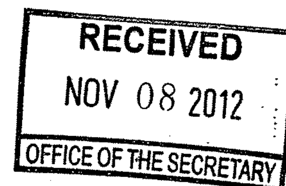
ADMINISTRATIVE PROCEEDING
FILE NO. 3-15006

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



In the Matter of

RAYMOND J. LUCIA COMPANIES, INC. and RAYMOND J. LUCIA, SR.

DIVISION OF ENFORCEMENT'S PRE-HEARING BRIEF

I. INTRODUCTION

The Division of Enforcement ("Division") respectfully submits this pre-hearing brief in support of its enforcement action against Raymond J. Lucia Companies, Inc. ("RJL") and Raymond J. Lucia, Sr. ("Lucia") (collectively "Respondents"). The Division alleges that RJL violated, and Lucia aided and abetted violations of, Sections 206(1), 206(2), 206(4), and Rule 206(4)-1(a)(5), 15 U.S.C. §§ 80b-6(1), (2), and (4), and 12 C.F.R. § 206(4)-1(a)(5), and that RJL violated Rule 204-2(a)(16), 12 C.F.R. § 204-2(a)(16).

RJL is an investment adviser firm that was founded, owned, and run by Lucia. For years, RJL and Lucia have lured clients and generated millions in fees by promoting their trademarked, proprietary "Buckets of Money®" ("BOM" or "Buckets of Money') retirement strategy as a means of obtaining "inflation-adjusted income for life and sustained portfolio growth" through good times and bad. However, throughout this period, Respondents materially, and dramatically, misrepresented how the BOM strategy performed in a slide presentation used at seminars across the country.

Respondents claimed that they had tested how the BOM strategy would have performed through the "Grizzly Bear" market of 1973-74, and the flat market from 1966 to 1982, and the

results validated the BOM strategy. Respondents presented specific results in their slide show presentation. Specifically, Respondents claimed that $1 million invested using the BOM strategy in 1973 would provide inflation-adjusted income for 21 years and would grow to a value of $1,544,719, even though the investment began during the "Grizzly Bear" market of 1973. Respondents claimed that $1 million invested using the BOM strategy in 1966 provided inflation-adjusted income for 38 years and the value of the portfolio grew to $4,719,741. In the slide show, and in other materials, Respondents claimed that they had backtested the BOM strategy through these difficult periods, and the results of their backtests validated the strategy.

In fact, Respondents' performance claims were misleading for several reasons. First, Respondents did not actually backtest the BOM strategy because they did not perform any calculations using actual historical inflation rates. Second, Respondents disclosed that they used an assumed hypothetical 3% inflation rate in their 1966-2003 test, but failed to disclose that using an assumed 3% inflation rate dramatically and materially affected the performance results. Respondents did not specifically disclose any inflation assumption for the 1973 backtest. However, keeping all other data constant, but using actual historical inflation rates over the same 1966 and 1973 periods, results, in both cases, in the BOM portfolio going broke. Going broke is materially different from the riches that were shown in the results presented by Respondents.

Third, Respondents failed to disclose the impact that management fees would have had on their performance results, and failed to disclose that they were making assumptions about the liquidity, safety, and existence of real estate investment trusts ("REITs") that were contrary to the risks presented by REITs as disclosed in their slide show, and the fact that REITs were not available during a period when they included them in their calculations. Fourth, Respondents failed to disclose to prospective investors that their performance calculations, offered to validate the BOM strategy, in fact did not follow the BOM strategy presented in the seminar slide shows. Respondents' calculations show that their backtests from 1966 and 1973 were 100% invested in equities for the majority of the time periods tested, which was not the three bucket strategy that Respondents were advocating in their seminar and slide show. However, Respondents failed to

disclose to prospective clients that their "astonishing" performance results were not achieved by following the BOM investment strategy being described and sold through the slide show and seminars.

In response to the Division's allegations, Respondents deny that they even understand the concept of backtesting (*see* Lucia Answer at ¶ 6, RJL Answer at ¶ 6); defend the use of an assumed 3% inflation rate because they now say their backtests were really forward-looking hypotheticals rather than performance tests or backtests; and offer arguments that retirees experience a lower rate of inflation as a justification for their use of an assumed inflation rate that was lower than the average inflation rate during the period tested. The Court should reject these after-the-fact rationalizations because Respondents never offered these explanations to the public when they were promoting BOM. Moreover, even assuming that Respondents are correct that their "backtesting" should be viewed as hypotheticals, Respondents failed to disclose the effect of material economic conditions, *e.g.*, the actual historic inflation rates, on the results portrayed. Respondents also failed to disclose that the investment strategies used in their calculations changed materially from the BOM strategy described in their presentation. Even Lucia agreed, during testimony, that the 1966 performance data was not a backtest, and Respondents are not offering any expert testimony to support the claims made in the seminar presentation to have backtested the BOM strategy. In short, Respondents do not have a valid defense or explanation for their misleading performance data and unfounded backtesting claims.

After presenting their misleading BOM performance data at seminars, Respondents signed up clients and sold them products which generated substantial income for Lucia. The Division estimates that in one year Lucia made between $8 and $10 million on commissions from the sale of investment products by RJL advisers and from marketing reimbursements from non-traded REIT issuers. Lucia knew that he did not have "Back Tested Buckets," that his assumed 3% inflation rate was too low over the period of the 1970s, and that a higher rate of inflation "would have a very damaging impact on the results of the study." Yet Respondents never told their prospective clients that, in reality, BOM did not and could not produce the

advertised results over the period from 1973 or from 1966. In view of Lucia's position as an investment adviser, and his ownership of RJL which was a registered investment adviser, the misrepresentations over a period of years are particularly egregious.

As sanctions, the Division requests a cease and desist order, revocation of RJL's registration as an investment adviser, revocation of Lucia's registration as an investment adviser and a bar from association with any investment adviser or broker-dealer, a third tier civil penalty against RJL in the amount of $725,000 and a third tier civil penalty against Lucia in the amount of $150,000. Finally, the Division requests that the cease and desist order require Lucia to disclose that he is subject to a cease and desist order for materially misrepresenting the performance of his BOM strategy at any future seminars on the topic of planning for retirement or any type of investment advice.

II. FACTS

A. Respondents' Development of the BOM Strategy and Their Claims About Backtests and Performance of a BOM Portfolio

Respondents RJL and Lucia have built a cottage industry promoting a their trademarked "Buckets of Money®" retirement strategy, which they promoted as being "science, not art," and a means of obtaining "inflation-adjusted income for life and sustained portfolio growth." (Ex. 31 (RJL Internet page); *see also* Exs. 27, 29.) Respondents promoted BOM nationwide, using the Internet, print and broadcast media, and in-person seminars that Lucia conducted across the country. At the seminars (and in other media), Lucia presented "backtests" claiming how Respondents' BOM strategy would have performed over two periods of time: (1) from 1973 to 2003, covering the "Grizzly Bear market" of 1973-1974; and (2) from 1966 to 2003, covering the 18-year "flat market" from 1996 to 1982. The backtests and performance results present specific results from a portfolio using the BOM strategy: (1) the 1973 backtest claims that a $1 million BOM portfolio invested in 1973 would have provided inflation-adjusted income for 21 years and the portfolio balance would have grown to $1,544,719; and (2) the 1966 backtest claims that a $1 million BOM portfolio invested in 1966 would have provided inflation-adjusted

income for 38 years and the portfolio balance would have grown to $4,719,741. Respondents' presentation of those performance results is the issue in this case.

