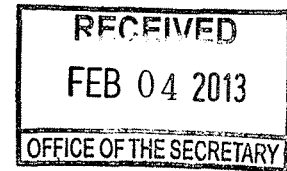


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ADMINISTRATIVE PROCEEDING
FILE NO. 3-15006

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 POST-
HEARING BRIEF

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I. INTRODUCTION

The Division of Enforcement (“Division”) alleged, and the evidence established, that Respondents Raymond J. Lucia Companies, Inc. (“RJC”) and Raymond J. Lucia, Sr. (“Lucia”) (collectively “Respondents”), made materially misleading statements and omissions about the performance of their “Buckets of Money” (“BOM”) strategy in slideshows that Lucia presented at seminars Respondents held nationwide since at least 2003. There is no dispute that, over a period of years, Respondents presented slideshows at seminars in which they claimed to have back-tested the BOM strategy to 1966 and 1973, and presented the results of their calculations in the seminar slideshows. A back-test of an investment strategy involves calculating how that strategy would have performed over a historical period using actual historical data. In their slideshows and seminars, Respondents claimed their purported back-tests proved the BOM strategy “really does work” through bear markets (1973) and flat markets (1966) to produce inflation adjusted income and sustained portfolio growth.

At the hearing, the evidence established that Respondents had not back-tested the BOM strategy as represented in the slideshow. The Division’s expert testified that the calculations Respondents presented as support for their 1966 and 1973 back-tests were not, in fact, back-tests. Even Respondents’ expert agreed that they were not back-tests.

In addition, whether the Respondents’ performance calculations are called “back-tests” or portfolio values or hypotheticals, the evidence established that these performance calculations were misleading for a number of reasons. Respondents used an assumed inflation rate of 3% for their purported back-tests, but performing the same calculations over the same historical period using actual inflation rates produced materially different results: (1) Respondents’ slide presenting the results of their purported back-test of the BOM strategy to 1973, titled “Back Tested Buckets,” showed that \$1 million invested using a BOM strategy on January 1, 1973 would generate inflation-adjusted income and the portfolio would grow to a value of \$1,544,789 by 1994; however, the Division’s expert showed that when actual inflation rates are used, the BOM portfolio in fact goes to zero by 1989; and (2) Respondents’ slide presenting the results of

their purported back-test of the BOM strategy to 1966 showed the value of the portfolio grew to \$4,719,741 by 2003, but the Division's expert showed that when actual inflation rates are used, the BOM portfolio goes to zero by 1986.

The evidence established that Respondents knew that using actual inflation rates in their purported back-tests would result in the BOM portfolios going to zero – the same as other strategies that Respondents presented during their slideshows. There is no dispute that Respondents never disclosed in their slideshows or during the seminars that using actual inflation over the historical periods covered by the test would materially change their results. As Lucia conceded, if the purpose of the slideshow and seminars was to sell the BOM strategy (which it was), then telling audiences that the strategy went broke would not be very effective.

Respondents' claims about the performance of the BOM strategy over historical periods from 1966 and 1973 were misleading for other reasons as well. While Respondents disclosed that they assumed an investment in a real estate investment trust ("REIT") would return 7% annually, Respondents failed to disclose that using available historical information on REIT returns would have substantially diminished the performance of their BOM portfolios. Respondents also failed to disclose that they made unrealistic assumptions about the REIT investments in their calculations, including that they were risk-free, did not change in value, and were perfectly liquid. Respondents' assumptions in this regard were directly contrary to the risks of investments in REITs which Respondents disclosed in their slideshows at their seminars.

In addition, Respondents failed to disclose the effect that fees and management costs would have had on the performance of the BOM portfolios. The Division introduced evidence that deducting fees from Respondents' calculations materially reduced the performance results from those presented by Respondents in their slideshows. Moreover, the evidence showed that Respondents did not even follow their BOM strategy when they calculated the performance of the BOM portfolios in their purported back-tests. The BOM strategy, as explained in the slideshows, allocates assets among three buckets: a safe and liquid "Income" bucket, a relatively safe "Safety" bucket, and a higher-risk, long-term "Growth" bucket. However, when

Respondents performed their purported back-test calculations, the spreadsheets showing the calculations reveal that Respondents allocated 100% of the portfolios into stocks for the majority of the period tested by their purported back-tests. Thus, the portfolio results that Respondents presented did not actually test a BOM strategy, but instead relied for the majority of the time on a high-risk strategy in which all assets were put into one high-risk bucket. Such a concentration of a portfolio in stocks was contrary to Lucia's expressed views that clients should never be invested 100% in stocks. It is undisputed that Respondents never disclosed in the slideshow, or to seminar attendees, that their purported back-tests involved putting 100% of the portfolio into high-risk stocks for the majority of the time period of the test.

In response to this evidence, Respondents took a number of surprising and oft-times inconsistent positions at the hearing. Respondents admitted that they had no documentary support for their claimed 1973 back-test performance numbers, admitted for the first time to errors in the numbers and calculations presented in the 1973 "Back Tested Buckets" slide, and surprisingly admitted for the first time that the "Back Tested Buckets" slide falsely stated that actual S&P 500 and T-Bill returns were used for the calculations. Respondents admitted that the 1973 calculations used for the "Back Tested Buckets" slide did not use actual historical data as they had represented on the slide. Accordingly, Respondents had no reasonable basis for putting forth the "Back Tested Buckets" slide as a back-test, or as any kind of proof or support for how the BOM strategy may have performed from 1973, and to do so was materially misleading.

Respondents also introduced inconsistent evidence about the calculations they had presented in their slideshows as back-testing. While Respondents' expert – under questioning from Respondents' counsel – opined that Respondents' 1966 and 1973 calculations and the results presented in the slideshows were not back-tests, Lucia disagreed. Lucia contradicted his own expert and testified that he personally back-tested the BOM strategy to 1966, 1973, and 1987, but he had not retained any documentation of his back-tests because he thought it was not necessary. Then, during the hearing Respondents attempted to re-define what they had done by inventing a new term – "forward looking back-testing." There is no evidence Respondents ever

used the term “forward looking back-testing” at any seminar, in any slideshow, or in any of their literature that discussed their back-testing. Thus, Respondents simultaneously admitted that they had not back-tested the BOM strategy, claimed that they had back-tested the BOM strategy, and tried to re-define their prior, repeated use of the term “back-test.” The simple fact is that Respondents did not have any reasonable basis to claim that they had back-tested the BOM strategy to 1973 and 1966, as they repeatedly did in slideshows presented at seminars for years.

At the hearing, Respondents played a recording of a webinar of one of Respondents’ slideshow presentations, purportedly to provide context for the back-testing claims. However, the webinar – which Respondents produced after the OIP was instituted – supports the Division’s claims. The webinar shows that Respondents presented the results of their claimed back-tests as proof that the BOM strategy worked. After explaining that he used the 1966 calculations to convince Ben Stein about BOM, Lucia then claims: “Buckets of Money. And it works. It really does work.” The context of the slideshow, and the webinar, shows that after explaining the theoretical basis for the BOM strategy, Respondents used their claimed back-testing to validate and prove that the BOM strategy “works.” As investment advisers and fiduciaries, Respondents had a duty to avoid misleading prospective clients and to make full and fair disclosure of all material facts. The evidence conclusively established that Lucia and RJL violated that duty, as alleged in the OIP.

Finally, the evidence established that RJL did not maintain necessary books and records. During the Commission’s 2010 examination of RJL, when asked to produce documentation of their claimed back-testing, Respondents produced a two-page spreadsheet that purportedly supported the 1973 “Back Tested Buckets” slide, but eventually admitted that they had no documentation for their back-testing claims. At the hearing, Respondents claimed they also produced documentation for the 1966 back-test during the examination, but their evidence is contradicted by the testimony of the Commission’s examination staff. Moreover, contemporaneous documents show that the only documents Respondents provided during the examination to support their claimed back-testing was a spreadsheet for 1973, which they admit is not, in fact, support for the performance numbers shown on the “Back Tested Buckets” slide.

The Division requests that the Court find that RJJ violated, and Lucia aided and abetted RJJ's violations of, Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-6(1), (2), and (4), and Rule 206(4)-1(a)(5) thereunder, 17 C.F.R. § 275.206(4)-1(a)(5), and that RJJ violated Rule 204-2(a)(16), 17 C.F.R. § 275.204-2(a)(16). The Division requests that an order be issued making appropriate findings, revoking the registrations of RJJ and Lucia, banning Lucia from association with a registered investment adviser and registered broker dealer, and imposing third tier civil penalties in the amount of \$150,000 on Lucia individually and \$725,000 on RJJ.

Finally, the Division requests that the Court issue a cease and desist order requiring RJJ and Lucia to cease and desist from further violations of the Advisers Act. With regard to the cease and desist order, although Respondents have represented that they have stopped engaging in the challenged conduct, evidence at the hearing established that Respondents had provided such assurances in the past, but then resumed the challenged conduct anyway. Under the circumstances, a cease and desist order is necessary to prevent continued violations of the Advisers Act.

