally inconsistent with specific instructions Zavanelli had given Bauchle to follow the previous format ZPRIM had used to place its 2008 April advertisement in *SmartMoney.* TR-1413, 1414. *See also* DX-21, ZPR Advertise 00004.

[31] The non-compliant GIPS deficiencies that appears in the *SmartMoney* advertisements were corrected through other GIPS compliant disclosures being made available by ZPRIM, which effectively rebuts the ID's findings that ZPRIM was trying to hide its performance results through these advertisements. ID, page 24.

[32] The first time that Zavanelli ever saw the *SmartMoney* advertisements was on February 2, 2009, when Cabot showed them to him during the SEC's on-site examination of ZPRIM. TR page 1415-1417.

In addition, Zavanelli testified that at no time in 2008 did Bauchle ever express any concerns to him that any advertisement ZPRIM was going to run was not GIPS compliant.[33] TR page 1479, lines 1-5.

The evidence showed that Bauchle's knowledge about the GIPS Advertising Guidelines in 2008 was limited and oftentimes misguided. For example, during his investigative testimony before the SEC in October 2010, he testified that he did not believe the January 2008 *SmartMoney* advertisement was GIPS compliant since it did not contain one, three and five years of annualized returns. DX-155, page 103, lines 12-25. During the final hearing, however, Bauchle contradicted himself and agreed that the five year annual performance results contained in prior advertisements placed by ZPRIM, which included the same January 2008 advertisement were GIPS compliant. TR page 402, lines 9-24.

Bauchle was also unaware of any concerns about GIPS compliance issues in July 2008 when he reviewed a proposed advertisement that he and others (but not Zavanelli) had created and which was inconsistent with the advertisement format ZPRIM had previously been using. Compare RX-46 and RX-48 with DX-21, ZPR Advertise 00004 and 00005. Bauchle's comments about the new proposed format were as follows:

> Easy to read. . . . Footnote needs some updating. When you guys decide on a final ad, make sure Amy [Bauchle's wife] gets a doc version to update the footnote. P.S. Ruth Ann will want you to ad "Inc." to the end of our company name. [Emphasis Supplied] RX-46

On July 18, 2008, Bauchle provided the corrected footnote language to include in the new advertisement but never mentioned the need to include one, three and five years of annualized performance returns in this ad. RX-46. This advertisement format -- not the format Zavanelli

[33] Fay also testified that before the SEC's examination in February 2009, she had never discussed any GIPS compliance issues with Bauchle. TR page 1264-1267.

had instructed Bauchle to follow -- was then used for the October, November and December 2008 advertisements.[34] RX-48, DX-21, pages 00005-00007.

Clearly, Bauchle was unaware of the need for one, three and five year annualized returns to be included in advertisements for GIPS compliance at this time and, therefore, could not have spoken with Zavanelli or Fay about this issue before the October – December 2008 *SmartMoney* advertisements were placed since he would have raised the issue in July 2008 when he reviewed the new proposed advertising format, which was obviously much different than the format ZPRIM had previously used. Compare RX-46 and RX-48 with DX-21, ZPR Advertise 00004. Bauchle's recollection of dates, events and conversations regarding the October, November and December 2008 advertisements was simply inaccurate and, therefore, the ID erroneously found that his testimony on this issue was credible. ID, page 24.

O. ZAVANELLI'S TESTIMONY RELATING TO THE OCTOBER, NOVEMBER AND DECEMBER 2008 *SMARTMONEY* ADVERTISEMENTS WAS NOT CONTRADICTORY

Zavanelli consistently maintained that he was not provided with copies of the 2008 October, November and December *SmartMoney* advertisements and therefore, never reviewed them before publication. TR-1415, 1416. The testimony he provided during the SEC's investigation and at the final hearing regarding an edit of the October 2008 advertisement does not contradict his position that he did not review the advertisement before they were published. TR-1418, 1419; DX-89 at 55, 140. In fact, his instructions to the ad formatter to chop the

[34] It is also important to note that when these advertisements were placed and purchased, Zavanelli was out of the country due to economic turmoil that affected the Asian financial markets. TR page 1418 through 1420. Upon his return to the ZPRIM office in October 2008, Zavanelli testified that he had no discussions with Bauchle about these advertisements or any GIPS issues regarding the advertisements. *Id.*

advertisements because of their length were made over the telephone[35] and there was no evidence to suggest Zavanelli had a copy of the advertisements during this call.[36] Thus, the ID erroneously concluded that Zavanelli's testimony was contradictory with respect to these advertisements. ID, pages 25, 26.

P. ZPRIM APRIL AND DECEMBER INVESTMENT NEWSLETTERS DID NOT HAVE TO FOLLOW THE GIPS ADVERTISING GUIDELINES

ZPRIM did not make a claim of GIPS compliance in its April or December 2009 newsletters in the context of being required to follow the GIPS Advertising Guidelines.

Zavanelli had written an article in the April 2009 newsletter that discussed the impact of the SEC's uptick rule on ZPRIM's performance results. TR page 1441, 1442. This article was not attempting to promote ZPRIM or solicit any new clients and was simply designed to illustrate a point that was totally unrelated to marketing or advertising. RX-23, page 3. This newsletter also revealed that the ZPRIM's SCV composite underperformed the Russell 2000 and the S&P 500 indices in 2008.[37]

In the December 2009 client newsletter, ZPRIM affirmatively stated that this publication was not GIPS compliant. [Emphasis Supplied] RX-24, page 4. Also, Zavanelli's comments and opinions about GIPS that are contained in this newsletter do not violate the GIPS Advertising Guidelines as Feliz testified. TR 1083, lines 9-14. Feliz also testified that the GIPS Advertising Guidelines do not apply for advertisements that don't contain a claim of GIPS compliance. TR-

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[35] *See* TR-1418, 1419.