1. Lucia creates the BOM Model

Lucia has been self-employed in the financial services sector for most of his professional life. In 1994, Lucia incorporated respondent RJL, an investment adviser registered with the Commission. RJL did business as "RJL Wealth Management." Lucia also registered with the Commission as an investment adviser and a registered representative, and at various points in time has held Series 7, 24, 63, and 66 licenses. In the early 1990s, Lucia started in talk radio with *The Ray Lucia Show*, a daily syndicated radio show. Lucia also hosts a syndicated television show. Lucia describes himself as "a nationally syndicated radio and television host. I do consulting and I do public speaking."

As Lucia tells the story of his creation of BOM, at some point in the early to mid-1990s, a caller to his radio show wanted a "bulletproof" strategy for investing profits from the sale of company stock. Lucia told the caller to design an asset allocation model, but after the call Lucia was bothered by his recommendation. Lucia cites this telephone call as the beginnings of BOM. Lucia tells of reading various articles after that to create a "bulletproof" investment strategy. A 1998 article inspired Lucia with the concept of "bucketizing" portfolios. Lucia made some calculations to see how his bucketizing strategy would stand up to the "Grizzly Bear" market of 1973-1974, which at the time was the worst bear market of Lucia's adult life. Lucia's calculations confirmed in his mind that the concept of a "spend down bucket" produced better results than standard portfolio allocation theory. However, Lucia did not keep, or cannot locate, copies of these calculations that were the foundation of BOM.

In 2003, Lucia met Ben Stein at a speaking engagement. Lucia knew that Stein was, at the time, a growth and income investor, which meant to Lucia a 60/40 mix of stocks and bonds in one's portfolio. Lucia explained to Stein how his BOM strategy performed through the 1973 bear market. Stein then asked how the strategy would have done if Lucia started in 1966,

because from 1966 to 1982, the Standard & Poors 500 index ("S&P 500") stayed "flat" – it closed at around 1,000 in 1966 and in 1982.

Lucia asked his associate, Richard Plum, to test how a BOM portfolio would hold up under that type of stress test. Plum performed the calculations as instructed using actual Treasury Bill ("T-Bill") and S&P 500 data, and delivered the results to Lucia. According to Lucia, the spreadsheets compared the performance of three $1 million portfolios from 1966 to 2003, from which inflation-adjusted income was drawn: (1) a portfolio invested 100% in T-bills; (2) a portfolio invested 60/40 in stocks and bonds; and (3) the same 60/40 mix of stocks and bonds, but income was drawn first from bonds until the bonds were exhausted and then income was drawn from stocks. Plum's analysis showed the first portfolio ended with $30,000; the second grew to $1.2 million; and the third grew to $4.7 million. In one of his books, Lucia described these results "truly astonishing." (Ex. 68 at pp. 57-58.)

Respondents explain their trademarked BOM strategy, in simple terms, as involving three "buckets." Bucket # 1 is called "Income" and its purpose is potentially to provide investors with guaranteed income for life; it is designed to spend down over 5 to 7 years. Bucket # 2 is called "Safety," and is meant to be a bridge between Bucket #1 and Bucket #3 (the "Growth" bucket). Bucket # 2 is designed to replenish Bucket #1 when it is exhausted to replenish income and give additional time for Bucket # 3 to grow. Bucket #3 is called "Growth" and is designed to provide growth and income over the long-term. The potential "growth" investments for Bucket #3 are non-traded REITs and/or domestic and international stocks. (*See*, *e.g.*, Ex. 20 (page from www.rjlwm.com, "Ray Lucia's buckets of Money® Retirement Solutions"); Ex. 1 at 00181 (slide in slide presentation showing the titles of the three buckets).)

2. Respondents begin publicizing their claimed backtests of the BOM portfolio

At some point, Lucia and RJL began conducting seminars for investors across the United States at which Lucia discussed retirement planning and publicized the BOM strategy. RJL and Lucia publicized the seminars and his strategy on the internet, at RJL's websites, www.rjl.com

and www.rjlwm.com, and on Lucia' website, www.raylucia.com. Lucia also authored three books that explained his BOM strategy: *Buckets of Money: How to Retire in Comfort and Safety* (2004), *Ready... Set... Retire!* (2007), and *The Buckets of Money Retirement Solution: The Ultimate Guide to Income for Life* (2010).

a. Their claimed "Back Tested Buckets" results from 1973

Beginning around 2003, the slides for Respondents' BOM seminars included a slide titled "Back Tested Buckets." That slide claimed that if a $1 million portfolio had been invested using the BOM strategy beginning on January 1, 1973, then, drawing specified amounts of annual income adjusted every 4-5 years, it would have grown to a "Balance in 21 Years: $1,544,789." (Ex. 1 at SEC-LAA3937-00200; Ex. 21 at SEC-LA3937-01094; Ex. 22 at SEC BD-002954.) Respondents used this "Back Tested Buckets" slide in their seminar presentations conducted nationwide, as well as in webinars broadcast over the Internet, from around 2003 through 2010.

In response to a 2010 request from the Commission's examination staff for the support for their backtests, Respondents provided a two page spreadsheet titled "1973 40-20-40 mix, All Income from Bonds and REIT first, $60,000 annual income." (Ex. 13.) However, the Commission's examination staff found that the 1973 spreadsheet did not support the performance claims made in the "Back Tested Buckets" slide. Indeed, as of this date, despite a subpoena from the Division and the institution of this proceeding, Respondents have not produced any documentation that supports the results presented in the "Back Tested Buckets" slide.[1]

b. Their claimed backtested results for 1966 to 2003

At some point, Respondents also began incorporating the 1966-2003 backtest into their literature. Specifically, they claimed that $1 million invested in a BOM portfolio in 1966 would

[1] In this proceeding, Respondents have hired an economist, John Hekman, who did not purport to backtest any of Respondents' performance claims. Hekman produced a spreadsheet that purported to replicate the 1973 calculations, but he used different assumptions and his spreadsheet does not support the performance results in the "Back Tested Buckets" slide.

have provided inflation-adjusted income for 38 years and the value of the portfolio would have grown to over $4.7 million as of 2003.

In his 2007 book *Ready... Set... Retire!,* Lucia claimed his strategy was successful because it had been "backtested" during some difficult economic times:

> That's why retirees need a strategy that will work in both good times and bad. Buckets of Money is such a strategy. It's not designed to make anyone rich, nor does it come with any guarantees. But *it has stood up to numerous backtests* representing some of the worst eras in past market history.

(Ex. 63 at p. 56 (emphasis added).) On the next page, Lucia set out the results of Respondents' backtest covering the period 1966-2003:

> But I believe – and *have shown empirically* – that this simple yet sophisticated concept reduces risk while taking advantage of growth. But you don't have to believe me. Others, perhaps far smarter than I, have come to the same conclusion. One such guy is economist and market guru Ben Stein, who concurred, *after I back-tested the strategy over several decades,* that it works in good times and bad.
>
> *In fact, I backtested it over several bear markets,* including the dismal period beginning in 1966. Figuring 3 percent inflation, I found that drawing down $50,000 a year from a non-bucketized, $1 million portfolio (60 percent stocks and 40 percent T-bills, with a pro rata distribution) would produce this result after 38 years:
>
> **Portfolio value: $30,000**
> **Annual income: $0**
>
> By contrast, a similar $1 million portfolio from which the investor first takes the income from the T-bills (a partial Buckets of Money strategy) would conclude the period with:
>
> **Portfolio value: $1.2 million**
> **Annual I\income: $150,000**
>
> Or try the complete Buckets of Money approach (assume 40 percent stocks, 20 percent real estate investment trusts, and 40 percent T-bills), and take income first from the T-bills and REIT dividends (assuming a 7 percent yield and no REIT growth), then spend the REIT principal before finally digging into the stock money. The results then become truly astonishing:
>
> **Portfolio value: $4.7 million**
> **Annual income: $150,000.**

(Ex. 68 at pp. 57-58 (italics added, bold in original).)