II. FACTS

A. Lucia's Background

Lucia began as an agent with Penn Mutual Insurance Company in 1973 or 1974, and worked with that company through 1991. (Trial Tr. (Lucia) 1031:4-14.) Lucia obtained his Series 7 license through Penn Mutual in 1983. (Trial Tr. (Lucia) 1032:12-15.) Lucia became registered with the Commission as an investment adviser in 1996. (Trial Tr. (Lucia) 1035:8-12.) Lucia took his Series 24 securities principal examination in 1997 (Trial Tr. (Lucia) 1035:13-16), and in May 2002 obtained his Series 63 license. (Trial Tr. (Lucia) 1035:17-20.)

After working with several companies between 1991 and 1994, Lucia formed RJJ in 1994. (Trial Tr. (Lucia) 1026:12-14.) RJJ was a registered investment adviser from September 2002 through December 2011. (RJJ Answer ¶ 1; Lucia Answer ¶ 1.) From approximately 2006 through 2010, RJJ did business under the name RJJ Wealth Management. (Trial Tr. (Lucia) 1026:15-1027:9.) In 2010, Lucia sold the assets of RJJ to his son, Ray Lucia Jr. ("Lucia Jr."),

who operates the business under the name RJL Wealth Management LLC (“RJLWM”), which is also a registered investment adviser. (Trial Tr. (Lucia) 1027:10-16; Trial Tr. (Lucia Jr.) 1642:22-1643:1, 1599:16-1600:1.) Lucia is currently registered as an investment adviser with RJLWM. (Trial Tr. (Lucia) 1024:16-18.) In at least one document, RJLWM refers to Lucia as “our founder.” (See Resp. Ex. 2 at SEC-LA3937-00076.)

Around 1990, Lucia began hosting a talk radio show on radio station KFMB AM in San Diego called *The Ray Lucia Show*. (Trial Tr. (Lucia) 1025:22-25.) Since about 2000, Lucia’s radio show has been nationally syndicated on the business talk radio network. (Trial Tr. (Lucia) 1026:1-4.) Since September 2010, *The Ray Lucia Show* was picked up for television by the BIZ network. (Trial Tr. (Lucia) 1026:5-8.)

B. Respondents’ Development Of The BOM Strategy

1. Lucia Created BOM Around 1998

Lucia created the BOM retirement planning strategy. (Trial Tr. (Lucia) 1024:13-15.) Lucia testified that an article he read in 1998 by John J. Bowen, Jr. is what got him started on the “whole concept of bucketizing portfolios.” (Trial Tr. (Lucia) 1037:14-1038:1; see also Lucia Answer ¶ 5 (“Lucia admits the idea for the BOM strategy was a 1998 article in *Financial Planning* by John J. Bowen, Jr.”); RJI Answer ¶ 5 (same); Govt. Ex. 80 (John J. Bowen, Jr. article entitled “A Retirement Dilemma,” published in the August 1998 issue of *Financial Planning*.) Around 2000, Lucia trademarked the terms “Buckets of Money,” “bucketeer,” and “bucketize.” (Trial Tr. (Lucia) 1046:14-25.)

2. The BOM Strategy

In simplest terms, the BOM strategy involves allocating a client’s assets among three “buckets” with the goal of providing “inflation-adjusted income for life and sustained portfolio growth.” (See, e.g., Govt. Ex. 8; Govt. Ex. 27; Govt. Ex. 29; Govt. Ex. 31; Trial Tr. (Ochs) 625:10-21; Trial Tr. (Ochs) 626:7-14; Trial Tr. (Lucia) 1082:13-1083:3; Trial Tr. (Plum) 741:21-742:9.) Respondents repeatedly described the BOM strategy as being “science, not art.” (See, e.g., Govt. Ex. 10; Govt. Ex. 32; Trial Tr. (Ochs) 530:9-17; Trial Tr. (Plum) 740:21-741:9.)

Respondents claimed that the BOM strategy was “proven” (Trial Tr. (Lucia) 1111:1-4) and “time-tested” (Trial Tr. (Lucia) 1111:5-10) and based on “empirical evidence.” (Trial Tr. (Lucia) 1111:11-14.)

Respondents graphically explained how a client allocated their assets using the BOM strategy by showing three buckets, which were labeled “Bucket # 1 – Income”; “Bucket # 2 – Safety”; and “Bucket # 3 – Growth.” The purpose of Bucket # 1 is to provide short-term assets, such as cash, to pay short-term liabilities, such as living expenses. The purpose of Bucket # 2 is to provide other safe assets that can be used to replenish Bucket # 1 when it is depleted of funds. The purpose of Bucket # 3 is to provide growth over the long term using higher risk money. Respondents identified non-traded REITS, domestic and international stocks, and other long-term assets as potential growth investments for Bucket # 3. (*See, e.g.*, Govt. Ex. 1 (seminar slide show explaining the three buckets); Govt. Ex. 8 (brochure with three buckets); Govt. Ex. 16 (handout graphically showing three buckets); Govt. Ex. 20 (internet page showing three buckets); Govt. Ex. 21 (slide show explaining three buckets); Trial Tr. (Lucia) 1055:10-1056:8.)

C. Respondents Promoted The BOM Strategy Nationwide At Seminars Where They Claimed To Have Back-Tested The BOM Strategy

RJL and Lucia promoted the BOM strategy at seminars held nationwide, and Respondents do not dispute that Lucia presented a slideshow to the audience during the presentations. One version of the slideshows was marked as Govt. Ex. 1, and other versions of the slideshow were also admitted into evidence. (Trial Tr. (Ochs) 572:1-12; *see also* Govt. Ex. 21; Govt. Ex. 22.) Lucia was responsible for the content of the slides used at the seminar, and approved the content before any slides were used. (Trial Tr. (Lucia) 1066:17-1067:3; Trial Tr. (Plum) 834:21-23; Trial Tr. (Ochs) 572:9-12.)¹ At the hearing, Respondents showed a webinar

¹ Respondents’ Chief Compliance Officer admitted that RJL did not have any procedures in place to make sure that slides used in Lucia’s seminar presentations did not contain numerical errors. (Trial Tr. (Ochs) 668:5-9.)

that showed a different version of the slides than the slideshow marked as Govt. Ex. 1, but the slideshow in the webinar also contained the back-test slides at issue in this proceeding.²

1. Respondents Promoted The BOM Strategy At Seminars Held Nationwide

Lucia and RJL marketed the BOM strategy through seminars conducted by Lucia. (Trial Tr. (Lucia) 1058:8-11; Lucia Answer ¶ 3; RJL Answer ¶ 3.) Lucia has been giving BOM seminars since early 2000. (Trial Tr. (Ochs) 672:1-3.) Lucia estimated that the number of attendees at any seminar during the period from 2003 through 2010 ranged from 100 to 500 people. (Trial Tr. (Lucia) 1061:6-16.) Respondents' Chief Compliance Officer thought the number of attendees ranged from 200 to 400 people, depending on the venue. (Trial Tr. (Ochs) 676:23-677:1.) Lucia and RJL estimated that over 50,000 people have attended his BOM seminars. (Trial Tr. (Lucia) 1061:17-20.)

RJL and Lucia held BOM seminars at locations nationwide, in cities such as Washington D.C.; Philadelphia; San Francisco; Seattle; Los Angeles, Houston; and Dallas, among other places. (Trial Tr. (Lucia) 1059:18-1060:4; *see also* Govt. Exs. 26-30 (documents listing times and locations of seminars).) Lucia guessed that he spent around 145 days a year on the road promoting BOM at seminars. (Trial Tr. (Lucia) 1054:16-1055:3; 1070:9-12.) Employees of RJL and Lucia, including Richard Plum, accompanied Lucia to "hundreds" of BOM seminars. (*See* Trial Tr. (Lucia) 1069:24-1070:8; Trial Tr. (Plum) 876:15-17.)

Lucia testified that Respondents promoted the seminars through a variety of means of interstate commerce. This included radio, newspaper ads, and email. (Trial Tr. (Lucia) 1058:8-1059:14.) Respondents also publicized the seminars on the Internet, at RJL's websites, www.rjl.com and www.rjlwm.com, and Lucia's website, www.raylucia.com. In addition, Lucia

² Lucia testified that he was not sure that the slides shown during the webinar were ever used "other than in that webinar." (Trial Tr. (Lucia) 1315:10-14.) Respondents did not mark as an exhibit or produce to the Court or the Division a copy of the slides used in the webinar. When questioned about changes to disclaimers and REIT disclosures in the webinar slides, Lucia disclaimed knowledge about the changes, even though he and his agents admitted he was ultimately responsible for the content of the slides. (*See, e.g.*, Trial Tr. (Lucia) 1308:9-1315:1.)

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). (RJL Answer, ¶ 3; Lucia Answer, ¶ 3.)

2. Lucia And RJL Claimed To Have Back-Tested BOM At The Seminars

There is no dispute that Lucia and RJL repeatedly told seminar attendees that they had back-tested BOM to 1973 and 1966, and that these back-tests demonstrated that the BOM strategy produced inflation adjusted income and portfolio growth through bear markets and flat markets. Respondents' personnel, including Lucia Jr., Plum, and Ochs, testified that they heard Lucia tell clients and potential clients at BOM seminars that Respondents had back-tested the BOM strategy. The slideshows that Respondents showed at seminars specifically used the term back-test to describe their test of the BOM strategy.

