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SEC Administrative Law Judge Bars Investment Manager for Misrepresenting GIPS Compliance

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Introduction

On May 27, 2014, an administrative law judge (ALJ) found ZPR Investment Management, Inc. (ZPRIM) and its former owner, Max Zavanelli, to have violated the Investment Advisers Act of 1940 for publishing misleading advertisements that fraudulently claimed compliance with the Global Investment Performance Standards (GIPS).¹ As a result, ZPRIM was censured, issued a cease-and-desist order, and fined \$250,000 in civil penalties. Zavanelli was permanently barred from association with investment advisers and other financial services organizations, issued a cease-and-desist order, and fined \$660,000 in civil penalties. The decision is particularly significant because the ALJ issued such severe sanctions based solely on false claims of GIPS compliance notwithstanding the fact that all reported performance returns were accurate and no investors relied on or were harmed by the false claims of compliance. The Zavanelli case should serve to put firms on notice that persistent noncompliance with the GIPS standards can have serious consequences and that all marketing materials should be subject to effective review and approval policies and procedures prior to distribution or publication to ensure compliance with the GIPS standards.

Background

GIPS is a standardized set of voluntary, ethical reporting principles for performance reporting published by the CFA Institute.² It was created to standardize performance result reporting to provide comparability among asset managers and facilitate investor confidence in reported returns. When a firm claims compliance with GIPS, the firm is required to follow specific guidelines to calculate and report performance results.³ While claiming GIPS compliance is voluntary, it is becoming increasingly important to attract institutional investors. Although the U.S. Securities and Exchange Commission (SEC) has brought a number of actions against investment advisers for misrepresenting compliance with GIPS,⁴ the recent sanctions

¹ Decision located at: <http://www.sec.gov/alj/aljdec/2014/id602ce.pdf>

² ZPR Inv. Mgmt., Inc., SEC Initial Decision Release No. 602, Admin. Proceeding File No. 3-1526, at 3 (SEC May 27, 2014) (internal citation omitted).

³ *Id.* at 3.

⁴ See e.g., Locke Capital Mgmt., SEC Initial Decision Release No. 450, Admin. Proceeding File No. 3-14457 (SEC Feb. 7, 2012) (ALJ barred investment adviser and ordered him to pay over \$3.5 million in disgorgement and civil penalties for falsely claiming GIPS compliance, lying to investors and regulators by maintaining a fabricated client, falsely inflating assets, and falsifying records and filings made with the SEC); Stan D. Kiefer & Assoc., SEC Initial Decision Release No. 2023, Admin Proceeding File No. 3-10736 (Mar. 22, 2002) (ALJ ordered censure, cease-and-desist, and civil penalty of \$10,000 for investment adviser's violations concerning advertisements highlighting firm's performance during years the firm did not exist, materially overstating the firm's number of clients and assets, and disseminating advertisements that falsely claimed compliance with GIPS's predecessor, the Association for Investment Management & Research's Performance Presentation Standards (AIMR-PPS)). See also Schield Mgmt. Co., SEC Initial Decision Release No. 1872, Admin. Proceeding File No. 3-10008 (SEC May 31, 2000); Engbretson Cap. Mgmt. SEC Initial Decision Release No. 1825, Admin. Proceeding File No. 3-10010 (SEC Sept. 13, 1999).

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against ZPRIM and Zavanelli demonstrate that GIPS violations alone, even if no investors are harmed, can constitute material misrepresentations prompting SEC enforcement and can result in severe penalties, including heavy fines and a permanent bar from the industry.⁵

GIPS Violations

ZPRIM is an SEC-registered investment adviser founded by Zavanelli. Zavanelli was responsible for all final business decisions, including the distribution and publication of ZPRIM's marketing materials. Between 2008 and 2011, ZPRIM published magazine advertisements and investment report newsletters claiming GIPS compliance, despite being informed that the advertisements failed to include information required under the GIPS standards. Specifically, the advertisements failed to: (1) provide information on how an interested investor could receive a GIPS compliant presentation; (2) disclose the currency used to express returns; and (3) present performance returns for the periods required under GIPS.⁶ Further, the advertisements demonstrated selective period reporting ("cherry-picking") by ZPRIM and Zavanelli that presented ZPRIM's composites in a more favorable light by allowing ZPRIM to avoid revealing negative returns and unfavorable benchmark comparisons.