These backtest results were incorporated into Respondents' seminar slide show, used at the seminars around the country and in webinars broadcast over the internet. The seminar slides set forth some of the assumptions used to calculate the performance results, including that "inflation is based at 3% annual." (Ex. 1 at SEC-LA3937-00203-211.) In the slide show summary page, Respondents provide the specific value of the "complete Buckets of Money approach" in 2003 of $4,719,741. (Ex. 1 at SEC-LA3937-00211.)

In 2010, when the Commission's examination staff asked for all supporting documentation for Respondents' backtesting, Respondents did not provide any documentation for the backtests they claimed to have conducted for the period 1966-2003. After the Commission issued a formal order of investigation and the Division issued a subpoena for all documents supporting their backtesting, Respondents produced the two-page spreadsheet for 1973-2003 that had been produced to the examination staff (Ex. 13), and a two-page spreadsheet titled "1966 40/20/40 Bond and REIT Income first." (Ex. 12.)

B. Respondents Use Performance Data and Backtests to Validate the BOM Strategy in the Seminar Slide Show

In one part of the seminar slide show, Respondents illustrate three conventional investment strategies over a series of slides and then explain how the BOM portfolio strategy allegedly provided inflation-adjusted income and portfolio growth. In the presentation cited in the Order Instituting Proceedings in this matter (the "OIP"), Respondents provide illustrations of three investment strategies: (1) the "Conservative Campbells," who invest in certificates of deposit and low-risk investments producing a hypothetical 6% return, and who go "broke" in 27 years if they index their income to inflation, leaving their children nothing; (2) the "High Rolling Hendersons," who invest 100% in the stock market and have $4.2 million after 30 years if they took inflation-adjusted income, but not if they retired in the bear market of 1973 in which case they would be "bankrupt in 17 years"; and (3) the "Balanced Buttafuccos," who invest 40% in bonds and 60% in stocks, but when their strategy is backtested to 1973-74, they would go broke after 21 years. (Ex. 1 at pp. 00152-177.)

The seminar then uses the "Bold Bucketeers" to explain how the BOM strategy provides dramatically superior results. Respondents explain how the BOM strategy works with three buckets of money. The slide show explains the three bucket strategy, and assuming a $1 million portfolio value at the beginning, shows how the BOM portfolio strategy would allegedly provide the Bold Bucketeers with inflation-adjusted income for 12 years, during which time the $1 million portfolio would have grown to $1.4 million from the growth in Bucket #3. At that point, Respondents explain that they "re-bucketize for another 12 years." (*Id.* at pp. 178-198.)

The seminar then asks the question: "But Can Buckets Stand Up To The Test Of The '73/'74 Grizzly Bear?" (*Id.* at 199). Then, Respondents present the results of their 1973 backtest to validate the success of the BOM strategy. Respondents show the slide titled "Back Tested Buckets" which shows the performance results from 1973, discussed above, in which a $1 million portfolio, beginning on January 1, 973, with a 20% invested in REIT, and with inflation-adjusted income drawn from the portfolio, would have a "Balance in 21 Years" of "$1,544,789." The slide parenthetically notes that this would be "when 'Balanced Buttafucco' portfolio = 0." (*Id.* at 200.) In small print on the bottom of the slide, Respondents state this is a "hypothetical illustration and is not representative of an actual investment. An investor's results may vary. Past performance does not guarantee future results. This example uses actual treasury rates of return to calculate fixed income/bond returns and actual S&P returns to calculate growth returns. An investment may not be made directly in an index." (*Id.*) The following slide shows the Bold Bucketeers in 1994, after the 1973-74 "Grizzly Bear" market, with "$1,544,789." (*Id.* at 201.)[2]

The seminar slides then ask the "Ben Stein question" – "But Raaaaay....What would have happened if you retired in 1966..." (*Id.* at 203.) Respondents then present the results of their so-called 1966 backtest. Respondents show a slide that lists their "Notes and Assumptions," that the "following examples are based on actual market returns for the period(s) listed, Bond returns are based on US Treasury returns, Stock returns are based on S&P 500

[2] Notably, the 1973 "Back Tested Buckets" slides do not disclose the inflation rate used in the calculation, and specifically refer to the results as "past performance."

returns"; "REIT returns are based on a 7% annual return"; and "Inflation is based at 3% annual." (*Id.* at 204.) Respondents then present their performance results for three different strategies which all begin in 1966 with a balance of $1 million and end in 2003: (1) a "60-40 portfolio, income from stocks & bonds (pro rata)," results in a "portfolio "value" of $30,000 and "annual income" of $0 (*id.* at 206); (2) a "60-40 Portfolio, Buckets of Money Portfolio (without REIT)," results in a "portfolio value" of $1.2 million and "annual income" of $150,000 (*id.* at 208); and, finally, (3) a "Buckets of Money Portfolio (40-20-40) (with Real Estate Investment Trusts)" results in a "portfolio value" in 2003 of $4.7 million and "annual income" of $150,000. (*Id.* at 210.) Respondents conclude this portion of the seminar with a "Summary" that lists the results of the three portfolios after 38 years, and for the "Buckets" Portfolio provides not just a portfolio value of $4.7 million, but includes the specific claim that its value in 2003 would be "$4,719,741." (*Id.* at 211.)

C. Respondents' Performance and Backtesting Claims Are Misleading

Respondents use their alleged backtests and claimed performance results of their BOM strategy for portfolios during the period 1973 to 2003, and then the for the period 1966 to 2003, to validate their claim that BOM provides inflation-adjusted income and sustained growth in the value of a portfolio. However, for several reasons, Respondents' backtesting and performance claims presented in the seminar slide show are materially and dramatically misleading.

1. Respondents failed to disclose how their assumed 3% inflation rate materially altered the performance of the BOM strategy

Respondents failed to disclose that their use of an assumed hypothetical 3% inflation rate materially and dramatically altered their claimed BOM performance results. If actual historical inflation rates were used in the Respondents' backtests – as they should have been – the backtests would have shown the BOM portfolios going broke in both the 1973-2003 and 1966-2003 periods. Lucia was well aware that the assumed 3% inflation rate was lower than the actual historical inflation rate during the 1970s and early 1980s, and as he admitted, he intuitively knew

that using a higher inflation rate would be "damaging" to the results of Respondents' backtests, or performance calculations.