Teresa Ochs, RJL's Chief Compliance Officer who has known Lucia since 2005 or 2006 (Trial Tr. (Ochs) 444:17-19), testified that she had seen Lucia tell the public that he had back-tested the BOM strategy to 1966 (Trial Tr. (Ochs) 536:20-537:2), and that he had back-tested the BOM strategy to 1973. (Trial Tr. (Ochs) 537:3-7.) Richard Plum, who has worked for Lucia since 1993 (Trial Tr. (Plum) 713:10-12) and attended "hundreds" of seminars (Trial Tr. (Plum) 876:15-17), testified that he "most definitely" heard Lucia claim at seminars that the BOM strategy had been back-tested. (Trial Tr. (Plum) 358:10-359:8.) Lucia Jr., who has attended BOM seminars for many years, testified that he heard his father use the term "back-test" during seminars to describe the 1966 and 1973 back-tests. (Trial Tr. (Lucia Jr.) 1686:25-1687:17.)

Moreover, there can be little dispute that Respondents presented the back-tests of the BOM strategy as evidence that BOM worked and stood the test of historical market conditions. Lucia testified that the purpose of going back in time to a historical period and a specific date is to test how BOM would have performed under "historical circumstances." (Trial Tr. (Lucia) 1097:5-11.) Lucia presented the results of such looks back in time to validate his strategy. (Trial Tr. (Lucia) 1097:12-15.) Lucia conceded that by going back over historical periods, Lucia was

endeavoring to show how BOM strategy performed relative to other strategies. (Trial Tr. (Lucia) 1098:3-8.) As Lucia testified:

What I am doing in this so-called back-test is I'm looking at market performance during a time back in history to replicate that today so if you and I are sitting and talking about your financial plan, I can say to you this particular strategy, this withdrawal strategy has stood up to the test of the market performance of 1973, '74, 1966, 1987 has absolutely nothing to do with a model portfolio.

(Trial Tr. (Lucia) 1096:11-19.) In fact, in the webinar, after presenting the "results" of the 1966 back test of the "real Buckets of Money portfolio," Lucia explained how the back test had convinced Ben Stein that BOM worked, and Lucia stated: "Buckets of Money. And it works. It really does work." (Resp. Ex. 30; Govt. Ex. 66 at 51:9-10.)

a) The 1973 "Back Tested Buckets" Slides

In his slide show presentation, Lucia shows a series of three slides that purport to show the results of a back test of the BOM strategy through the 1973-1974 "Grizzly Bear" market. (Govt. Ex. 1 at SEC-LA3937-00199-201.) The first slide asks the question: "But Can Buckets Stand Up To The Test Of The '73/'74 Grizzly Bear?" (Govt. Ex. 1 at SEC-LA3937-00199.) The next slide, captioned "Back Tested Buckets," answers the question and shows the results of the portfolio beginning on "1/1/73," drawing income from 1973 through 1994, with a "Balance in 21 Years" of "\$1,544,789." This "Back Tested Buckets" slide includes a disclaimer that, among other things, states Respondents used "actual treasury rates of return to calculate fixed income/bond returns and actual S&P 500 returns to calculate growth returns." (Govt. Ex. 1 at SEC-LA3937-00200.) The next slide shows the "Bold Bucketees in 1994, After The 1973-74 Bear Market," with "\$1,544,789." (Govt. Ex. 1 at SEC-LA3937-00201.) Respondents began using these slides around 2003, and used them at seminars through at least 2010.

In the webinar, Lucia introduces the 1973 "Back Tested Buckets" slide as follows: "But the key here is can the Buckets of Money strategy stand up to the true test of the 1973/74 Grizzly Bear market? Well, let's see." (Resp. Ex. 30; Govt. Ex. 66 at 46:16-19.) Lucia then discusses the results of the back test.

b) The “1966 Buckets Of Money Portfolio. (40-20-40)” Slides

In the slide show, after presenting the back test of the BOM strategy through the “Grizzly Bear” market of 1973-74, Lucia asks how BOM would perform if one retired in 1966. (Govt. Ex. 1 at SEC-LA3937-00203.) In a series of slides, Respondents then present the results of back-tests of the BOM portfolio, and two other portfolios, beginning in 1966. The slides at issue in this proceeding present the results of Respondents’ back-test of a real BOM portfolio, which appear on a slide captioned “1966 Buckets of Money Portfolio. (40-20-40)” (Govt. Ex. 1 at SEC-LA3937-000477), and the following slide that summarizes the results. (*Id.* at -000478.)

In presenting the 1966 back-test results, Respondents first present a slide with “Notes & Assumptions,” and then presents the performance of three portfolios. (Govt. Ex. 1 at SEC-LA3937-00204-00211.) The “Notes & Assumptions” slides states:

- 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 returns
 - REIT returns are based on a 7% annual return
 - Inflation is based at 3% annual

(Govt. Ex. 1 at SEC-LA3937-00204.)

The seminar slide show then presents the results for three portfolios: (1) “60-40 Portfolio. Income from stocks & bonds (pro rata)” (Govt. Ex. 1 at SEC-LA3937-00205-206); (2) “60-40 Portfolio. Buckets of Money Portfolio (Without REIT)” (Govt. Ex. 1 at SEC-LA3937-00207-208; and (3) “Buckets of Money Portfolio. (40-20-40) (With Real Estate Investment Trusts)” (Govt. Ex. 1 at SEC-LA3937-00209-210.) In the summary page that compares the performance of the three portfolios, Respondents state that the “Buckets’ Portfolio” has a “Value 2003 \$4,719,741” in 2003. (Govt. Ex. 1 at SEC-LA3937-00211.)

In the webinar, Lucia introduces the 1966 calculations by stating that his friend Ben Stein asked him what would happen if he started in 1966, and Lucia then states: “Well, I did a back-

test for Ben.” (Resp. Ex. 30; Govt. Ex. 66 at 47:22.) Lucia explains that according to Stein, in 1966 the Dow Jones Industrial Average was around 1,000, and in 1982, it was still at 1,000, so the question was “How would your Buckets of Money strategy have stood up to that test?” (Resp. Ex. 30; Govt. Ex. 66 at 48:9-14.) Lucia describes the 1966 “Buckets of Money Portfolio (40-20-40) slide as representing “the real live Buckets of Money strategy.” (Resp. Ex. 30; Govt. Ex. 66 at 50:2-3.) Lucia continues, in the webinar, to explain: “how would this portfolio have looked in 2003 using the Ray Lucia Buckets of Money strategy? Try 4.7 million dollars.” (Resp. Ex. 30; Govt. Ex. 66 at 50:12-14.) Lucia then explained how this back test convinced Ben Stein, claiming that Stein’s “drunk the Kool-Aid, he’s got religion. Buckets of Money. And it works. It really does work.” (Resp. Ex. 30; Govt. Ex. 66 at 51:7-10.)

Respondents began using the 1966 back test in the seminar slide show in 2005 or 2006, and continued to use it through at least 2010. (Trial Tr. (Ochs) 585:6-9; Govt. Ex. 1.)

D. Respondents Made Materially Misleading Statements And Material Omissions About Their Back-Testing

1. Respondents Did Not Back-Test The BOM Strategy

a) The Division Presented Evidence That Respondents’ Spreadsheets Were Not Valid Back-Tests

The Division presented expert testimony from Steven Grenadier, who testified that Respondents did not back test the BOM strategy. (See Govt. Ex. 70 (Expert Report of Steven Grenadier).) Grenadier provided a simple definition of back test: “A back-test of an investment strategy uses historical data to evaluate how that strategy would have actually performed had it been implemented in the past.” (Govt. Ex. 70 ¶ 10.) Respondents did not offer any evidence to contradict that definition. In fact, Respondents’ explanations of their 1973 and 1966 back-tests in the seminar – as seeing how BOM would have performed if it had been implemented beginning in the bear market of 1973 or the flat market of 1966 – comport with Grenadier’s definition. Grenadier explains the importance of using actual, historical data to obtain an accurate test of a strategy. (Govt. Ex. 70 ¶¶ 10-12.) Grenadier opined that Respondents did not

perform back-tests of the BOM strategy from 1973 and 1966, and the numbers presented in the spreadsheets “do not accurately reflect the results of the investment strategy that is being tested for several reasons.” (Govt. Ex. 70 ¶ 12.)

b) Respondents Presented Inconsistent Evidence Whether They Back-Tested The BOM Strategy

Respondents presented inconsistent evidence whether they had back-tested the BOM strategy. On the one hand, Respondents’ expert testified that their calculations were not back-tests, while on the other hand Lucia swore he back-tested the BOM strategy. So, although Respondents repeatedly told prospective clients that they back-tested the BOM strategy, Respondents’ apparently cannot decide whether they, in fact, back-tested the BOM strategy.

Lucia testified that he back-tested the BOM strategy to 1966, 1973, and 1987, but he did not produce any documentation to support his back-tests because his “understanding was you didn’t need to produce documentation on a hypothetical. None of this relates to any model portfolio or trading strategy or managed account.” (Trial Tr. (Lucia) 1094:12-1095:6.) While Lucia testified that he back-tested the BOM strategy to 1987, his long-time employee Plum was not aware of any 1987 back-test. (Trial Tr. (Plum) 855:8-856:8.) Plum testified that the 1973 calculations “were a back-test of the strategy,” and that “the whole idea, again, was to illustrate a downturn in the market, historical downturn in the market and then the subsequent recovery.” (Trial Tr. (Plum) 842:22-843:7.) Plum testified that he understood back-testing used historical data and returns to test a strategy or model. (Trial Tr. (Plum) 838:17-23.) Plum agreed that it was important to use accurate historical data in conducting a back-test, particularly where Respondents were showing what would happen if the BOM strategy were used beginning in the 1973-74 bear market.³ (Trial Tr. (Plum) 766:20-767:15.)

