UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15263

In the Matter of	
ZPR INVESTMENT MANAGEMENT, INC., AND MAX E. ZAVANELLI,	
Respondents.	

DIVISION OF ENFORCEMENT'S RESPONSE TO RESPONDENTS' SUPPLEMENTAL BRIEF IN SUPPORT OF MOTION FOR RECONSIDERATION

I. INTRODUCTION

The First Circuit Court of Appeals' recent decision in *Flannery v. SEC*[1] does not, in contrast to the arguments of Respondents ZPR Investment Management ("ZPRIM") and Max E. Zavanelli, provide a basis for the Commission to reconsider its opinion in this matter.

Respondents' arguments about the applicability of *Flannery* to this case are wrong for two primary reasons. First, ZPRIM and Zavanelli misconstrue the Commission's findings against them. They argue that, under *Flannery*, the Commission erred in finding them liable for omitting performance return information from ZPRIM's advertisements because the omitted returns were available through other sources. Therefore, the omitted information allegedly was not material when considering the "total mix" of information. However, this claim does not address the Commission's chief finding against Respondents: that their advertisements falsely claimed compliance with the Global Investment Performance Standards ("GIPS"). Respondents do not dispute the finding that they claimed GIPS compliance in advertisements that did not

[1] Case No. 15-cv-10n80, 2015 WL 8121647 (1st Cir. Dec. 8, 2015).

comply with GIPS. Nor do they claim that the fact that they did not comply with GIPS was available through other sources. Nor could they. There is no evidence in the record that ZPRIM and Zavanelli ever disclosed their failure to comply with GIPS.

Second, the facts in *Flannery* are inapposite to the instant case. As set forth in more detail below, unlike the situation here, there were no findings in *Flannery* that the Respondents had misrepresented *actual* performance results or compliance with a highly-regarded industry standard. Nor was there any finding in *Flannery* that the Respondents deliberately chose to ignore an industry standard and publicly misrepresent facts, which is exactly what the Commission found ZPRIM and Zavanelli did here.

For those and the other reasons discussed below, *Flannery* does not provide a basis for the Commission to reconsider its opinion.

II. BACKGROUND

A. The Order Instituting Administrative Proceedings and Initial Decision

The Commission issued the OIP in this matter on April 4, 2013 against ZPRIM and Zavanelli. In September and October 2013, the Law Judge held a seven-day public hearing in Washington, D.C. The Law Judge issued his 66-page Initial Decision on May 27, 2014.[2] The Law Judge found the Respondents engaged in eleven violations of the federal securities laws between October 2008 and March 2011.[3] Specifically, the Law Judge found ZPRIM violated Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") by misrepresenting compliance with GIPS in magazine advertisements and investment report newsletters, and violated Sections 206(2) and 206(4) and Rule 206(4)-1(a)(5) of the Advisers Act

[2] Initial Decision Release No. 602.

[3] *Id.* at 61

by making misrepresentations in Morningstar Reports that there was no pending Commission investigation of ZPRIM and ZPRIM's performance returns had been audited.[4] The Law Judge also found Zavanelli aided and abetted ZPRIM's violations of Sections 206(1), 206(2), and 206(4).[5]

B. The Commission's Opinion

Respondents appealed the Initial Decision, and on October 30, 2015, the Commission issued an Opinion sustaining the Law Judge and finding ZPRIM and Zavanelli made misrepresentations in advertisements regarding, among other things, compliance with GIPS. The Commission held that it is in the public interest to impose an industry bar on Zavanelli, censure ZPRIM, order Respondents to cease and desist from further violations, and assess a $250,000 civil money penalty on ZPRIM and a $570,000 civil money penalty on Zavanelli.

C. Respondents' Motion for Reconsideration

On November 16, 2015, Respondents filed a motion for reconsideration of the Commission's opinion. The Commission did not direct the Division to file a response. On December 14, 2015, Respondents moved to file a supplemental brief addressing the applicability of *Flannery* to this proceeding. The Commission granted that motion and directed the Division to file a response to the supplemental brief.

III. RESPONDENTS' SUPPLEMENTAL BRIEF FAILS TO SET FORTH A BASIS FOR RECONSIDERATION OF THE COMMISSION'S OPINION

A. Standard for Motion for Reconsideration

Reconsideration is an extraordinary remedy "designed to correct manifest errors of law or

[4] *Id.* at 46-59.