[36] Respondents' Exhibits 46 and 48 also demonstrated that Zavanelli did not participate in creating the advertisement format and was not aware that David Sappir ("Sappir") was involved in this process. Sappir acts as a marketing consultant for ZPRIM. DX-59.

[37] Ashland reviewed the April 2009 newsletter as part of its verification process and had no concerns with it. TR page 990, 991.

1081. Accordingly, the ID erroneously found that the ZPRIM was required to follow the GIPS Advertising Guidelines in its April and December 2009 investment newsletters. ID, page 31.

Q. THE TESTIMONY PROVIDED BY ZAVANELLI ABOUT *MORNINGSTAR* REPORTS WAS CREDIBLE

ZPRIM began providing data about its investment performance results to *Pensions and Investments* in 1991 and then later to *Morningstar* who forwarded it to *Pensions and Investments.* TR-1463, 1464.

Zavanelli's unrebutted testimony, which was also corroborated by Bauchle demonstrated that Bauchle was solely responsible for providing data to *Morningstar*; that Zavanelli did not have a login password to the *Morningstar* database; and that Zavanelli never accessed the *Morningstar* data base.[38] TR-269, 270, 277, 1466, 1581.

Zavanelli also testified that the first time he learned the *Morningstar* reports had a "pending SEC investigation box," was when ZPRIM received a Wells notice from the SEC on April 27, 2012. TR-1467. *See also* RX-28, page 27. This testimony was likewise unrebutted and should have been viewed by the ALJ as credible. As a result, the ID's erroneously found that Zavanelli's testimony about the *Morningstar* reports was not credible. ID, page 32.

[38] The evidence further showed that he was not aware of the specific information Bauchle was providing to *Morningstar* until at least May 12, 2011 and clearly after the September 30, 2010 and March 31, 2011, *Morningstar* reports raised in the OIP were published. DX-157, RX-25, 26.

R. *MORNINGSTAR* INSTRUCTIONS REQUIRED THAT CHARGES BE FILED BEFORE DISCLOSURE OF AN SEC INVESTIGATION WAS NECESSARY

Exhibit RX-38 was admitted into evidence and represented screen shots from the *Morningstar Institutional Data Manager* through which Bauchle would upload information about ZPRIM . Pages 3 and 4 of RX-38 contain the phrase "Pending SEC Investigation Charge" and "Effective Date" which prompts the firm who is providing data to *Morningstar* to answer "yes" or "no". If "yes" is answered to a "Pending SEC Investigation Charge," then the date of the charge ("Effective Date") must be provided. *Id.*

Since no formal "charges" were filed by the SEC before the date of the OIP, April 4, 2013, ZPRIM understandably did not answer "yes" and report a "Pending SEC Investigation Charge" in *Morningstar* reports dated September 30, 2010 and March 31, 2011. RX-25, 26.

Zavanelli's testimony about how ZPRIM responded to the *Morningstar* disclosure item concerning a "Pending SEC Investigation" was, therefore, credible and consistent with the very requirements of *Morningstar* itself[39] and the ID's contrary finding is clearly erroneous. ID, page 34.

III. ERRONEOUS CONCLUSIONS OF LAW

A. THE ID ERRONEOUSLY CONCLUDES THAT WHILE ALL OF THE INFORMATION IN THE MAGAZINE ADVERTISEMENTS AND NEWSLETTERS REGARDING PERFORMANCE WAS ACCURATE AND COMPLIED WITH THE GIPS STANDARDS REGARDING PERFORMANCE, THE ADVERTISEMENTS WERE MISLEADING BECAUSE, IN A FOOTNOTE, THE FIRM SAID IT WAS GIPS COMPLIANT. ID, PAGES 47-49.

The evidence was uncontradicted that ZPRIM was GIPS compliant from December 31, 2000 to December 31, 2012 and was verified by GIPS compliance firms. RX-14, ZPR Ashland Opinions 00001, RX-22 and RX-29, page 2. Notwithstanding this evidence, the ID concluded

[39] *See* TR-1714, 1715; RX-38.

that failing to follow the GIPS Advertising Guidelines regarding performance periods somehow rendered the ZPRIM advertisements misleading since they included a claim that the firm was GIPS compliant. The claim of GIPS compliance was included in a footnote to the advertisements and should not be viewed in isolation. Whether a misrepresentation is material is satisfied when there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available." *See Basic, Inc. v. Levinson,* 485 U.S. 224, 236, 108 S.Ct. 978, 985, 99 L.Ed.2d 194, 211 (1988); *Matrixx Initiatives, Inc. v. Siracusano,* 131 S.Ct. 1309, 179 L.Ed.2d 398 (2011). The evidence demonstrated and the ID concluded that if someone responded to an advertisement placed by ZPRIM before becoming a client they would receive a GIPS compliant presentation. ID, page 9, footnotes 6, 13. In addition, the advertisements directed the reader to the firm's website which also contained the GIPS compliant presentations until March 2010. ID, page 12. The website also contained ZPRIM annualized returns that included one, three and five year performance periods. *Id.* The website also provided bar charts showing the performance of the firm's composites as compared to their bench marks. *Id.* When this "total mix" of information is then taken into consideration, it is impossible to conclude that the ZPRIM advertisements were misleading or misrepresented the performance results of the firm. For example, it has been held that accounting irregularities that related to a small portion of the overall financial picture were immaterial as a matter of law. *See Schuster v. Symmetricon, Inc.,* 2000 WL 33115909 [2000-2001 Transfer Binder] Fed.Sec.L.Rep (CCH) ¶91,206 (N.D. Cal. 2000) and *Hutchison v. Deutsche Bank Securities, 647 F.3d 479 (2d Cir. 2011).* It would also be impossible for a prospective client to conclude the firm was not GIPS compliant since it was, in fact, GIPS compliant which was confirmed by the verification firms that reviewed the