³ Although Plum testified about the purpose of the 1973 back-test, for the first time at trial Plum revealed that he did not perform the 1973 back-test, contrary to the information Respondents had provided to the Commission’s staff during the examination and the investigation.

Contrary to Lucia's testimony, Respondents' economic expert, John Hekman, testified that Respondents had not back-tested the BOM strategy. Hekman testified that in his opinion the calculations presented in the seminar slides would not be considered back-tests. In response to questions from Respondents' counsel, Hekman testified:

Q: It's not your opinion, is it, that any of the calculations performed in the slides that Mr. Lucia presented in his seminars are back-tests as Dr. Grenadier defined the term?

A: That's correct. I don't consider them to be back-tests.

(Trial Tr. (Hekman) 1541:24-1542:4.) On this point, Hekman agreed with the Division's expert, Steven Grenadier, who also opined that the spreadsheets produced by Respondents did not show back-testing of the BOM strategy from 1966 or 1973. (*See generally* Govt. Ex. 70.)

Thus, Respondents conceded that the calculations presented as back-tests were not back-tests, while at the same time claiming that they had performed back-tests, which they also referred to as "hypotheticals."⁴

2. Respondents Failed To Disclose The Material Effect Of Actual Inflation On Their Back-Tests

The 1973 "Back Tested Buckets" slide does not include any specific disclosure about inflation, although Respondents have at times asserted that they may have used an assumed 3% inflation rate for some of those calculations. The 1966 back-test does present the assumption that "inflation is based at 3%." However, it is undisputed that Respondents did not disclose the material effect of using the historical inflation rate in their back-tests.

The Division presented undisputed evidence that using actual inflation materially affected the results of the back-tests. (*See* Govt. Ex. 70 (Report of Steven Grenadier) at ¶¶ 13-18 and Exs. 2a, 2b, 2c.) Specifically, the Division's expert replicated the 1966 calculation using actual

⁴ By definition, any back-test is a hypothetical because the strategy or portfolio did not exist or was not used in the past. The purpose of a back-test is to test a strategy using actual historical data to see how it would have performed under historical conditions. In fact, that is exactly how Respondents presented the results of their back-tests in the seminars.

inflation rates. Rather than producing inflation adjusted income and growing to \$4,719,741, using actual inflation results in the “real Buckets” portfolio declining to in value to zero after 21 years, in 1986. (See Govt. Ex. 70 at Ex. 2a.) The Division’s expert also replicated the 1973 spreadsheet (Govt. Ex. 13) using actual historical inflation rates, which also produced materially different results. Rather than ending up with a portfolio valued at \$1,544,789 in 1994 as claimed in Respondents’ seminars, the BOM portfolio has a zero value after 17 years – in 1989. (See Govt. Ex. 70 at Ex. 2b.)⁵

There is no dispute that Lucia did not disclose during the seminars the material effect that the 3% inflation assumption had on the results of Respondents’ back-tests. Janean Stripe, a long-time employee of Respondents, testified that in the 20 seminars she attended she did not recall Lucia ever disclosing that if actual inflation had been used, then the “Bold Bucketees” would have gone broke. (Trial Tr. (Stripe) 1591:2-6.) Lucia’s son testified that he attended hundreds of BOM seminars, but he did not recall hearing Lucia say that if actual inflation was used that the Bold Bucketees would go broke, or even that the ending portfolio balance on the slide would have been substantially less. (Trial Tr. (Lucia Jr.) 1685:11-1686:9.) Lucia Jr. also did not believe his father ever specifically stated that if actual inflation was used for the 1973 back-test, that the balance would be substantially less. (Trial Tr. (Lucia Jr.) 1686:1-9.) Another long-time employee, Richard Plum, testified that he could not recall Lucia ever stating at a seminar that using actual inflation rates would result in the BOM strategy going broke. (Trial Tr. (Plum) 870:23-871:24.) Even Lucia admitted that he could not recall ever stating during a seminar that a BOM portfolio would go broke. (Trial Tr. (Lucia) 1151:8-13.) Lucia himself conceded that to the extent the purpose of the seminars was to sell the BOM strategy to clients or prospective clients, it would be self-defeating to say that the BOM strategy would end up with the client

⁵ Respondents’ long-time employee Plum ran the 1966 calculations using an average annual inflation rate, and found that the BOM portfolio ran out of money prior to 2003, although he could not remember when. (Trial Tr. (Plum) 816:18-817:4.) Respondents did not provide those calculations to the Division or to the Court.

going broke. (Trial Tr. (Lucia) 1151:14-1152:17.)

3. Respondents Failed To Disclose The Material Impact Of Their Assumptions Concerning REIT Returns And Liquidity, And Their Failure To Account For Fees

a) REIT Returns And Liquidity

In the spreadsheets produced as the support for the claims made in the seminar presentation about the performance of the BOM strategy from 1966 and 1973, Respondents assumed the availability of a REIT investment, used an assumed rate of return, and assumed the REIT held a steady value and was perfectly liquid. (See Govt. Exs. 12 & 13; Trial Tr. (Lucia) 1123:14-1124:4.) While Respondents disclosed that they were allocating some of the BOM back-tested portfolio to an investment in a REIT and that they were assuming a rate of return, Respondents failed to disclose the material impact of those assumptions on their back-test.

First, there is no dispute that Respondents did not use historical REIT returns in their back-tests, but instead used disclosed assumed rates of return. The Division's expert and Respondent's real estate expert agreed that historical data on REIT returns was readily available beginning in 1972. The Division's expert, Grenadier, reported that "[a]ctual, historical returns data on publicly-traded REITs dating back to 1972 are available in the form of indices published by the National Association of Real Estate Investment Trusts ("NAREIT")." (Govt. Ex. 70 ¶ 23 (footnote omitted).) Grenadier testified that Respondents used a "fictitious return" for REITs in their calculations. (Trial Tr. (Grenadier) 943:6-944:19.) Respondents' real estate expert, Gannon, agreed that NAREIT index information was "readily available from 1972 onward," that it could be found on Bloomberg in "minutes," and that using that data available on Bloomberg one could easily calculate annual returns for the index from 1972 forward. (Trial Tr. (Gannon) 1380:3-14.) Respondents' real estate expert agreed that it would not be reasonable to use a hypothetical 7% rate of return for REITs in a back-test, and that one would use actual data in a back-test. (Trial Tr. (Gannon) 1387:6-15.)

The Division's expert, Grenadier, found that re-calculating Respondents' numbers for the 1966 back-test, only substituting for actual REIT data once it became available in 1972, resulted

in an ending portfolio value of \$1,297,711 in 2003. This is more than \$3.4 million less than the \$4,719,741 that Respondents told audiences the BOM strategy would generate. (See Govt. Ex. 70 ¶¶ 23-24 & Ex. 5a.)⁶

Second, Respondents failed to disclose that they were making unrealistic assumptions about the stability of REIT values and the liquidity of REIT investments. (Govt. Ex. 70 ¶¶ 23-26.) Respondents' spreadsheets for the 1966 and 1973 back-tests show that they assumed a constant value for REITs of \$200,000, and that REITs were liquidated on demand to replenish Bucket # 1. (See Govt. Exs. 12 & 13; Govt. Ex. 70 ¶¶ 23, 25.) However, Respondents' expert produced historical data that REIT returns were substantially negative from 1972 through 1974. (See Resp. Ex. 34 Ex. C.)

The Division's expert found that applying historical returns to the Respondents' 1966 and 1973 spreadsheets materially changed the REIT values. For the 1966 spreadsheet, the REIT value decreases from \$200,000 to \$85,646 at the time the REIT investment is liquidated. (Govt. Ex. 70 ¶ 23 & Ex. 5a.) For the 1973 spreadsheet, the REIT value decreases from \$200,000 to only \$134,031 at the time it is liquidated. (Govt. Ex. 70 ¶ 23 & Ex. 5b.)

Third, there is no dispute that REITs were not generally available from 1966 to at least 1971. Respondents' real estate expert testified that REITs were generally not available to individual investors during the time period from 1966 to 1971. (Trial Tr. (Gannon) 1379:7-12.) Respondents' real estate expert agreed with the Division's expert that REITs were generally not available between 1966 and 1971. (Govt. Ex. 70 ¶¶ 20-22, 25-26.) In the seminar slides for the 1966 back-test, Respondents specifically refer to a 20% REIT investment. (Govt. Ex. 1 at SEC-LA3937-00209.) Respondents did not disclose that REITs were not generally available from 1966 to 1971.

⁶ Grenadier's calculation for 1973 also resulted in a lower balance, although Respondents conceded at trial that the 1973 spreadsheet, Govt. Ex. 13, was not support for the 1973 "Back Tested Buckets" slide and had nothing to do with the seminar slides. Respondents have not provided any documents or explanation for exactly how they arrived at the numbers on the 1973 "Back Tested Buckets" slide. Respondents' economic expert, Hekman, replicated Respondents' 1966 calculations, but could not replicate the 1973 calculations.