In response to the Division's allegations, Respondents argue that a 3% inflation rate is reasonable for a forward-looking calculation. However, their claims about how the BOM strategy would have performed over historical periods, based on historical market returns, are not forward-looking calculations, and in fact, are presented as proof that the BOM strategy would provide inflation-adjusted income and portfolio growth over two difficult time periods in the market. Moreover, Respondents' use of an assumed 3% inflation rate in both backtests allowed them to capture the extraordinary returns on T-Bills during the 1970s in their "Income" bucket, when inflation rates far exceeded 3%. At the same time, by assuming an artificially low inflation rate, Respondents understated the increased income need during that period of high inflation. It is generally well understood that T-Bill returns tend to track inflation (*see* Grenadier Ex. 4), so the assumed inflation rate of 3% had the compound effect of decreasing the income need while realizing extraordinary returns on low-risk T-Bills. Lucia, an experienced investment adviser, failed to disclose the effect material economic conditions, and specifically the high inflation rates of the 1970s and 1980s, had on the results portrayed.

a. The 1973-2003 "Back Tested Buckets"

The "Back Tested Buckets" slide presents the results of how a BOM portfolio started in 1973 performed using historical data, and the seminar slide does not provide any information about an assumed inflation rate. The spreadsheet that Respondents produced as support for their "Back Tested Buckets" used a 3% inflation rate.[3] (*See* Ex. 13.)

During the Commission's examination in 2010, when Respondents' staff was asked why an assumed 3% rate was used in the spreadsheet, their initial response was that actual inflation data was not available. The examination staff pointed out that historic inflation data is readily

[3] In fact, as Respondents' expert John Hekman pointed out, Respondents erred In their calculation of how the income need increased using their assumed 3% inflation rate, and as a result, understated the income need for a six-year period of their test.

available from the U.S. Department of Labor, Bureau of Labor Standards ("BLS"), on the internet. Respondents' personnel then posited two additional explanations: that if they used real historic inflation rates, then the BOM portfolio would go bankrupt too, and that the "Back Tested Buckets" slide was a forward-looking analysis so it was reasonable to use an assumed inflation rate of 3%.[4]

The Division's expert witness, Professor Steven Grenadier of Stanford University, replicated Respondents' 1973 backtest using actual inflation rates, which dramatically and materially changes the results. Using historic inflation rate data, the Bold Bucketeers are completely broke after just 17 years. (Grenadier Report, Exs. 2b, 2c.) Respondents do not contend that they ever explained to their audiences, in the slides or verbally, that their use of an assumed 3% inflation rate in their performance calculation materially inflated their results, or that if actual inflation rates were used the BOM strategy did not deliver as promised.[5]

b. The 1966-2003 Backtest and Performance Results

In the slide show presentation of the performance results for the period from 1966 to 2003, the slide show discloses that a 3% annual inflation rate was assumed. However, Respondents again failed to disclose how that important economic assumption materially and dramatically altered the performance results. Lucia admitted during testimony that he intuitively knew that inflation was higher than 3% in the 1970s and 1980s, and conceded that he knew using an inflation rate higher than 3% would be "damaging" to the results of their backtest. After the OIP was instituted, Respondents "discovered" a recording of a webinar broadcast of a BOM

[4] This explanation is inconsistent with the title of the slide "Back Tested Buckets," the fact that Respondents used actual historical returns for T-Bills and the S&P 500 index, and Respondents were purporting to show how a BOM portfolio performed if it began in the "Grizzly Bear" market of 1973-74.

[5] Respondents' expert, John Hekman, proposes that the purpose of the seminar presentation was to show that BOM was superior to the alternative strategies presented because even though the BOM portfolio went bankrupt, it went bankrupt a few years later. However, Respondents did not claim that BOM would keep the wolves from the door for a few years longer than alternative strategies, but rather that it allowed one to enjoy inflation-adjusted income and increase the value of one's portfolio.

slide show in which Lucia acknowledged that he knew the inflation rate over that period was higher than 3%, but as says in the webinar, let's "pretend" it was 3%. However, Respondents did not disclose in their seminars, or anywhere, that using an assumed 3% inflation rate, whether in the context of a backtest, a hypothetical, or just "pretending," materially altered the results and performance of the BOM portfolio. Lucia did not tell his audiences that the "truly astonishing" results were produced primarily by the assumed 3% inflation rate, and failed to disclose the effect of material economic conditions – specifically use of the historical inflation rate – on the results presented.

The Division's expert, Professor Grenadier, also replicated Respondents' 1966-2003 backtest using historical inflation rates. (Grenadier Report, Exs. 2a, 2c.) Professor Grenadier found that when actual, historical inflation rates are used, the BOM portfolio goes "broke" in 1986, after 21 years, and did not provide "inflation-adjusted" income for 38 years or grow to a total value of $4,719,741 as Respondents claimed. (Grenadier Report, Exs. 2a, 2c.) Thus, if an investor had actually followed the BOM portfolio model beginning in 1966, that individual would have no income after 1986 – not the "buckets of money" represented by Respondents.

Professor Grenadier's findings are to some extent corroborated by a calculation performed by Respondents' expert economist, John Hekman. Hekman tested the performance of Respondents' BOM strategy over the period from 1966 to 2003, and in one test he used actual historical inflation rates less 1.2% each year until 1996, and less 1% thereafter.[6] While the Division does not concede the validity of Hekman's adjustment to the historical inflation rates, even after reducing inflation by at least 1% per year, Hekman calculated that the BOM portfolio

[6] In correspondence with the examination staff and the Division, Respondents claim that the hypothetical 3% inflation rate was "reasonable" because seniors experience a lower inflation rate than other consumers "other than health costs," or alternatively because retirees' spending decreases over time. In fact, the BLS has an experimental consumer price index ("CPI") for the elderly, called CPI-E, and that rate is marginally higher than the CPI for all urban consumers, CPI-U. Moreover, Respondents promised "inflation-adjusted income" in their seminars, and never explained that meant something other than how the term would be commonly understood.

would go bankrupt in 1993 – which is again contrary to Respondents' performance claims. (Hekman Report, App. 10.)

Bankruptcy is a materially different result than a bucket of money with over $4.7 million in it. But Respondents never explained to investors that their assumed inflation rate materially and dramatically changed the performance of their BOM portfolio.

2. Respondents failed to disclose the material impact of their failure to account for fees and their assumptions concerning REIT returns and liquidity

Respondents failed to disclose that their backtests used hypothetical REIT returns that were pure fiction, and did not take management fees into account.

First, REITs were not generally available from 1966 to 1973, so Respondents are assuming material market conditions that did not exist. Second, Respondents did not use historical data on REIT returns, which was readily available beginning in 1973. Third, Respondents use their hypothetical REITs in a manner which assumes consistent returns, no change in value of the investment, and perfect liquidity. These assumptions are directly contrary to Respondents' disclaimers in their slide show about the risks of REITs. In their presentation, Respondents warn that REITs "involve special risk, such as: limited liquidity and demand for real property … loss of investment …real estate values may fluctuate based on economic, environmental and other factors." (Ex. 1 at 148.) Respondents failed to disclose to their audience that they ignored these cautions in their backtests. In Respondents' calculation, $200,000 invested in REITs in 1973 retained a constant value until 1981, when the REITs were liquidated at full value after providing a 7% return during the interim period. (Ex 13.) Respondents used a similar assumption in the 1966 backtest. (Ex. 12.)

Respondents' expert, Kevin Gannon, conceded that historical information on REIT returns are available beginning in 1973, which is when REITs first became generally available. Respondents failed to disclose that they were assuming an asset, and a return, that was not available in the market from 1966 to 1973, and failed to disclose the effect of that assumption on the results portrayed. Moreover, Respondents failed to disclose that their assumed 7% return

was dramatically different than actual REIT returns beginning in 1973. As Respondents' expert Gannon conceded, REIT returns in 1973 and 1974 were substantially negative. When historical REIT returns are used in the 1973 backtest, the value of the REIT investment declines from $200,000 in 1973 to $134,031 by 1979. (Grenadier Report, Exs. 5b and 5c.) Professor Grenadier's report also shows the substantial effects that Respondents' failure to use historical REIT returns has on the 1966 results. When historical REIT returns are used beginning in 1973, the portfolio is worth only $1,297,771 after 38 years – rather than $4,719,741 claimed by Respondents. (Grenadier Report, Exs. 5a, 5c.)