[5] *Id.* at 59.

fact or permit the presentation of newly discovered evidence."[6] Respondents may not use motions for reconsideration to reiterate arguments previously made or to cite authority previously available.[7] Motions for reconsideration are granted only in exceptional cases.[8]

B. Respondents Misconstrue the Commission's Opinion and the OIP in this Case

Respondents' arguments miss the mark because they fail to address the actual conduct for which the Commission found Respondents liable. In reality, the OIP alleged and the Commission found that ZPRIM, through Zavanelli, made false claims of compliance with GIPS in its advertisements.[9] GIPS is a standardized set of voluntary, ethical principles for investment advisers; it is published by the CFA Institute, is based on ideals of full disclosure and fair representation, and includes guidance on how to calculate and report investment performance results to prospective clients.[10] GIPS includes specific guidelines applicable to performance advertisements when those advertisements claim GIPS compliance.[11] As the Commission correctly found, compliance with the GIPS Advertising Guidelines ensures that, where a firm claims compliance and discloses financial results, those results are complete, fairly presented,[12]

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[6] *Steven Altman, Esq.*, Exchange Act Release No. 63665, 2011 WL 52087, at *1 (Jan. 6, 2011).

[7] *Daniel Imperato*, Exchange Act Release No. 74886, 2015 WL 2088435, at *1 (May 6, 2015) (citing *Altman*, 2011 WL 52087, at *1).

[8] *Francis V. Lorenzo*, Exchange Act Release No. 9803, 2015 WL 3505301, at *1 (June 3, 2015).

[9] OIP at 2-5; Opinion at

[10] *Id.* at 3.

[11] *Id.* at 2-5.

[12] Opinion at 18 (citing 2005 GIPS at 1, Section I.A.3. (preamble) ("Requiring investment management firms to adhere to performance presentation standards will help assure investors that the performance information is both complete and fairly presented."); and 2005 GIPS at 2, Section I.D.10.b. (reciting that one of "several key characteristics" of GIPS is that "[t]he GIPS standards are ethical standards for investment performance presentation to ensure *fair representation and full disclosure* of a FIRM'S performance.") (emphasis added in Opinion)).

and comparable to those of other firms.[13]

In ZPRIM's advertisements, Respondents claimed GIPS compliance while failing to comply with GIPS in those same advertisements. Specifically, they omitted information GIPS requires firms to include in advertisements that include representations of GIPS compliance. Because the advertisements did not comply with GIPS, the Commission correctly sustained the Law Judge's finding that Respondents falsely claimed GIPS compliance in the advertisements. Respondents do not challenge this finding. They do not – and cannot – argue that the truth about ZPRIM's non-compliance with GIPS was available elsewhere. They try to get around this glaring flaw by arguing that the omitted returns that would have made the advertisements GIPS compliant were available elsewhere. Thus they claim their failure to comply with GIPS – and their misrepresentation as to actual compliance – was not material in the total mix of information.

However, as the Commission correctly held, Respondents' argument cannot be squared with a fundamental purpose of GIPS: requiring that advertisements that represent GIPS compliance disclose financial performance data intended to assure comparability of performance numbers among financial advisers.[14] Investors should not be required to search for additional information that a firm represents it has already provided through its claims of GIPS

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[13] *Id.* (citing 2005 GIPS at 1, Section I.C.6. (explaining that one GIPS objective is "[t]o obtain worldwide acceptance of a standard for the calculation and presentation of investment performance in a fair, comparable format that provides full disclosure"); 2005 GIPS at 33, Appendix C – GIPS Advertising Guidelines, Section A. (explaining that GIPS provides "greater uniformity and comparability among investment managers . . . to facilitate a dialogue between FIRMS and their prospective clients about the critical issues of how the FIRM achieved historical performance results and determines future investment strategies")).