performance of ZPRIM during the relevant periods of time. RX-14, 22. As a result, a footnote in the six ZPRIM magazine advertisements at issue that contained a claim of GIPS compliance when coupled with the "total mix" of information was not misleading. *See In Re. Michael R. Pelosi*, Release No. IA-3805, March 27, 2014.

B. SCIENTER: MAGAZINE ADVERTISEMENTS AND NEWSLETTERS. THE ID ERRONEOUSLY CONCLUDES THE RESPONDENTS ACTED WITH SCIENTER WHEN THE GIPS ADVERTISING GUIDELINES WERE NOT FOLLOWED.

Scienter is generally defined as a mental state embracing intent to deceive, manipulate or defraud. *Ernst & Ernst v. Hochfelder*, 425 US at 185, 193 (1976). The Eleventh Circuit, which would have jurisdiction of this matter in the event of an appeal, requires that scienter be proven by a "showing of either an 'intent to deceive, manipulate, or defraud,' or 'severe recklessness.' *See Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1238 (11th Cir. 2008) (quoting *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1284 (11th Cir. 1999). If the Respondents intended to deceive, manipulate, or defraud a prospective client through the advertisements, they would not have provided the reader with a plethora of information that provided full and fair disclosure of all material facts necessary for a prospective client to make before becoming an actual client of ZPRIM. This information clearly showed that the firm in 2008 was underperforming its benchmarks in 2008. *See* RX-8 through 11. At this time, the Russell 2000 and S&P 500 benchmarks were in negative territory and so were the firm's investment composites as reflected by the information that Respondents readily made available. *Id.* The inquiry then turns to the issue of "severe recklessness," which was defined by the Eleventh Circuit in *Bryant* as follows:

> Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence

> but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it. [Emphasis Supplied]

Id. (quoting *Bryant,* 187 F.3d at 1282 n. 18 (quotation marks omitted by the Mizzaro court).

When the conduct of the Respondents is viewed under this standard, it is clear that there was no danger that a prospective client was being misled, since a flood of additional information was being openly provided by ZPRIM regarding its investment performance. The advertisements, even if viewed in isolation, would not be considered "highly unreasonable misrepresentations" since the accuracy of all of the information in the body of the ZPRIM advertisements is not in dispute. ID, pages 48, 49. At best, the conduct of the Respondents would amount to simple or excusable negligence in failing to follow the GIPS Advertising Guidelines but does not rise to the level of severe recklessness. As a result, the Respondents did not act with scienter and therefore, did not violate Section 206(1) of the Adviser's Act. *Bryant, supra.*

C. SCIENTER: *MORNINGSTAR* REPORT MARCH 31, 2011. THE ID ERRONEOUSLY CONCLUDED THAT THE RESPONDENTS ACTED WITH SCIENTER BY FAILING TO DISCLOSE THE SEC INVESTIGATION IN THE REPORT.

The ID found that in regard to the September 30, 2010, *Morningstar* report, which claimed that Ashland had audited[40] the firm, ZPRIM acted only negligently through Bauchle with no intent to defraud. ID, page 55. However, the ID then states that as to the March 31, 2011, *Morningstar* report, ZPRIM acted with scienter in failing to disclose the SEC investigation since Bauchle (who was responsible for keeping the *Morningstar* data base current) acted with

[40] As noted, Ms. Feliz testified that the use of the word "audit" in an advertisement was not material and did not jeopardize a claim of GIPS compliance. TR-1068, 1069.

"willful blindness" and was thus reckless. The ID also concluded that the failure of Bauchle to update the *Morningstar* report regarding the SEC investigation was not "an intentional effort to mislead...," ID, page 56. During the final hearing as discussed, evidence was produced that until formal charges were brought, Bauchle honestly did not believe ZPRIM was required to disclose information to *Morningstar* regarding a "Pending SEC Investigation Charge." TR-285; RX-38. *See also* RX-28 (Disclosure of SEC Wells notice by ZPRIM on Form ADV). At best, this evidence demonstrates negligence on the part of the firm but not recklessness as the ID found. ID, page 56. The ID confusingly gives weight to Zavanelli's testimony in response to a question asking how he would have answered the question on the *Morningstar* data base regarding the SEC investigation. The question was irrelevant and called for speculation because the evidence was clear that Zavanelli had no involvement in providing information to *Morningstar*. TR-269, 270. Zavanelli testified that he would have checked the box "no" when asked if there was an investigation. However, omitted from the ID was the testimony of Zavanelli explaining why he would have answered "no". Zavanelli testified that if the box were checked "yes," the next question then asks you to disclose the charges and the date. Up until the OIP there were no charges and no date relating to the charges. Zavanelli also testified that his son, Mark Zavanelli, who became the chief operating officer for the firm in October 2011, checked with *Morningstar* who stated if there were no charges, you answer the question "no". TR-1714. Under the rational of *Bryant, supra,* it is clear that the Respondents were not severely reckless and therefore, did not act with scienter when responding to the *Morningstar* website inquiry. Finally, the evidence also showed that the general public did not have access to the *Morningstar* data base. RX-37. The two ZPRIM reports raised in the OIP were only available to institutional investors who paid *Morningstar* fees for access and ZPRIM has never received any

clients through *Morningstar*. RX-37; tr-1587. Mark Zavanelli also testified that he individually purchased a general subscription package from *Morningstar* and when he searched under ZPRIM there was no reference to the firm. TR-1797, 1798.