Respondents also failed to take management fees into account in their backtests. Even assuming modest fees negatively impacts the results of both the 1973 and 1966 backtests. (Grenadier Report, Exs. 6a, 6b, and 6c.) A relatively minor reduction for management fees results in the 1966 portfolio achieving a value of only $2,525,916 after 38 years, which is substantially less than the $4,719,741 Respondents claimed. (*Id.*, Exs. 6a, 6c.)

3. Respondents did not disclose that the combined effect of their assumptions materially changed their performance results

Respondents failed to disclose that the combined effect of their assumptions materially overstated how a portfolio following the BOM strategy would perform for the periods 1973-2003 and 1966-2003. For the 1973-2003 backtest, the combined effect of using an assumed inflation rate, invented REIT returns, and ignoring management fees allowed Respondents to make the otherwise unsupportable claim that after 21 years the Bold Bucketeers would have enjoyed inflation-adjusted income and had a portfolio that had grown from $1 million to $1,544,798. However, if actual historic inflation rates, historic REIT rates of return, and management fees are taken into account, then the BOM strategy would go broke by 1986 – which is a materially different result than the claims made by Respondents. (Grenadier Report, Exs. 9b, 9c.) Whether couched as a backtest, performance returns, or a hypothetical, Respondents failed to disclose the effect of these material market and economic conditions on their results.

For the period 1966 to 2003, the cumulative effect of using the historical inflation rate, historical REIT returns when they became available in 1973, and deducting a management fee, would result in a BOM portfolio running out of money in 1983, after just 18 years. (*Id.*, Ex. 9a.) However, once again Respondents failed to provide this material information to prospective clients, or to clients, during their seminars or webinars. Indeed, it would defeat the marketing purpose of the seminars to divulge to attendees that the BOM portfolio strategy would result in a retiree running out of money and having nothing left for their heirs.

4. Respondents failed to disclose that their 1973-2003 and 1966-2003 backtests did not even use the BOM portfolio strategy

Respondents failed to disclose that their so-called backtests and their performance data on the BOM strategy did not actually follow a BOM strategy, because for the majority of the period of both backtests, the BOM portfolio was not divided into three buckets but instead was invested 100% in stocks. As it happened, by failing to re-bucketize, Respondents took advantage of a sustained bull market in stock when average annual returns were substantially higher than historical averages – averaging around 15% rather than around 10%. By strategically staying in stocks during this period of higher than average returns, Respondents artificially inflated their performance results. Respondents failed to disclose that they materially changed the BOM strategy for the majority of the periods covered by each backtest to utilize a strategy that they rejected – being 100% invested in stocks.

Part of the BOM strategy is to "re-bucketize" (Ex. 1 at 198) and replenish the income and safety buckets when they are depleted, to make sure that retirees have readily available cash for short-term needs. However, in both of their alleged backtests, Respondents fail to re-bucketize. Instead, as can readily be seen by looking at Respondents' spreadsheets, Exhibits 12 and 13, both supposed BOM portfolios are 100% invested in the stock market for the majority of the time. This is the "High Rolling Hendersons" strategy, not the "Bold Bucketeers." (See Grenadier Exs. 7a, 7b.) In their 1973-2003 backtest, the supposed BOM portfolio was 100% invested in the stock market for over 50% of the time – or for the last 17 years of the calculation. In their 1966-

2003 backtest, the supposed BOM portfolio was 100% invested in the stock market for over 60% of the period covered by the study – for the last 24 years of the 38 year period. (See Exs. 12, 13, Grenadier Exs. 7a, 7b.)

Respondents did not follow the strategy in their backtests that they were selling to the public in their presentations. Moreover, Respondents failed to disclose this material change in strategy when they presented their performance results. Indeed, while Respondents present themselves as offering a strategy that minimizes risk and uses an "income" bucket and a "safety" bucket to make sure that investors do not go broke, their backtest went from a balanced portfolio to a highly risky portfolio 100% invested in stocks – a strategy that Respondents dismissed as too risky in the section of the slide show about the "High Rolling Hendersons."

Not only did Respondents fail to follow the BOM strategy in their backtests, but they followed a strategy that Lucia flatly rejected. As Lucia stated in a 2008 letter to RJL clients:

> And of course, let me qualify that by saying that I would never – NEVER – advocate being 100% invested in stocks, but that kind of return does illustrate the power of the stock market. It shows the need to stay committed to stock, with at least some of your investments.

(Ex. 35 (emphasis in original).)

Respondents' failure to re-bucketize was extremely advantageous to their backtests, because they choose to deviate from their strategy during a period when it was most beneficial for their results. The Division's expert, Professor Grenadier, graphically shows that Respondents obtained the "truly astonishing" results for their BOM strategy by concentrating the portfolio 100% in stocks for the majority of the period tested, which coincided with a period of extraordinarily high returns in the stock market. (Grenadier Exs. 7a, 7b, 8a, 8b.) Respondents did not disclose that the "truly astonishing" results from 1966-2003, or their claim to have successfully backtested through the "Grizzly Bear" market of 1973-74, were achieved not by following a BOM portfolio allocation model that minimized risk, but rather by concentrated 100% in the stock market to take advantage of higher-than-average returns.

D. Respondents Profited Substantially From Their Misleading Presentations

Respondents profited handsomely from their misleading promotion of the BOM strategy in a number of ways. Lucia and his companies earned over a million dollars in marketing reimbursements from non-traded REIT issuers in one year. RJL hired investment advisers on a salary plus bonus basis, under the theory that since clients were drawn in by Lucia's presentations and BOM strategy, all of the clients belonged to Lucia's and he was entitled to all commissions on products sold to them. An income statement for Lucia showed that in 2009, he received about $8.7 million in commissions just from sales by RJL advisers of non-traded REITs. (Ex. 2 at p. 7; *see also* Exs. 52, 53, 54, 55, 56.)

E. In Response to Commission Inquiries, Respondents Back Away From Their Claims to Have Backtested Their Performance Claims

As the Commission's examination staff and the Division have pursued information about Respondents' backtests, Respondents have backed away from their very public claims to have backtested their BOM strategy, to the point where Lucia and RJL have each refused, in their Answers, to admit that they even understand the term "backtesting" or "backtest." (Lucia Answer ¶ 6; RJL Answer ¶ 6.) It is unclear how Lucia, with all his experience as an investment adviser and after making numerous claims about backtesting his BOM strategy, is unable to agree to a simple definition of the term. In contrast, Respondents' experts are both familiar with backtesting, and when shown the Commission's definition of "backtest" set forth in Paragraph 4 of the OIP, generally agreed that it was an accurate definition.

During the 2010 examination, RJL's staff did not deny or otherwise question that Respondents had performed backtests. When asked for supporting documentation for their claimed backtests, Respondents provided the 1973 spreadsheet (Ex. 13). Then, when asked for additional information on backtests, Respondents produced Richard Plum, who discussed Respondents' backtesting. The Commission's examination staff issued a deficiency letter to RJL in December 2010 that, among other things, cited Respondents for not having documentation to support their backtests, failing to disclose the material impact of an assumed 3% inflation rate

rather than historical inflation rates, failing to disclose material information about fees and REITs, and failing to disclose that the 1973 backtest did not follow the BOM strategy. (Ex. 3.)