[14] Opinion at 19 (citing 2005 GIPS at 33 ("The guidelines are mandatory for FIRMS that include a claim of compliance with the GIPS Advertising Guidelines in their advertisements.")).

compliance.[15] Moreover, Respondents cannot demonstrate that the exact same information omitted from the advertisements was available to investors. Even if they could, this would not change the Commission's finding that the advertisements were misleading because ZPRIM failed to adequately draw attention to that information.[16] The Commission correctly relied on the Eleventh Circuit Court of Appeals decision in *SEC v. Morgan Keegan & Co., Inc.* that "[t]he way information is disclosed can be as important as its content."[17] In that case, the Eleventh Circuit found that the defendant's "weak, or non-existent, distribution of written disclosures," did not render contrary oral misrepresentations immaterial as a matter of law.[18]

C. The Facts in *Flannery* are Inapposite to the Instant Case

Respondents argue *Flannery* supports a finding that the misrepresentations here were not material given the "total mix of information" available to investors. They are wrong. In the relevant portion of *Flannery*, the Commission's findings against one respondent, James Hopkins, were based on a presentation he made to an investor, during which he used a slide deck that included a slide titled "Typical Portfolio Exposures and Characteristics—Limited Duration Bond Strategy." This slide depicted an allocation of 55% in asset-backed securities, when in fact the

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[15] *Id.* (citing *Dolphin & Bradbury, Inc.*, Exchange Act Release No. 54143, 2006 WL 1976000, at *9 (July 13, 2006) (declining to include information disclosed in local media accounts in total mix of information), *petition denied*, 512 F.3d 634, 641 (D.C. Cir. 2008); *Donner Corp. Int'l*, Exchange Act Release No. 55313, 2007 WL 516282, at *10 (Feb. 20, 2007) (rejecting "Applicants' argument that the research reports did not need to disclose the omitted facts because they believed a reasonable investor would read the company's public filings and obtain the information from those filings and because some reports provided a hyperlink to the Commission's website where those filings were available"); *Richmark Capital Corp.*, Exchange Act Release No. 48758, 57 SEC 1, 2003 WL 22570712, at *7 (Nov. 7, 2003) (finding that letter to stockholders, press release, and brief mentions of relevant contract in "media reports were not part of the 'total mix' of information reasonably available" to respondent's customers).

[16] Opinion at 20.

[17] *Id.* (citing *Morgan Keegan*, 678 F.3d 1233, 1250 (11th Cir. 2012)).

[18] *Id.* at 1252.

fund's investment in asset-back securities had reached nearly 100%. The First Circuit found the evidence of materiality was marginal, and noted the slide was labeled "Typical," it was one in a deck of at least twenty, and accurate allocation information was available to investors upon request, as well as through various fact sheets, a password-protected website, and annual audited financial statements.[19] The Court also relied on expert testimony that "a typical investor" in an unregistered fund would not rely solely on a slide presentation, but would perform additional due diligence, and would know that it could specifically request additional information.[20]

Those facts are inapposite to the present case. First, contrary to Respondents' argument, the Court in *Flannery* made clear that the holding concerning accurate information and materiality applies only to a narrow set of circumstances that are not present here. As the Court explained:

> We do not suggest the mere availability of accurate information negates an inaccurate statement. Rather, when a slide is labeled "typical," and where a reasonable investor would not rely on one slide but instead would conduct due diligence when making an investment decision, the availability of actual and accurate information is relevant.[21]

This case does not present analogous facts. ZPRIM's advertisements did not purport to show "typical" information about ZPRIM. The advertisements reported *actual* returns, and failed to disclose the *actual* returns required by GIPS to claims GIPS-compliance. Respondents presented no evidence that a potential investor would not have relied on the advertisement and would have conducted due diligence to supplement the information presented. As the Commission correctly found, "[i]nvestors should not be required to search for additional

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[19] *Flannery*, 2015 WL 8121647, at *8.

[20] *Id.*

[21] *Id.* at n. 8.

information that a firm represents it has already provided through its claims of GIPS compliance."[22] Nor did Respondents disclose anywhere that in truth, ZPRIM was not a GIPS-compliant firm. Thus, the finding in *Flannery* regarding the materiality of the "Typical Portfolio Slide" is inapplicable to the Commission's assessment of the materiality of the misrepresentations and omissions of *actual* returns in this case.

Second, Respondents' argument that performance return information was available in other locations misses the mark. As set forth above, this ignores the actual violation at issue – a false claim of GIPS compliance, which Respondents do not challenge. Nor do Respondents argue they disclosed the lack of GIPS compliance anywhere. Moreover, while the respondent in *Flannery* distributed actual performance results omitted in the presentation slide, here, the Commission correctly found the evidence does not support Respondents' contention that ZPRIM in fact corrected the false statements of GIPS compliance through other sources.[23] Respondents provide no newly discovered evidentiary support for their assertion because there is no such evidence.