D. MATERIALITY: THE ID ERRONEOUSLY CONCLUDES THAT THE MISREPRESENTATIONS IN THE ADVERTISEMENTS WERE MATERIAL SINCE AN INVESTOR WOULD HAVE CONSIDERED THE INFORMATION TO BE IMPORTANT IN DECIDING TO INVEST AND THE OMITTED FACTS WOULD HAVE SIGNIFICANTLY ALTERED THE 'TOTAL MIX' OF INFORMATION

The ID relies heavily on the fact that the October, November and December 2008 *SmartMoney* advertisements placed by ZPRIM reported five, 10 and 20-year returns, which showed strong returns that were double and triple the SCV Composite benchmarks. If one year returns and period to date results had been included as required by the GIPS Advertising Guidelines, the data would have shown that the SCV composite was negative and underperforming one of the benchmarks, the Russell 2000 index. ID, page 57. The ID, however, makes no reference to all of the additional information that was available on the ZPRIM website and being provided to prospective clients, which included the one year and the period to date returns that accurately reflected the negative performance of the SCV composite for those periods and its underperformance against the Russell 2000 benchmark. *See* RX-8 through RX-11. The ID then determined that the representations made by ZPRIM in the two *Morningstar* reports at issue, regarding its GIPS verification through the present were inaccurate. ID, page 57. The evidence, however, demonstrated that the firm had been GIPS compliant from December 31, 2000 through the dates of the two *Morningstar* reports (September 30, 2010 and March 31, 2011). RX-14, 22. Therefore, when the "total mix" of information is evaluated, a claim of GIPS compliance by ZPRIM within the advertisements and the *Morningstar* reports

raised in the OIP is not material nor is it misleading unless viewed in isolation which is contrary to the holding in *Basic v. Levinson, see infra.*

E. ASSOCIATIONAL BAR: THE ID ERRONEOUSLY CONCLUDES THAT MAX ZAVANELLI SHOULD BE SUBJECT TO A PERMANENT ASSOCIATIONAL BAR

(a) **ZAVANELLI SHOULD NOT BE SUBJECT TO A PERMANENT BAR.** If the Commission accepts Respondents' position on the merits, it follows that the sanctions imposed by the ID against both ZPRIM and Zavanelli cannot stand. However, even if the ID's findings of violations of the Adviser's Act are upheld in whole or part, the Commission can and should modify the sanctions so that Zavanelli is not subject to a permanent associational bar. A lifetime bar is an extraordinary remedy, usually reserved for those defendants who intentionally engaged in prior securities violations under circumstances suggesting the likelihood of future violations. *SEC v. Blatt,* 583 F.2d 1325, 1334 (5th Cir. 1978); *SEC v. Boey,* 2013 WL 3805127, 3 (D.N.H. 2013); *SEC v. Drexel Burnham Lambert, Inc.*, 837 F.Supp. 587 (S.D.N.Y. 1993), *aff'd, SEC v. Posner,* 16 F.3d 520 (2d Cir. 1994).

(i) The *Steadman* Factors Do Not Support A Permanent Bar. The ID devotes but a single paragraph to addressing whether the conduct at issue in this case was egregious for sanctions purposes. ID, page 61. And that one paragraph is concerned exclusively with equating Respondents' conduct to the violations found in *In the Matter of Seaboard Investment Advisers, Inc.*, 54 S.E.C. 111(2001). Yet this case and *Seaboard* are vastly different. In *Seaboard*, the individual respondent, Hansen, sent letters to advisory clients that affirmatively misrepresented the performance of their accounts in relation to benchmark indices. He went so far as to alter the performance of one referenced index. In addition, Hansen ignored internal procedures for securing approval of the client letters before they were sent, and his misconduct

occurred while he already was subject to a consent injunction issued along with a prior 12-month associational suspension. *Id.* at 1112-14.

By contrast, it is undisputed that all ZPRIM clients received GIPS-compliant presentations before they opened accounts. ID, page 9, footnote 6. The record contains no evidence that any client ever even saw any of the magazine advertisements at issue in this case, much less was misled by them. There was also no evidence that any client ever saw the challenged *Morningstar* reports and in any event, those reports are irrelevant to Zavanelli's sanctions because the ID acknowledges that a different individual, former ZPRIM employee, Bauchle, was responsible for the *Morningstar* database. ID, pages 55-56.

Thus, the ID asserted reasons for finding Zavanelli's conduct egregious – that it was closely similar to the conduct in *Seaboard* – cannot withstand scrutiny. The very brevity of the ID's discussion of this point indicates that the ALJ did not meaningfully consider the egregiousness factor when he determined Zavanelli's sanction. *See Monetta Financial Services, Inc. v. SEC*, 390 F.3d 952, 957 (7th Cir. 2004) ("Although the SEC's opinion references these factors, the opinion does not reflect that the SEC meaningfully considered these factors when it imposed sanctions.") (footnote omitted).