Fourth, Respondents failed to disclose the material effect of their assumptions about the stability and liquidity of REITs as used in their calculations. While Respondents included a slide disclosing the risks of REITs in the seminar slide show (*see, e.g.*, Govt. Ex. 1 at SEC-LA3937-00148), Respondents disregarded those cautions in the manner in which they used REITs to calculate their back-tests. As the Division's expert states, if there were actually a REIT investment that offered a fixed rate of return of 7% with no capital appreciation or depreciation, it would make no sense for an investor to invest in T-Bills as shown in the spreadsheets. (Govt. Ex. 70 ¶ 24.) In their back-tests, Respondents use a fictitious REIT investment that is "risk free (and perfectly liquid)." (Govt. Ex. 70 ¶ 24.) Grenadier stated: "I am not aware of any risk-free REIT investment." (Govt. Ex. 70 ¶ 24.) Respondents offered no evidence of any such risk-free REIT, particularly one that existed during 1972-1974. Lucia did not disclose information about fees and commissions on REITs during his seminars. (Trial Tr. (Stripe) 1581:19-25.) There is no dispute that Respondents failed to disclose all the material economic assumptions they made about REITs in performing their calculations to arrive at the values of the back-tested 1966 and 1973 BOM portfolios.

b) Effect Of Fees

There is no dispute that Respondents did not include the effect of management and other fees in their calculations of the back-tested 1966 and 1973 BOM portfolios presented in the seminars. The Division presented evidence that it is important to include implementation costs in a back-test of the performance of a strategy that has such costs. (Govt. Ex. 70 ¶ 27.) Grenadier stated: "Implementation costs for a strategy are important because they may reduce, and at times eliminate, the benefits of a particular strategy." (*Id.*) Respondents' spreadsheets do not include or consider any costs to implement the BOM strategy, effectively assuming an implementation cost of zero. (*Id.*) The Division's expert opined that, at a minimum, there would be costs associated with an investment in the S&P 500 Index, in T-Bills, and in REITs.⁷ (*Id.*)

⁷ There was substantial debate at trial concerning the amount of compensation earned by

The Division showed that even a nominal allowance for fees can have a substantial impact over the time periods covered by Respondents' 1966 and 1973 back-tests. (*Id.* & Exs. 6a, 6b, 6c.) For example, a relatively minor allowance for fees for the 1966 back-test results in the value decreasing from \$4,719,741 in 2003, to only \$2,525,916. (*Id.* Ex. 6a.) There can be no question that a \$2.2 million change in a \$4.7 million portfolio is material.

Lucia was aware that imposing fees on a portfolio will produce significantly lower results over the thirty to forty year time span covered by the 1966 and 1973 back-tests. (Trial Tr. (Lucia) 1203:10-15.) Indeed, Respondents' internal documents calculating returns of portfolios include gross returns before fees, and net returns after fees, which shows that Respondents were well aware of the effect of fees on portfolio performance. (Govt. Ex. 57, Trial Tr. (Ochs) 521:1-525:19.) Of course, such documents were for "internal use only" and "not for public distribution."⁸ (*Id.*) However, Respondents never disclosed during seminars the impact of fees on the 1966 and 1973 BOM portfolios. (Trial Tr. (Stripe) 1574:18-23; Trial Tr. (Chisholm) 374:14-24.)

4. Respondents Failed To Disclose That Their Back-Tests Did Not Follow The BOM Strategy

Respondents' descriptions of the BOM strategy at seminars involved allocating assets into different types of investments to generate "inflation adjusted retirement income for life with minimal risk." (Trial Tr. (Lucia) 1055:10-23; Govt. Ex. 8.) As summarized in the seminar slide show, the BOM strategy involved "short term investments to fund a current need for income," "mid-term 'relatively safe' money to provide for portfolio stability," and "long term investments to provide growth for potential long term financial goals." (Govt. Ex. 1 at SEC-LA3937-00179.) Respondents explained that "Bucket # 1 – Income," and "Bucket # 2 – Safety," provided funds

Respondents, directly or indirectly, from their sales of non-traded REITs to their clients. There can be no dispute that Respondents were well aware that investments in REITs involve commissions, and they failed to account for that in their spreadsheets and back-tests.

⁸ Ochs testified that if one of Respondents' personnel showed such a document to the public, "they would die." (Trial Tr. (Ochs) 525:10-16.)

for day-to-day expenses and stability while monies invested in higher-risk investments in “Bucket # 3 – Growth” could grow over time. In the seminar, Lucia explained that when the Income and Safety buckets were exhausted, clients should “re-bucketize” and re-fill those buckets from Bucket # 3, and start the cycle again. (*See, e.g.*, Govt. Ex. 1 at SEC-LA3937-00198; Resp. Ex. 30 (webinar); Govt. Ex. 66 (transcript of webinar).) Indeed, Respondents’ explanation of their back-test of the BOM strategy to 1966 explicitly stated that 40% of the portfolio was invested in stocks, 20% in REITs, and 40% in bonds. (Govt. Ex. 1 at SEC-LA3937-00209.)

However, in calculating the performance of the BOM strategy for the 1966 and 1973 spreadsheets, it is indisputable that Respondents did not follow a BOM strategy, and instead Respondents put 100% of the assets in high-risk stocks for a majority of the period covered by the back-tests. (*See* Govt. Exs. 12 & 13; Govt. Ex. 70 ¶¶ 30-31, Exs. 7a & 7b.) For the 1973 spreadsheet, the BOM portfolio is invested 100% in stocks for the last 17 years, or over 50% of the time period. (Govt. Ex. 13; Govt. Ex. 70 ¶ 31 & Ex. 7b.) For the 1966 back-test, the BOM portfolio is invested 100% in stocks for the last 24 years of the 38-year period, or over 60% of the time period. (Govt. Ex. 12, Govt. Ex. 70 ¶ 31 & Ex. 7a.)

Respondents never explained to seminar attendees that the BOM strategy involved being 100% invested in stocks. (Trial Tr. (Ochs) 535.2-6.) Lucia, in a letter to clients in 2008, stated that he “would never – NEVER – advocate being 100% invested in stocks.” (Govt. Ex. 35 at RJL-SEC-0000195 (emphasis in original).) Lucia himself wrote those words and was responsible for the statement. (Trial Tr. (Ochs) 533:1-4, 534:3-10.)

The Division presented evidence that the 100% concentration of assets in stocks was inconsistent with the general discussions of asset allocation and diversification discussed in the seminar slide show. (Govt. Ex. 70 ¶ 31.) Being entirely invested in stocks is inconsistent with the general discussions in the BOM seminar slide show about asset allocation and diversification. (*Id.*) Moreover, for both the 1966 and 1973 back-tests, the average S&P 500 return over the time period in which the portfolio is entirely invested in stocks is higher than the average return over the time period in which the portfolios are invested in other assets, thus inflating the returns

shown in Respondents' back-tests. (*Id.* ¶ 31, Exs. 8a & 8b.)

E. The Commission's 2010 Examination Of RJL, And Respondents' Failure To Provide Support For Their Back-Testing Claims

At trial, there was conflicting testimony about the information that was provided to the Commission's examination staff in 2010 in response to its requests for support for Respondents' back-testing claims. However, there can be no dispute that Respondents have no support for their 1973 "Back Tested Buckets" slide, and that the spreadsheet supporting the 1966 back-test was not produced during the 2010 examination.

1. The Examination Staff Asked For All Support For Respondents' Back-Testing

There is no dispute that during the 2010 examination, the Commission's examination staff asked Teresa Ochs, Chief Compliance Officer of RJL, for all supporting documentation of any back-testing done by Respondents. (Trial Tr. (Bennett) at 87:10-18.) Bennett testified that in preparation for the examination, the Commission's examination staff noted that Respondents frequently referred to the BOM strategy as "being time tested, a proven way to generate inflation adjusted income and provide growth and that it had been back-tested over several decades and it was based on empirical type of evidence." (Trial Tr. (Bennett) 62:19-63:17.) The examination staff noticed this as an area of interest, in view of Rule 206(4)-1 and the Clover Capital Management no-action letter, and so asked for support for Respondents' claims. (Trial Tr. (Bennett) 62:19-63:17.)

2. The Examination Staff Received Only The 1973 Spreadsheet During The 2010 Examination

According to the testimony of the Commission's examination staff, the examination report, and contemporaneous correspondence about the examination findings, during the 2010 examination Respondents produced a single printed spreadsheet, titled: "1973, 40-20-40 mix, All income from Bonds and REIT first, \$60,000 annual income, Using T-Bill Returns" (marked as Govt. Ex. 13). (Trial Tr. (Bennett) at 19-23.) This was the only documentary support for

Respondents' claims of back-testing and empirical data produced during the 2010 examination. (See Trial Tr. (Bennett) 87:21-88:12, 89:20-24.)