In 2009, the SEC conducted an examination of ZPRIM that identified numerous GIPS compliance deficiencies. The SEC subsequently issued a deficiency letter stating that one of ZPRIM's performance advertisements failed to comply with the GIPS Advertising Guidelines, and two ZPRIM publications made inaccurate claims stating that ZPRIM's GIPS compliance had been "audited," rather than verified. ZPRIM responded that it would make the necessary corrections, but in many cases did not. In August 2010, the SEC began an official investigation which culminated in an Order Instituting Administrative and Cease-and-Desist Proceedings against ZPRIM and Zavanelli, highlighting 11 instances where ZPRIM published advertisements claiming GIPS compliance that Zavanelli knew, or had reason to know, were noncompliant.

The ALJ found that Zavanelli either engaged in intentional deception or acted in a manner that was an extreme departure from the necessary standard of care. Zavanelli designed ZPRIM's advertisements, wrote ZPRIM's reports, and the evidence demonstrated that he personally made the decision to claim GIPS compliance but not adhere to the standards. The ALJ considered, among other factors, the egregiousness of Zavanelli's conduct, Zavanelli's lack of recognition of the wrongful nature of conduct, and likelihood that Zavanelli's occupation would present opportunities for future violations.⁷ Importantly, Zavanelli argued and the ALJ acknowledged that Zavanelli's violations did not cause harm to investors, yet the ALJ stated in its decision that Zavanelli's intentional misrepresentations to current and potential clients and his refusal to accept responsibility presented a threat to the public good. As such, the ALJ permanently barred Zavanelli from association with investment advisers,

⁵ See *Riggs Inv. Mgmt. Corp. v. Columbia Partners, LLC*, 966 F. Supp. 1250, 1269 (D.D.C. 1997) (holding that claiming compliance with AIMR-PPS yet linking non-portable, prior firm performance to a firm's composite track record in contravention of such standards constituted materially misleading conduct).

⁶ ZPRIM also misrepresented to Morningstar that ZPRIM was not under any SEC investigation, a misrepresentation that facilitated what the ALJ deemed to be a misleading Morningstar report.

⁷ The ALJ's decision cited Zavanelli's uncooperative conduct and inability to take responsibility for the GIPS violations as considerations in determining his sanctions. "Max Zavanelli does not understand the regulatory and fiduciary responsibilities of an investment advis[e]r." *Id.* at 62 (internal citations omitted).

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brokers, dealers, municipal securities dealers, municipal advisers, transfer agents, and nationally recognized statistical rating organizations.

Conclusion

While Zavanelli violated the GIPS Advertising Guidelines by falsely advertising compliance, his advertisements neither misstated performance returns nor caused investor harm. The Zavanelli decision reinforces the notion that the SEC does not need to prove that investors relied on misleading advertisements or were harmed in order to bring an enforcement action and succeed in imposing serious penalties upon the offending adviser and the responsible individuals. As such, firms claiming GIPS compliance must ensure that they have the appropriate GIPS policies and procedures and diligently review their advertisements for accuracy and compliance with the GIPS standards.

Furthermore, the CFA Institute has recently proposed a new mandate that would require firms claiming GIPS compliance to notify the CFA Institute.⁸ This requirement may further increase the need for review and verification practices, as firms advertising GIPS compliance may become more readily identifiable and, thus, more susceptible to enhanced SEC scrutiny.

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⁸ Proposal comment page located at: <http://www.gipsstandards.org/news/Pages/detail.aspx?ID=39>