Apart from the stark differences between this case and *Seaboard*, a conclusion that Zavanelli's conduct was egregious – that it was "extremely or remarkably bad" or "flagrant" – deprives that word of any meaningful utility in the determination of sanctions. It is one thing to cause direct financial injury to a client, *see Gonchar v. SEC*, 409 Fed.Appx. 396, 400 (2nd Cir. 2010) (conduct was "egregious" and warranted bar where customers were charged excessive markups), or where an advisor has pleaded guilty to criminal securities fraud and to lying to the Commission, *Korman v. SEC*, 592 F.3d 173 (D.D.C. 2010). That is clearly egregious behavior,

but nothing remotely like that occurred here. In addition, there was never even a possibility that any client would be misled about ZPRIM's performance because it is undisputed that every client received a GIPS-complaint presentation before being allowed to invest, and the firm's performance, presented in compliance with GIPS, also was publicly available on its website. TR pages 363, 681 and 1041. *See also* RX-8. Nor does this case involve any false representations of ZPRIM's actual performance. *See* RX-1. At most, as it relates to Zavanelli, this case involves a rather arcane distinction between how GIPS requires a firm to *calculate* its investment performance, on one hand, and the format that GIPS' Advertising Guidelines prescribes for *communicating* that performance. To call the mistakes in ZPRIM's ads "egregious" is to diminish the exceptional meaning of that word.

In a recent decision entered on August 13, 2014 by the United States District Court for the Northern District of Illinois, Eastern Division, the Magistrate Judge refused to issue a permanent penny stock associational bar against the defendant, Philip Powers ("Powers") who admitted that he violated the securities laws by failing to register as a broker dealer. *SEC v. Benger, et al.*, (N.D. Ill.) Case No. 09-C-676, 2014. In *Benger* Powers participated as an escrow agent in the offer and sale of Regulation S stock on behalf of various penny stock issuers. *Id.* at page 5. Although Powers did not effectuate the transactions, he received and disbursed funds from the stock sales and received commissions of over $77,000. *Id.* The court noted that the failure by Powers to register as a broker dealer, while not insignificant, was not so egregious as to warrant a lifetime permanent bar and it so held despite finding Powers had acted within scienter. *Id.* at page 6. *See also SEC v. Metcalf*, Fed.Sec.L.Rep. P 97, 203 (S.D.N.Y. 2012)

The facts outlined in both *Benger* and *Metcalf* involved conduct that was significantly more serious than Zavanelli's actions in this case. Unlike the respondents in those cases, neither Zavanelli nor ZPRIM realized any monetary gain and no investor transactions were implicated.

(b) ***The "Recurrence" Factor Does Not Support A Permanent Bar.*** The ID is too glib in declaring that "[r]espondent's eleven violations between October 2008 and March 2011 were obviously recurrent." ID, page 61. That conclusory assertion elides important distinctions. Six of the 11 violations consisted of magazine advertisements, published in 2008 and 2011 (but not 2009 or 2010). What the record, but not the ID, makes clear is that these six advertisements resulted from just two decisions. The first was ZPRIM's decision to enter into a three-ad purchase agreement with *SmartMoney* for publication of the October, November and December 2008 ads. TR-1408. In the second decision, ZPRIM contracted with *Pensions & Investments* magazine for permission to reprint certain tables, originally published in that magazine, which compared ZPRIM's performance to peer money managers. RX-21. The contract required ZPRIM to reprint the tables as they had been published in *Pensions & Investments*. As a result, ZPRIM reprinted the tables in ads in the February and May 2011 editions of *SmartMoney* and the March 21, 2011 edition of *Barron's*. See RX-15, 17 and 19. The same sin was committed in each of the six ads – the inclusion of a footnote statement that ZPRIM was GIPS-compliant without setting forth all information called for by GIPS' Advertising Guidelines. But when the six magazine ads are properly viewed as the results of just two distinct publishing decisions, calling them "recurrent" violations is a distortion.

The recurrence factor set forth in *Steadman* is not automatically established through separate actions. The Magistrate Judge in *Benger* found that the SEC had not made "a convincing case" that recurrent violations had occurred despite escrow agent Powers' role in

1,400 transactions. *Benger Id.* at pages 10-12. In addition, where prior violations of a defendant occurred years in the past, especially the conduct is unrelated, repeat offenses or recidivism is not present. *In Re. Reserve Fund Securities and Derivative Litigation*, 2013 WL 5432334, 23 (S.D.N.Y. 2013) (30 years between violations does not establish the defendant as a repeat offender).

All of the charges raised in the OIP against the Respondents, with the sole exception of disclosing the SEC investigation in two *Morningstar* reports, related to claims of GIPS compliance made within advertisements, client newsletters and one *Morningstar* report. Under *Benger* and cases it relied on, the conduct of Respondents cannot be viewed as recurrent. In addition, the prior Offer of Settlement that Zavanelli and Zavanelli Portfolio Research entered into with the SEC was over 26 years ago involved minimal sanctions that included a censure and the inability to solicit or accept new clients for 180 days. RX-32. As discussed, these sanctions were not the result of any intentional fraudulent or deceptive conduct. Under the rational of *In Re. Reserve Fund Securities and Derivative Litigation*, the prior violations of Zavanelli and Zavanelli Portfolio Management are isolated events and do not establish that these parties are repeat offenders. *Id.*

Accordingly, the Commission should reject the ID's conclusion that *Steadman*'s recurrence factor weighs heavily in favor of the sanctions against Zavanelli.