Third, the evidence of scienter in this case significantly distinguishes it from *Flannery*. Here, there were specific guidelines ZPRIM had agreed to abide by claiming GIPS compliance. Zavanelli admitted he knew what the guidelines were, and the evidence showed he

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[22] Opinion at 19.

[23] Opinion at 17-18. In the instant brief, Respondents cite only the testimony of independent soliciting agent David Sappir and Respondents' Exhibit 11 for their assertion that ZPRIM sent potential investors the omitted information. (Resp. Br. at 2-3) (citing Hearing Transcript at 1192-93). However, as the transcript shows, Sappir testified only that he forwarded potential investors' contact information to ZPRIM and ZPRIM did not notify him about sending materials to investors, and Sappir did not testify about Exhibit 11. Nor does Respondents' Exhibit 11 disclose ZPRIM's non-compliance with GIPS or cure the omissions. Instead, as Feliz testified, Exhibit 11, which states ZPRIM is GIPS compliant, is not GIPS-compliant. (Hearing Transcript at 1105:24-1106:3; RX-11).

made a deliberate, conscious choice not to follow them yet still claim GIPS compliance. These facts set the instant case apart from *Flannery*, in which it was not alleged that the respondent had failed to follow specific guidelines or had made a conscious choice to violate governing standards.

Fourth, Respondents' reliance on *Flannery* to argue the Commission erred in finding materiality because the Division failed to call a witness to testify about materiality is flawed. In *Flannery*, the Court found that a letter edited by the other respondent, John Flannery, was not misleading. The Court noted the Division did not present testimony on the issue of materiality, and Respondents seize on this to argue the Division must call an *investor* witness to testify that the claim of GIPS compliance in ZPRIM's advertisements was material. However, there is no requirement that materiality be proved in any particular way, and here both ZPRIM's vice president, Ted Bauchle, and GIPS verifier, Feliz, testified that many institutional investors will not consider investment advisers unless they provide GIPS-compliant returns.[24] Moreover, Zavanelli admitted that GIPS compliance is a threshold factor for institutional investors considering money managers.[25] It stands to reason that firms like ZPRIM include claims of GIPS compliance in their advertisements because, to institutional investors, GIPS compliance is important in deciding whether to invest. Indeed, Bauchle testified ZPRIM began claiming GIPS compliance after learning it helped attract institutional investors, and Zavanelli conceded at the hearing that claiming GIPS compliance helped attract institutional investors.[26] All of this evidence went to materiality.

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[24] *Id.* at 18.

[25] Initial Decision at 56.

[26] *Id.* at 51.

Additionally, "misrepresentations overstating [Respondents'] performance as against market benchmarks [are] material."[27] Zavanelli admitted that knowledge that a firm's composites did not meet its benchmarks is important to investors.[28] These facts are not analogous to *Flannery*, which did not involve misrepresentations concerning an industry standard and admissions by the Respondents that the misrepresented facts were important to investors.

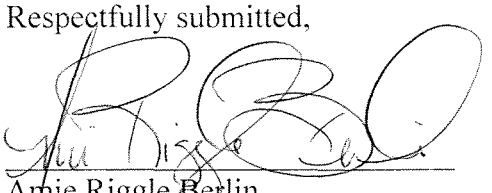
Accordingly, *Flannery* is inapposite to the present case and does not support reconsideration of the Commission's opinion in this matter.

IV. CONCLUSION

Respondents have failed to carry their burden of demonstrating that the Commission should reconsider its Opinion. Accordingly, the Commission should deny the extraordinary relief the Respondents seek.

January 20, 2016

Respectfully submitted,



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[27] *Seaboard Investment Advisers, Inc.*, 54 S.E.C. 1111, 1118 (2001).

[28] Initial Decision at 56.

CERTIFICATE OF SERVICE

I hereby certify that an original and three copies of the foregoing were filed with the Securities and Exchange Commission, Office of the Secretary, 100 F Street, N.E., Washington, D.C. 20549-9303, and that a true and correct copy of the foregoing has been served by overnight, on this 20th day of January 2016, on the following persons entitled to notice:

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

And a true and correct copy of the foregoing has been served via e-mail, facsimile and/or UPS on this date to:

The Honorable Cameron Elliot
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