In response, Respondents began backing away from their claims to have backtested BOM over several bear markets, or over several decades. Respondents began characterizing their backtests as hypotheticals and illustrations. In his testimony during the Division's investigation Lucia admitted that the spreadsheets Respondents produced (Exs. 12 and 13) were all the documentation Respondents had to support their claims of numerous backtests. But just as his lawyers had done in prior correspondence, Lucia tried to run away from his claim to have backtested a BOM portfolio from 1966 to 2003:

> And if – if I may just suggest that the term back test be referred to in this case as a hypothetical because it was not a true back test of a model portfolio, it was strictly a hypothetical based on a scenario that Mr. Stein presented to me.

(Lucia test. at 45:3-7.)

Respondents' effort to run away from the term "backtest" is belied by the fact that they freely used the term for a number of years. The "Back Tested Buckets" slide was used from about 2003 through 2010. Lucia wrote about his extensive "backtesting" of the BOM strategy in his 2007 book. And Respondents used the term in other literature. For example, RJL's training manual titled "Buckets of Money® University" states: "Buckets of Money® has back tested to the bear market of 1973-1974." (Ex. 50 at p. 22.) In a 2008 market commentary addressed to existing clients, Respondents wrote: "That 'when' is 'now' and a properly allocated 'Buckets of Money" plan should stand up to the test...just like it did when I back-tested 'Buckets of Money" to 1966, 1973 and 1987."[7] (Ex. 35.)

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[7] Despite subpoenas for all backtesting documentation, Respondents have never produced any documentation of a 1987 backtest.

III. LEGAL DISCUSSION

A. RJL Violated, and Lucia Aided and Abetted RJL's Violations of, Sections 206(1), (2), and (4) of the Investment Advisers Act, and Rule 206(4)-1(a)(5)

The Division will show that Respondent RJL, by engaging in the conduct discussed above, violated Sections 206(1) and 206(2) of the Investment Advisers Act, and that Lucia aided and abetted and caused RJL's violations of Sections 206(1), 206(2), and 206(4) of the Adviser Act, and Rule 206(4)-1(a)(5).

1. The Legal Standard for Respondents' Violations of Sections 206(1), 206(2), 206(4) and Rule 206(4)-1(a)(5)

Section 206 of the Investment Advisers Act states in relevant part:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly –
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> * * *
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

15 U.S.C. §§ 80b-6.

Rule 206(4)-1(a)(5) provides that it is a violation of Section 206(4) for an investment adviser to publish, circulate, or distribute any advertisement "which contains any untrue statement of a material fact, or which is otherwise false or misleading." 12 C.F.R. § 206(4)-1(a)(5). The term "advertisement" is defined to include "any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers . . . [any] investment advisory service with regard to securities." See *C. R. Richmond*, 565 F.2d at 1105 (book and market letter constitute advertisements under Rule 206(4)-1).

The Supreme Court has held that Section 206 establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients. *Transamerica Mortgage Adviser, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) ("Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.") Those fiduciary duties require advisers to exercise "an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading his clients." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). The focus of the Advisers Act is on the investment adviser and his actions, and clients and prospective clients are mentioned only in relation to advisers. *SEC v. Gruss*, 859 F. Supp. 2d 653, 662-63 (S.D.N.Y. 2012.) It is important, then, to look at how the adviser behaved, rather than how prospective clients viewed that behavior.

In general, to establish a violation of Section 206(1), the Division must prove that (1) respondent is an investment adviser, (2) respondent utilized the mails or any other means or instrumentality of interstate commerce, directly or indirectly, (3) to make a misstatement or omission of material fact to a client or prospective client, and (4) respondent acted with scienter. *See, e.g., SEC v. Bolla*, 401 F.Supp.2d 43, 67 (D.D.C. 2005); *see also SEC v. Wall Street Publishing, Inc.*, 591 F.Supp. 1070, 1083 (D.D.C. 1984). Recklessness satisfies the scienter requirement of Section 206(1). *See Vernazza v. SEC*, 327 F.3d 851, 860 (9th Cir. 2003).

While scienter is a required element for a violation of Section 206(1), there is no scienter requirement for a violation of Section 206(2) and 206(4). *See SEC v. Steadman*, 967 F.2d 636, 643 n. 5 (D.C.Cir.1992) ("a violation of § 206(2) of the Investment Advisers Act may rest on a finding of simple negligence"); *SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1105 (9th Cir. 1977) (citing *Capital Gains Research*, 375 U.S. at 195) (scienter is not an element of a violation of Section 206(4)).

Materiality under the Advisers Act is defined by the same standard used under the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, so that a fact is material if there is a substantial likelihood that a reasonable investor would consider

it important in making a decision because the fact would significantly alter the "total mix" of available information. *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988).

2. Respondents Violated the Relevant Fraud Provisions of Section 206 of the Advisers Act

The evidence will show that the Respondents engaged in fraud in violation of Section 206 and Rule 206(4)-1(a)(5). The distribution of false or misleading performance advertisements by an investment adviser can violate Sections 206(1) and 206(2). *See, e.g., Valicenti Advisory Services, Inc.*, Investment Advisers Act Rel. No. 1774 (Nov. 18, 1998), *aff'd, Valicenti Advisory Services v. SEC*, 198 F.3d 62 (2d Cir. 1999). Advertisements that are "deceptive and misleading in their overall effect" can be found to violate the Act "even though when narrowly and literally read, no single statement of a material fact was false." *C. R. Richmond & Co.*, 565 F.2d at 1106-07 (quotation omitted). Conduct with respect to this rule "is to be measured from the viewpoint of a person unskilled and unsophisticated in investment matters." *Id.* at 1105.

For example, in *In the Matter of William J. Ferry*, Investment Adviser Release No. 1747 (August 19, 1998), a registered investment adviser maintained a website promoting its market timing services by presenting hypothetical, backtested performance results of the market timing strategies of Ferry, the adviser's president and principal owner. The performance results were presented in various graphs and tables showing that an investment which followed Ferry's trading system would have outperformed major market indices. The website failed to disclose, among other things, that the timing systems had changed materially during the time period portrayed in the backtest results, and the inherent limitations of the process producing those results (*e.g.*, the impact that economic and market factors might have had on Ferry's decision-making if he were actually managing client money). By failing to make those disclosures, the adviser violated Section 206(4) and Rule 206(4)-1(a)(5) thereunder, and Ferry – who prepared the advertising, and thus, knew or was reckless in not knowing that the advertising was misleading – aided and abetted the adviser's violations.

In *In the Matter of LBS Capital Management, Inc.*, Investment Adviser Release No. 1644 (July 18, 1997), an investment adviser developed a mutual fund timing and selection service, using financial data from 1983 through 1986, then tested the quantitative validity of the service by applying it retroactively to the period from 1987 through 1993, deriving simulated performance results for those years. In 1994 he distributed ads that contained the simulated performance results, disclosing in a footnote that the results were "pro-forma," that "model" performance was no guarantee of future results, that the service had first gone live in 1994, and that "actual results" were available upon request. Nonetheless, the ad was found to be "materially misleading because it failed to disclose with sufficient prominence or detail that the advertised performance results . . . did not represent the results of actual trading using client assets but were achieved by means of the retroactive application of a model."