During the 2010 examination, when asked for back-up for their back-testing, Respondents did not state that they had not performed any back-testing. (Trial Tr. (Bennett) 88:13-16.) Respondents' Chief Compliance Officer, Teresa Ochs, did not tell the examination staff that she did not know what was meant by back-testing. (Trial Tr. (Bennett) 88:21-24.) In fact, Ochs testified that back-testing calculates how a strategy may have performed if it had actually been applied in the past, and that back-testing needs to use accurate historical data in order to provide an accurate indication of how a strategy may have performed in the past. (Trial Tr. (Ochs) 575:9-20.) When Ochs was asked during the 2010 examination for support for Respondents' back-testing, she initially went to Lucia because he was the person who was giving the slideshow (Govt. Ex. 1) that included the back-testing. (Trial Tr. (Ochs) 576:15-577:1.) Lucia directed Ochs to Plum, who emailed her a 1973 spreadsheet – Govt. Ex. 13. (Trial Tr. (Ochs) 576:20-577:8.) Ochs testified that she received the 1973 spreadsheet (Govt. Ex. 13) from Plum and provided it to the examination staff during the 2010 examination. (Trial Tr. (Ochs) 577:2-8.)

Ochs testified at trial that she also provided a second spreadsheet, support for the 1966 back-test (Govt. Ex. 12), to the Commission's examination staff during the 2010 examination. (Trial Tr. (Ochs) at 538:20-540:17.)⁹ However, Ochs' testimony is not corroborated by any contemporaneous documents, and in fact conflicts not only with the testimony of the Commission's examination staff, but also with contemporaneous documentation of the 2010

⁹ Lucia also claimed to have back-tested the BOM strategy to 1987. (See, e.g., Ex. 35, Trial Tr. (Lucia) 1094:17-19.) Respondents never produced any back-up for a 1987 back-test during the 2010 examination or otherwise. Ms. Ochs was noncommittal when asked if she had ever seen a document showing a back-test to 1987. (Trial Tr. (Ochs) 538:10-14.) Ms. Ochs could not recall if in response to the examiners' request, RJL or Lucia provided any information on a 1987 back-test. (Trial Tr. (Ochs) 538:15-19.) Mr. Plum testified that he had never had any discussion with Mr. Lucia about a back-test to 1987, had never seen any documents that reflected a back-test to 1987, had never heard from anyone that a back-test to 1987 had been performed, had never performed a back-test to 1987, and was not aware of anyone else that had back-tested to 1987. (Trial Tr. (Plum) 855:8-856:8.)

examination. The examination staff's contemporaneous examination report states that they were only provided with a single spreadsheet for the 1973 calculation. (Govt. Ex. 2 at pp. 21-22.) The deficiency letter issued to RJL on December 17, 2010 corroborates the testimony of the examination staff and states: "RJL furnished a spreadsheet that provided calculations for a single portfolio (a back-tested Buckets of Money portfolio for the period of 1973 through 2003)." (Govt. Ex. 3 at p. 14.)

Respondents and their counsel wrote several letters to the examination staff in response to the deficiency letter, and while contesting virtually each and every deficiency in those letters, Respondents never claimed that they had produced more than one spreadsheet or had provided support for the 1966 back-test. (*See* Resp. Ex. 7 (February 1, 2011 letter); Resp. Ex. 8 (February 14, 2011 letter); Resp. Ex. 10 (April 12, 2011 letter).) In view of Respondents' rejection of most of the deficiencies identified by the examination staff, it would be powerful ammunition if Respondents could have argued that the examination staff had failed to consider documents that had been provided during the examination. In fact, Respondents' letters do not contradict the statement in the deficiency letter that only one document was produced. Respondents' Chief Compliance Officer could not recall that any of Respondents' responses to the deficiency letter ever claimed that the examiners' statement that only one spreadsheet was furnished was incorrect. (Trial Tr. (Ochs) 579:16-20.)

F. Respondents Admit They Have No Support For The 1973 "Back Tested Buckets" Slide, Which They Now Concede Has Numerous Errors

1. Respondents Have No Support For The Calculations On The 1973 "Back Tested Buckets" Slide

At trial, Respondents admitted that a spreadsheet showing calculations for performance of a portfolio from 1973 (marked as Govt. Ex. 13) has nothing to do with the seminar slide show, and they do not have any documentary support for the 1973 "Back Tested Buckets" slide. Respondents' employee, Richard Plum, testified that the 1973 spreadsheet (Govt. Ex. 13) did not

in any way support anything with respect to the seminar.¹⁰ (Trial Tr. (Plum) 808:22-24.) Lucia also testified that Respondents do not have any documentation to support the calculations on the 1973 “Back Tested Buckets” slide. (Trial Tr. (Lucia) 1078:1-9.) Respondents’ economic expert, Hekman, did not provide any calculations to support the 1973 “Back Tested Buckets” slide, although he provided numerous variants on the 1966 back-test.

Respondents have not provided a single calculation or document to support the numbers presented in the 1973 “Back Tested Buckets” slide, which they presented as fact to numerous clients and potential clients from at least 2003 through 2010.

2. Respondents Admitted At The Hearing That The 1973 Slide Has Errors That Were Not Disclosed To Seminar Attendees

At the hearing, for the first time, Respondents admitted that there were errors in the 1973 “Back Tested Buckets” slide. Respondents had not previously disclosed these errors to the Division, or the examination staff, and had not included them in their answers or other papers filed in this administrative proceeding.

First, on November 13, 2012, Respondents (through the testimony of Plum) revealed that the 1973 “Back Tested Buckets” slide had a false disclaimer. The disclaimer stated that Respondents calculated the performance returns presented on the slide using actual T-Bill rates and actual S&P 500 rates of return. Plum testified that he had just learned that statement was false and that such actual historical data had not been used to calculate the portfolio performance numbers presented on the 1973 “Back Tested Bucket” slide. (Trial Tr. (Plum) 874-9.)¹¹ Lucia confirmed that the disclaimer was false, but claimed that Respondents had only “figured it out within the last couple weeks.” (Trial Tr. (Lucia) 1078:14-23.)

¹⁰ During the 2010 examination and throughout the Division’s investigation, Respondents stated that Plum had prepared the 1973 calculations supporting the “Buckets of Money” slide. At trial, Respondents changed that part of their story, too, and for the first time identified “Brian Johnson” as the person responsible for the 1973 calculations. (Trial Tr. (Plum) 754:8-13.)

¹¹ During Plum’s investigative testimony in September 2011, Plum did not testify that the information on the 1973 “Back Tested Bucket” slide was incorrect. (Trial Tr. (Plum) 875:24-876:8.)

Second, Respondents conceded that the inflation adjusted income amount for the years 1991-1994, which is stated as \$96,000 on the slide, is also erroneous. (Trial Tr. (Lucia) 1080:8-1081:25.) Respondents' economic expert, Hekman, used the amount \$102,092 for a calculation he did for a period beginning in 1973. (Resp. Ex. 35, App. 1.) Hekman testified that \$102,092 was the number that he got when he compounded using 3% inflation. (Trial Tr. (Hekman) 1537:6-21.) In fact, Hekman testified that Lucia told him that the \$96,000 amount used in the 1973 "Back Tested Buckets" slide in Govt. Ex. 1 was an error while Hekman was preparing his report. (Trial Tr. (Hekman) 1537:22-1538:1.)

Third, Lucia revealed that the calculation used to arrive at the values presented to seminar audiences as the results of the 1973 back-test were arrived at using a 10% rate of return for stocks after the first two years and 6% rate of return for bonds. (Trial Tr. (Lucia) 1079:7-1080:2.) Lucia admitted that he "neglected" to disclose on the slide, or to disclose in the live presentations, accurate information about how Respondents calculated the returns presented on the 1973 "Back Tested Buckets" slide. (Trial Tr. (Lucia) 1079:20-1080:2.)

G. Respondents Earned Substantial Monies From Their Seminars

The Division introduced evidence that Lucia earned substantial fees, commissions, and other compensation derived from customers who attended the BOM seminars. (See Govt. Ex. 4 (Lucia Securities Examination Report) at SEC-LA3937-05032-33.) Substantial commissions were paid to Lucia because persons who attended the seminars were buying the BOM strategy and not the underlying products, so the potential sales were being generated by Lucia. (*Id.*) (See also Trial Tr. (Bennett) 101:24-105:12 (testimony concerning ways Respondents generated income from the seminars).) The amounts generated were substantial. For example, Lucia received \$8.7 million in commissions from the sale of non-traded REITs in the calendar year 2009 – even though he no longer dealt directly with many customers. (Trial Tr. (Bennett) 103:18-104:10.)

III. LEGAL DISCUSSION

A. RJI Violated Sections 206(1) And (2) Of The Investment Advisers Act, And Lucia Aided And Abetted And Caused RJI's Violations

The evidence established that Respondent RJI, 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 RJI's violations of Sections 206(1) and 206(2).

1. The Legal Standard For Violations Of Sections 206(1) And 206(2)

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;
- * * *

15 U.S.C. § 80b-6.

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).

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.”) *See also Fundamental Portfolio Advisors, Inc.*, Securities Act Release No. 8251 (July 15, 2003), 56 S.E.C. 651, 684; *see SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 194, 201 (1963). 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.” *Id.* at 194. 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). As fiduciaries, they are required “to act for the benefit of their clients, ... to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients.” *SEC v. DiBella*, No. 3:04-cv-1342 (EBB), 2007 WL 2904211, at *12 (D. Conn. Oct. 3, 2007) (quoting *SEC v. Moran*, 922 F. Supp. 867, 895-96 (S.D.N.Y. 1996)), *aff’d*, 587 F.3d 553 (2d Cir. 2009). “[W]hat is required is ‘... not simply truth in the statements volunteered but disclosure’ [of material facts].” *Capital Gains Research Bureau, Inc.*, 375 U.S. at 201. “The law is well settled . . . that so-called ‘half-truths’ - literally true statements that create a materially misleading impression - will support claims for securities fraud.” *SEC v. Gabelli*, 653 F.3d 49, 57 (2d Cir. 2011).