(c) ***The Scienter Factor Does Not Support A Permanent Bar.*** The ID is especially curt in its discussion of *Steadman*'s scienter factor as it relates to sanctions:

> Respondents' degree of scienter for each violation varied. As to the magazine advertisements, the scienter was relatively high, because Zavanelli intended to conceal his poor performance from investors. As to the newsletters and the March 31, 2011, Morningstar report, the scienter was relatively low, because Zavanelli sincerely, but recklessly, believed that the newsletters were not

> advertisements, and because Bauchle was willfully blind to the fact of the Commission's investigation. As to the September 30, 2010, Morningstar report, there was no scienter because the violation involved only negligence.

ID , page 61.

Even taking these conclusions at face value, they do not support the draconian remedy of a permanent bar for Zavanelli. As the ID notes, it found a total of 11 violations. ID, page 61. Six of these were for the magazine advertisements, but these six were the only violations which are said to have entailed a "relatively high" degree of scienter. The remaining five violations – two in the newsletters and three in *Morningstar* reports – involved only "relatively low" scienter or, in the case of the September 30, 2010, *Morningstar* report, no scienter at all. And *none* of the *Morningstar* reports can count against Zavanelli for *Steadman* purposes, given the ID's finding that he had no responsibility for those reports. Accordingly, so far as Zavanelli is concerned, more than 45% of the violations – five out of the 11 – involved either "relatively low" or *no* scienter. In that light, it cannot be said that *Steadman*'s scienter factor supports the regulatory equivalent of the death penalty against Zavanelli. *See, e.g., SEC v. Benger, supra,* (no permanent bar despite finding of scienter). *In the Matter of Leo Glassman*, 46 S.E.C. 209, 211-12 (1975) (although Commission viewed respondent's conduct "as extremely serious" and violations were committed while respondent was already under a consent injunction, record supported six-month suspension rather than 15-month bar with right to reapply for restricted positions, as the ALJ had ordered).

(d) ***No Likelihood Of Future Violations.*** *Steadman* also directs consideration of the sincerity of respondent's assurances against future violations and whether his occupation will present opportunities for future violations. Here, Zavanelli can point not merely to words but to actions – as of October 2013, he turned over complete ownership of ZPRIM to his son, Mark

Zavanelli. Under the new owner's stewardship, ZPRIM has hired a new outside compliance firm and taken other steps to insure that GIPS-related occurrences will not reoccur that the ID clearly recognized. ID, pages 35, 36. Zavanelli is no position to interfere with these remedial steps.

A modified bar is especially appropriate in light of the ID's statement that ZPRIM "has provided sincere assurances against future violations and recognized the wrongful nature of its conduct." ID, page 61. This acknowledgment that the firm is not likely to commit future violations also provides assurance that Zavanelli would not be in a position to do so if his role were limited to providing investment advice, without his having any involvement in any other aspect of the firm's business.

The evidence demonstrated that to address GIPS advertisement issues and other compliance matters, Zavanelli in October 2011 hired his son, Mark Zavanelli, to serve as the President and Chief Compliance Officer for ZPRIM and has also served as a director. TR-1747. He recently was appointed to serve as the firm's Treasurer after Zavanelli resigned. RX-Supplement 53.

Since taking on these responsibilities, Mark Zavanelli has addressed several compliance issues for the firm and "is making and has made considerable progress in improving its [ZPRIM] compliance practices." ID, page 61; TR-1764-1768. Mark Zavanelli's efforts have also included the retention of National Consulting Services to review ads and other areas of compliance for the firm. TR pg 1479.

Mark Zavanelli is a former mutual fund manager for OppenheimerFunds and holds a degree in economics from the Wharton School of Business. TR pg 1738-1740. He is also a member of the CFA Institute and is a Chartered Financial Analyst. TR pg 1741.

(e) ***Zavanelli's Acceptance Of Responsibility.*** It is ironic that the ID recognizes the sincerity and reliability of ZPRIM's assurances against future violations while crediting Zavanelli with none. It was, after all, Zavanelli who gave up all of his interest in ZPRIM and resigned as an officer and director, after this dispute arose, and installed the new owner who instituted the reforms that the ID recognizes as likely to prevent future violations.

The ID appears to hold it against Zavanelli that he defended against the Staff's allegations. Yet that cannot properly be deemed a factor in the sanctions determination. *See SEC v. Johnson*, 595 F.Supp.2d 40, 45 (D.D.C. 2009), *quoting SEC v. First City Financial Corp.*, 890 F.2d 1215, 1229 (D.C. Cir. 1989):

> The SEC also argues that Benyo has not recognized the wrongful nature of his actions because he testified in a July 2007 deposition that he thinks he did nothing wrong. Needless to say, Benyo has a right to vigorously contest the SEC's allegations and was not required "to behave like Uriah Heep in order to avoid an injunction."

In fact, it is impossible to read the ID without suspecting that the ALJ's annoyance with Zavanelli's pugnacious personality influenced his decision to impose the harshest possible sanction against Zavanelli. The ID devotes three single-spaced pages to a remarkable attack on Zavanelli's "demeanor," complaining about his "combativeness, evasion, and non-responsive answers" during investigative testimony. ID, page 43. To be sure, Zavanelli did not always appear to be trying to charm either the Staff or even his own counsel when he was on the stand. Given that Zavanelli is not a legal professional but a layman who was defending himself and the enterprise that is his life's work against charges of wrongdoing, it is hardly surprising that he was sometimes a difficult witness. On the other hand, in the colloquy that the ALJ chose to quote, Zavanelli *apologized* no fewer than four times when he realized that his impatience or his tendency to digress had gotten the better of him. ID, pages 44-45. Fairly assessed, the record

does not justify the conclusion that Zavanelli fails to appreciate the mistakes that he made and refuses to accept responsibility for them. Pages 43 through 45 of the ID, however, raise disturbing questions about whether Zavanelli was improperly penalized for behavior that should have no legal significance.