In *In the Matter of Meridian Investment Management Corporation, et al.*, Investment Adviser Release No. 1779 (December 28, 1998), the respondent investment adviser materially misstated its investment performance results when it failed to deduct its payment of third-party fees from those results – even though its advertising materials disclosed that a fee would be paid.

Consistent with those actions, the staff has taken the position that the use of model or actual results in an advertisement would be false or misleading, and in violation of Rule 206(4)-1(a)(5), "if it implies, or a reader would infer from it, something about the adviser's competence or about future investment results that would not be true had the advertisement included all material facts." *Clover Capital Management, Inc.*, (No Action Letter - File No. 801-27041, October 28, 1986). An adviser using an advertisement that contains model or actual results "must ensure that the advertisement discloses all material facts concerning the model or actual results so as to avoid these unwarranted implications or inferences." *Id.* In the *Clover* letter, the staff described disclosures that should accompany advertised actual or model performance results and express the view that Rule 206(4)-1(a)(5) prohibits an advertisement that, among other things:

- fails to disclose the effect of material market or economic conditions on the results portrayed;
- includes model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid;
- fails to disclose prominently the limitations inherent in model results, particularly . . . that they might not reflect the impact that material economic and market factors might have had on the adviser's decision-making if the adviser were actually managing clients' money;
- fails to disclose, if applicable, that the conditions, objectives, or investment strategies of the model portfolio changed materially during the time period portrayed in the advertisement and, if so, the effect of any such change on the results portrayed.

Here, the evidence will show that Respondents violated these standards. In the slide show, RJL presented materially misleading performance data to prospective clients about the BOM strategy, specifically the 1973 "Back Tested Buckets" and the 1966-2003 performance data. Lucia was responsible for creating the data, or supervising the creation of the performance data, and presented it to prospective investors as evidence of how the BOM strategy performed over historic periods. However, Respondents knew that using an assumed 3% inflation rate dramatically altered their performance results, or at a minimum, were reckless in not knowing that fact. Similarly, Respondents' failure to disclose that their results were based largely on an un-bucketized portfolio that was 100% invested in stocks for the majority of the test period was materially misleading. Respondents were presenting a strategy to retirees that was claimed to minimize risk by containing buckets labeled "income" and "safety," but Respondents' performance data was achieved by discarding that strategy and investing 100% in equities. It was materially misleading for Respondents to present their performance results as those from the BOM strategy, when they did not in fact follow that strategy in the calculations that gave rise to the results published to investors in their seminars.

It was also misleading for Respondents to present results that used REITs when such investments were not available, without disclosing to prospective investors that their performance results were based, in part, on an investment that was unavailable until 1973. It was also misleading for Respondents to disclose to investors that REITs may be illiquid, and may suffer losses, but then disregard those considerations in their performance tests by assuming perfect liquidity and capital preservation. Finally, it was misleading for Respondents to present performance results without taking into account fees, which could have a substantial effect over the period covered by the backtests and performance results.

Even assuming that Respondents present convincing evidence that their performance claims were only "hypotheticals" and they were careless in characterizing them as backtests, Respondents were still required to disclose all material information required to make those hypotheticals not misleading. Respondents knew, or were reckless in not knowing, that the use of actual T-Bill returns and stock data combined with an assumed inflation rate of 3% would materially skew their results, even if presented as a hypothetical, and yet failed to disclose that material fact. Similarly, even as a hypothetical, the 1966 and 1973 spreadsheets did not employ a BOM strategy for the majority of the period, yet Respondents presented them as BOM portfolios, without disclosing the change in the model, which was misleading.

Thus, under the applicable case law, there can be little dispute that RJL violated Sections 206(1), 206(2), and 206(4) of the Advisers Act, and Rule 206(4)-1(a)(5), by publishing materially misleading slides at its seminars about its backtesting of the BOM portfolio strategy and the performance of the BOM model over the periods from 1973 to 2003, and 1966 to 2003. Lucia, who was responsible for devising the strategies and putting together the backtests, substantially aided and abetted those violations, and had the requisite knowledge of the fraudulent activity.

3. Respondents acted with a high level of scienter

While the Division does not have to establish scienter for its claims under Sections 206(2) and 206(4), the evidence will show that Respondents acted with a high degree of scienter sufficient to establish a claim under Section 206(1). Lucia's scienter is imputed to RJL.

There can be little question that RJL, through Lucia, its sole shareholder, and Lucia, the serial seminar presenter and promoter of the BOM strategy, acted with a high level of scienter and conscious knowledge of their wrongful acts. Indeed, the fact that Lucia now claims not to even understand the concept of backtesting (Lucia Answer ¶ 6), shows that his actions were either intentional or extremely reckless. Lucia testified that he "intuitively knew that inflation was higher than 3 percent during that period of stagflation in the 1970s, so I was quite aware of that." When asked whether using the actual historical inflation rate, which averaged 4.8% per year during the period tested, would have a material effect on the 1966 backtest, Lucia "intuitively knew because I've been doing this for a number of years, and when you apply a significantly higher rate of inflation in this example, 1.8 percent compounded per year over a 30 or a 40 year time period, that it would have a very damaging impact on the results of the study." Similarly, Lucia knew "intuitively" that accounting for management fees in their backtests "would certainly produce significantly less results over a 30 or a 40 year time span."

Lucia admitted that he never disclosed to seminar attendees that if actual inflation rates had been used in the 1966 backtest, and accounting for management fees, that the BOM portfolio would have gone broke. Similarly, Lucia admitted that not re-bucketizing the 1966 backtest and the 1973 backtest was a conscious decision.

Lucia's admissions during the Division's investigation suggest a state of mind intent on deceiving investors by manipulating the results of the backtests, or performance results, or hypotheticals, to validate BOM by intentionally failing to disclose the impact of material economic conditions, and changes in the model assumptions, on the results portrayed.

4. Lucia Aided And Abetted RJL's Violations

Finally, the evidentiary record clearly establishes that Lucia aided and abetted RJL's violations of Section 206 and Rule 206(4)-1(a)(5). To establish aiding and abetting, the Division must show (1) an underlying violation of the act; (2) the respondent's knowledge of the fraudulent acts; and (3) the respondent's provision of substantial assistance to the primary violator. *See, e.g., SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009); *SEC v. Cedric Kushner Promotions, Inc.*, 417 F. Supp. 2d 326, 334 (S.D.N.Y. 2006). In an administrative proceeding, extreme recklessness is sufficient to establish that an individual willfully aided and abetted a primary violation. *See Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004); *Geman v. SEC*, 334 F.3d 1183, 1196 (10th Cir. 2003).

As discussed above, the evidence shows that there was a primary violation. Moreover, Lucia was the sole shareholder of RJL, created the BOM strategy, possibly performed some of the backtesting calculations himself (*i.e.*, the 1973-2003 backtest), and provided instructions to an employee and reviewed the 1966-2003 backtesting. Lucia characterized the results as backtests in books and letters he authored, and presented the results in seminars sponsored by RJL. Therefore, Lucia has knowledge of the fraudulent presentations and clearly assisted his company, RJL, in perpetrating the fraud.

B. RJL Did Not Maintain Books And Records In Violation of Rule 204-2(a)(16) of the Advisers Act

The Division's books and records claim against RJL is beyond dispute. Section 204 requires registered investment advisers to maintain certain books and records, and Rule 204-2(a)(16) requires an adviser to:

> make and keep true, accurate, and current the following books and records relating to its investment advisory business: . . .
>
> (16) all accounts, books, internal working papers, and any other records and documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes,

directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser).