2. The Evidence Establishes That Respondents Violated Sections 206(1) And 206(2) Of The Advisers Act

a) RJL And Lucia Were Registered Investment Advisers Who Used Instrumentalities Of Interstate Commerce To Promote BOM

It is not disputed that RJL and Lucia were registered investment advisers, or that Respondents used instrumentalities of interstate commerce to promote their BOM strategy at seminars held nationwide. The evidence supports finding that these two elements have been met.

RJL admitted in its Answer that it was registered with the Commission as an investment adviser from September 2002 through December 2011. (RJL Answer ¶ 1.) RJL admitted that Lucia is a registered investment adviser associated with RJLWM. (*Id.* at ¶ 2.) Lucia admitted in his answer that he is registered as an investment adviser associated with RJLWM. (Lucia Answer ¶ 2.) Moreover, Lucia testified that he is currently a registered investment adviser. (Trial Tr. (Lucia) 1024:16-18.)

Although Respondents did not admit in their answers that they used means or instrumentalities of interstate commerce, the evidence introduced at trial establishes this element of the claim. Lucia testified that Respondents marketed the BOM strategy through seminars that were promoted through a variety of media outlets, including radio, the internet, newspapers on occasion, and email. (Trial Tr. (Lucia) 1058:8-1059:14.) Lucia and other RJL personnel traveled nationwide to conduct their BOM seminars. (See, e.g., Trial Tr. (Lucia) 1059:18-1060:4, 1069:10-1070:16 (Lucia traveled to Washington, D.C; Baltimore; San Francisco; Seattle; Los Angeles; Houston; and Dallas to give BOM seminars; Plum travels with Lucia to most venues); Govt. Exs. 18, 26-31 (listing cities where seminars were being held); Trial Tr. (Ochs) at 672:1-5, 676:16-677:4; Trial Tr. (Lucia Jr.) at 1682:1-4.)

b) Respondents Made A Misstatement Or Omission Of Material Fact To A Client Or Prospective Client

The evidence shows that Respondents made misstatements or omissions of material fact to prospective clients at BOM seminars, specifically providing erroneous, false and otherwise misleading information that Respondents had back-tested the BOM strategy through the bear market of 1973/74, providing misleading information that Respondents had back-tested the BOM strategy from 1966, and omitting material facts about the effects certain assumptions had on the results of those back-tests.

(1) Respondents Made Materially Misleading Statements That They Had Back-Tested The BOM Strategy

The evidence unequivocally establishes that Respondents' slideshow states that they had back-tested the BOM strategy . In fact, Respondents did not back-test the BOM strategy to 1973 or 1966, and these representations were misleading.

(a) Respondents' Erroneous, False And Otherwise Misleading Information About Back-Testing The BOM Strategy To 1973

Respondents did not perform a back-test of the BOM strategy to 1973, as presented on the 1973 "Buckets of Money" slide in the slideshow. RJL, through Lucia, presented a slide at

seminars, beginning in 2003 through 2010, captioned “Back Tested Buckets,” which purported to show the results of a back-test of the BOM strategy through the “Grizzly Bear” market of 1973-74. (Govt. Ex. 1 at SEC-LA-3937-000200.) The slide was presented to show that the BOM strategy as explained actually worked, and Respondents presented results which showed the amount of income provided each year, as well as a specific ending portfolio value of \$1,544,789 in 1994. (*Id.*) Respondents admitted at the hearing that the slide as presented was riddled with errors, Lucia “neglected” to disclose to seminar attendees that the disclaimer contained inaccurate information about how the back-test was performed, the results were derived using average returns, and Respondents had not actually performed a back-test.

Respondents’ expert admitted that the calculations performed by Respondents to come up with the numbers presented as a back-test in the seminar slide show were not, in his opinion, a back-test. The Division offered expert opinion testimony that the 1973 spreadsheet, which at times Respondents claimed supported the “Back Tested Buckets” slide, was not a back-test. While Lucia claimed that he back-tested the BOM strategy to 1973, he testified that the calculations underlying the “Back Tested Buckets” slide were performed using a fixed 10% return for stocks and 6% for bonds, so that Respondents did not use annual historical data, but rather general averages.

Whether Respondents performed a back-test of the BOM strategy to 1973, or were presenting hypothetical performance results, it is indisputable that the results as presented contained mathematical errors and were not consistent with the disclosure that actual S&P 500 returns and actual T-Bill returns were used. Moreover, Respondents presented the 1973 “Back Tested Buckets” slide as empirical proof that the BOM strategy worked through a bear market. Performance data offered to validate or prove a theory is certainly material. *See, e.g., In the Matter of Valicenti Advisory Services*, Release No. 111, 64 S.E.C. Docket 2281, 1997 WL 362000 (July 2, 1997) (recognizing that “performance is clearly material”). The fact that Respondents had not performed a back-test makes their representation that they did false and misleading.

(2) Respondents Provided Misleading Information That They Had Back-Tested The BOM Strategy To 1966

Respondents presented to seminar audiences that they had back-tested the BOM strategy to 1966, and that their tests showed that the value of the BOM portfolio in 2003 was \$4,719,741. (Govt. Ex. 1 at SEC-LA3937-000211.) Respondents presented the back-test results to prove that the BOM strategy would provide superior results. As Lucia said in the webinar, after delivering the results of the 1966 back-test: “Buckets of Money. And it works. It really does work.” (Govt. Ex. 66 at 51:9-10; Resp. Ex. 35.) However, even Respondents’ economic expert opined that the calculations presented in the seminar slide show were not back-tests. The Division’s expert witness also opined that Respondents’ calculations were not back-tests. The evidence therefore supports the finding that Respondents did not back-test the BOM strategy to 1966, and it was misleading to claim that they had somehow tested their strategy when they had not, and to claim that their back-test showed that BOM “works.” There can be no dispute that information put forth by an investment adviser as empirical evidence that a strategy “works” is material and therefore must be based on facts and sound methodology.

(3) Respondents’ Statements About Back-Testing Were Material

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).

Respondents’ statements and representations about back-testing the BOM strategy were material. The 1973 and 1966 back-tests were presented after Respondents explained the BOM strategy, to show that the BOM strategy would have worked if employed (1) at the beginning of the bear market of 1973-74, and (2) at the beginning of the flat market of 1966. As Lucia stated during the webinar after disclosing the 1973 and then 1966 back-test results, “Buckets of Money.

And it works. It really does work.” (Resp. Ex. 35; Govt. Ex. 66 at 51:9-10.) As Lucia explained during trial, Respondents used the back-test to be able to say to investors that “this particular strategy, this withdrawal strategy has stood up to the test of the market performance of 1973, ’74, 1966, 1987....” (Trial Tr. (Lucia) 1096:11-19.) Lucia admitted that he presented the back-tests at the seminars to validate the BOM strategy. (Id. 1097:5-15.) The back-tests not only purported to validate the BOM strategy, but also supported Respondents’ claims that the BOM strategy was “time-tested,” “proven,” and was “science, not art.”

Clients and potential clients may consider an adviser’s claims about performance as an important factor in selecting an adviser. *See, e.g., CFTC v. Commonwealth Financial Group, Inc.*, 874 F. Supp. 1345, 1353-54 (S.D. Fla. 1994) (collecting cases) (past successes and experience are material factors which a reasonable investor would consider when deciding to invest with a firm or broker); *CFTC v. Flint McClung Capital LLC*, 2012 U.S. Dist. LEXIS 25127 (D. Col. Feb. 28, 2012). Courts have found performance projections to be materially misleading where a defendant failed to disclose information that would be useful to a reasonable investor in assessing the performance projections. *See SEC v. Morgan Keegan & Co., Inc.*, 678 F.3d 1233, 1253 (11th Cir. 2012); *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 768-69 (11th Cir. 2007) (collecting cases). The test for materiality of an omission is whether a reasonable person would attach importance to the fact omitted in determining a course of action. *Merchant Capital*, 483 F.3d at 768 (citing *Kennedy v. Tallant*, 710 F.2d 711, 719 (11th Cir. 1983)). As the Ninth Circuit recognized, a defendant makes a material omission when one paints a rosy picture of financial prospects, while knowing there were undisclosed and specific problems that undermined those projections. *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 935 (9th Cir. 2003); *see also SEC v. Gane*, 2005 U.S. Dist. LEXIS 607 (S.D. Fla. Jan. 4, 2005) (“an opinion or prediction is actionable if there is a gross disparity between prediction and fact”). Additionally, general cautionary language does not render omission of a specific adverse historical fact immaterial. *Merchant Capital*, 483 F.3d at 768 (citing *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 710 (3d Cir. 1996)).

In an obvious effort to distance themselves from their misrepresentations that they had back-tested the BOM strategy, at the hearing Respondents coined a new term: “forward looking back-test.” However, Respondents’ witnesses repeatedly testified that they had never heard Lucia use that term during any of the seminars they attended, and Lucia himself did not recall using that term. It does not appear in any version of the slideshow and is not mentioned during the webinar. The Division’s expert, Grenadier, when asked by Respondents’ counsel about “what Mr. Plum called a forward looking back-test,” responded: “I have no idea what a forward looking back-test is.” (Trial Tr. (Grenadier) 1014:24-1015:3.) Respondents offered no expert testimony to support their brand new term, and did not refer to any industry publication or other generally accepted publications or authoritative sources for this novel term.