F. CIVIL PENALTIES: THE ID ERRONEOUSLY CONCLUDES THE CONDUCT IN QUESTIONS WARRANTS SECOND TIER PENALTIES RATHER THAN FIRST TIER PENALTIES

For the reasons just discussed, the ID erred in concluding that application of the *Lybrand* factors supports assessment of Second-Tier penalties against both Respondents. ID, pages 63-64. This is true even if the Commission were to accept that the magazine ads, newsletters or *Morningstar* reports operated as a fraud or deceit (despite the complete lack of evidence that anyone was defrauded or deceived). It is well established that a fraudulent *effect* may result from conduct that is merely negligent, in which case first-tier rather than second-tier penalties are appropriate. *SEC v. Moran*, 944 F. Supp. 286, 297 (S.D.N.Y. 1996) ("While the language of the statute describing the Second Tier penalty includes fraudulent conduct, there is an unmistakable difference between conduct which negligently operates as a fraud when compared to conduct engaged in with the intent to defraud clients.") At worst, Respondents were negligent in failing to appreciate the implications of a reference to GIPS-compliance in a small-type footnote in the magazine ads, in failing to consider the newsletters as "advertisements" for GIPS purposes, and in their interpretation of *Morningstar's* reporting requirements. The absence of fraudulent intent is clear from, among other circumstances discussed above, Respondents' undisputed provision of GIPS-compliant presentations to each and every investor prior to opening an account and disclosure of other information that accurately represented ZPRIM's performance results during the relevant periods.

IV. IMPORTANT POLICY CONSIDERATIONS

A. WHETHER THE FAILURE TO FOLLOW A VOLUNTARY ADVERTISING GUIDELINE MAKES A CLAIM OF GIPS COMPLIANCE MISLEADING WHEN THERE HAS BEEN COMPLIANCE WITH ALL OF THE GIPS STANDARDS?

There was no evidence presented by the Commission that the Respondents failed to comply with any of the GIPS standards.[41] To the contrary, the evidence demonstrated that ZPRIM had complied with all of the GIPS standards over a period of 12 years. It is important to note the GIPS Advertising Guidelines specifically state the guidelines do not replace the GIPS standards. *See* Exhibit RX-3, page 33; RX-4, page 29, GIPS Advertising Guidelines. As a result, the Advertising Guidelines cannot be considered to be GIPS standards. Therefore, if a firm claims in an advertisement that it is GIPS compliant, the representation only relates to the GIPS standards and not the GIPS Advertising Guidelines. As a result, when ZPRIM claimed that it was a GIPS compliant firm in the advertisements, the statement was accurate and not misleading since ZPRIM had complied with all of the GIPS standards. RX-14, 22. This becomes important since there was no charge in the OIP that failing to follow the GIPS Advertising Guidelines amounts to a violation of the Adviser's Act. *See* RX-1.

The ID effectively concludes that a failure to follow any requirements under the GIPS Advertising Guidelines without consideration of any other information that is available to prospective client shall result in strict liability under the Adviser's Act. This result does not consider important factors such as good faith, materiality, substantial compliance or the lack of false or misleading statements pertaining to an advertisement that simply departs from the GIPS Advertising Guidelines. GIPS itself explicitly acknowledges that mistakes and errors may occur

[41] GIPS standards are separate from the GIPS Advertising Guidelines and are set forth in RX-4, pages 6, 7.

and can be addressed through the Error Correction Policies[42] without jeopardizing a firm's right to claim overall GIPS compliance.[43] The ID, if left undisturbed, will create a chilling effect amongst firms who currently or intend to claim compliance with GIPS for fear that innocent mistakes will result in harsh sanctions.

B. THE ID REPEATEDLY REFERS TO CIRCUMSTANCES WHICH WERE IRRELEVANT TO THE ISSUES CHARGED IN THE OIP SOLELY FOR THE PURPOSE OF CASTING THE RESPONDENTS IN A NEGATIVE LIGHT IN ORDER TO JUSTIFY THE DRACONIAN SANCTIONS

The ID repeatedly ventures into areas that were not included in the OIP, which is impermissible. *In Re. Int'l Shareholder Servs. Corp.*, [1975-1976 Transfer Binder] Fed.Sec.L.Rep (CCH), ¶80,493 (April 29, 1976), the Commission stated:

> If the staff thought it had a case in these areas, it should have touched on them in its pleading. Or having failed to do so the first time around, should have amended that pleading to raise fraud and quasi-fraud issues. But since the staff did not do that and since the order for proceedings does not even hint at fraud in any sense, the staff's effort to sneak fraud charges into the proceeding via the back door of 'public interest' was grossly improper.

At the outset of the hearing, the Staff insisted upon having a subpoena issued by the ALJ that required the Respondents to produce over 860,000 documents. *See* Order of ALJ dated October 11, 2013. The request caused a continuance and forced the Respondents to dedicate substantial time and effort to comply with the subpoena while not preparing for the hearing. The documents requested spanned periods of time that were not related to the time periods in the OIP. The Respondents objected to the subpoena which was overruled and the ALJ ultimately deemed that there had been compliance with the subpoena. After the production of the documents, which were e-mails between various personnel at ZPRIM , the e-mails were then

[42] RX-40, 41.
[43] RX-34 "Comments from the GIPS Helpdesk;" TR-1068, 1069 "Testimony of Ms. Feliz".

used to examine Mark Zavanelli and Max Zavanelli. TR-1623-1625. Many of the e-mails discussed the SEC investigation in an unfavorable light. The OIP, however, did not include any charges that the firm's books and records were deficient but the Commission requested an adverse inference in the proceeding for allegedly withholding and spoliation of evidence during the examination, which was denied by the ALJ. *See* ID, page 42. It is also important to note that upon the conclusion of the firm's examination by the SEC, the deficiency letter did not list any problems with the books and records of the firm. DX-77. Evidence relating to the e-mails produced in response to the trial subpoena was improperly relied on by the ALJ to evaluate both liability and sanctions against the Respondents. *See* ID, pages 37-43.