The Commission has expressly stated that advisers must preserve "worksheets or other documents containing the calculations that transform the underlying data into the performance figures [in its advertisements]." Advisers Act Release No. 1093 (November 5, 1987). *See also In the Matter of Market Timing Systems, Inc.*, et al., Rel. No. IA-2002 (Dec. 14, 2001), settled Rel. No. IA-2048 (Aug. 28, 2002) (registered investment adviser's failure to make and keep all documentation substantiating its performance advertising constituted willful violation of Section 204 and Rule 204-2(a)(16) thereunder).

There can be no dispute that RJL has not preserved the worksheets or other calculations supporting the calculations in the "Back Tested Buckets" slide, from 1973 to 2003. RJL produced a single, two-page spreadsheet which purported to be the support for those performance figures, but in fact it does not support those calculations.

With regard to the 1966-2003 performance calculations, RJL failed to produce that documentation to the Commission's examination staff during the 2010 examination. Eventually, RJL produced one two-page spreadsheet for one of the performance claims, but did not produce support for all the performance claims made about competing strategies. It is unclear why RJL was unable to produce the 1966-2003 spreadsheet during the examination in 2010, if it was maintained on a computer at RJL's office and simply needed to be printed.

In any event, RJL's failure to maintain any documentation supporting the 1973 "Back Tested Buckets" performance claims is a clear violation of the books and records requirement.

C. Respondents' Violations Warrant Revocation of Registration, Industry Bars, and Civil Penalties

The Fifth Circuit's decision in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir.1979), is recognized as the leading case that establishes the standard courts should use when evaluating administrative actions involving disciplinary sanctions. *See, e.g., Gibson v. SEC*, 561 F.3d 548, 554-55 (6th Cir. 2009); *Seghers v SEC*, 548 F.3d 129, 134 (D.C. Cir. 2008); *Lowry v. SEC*, 340 F.3d 501, 504 (8th Cir. 2003); *In the Matter of Gregory D. Tindall*, Administrative Proceeding

File No. 3-14894, 2012 SEC Lexis 3244 (Oct. 12, 2012). Under *Steadman*, a court must consider a number of factors when imposing disciplinary sanctions: (1) the egregiousness of the respondent's actions; (2) the isolated or recurrent nature of the infraction, (3) the degree of scienter involved, (4) the sincerity of the respondent's assurances against future violations, (5) the respondent's recognition of the wrongful nature of his conduct, and (6) the likelihood that the respondent's occupation will present opportunities for future violations. *Steadman*, 603 F.2d at 1140.

Respondents' actions in this case warrant substantial sanctions under the *Steadman* factors. Respondents' actions were egregious because they substantially misrepresented to prospective clients the performance results that could be achieved using the BOM portfolio strategy over a long period of time and in a variety of media outlets. Respondents presented performance data to support their claim that they could provide inflation-adjusted income and sustained portfolio growth, when in fact, that data was misleading because Respondents failed to disclose that they achieved such results only by assuming a hypothetical 3% inflation rate. Respondents also misrepresented that they used their BOM portfolio strategy to obtain the performance results, when in fact they were relying for the bulk of the time on a portfolio strategy they had disparaged as comparatively inadequate – 100% investment in the stock market. Lucia, an experienced professional who claimed that his BOM strategy was based on "science, not art," presented his performance data as "backtests" conducted over decades and over numerous bear markets, when he knew that Respondents had not actually performed a backtest.

Respondents' violations extended over a lengthy period and evidenced a high level of scienter, as discussed above. Lucia knew that the 1966-2003 performance data was not a backtest, yet called it a backtest in his book and presented it in RJL's seminars as empirical performance data that showed that BOM could, in fact, provide inflation-adjusted income and portfolio growth using historic market data. Indeed, the purpose of the examples was to show that BOM provided these results through a "Grizzly Bear" market and during a period when the

S&P 500 was flat. The purpose of the performance data was to validate the BOM strategy. Respondents knew, or were reckless, when they presented this performance data without disclosing the substantial effect on the performance results from the assumed 3% inflation rate.

While RJL has sold its business to RJL Wealth Management, LLC, a registered investment adviser owned by one of Lucia's sons, Lucia continues to own RJL and is affiliated with RJLWM, and continues to promote the BOM strategy. Respondents have claimed to discontinue using the misleading information, although Lucia's book remains in print and uncorrected. Moreover, given Lucia's occupation as the promoter of BOM, there is no assurance that he will not engage in similar activities in the future. Indeed, Lucia has not acknowledged the nature of his wrongdoing; instead, shortly after the OIP was issued, Lucia posted a response which defended his actions and, using a former SEC Commissioner as a character witness, criticized the enforcement action.[8] (Ex. 75.)

Accordingly, the Division requests that RJL's registration as an investment adviser be revoked, and that Lucia's registration as an investment adviser be revoked and that Lucia be permanently barred from association with any registered investment adviser. Because Lucia recently owned a registered broker-dealer and funneled some of the income from his seminars through the broker-dealer, it is also appropriate to bar Lucia from association with any registered broker-dealer.

The Division also seeks civil penalties against RJL and Lucia. In this case, imposition of third tier civil penalties is appropriate because the conduct involved fraud and deliberate or reckless disregard of a regulatory requirement, and Respondents obtained substantial pecuniary gain from their conduct. *See* Section 203(i) of the Advisers Act, 15 U.S.C. § 80b-3(i). The Division requests a third tier penalty in the amount of $725,000 be imposed upon RJL, and in the amount of $150,000 be imposed upon Lucia individually. *See* Section 201.1004 and Table IV to

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[8] Lucia quoted a statement from former SEC Commissioner Raul Campos. While Lucia identified Campos as affiliated with the law firm of Locke Lord, Lucia omitted any disclosure that Locke Lord was, and had been, defending him in this action as his counsel of record.

Subpart E, Adjustment of civil monetary penalties – 2009, 17 C.F.R. Part 201.1004 and Table IV. *See also SEC v. DiBella*, 587 F.3d at 571-72 (recognizing that aiders and abettors are subject to civil penalties under the Advisers Act).

The Division also seeks a cease and desist order requiring RJL to cease and desist, and Lucia from aiding and abetting RJL, from violating the specified sections of the Advisers Act, and for Lucia to disclose at any future seminars that he has been sanctioned for providing misleading performance data about the BOM portfolio strategy.

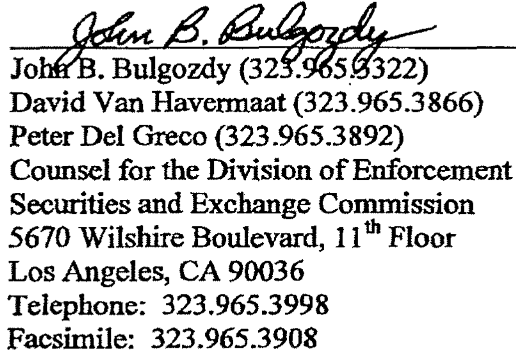
IV. CONCLUSION

For all the reasons stated, the Division requests that the Court find that Respondents have violated the specified provisions of the Advisers Act and impose the requested sanctions.

Respectfully submitted,

DIVISION OF ENFORCEMENT

Dated: November 5, 2012



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