In regard to the issue of these e-mails, the following dialogue took place regarding the involvement of Zavanelli with the firm after he resigned and his son assumed the responsibilities as the Chief Operating Officer for ZPRIM. The dialogue was between counsel and the ALJ concerning how Zavanelli was answering questions as follows (*see* TR-1623 – 1625):

Snyderburn: Yes, You Honor. Just for purposes of the record, the OIP in this particular case involves eight advertisements and a *Morningstar* publication. What I've listened to over the last three-and-a-half hours in the examination are events that took place in '11, '12 and '13.

I have not seen admitted one e-mail, I believe from the OIP period. And what I'm trying to figure out, and we've agreed to stipulate, Zavanelli is involved in the business, but I'm trying to figure out how this relates to the charges that are in the OIP. I mean, if Zavanelli was still the president of the company, what does that have to do with the price of tea in China, as it relates to the eight charges?

It seems to me what we need to focus on is did we violate the securities laws on those eight ads.

****

But we have spent yesterday afternoon and this morning on DX-Exhibits 115 through 145, and the only thing we've heard is are you [Max

Zavanelli] involved in the business. And all of a sudden, it seems my client is now being blamed for this ---- you know, he's not answering the questions the right way.

This also troubled the ALJ when the Commission requested a three week continuance on the first day of the hearing. *See* TR-22.

Judge Elliot: Okay. I disagree with you [counsel for the SEC]. Here's what you're going to do – or here's what I recommend you do. Obviously, this is not up to you or me. If you think there has been some sort of concealment, spoliation, whatever you want to call it, bring another charge against him [Max Zavanelli]. Bring another OIP for failure to cooperate with the examination or something like that.

But, until Sunday, you thought you could prove your case with the evidence you had, right? So I think we should get to that. I mean, you don't even know what's in this evidence, right?

In addition to the e-mails not being an issue in the OIP, the ID also relied upon other advertisements that were not included or charged in the OIP. *See* ID, page 28, "Additional Advertisement Issues."

The ID also references that ZPRIM used carve-outs in it GIPS complaint presentations without disclosing the carve-outs. Once again, however, there is no mention in the OIP of the advertisements being deficient due to the failure to disclose the carve-outs and therefore, any reference to these matters should be excluded. *See* ID, page 11.

The ID also references that certain advertisements placed by ZPRIM did not disclose the currency under the GIPS Advertising Guidelines that was being utilized in determining the performance. ID, page 29. There is no charge in the OIP that failing to disclose the currency in the advertisements renders the advertisements misleading and therefore, any reference made by the ID to these matters should be excluded.

The ID also references that the advertisements did not clearly disclose how an investor could receive a GIPS compliant presentation. ID, page 29. There is no charge in the OIP, however, that the advertisements were misleading due to this lack of disclosure and therefore, any reference to these matters in the ID should be excluded.[44]

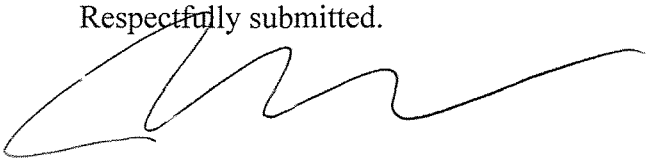
As a result of having to defend matters that were not included in the OIP, all reference to these extraneous issues, as described above, should be stricken from the ID and disregarded including all documents that were admitted into evidence that did not relate to the OIP charges.

V. CONCLUSION

The draconian penalties that have been recommended by the ALJ for failing to properly footnote six (6) advertisements; mistakenly referring to GIPS in the two investment newsletters; neglecting to remove the word "audit" and change a date in one *Morningstar* report; and possibly misunderstanding a *Morningstar* instruction relating to a "Pending SEC Investigation Charge" are simply unwarranted. If ZPRIM had not made a claim that it was a GIPS compliant firm in the advertisements or newsletters raised in the OIP, no investigation or administrative proceedings would have been commenced since there has never been any other allegation or contention by the Commission that such advertisements or investment newsletters were misleading or fraudulent. Common sense dictates that a five star rated *Morningstar* adviser should not be banned for life due to a footnote or other mistake that caused no financial or other harm to the public. Barring him from providing astute investment advice to his clients makes no sense whatsoever.

[44] As noted in this brief, the evidence demonstrated that ZPRIM sent each prospective client a GIPS compliant presentation. ID, page 9, footnote 6. As a result of this practice, the lack of instruction in an advertisement on how a reader could obtain a GIPS compliant presentation cries form over substance.

Respectfully submitted.



PHILIP J. SNYDERBURN, ESQUIRE
Florida Bar No. 0202592
E-Mail: psnyderburn@srslaw.net
K. MICHAEL SWANN, ESQUIRE
Florida Bar No. 0442410
E-Mail: mswann@srslaw.net
SNYDERBURN, RISHOI & SWANN, LLP
2250 Lucien Way, Suite 140
Maitland, Florida 32751
Telephone: 407-647-2005
Facsimile: 407-647-1522

Attorney for Respondents