(4) Respondents Omitted Material Information From The Slideshows And Seminars About The Effects Of Their Assumptions

(a) Respondents Omitted Material Facts About Their Inflation Assumption

Respondents omitted material information from the slideshows and seminars about the effect of their use of an assumed rate of inflation of 3% in their back-tests – whether they were actually back-tests, “forward looking back-tests,” or “hypotheticals.” The Division’s expert witness showed that using actual inflation materially changed the results, so much so that instead of having inflation adjusted income and a portfolio value of millions of dollars, in each case the BOM strategy resulted in a portfolio that ran out of money, and went broke, with a zero value, before the end of the test period. (See Govt. Ex. 70 (Grenadier Report) ¶¶ 16-18, Exs. 2a, 2b, 2c, 4.) It is indisputable that there is a material difference between having a portfolio that is worth \$0, and one worth \$4,719,741, or \$1,544,789.

For the 1966 calculation of the performance of the BOM strategy, the Division’s expert showed that when actual, historical inflation rates are used, the BOM portfolio goes “broke” in 1986, after only 21 years, and does not provide “inflation-adjusted” income for 38 years or grow to a total value of \$4,719,741 as Respondents claim. (*Id.* ¶¶ 16-18, Exs. 2a & 2c.)

For the 1973 calculation of the historical performance of the BOM strategy, the Division's expert used actual, historical inflation rates and showed that the BOM portfolio falls to a value of zero after 17 years – rather than producing inflation adjusted income and growing to a value of \$1,544,789 in 1994. (*Id.* ¶¶ 16-18, Exs. 2b & 2c.)

It is undisputed that Respondents never disclosed, either in the slideshow or verbally, the material impact that their assumptions had on their performance results. Lucia did not recall ever disclosing the impact of the 3% inflation assumption on the performance results. (Trial Tr. (Lucia) 1151:8-13.) Each witness who was asked at the hearing also testified that they could not recall Respondents ever disclosing at a seminar how using the actual, historical inflation rate would change the results from those achieved using the assumed 3% inflation rate. (*See* Trial Tr. (Stripe) 1591:2-11; Trial Tr. (Lucia Jr.) 1685:11-1687:11; Trial Tr. (Chisholm) 373:11-374:13; Trial Tr. (Desipio) 286:18-289:11.)

Any reasonable person would attach importance to the fact that the omitted information involved the effect of the interest rate assumption on the performance results of the BOM strategy. Particularly here, where Lucia admitted that he knew using actual inflation would result in a lower portfolio value, (Trial Tr. (Lucia) 1150:16-1151:1, 1192:2-15), the omission can only be a deliberate attempt to deceive about material facts. *See, e.g., Merchant Capital*, 483 F.3d at 768; *Commonwealth Financial Group*, 874 F. Supp. at 1353 (relevant information would include that customers would have lost all or substantially all of the money they invested).

**(b) Respondents Omitted Material Information
About Their REIT And Fee Assumptions**

Respondents omitted material information from their slideshow and seminar about the effect of their assumptions about REITs and their failure to take into account management fees in their calculations.

With regard to REITs, Respondents' slideshow explicitly recognized some of the "special risks" of REITS, such as "limited liquidity and demand for real property ... loss of investment ... real estate values may fluctuate based on economic, environmental and other factors." (*See*

Govt. Ex. 1 at SEC-LA3937-00148.) However, in their calculations, Respondents ignored these hazards and assumed the value would not fluctuate and the REITs could be liquidated upon demand. While Respondents disclosed that they were assuming a rate of return, Respondents failed to disclose that using actual, historical data for REIT returns for the historical period in question would decrease the performance of the BOM portfolios. (See Govt. Ex. 70 (Grenadier Report) ¶¶ 19-26, Exs. 5a, 5b, 5c.) When historical REIT returns are used in the 1973 model, the value of the REIT investment declines from \$200,000 in 1973 to \$134,031 by 1979. (*Id.* Exs. 5b & 5c.) When historical REIT returns are used in the 1966 calculation once they become available, the BOM portfolio is worth only \$1,297,771 at the end of the period – rather than \$4,719,741 claimed by Respondents. (*Id.* Exs. 5a, 5c.) Thus, Respondents’ assumptions about REITs have material effects on the performance of the portfolio, and there is no dispute that Respondents failed to disclose, either in the slideshow or during the presentation, how their assumptions about REITs materially impacted the performance results of the 1973 and 1966 back-tests.

There is no dispute that Respondents did not deduct management fees in their back-tests, or their spreadsheet calculations, and they did not disclose the effect that the failure to deduct or account for fees had on the performance results for the 1973 and 1966 portfolios. The Division’s expert demonstrated how even modest fees can have a material impact on the results. For example, for the 1966 BOM portfolio, modest fees reduce the value of the portfolio to \$2,525,916 at the end of the period, which is materially less than the \$4,719,741 Respondents claimed. (*Id.* ¶¶ 27-28, Exs. 6a, 6b, 6c.) There is no dispute that the impact of fees on a BOM portfolio was not discussed at the seminars when Respondents presented the performance of their BOM strategy from 1973 and 1966. (Trial Tr. (Chisholm) 374:16-24; Trial Tr. (Stripe) 1581:16-25.)

(c) Respondents Did Not Disclose That They Did Not Follow A BOM Asset Allocation Strategy In Their Back-Tests

The support that Respondents offered for their back-testing – the two spreadsheets that were marked at Govt. Ex. 12 and 13 – show that Respondents achieved their results by

concentrating 100% of the portfolio in stocks for the majority of the time, rather than following a strategy that allocated assets among three buckets. Respondents do not dispute that their calculations reflected in their spreadsheets did not “re-bucketize” assets from the high risk “Bucket # 3 – Growth” to the lower risk “Bucket # 1 – Income” or “Bucket # 2 – Safety.” Respondents also do not dispute that they never disclosed, in the slideshow or during seminars, that their back-tests involved placing 100% of the portfolio in stocks for the majority of the period tested.

Respondents’ slideshow emphasized allocating assets among different classes of assets to obtain inflation adjusted income for life and sustained portfolio growth. Respondents did not advocate concentrating 100% of one’s assets in stocks. However, by remaining fully invested in stocks during a period of historically high returns, Respondents inflated their performance results. (See Govt. Ex. 70 (Grenadier Report) ¶¶ 29-31, Exs. 7a, 7b, 8a, & 8b.) Respondents’ 1973 calculation was 100% invested in stocks for the last 17 years – over 50% of the period studied. (See Govt. Ex. 13 (1973 spreadsheet); Govt. Ex. 70 Ex. 7b.) Respondents’ 1966 calculation was 100% invested in the stock market for the last 24 years of the test – over 60% of the test period. (See Govt. Ex. 12 (1966 spreadsheet); Govt. Ex. 70 Ex. 7a.)

Respondents failed to disclose this material change in strategy when they presented their performance results. (See Trial Tr. (Chisholm) 374:25-375:9: “[O]f course I assumed [that he had rebucketized]. That is what this is all about . . . I had no reason to believe he would not.”) There can be little question that the fact that the back-tests did not follow the BOM strategy that was explained in the slideshow and the seminar is a material omission. See, e.g., *CFTC v. Machado*, 2012 U.S. Dist. LEXIS 103657 (S.D. Fla. Apr. 20, 2012) (a reasonable customer would want to know that examples of customer accounts were not being managed as represented by defendants).

c) Respondents Acted With Scienter

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). 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”). Recklessness satisfies the scienter requirement of Section 206(1). See

Vernazza v. SEC, 327 F.3d 851, 860 (9th Cir. 2003). The evidence shows that Respondents acted with a high level of scienter, or at the least, a high level of recklessness.

Respondents' use of an assumed 3% inflation rate and their failure to disclose the effect of that assumption shows a high level of scienter. 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 he intuitively knew that using a higher inflation rate would be "damaging" to the results of Respondents' back-tests. (Trial Tr. (Lucia) 1150:16-1151:1, 1192:2-15.) Thus, Lucia knew that the assumed inflation rate materially altered the results, yet failed to disclose that information to seminar attendees, either verbally or in any of the slides in the slideshow. Moreover, it is generally well understood that T-Bill returns tend to track inflation (*see* Govt. Ex. 70 (Grenadier Report) 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. (Trial Tr. (Grenadier) 940:15-942:16.) However, in their effort to convince prospective clients to sign up for the BOM strategy, Respondents deliberately and consciously failed to disclose the material information that the assumed 3% inflation rate dramatically changed their back-test results. Several witnesses confirmed that Respondents never disclosed to seminar attendees that if actual inflation rates had been used in the 1966 back-test, and accounting for management fees, that the BOM portfolio would have gone broke. (Trial Tr. (Plum) 870:23-871:16; Trial Tr. (Stripe) 1581:16-25, 1591:7-11; Trial Tr. (Lucia Jr.) 1686:25-1687:11.) Lucia conceded that if the purpose of the seminars was to sign up clients for Respondents' advisory services (which it clearly was), then disclosing that the BOM strategy would go bankrupt would not be very helpful. (Trial Tr. (Lucia) 1151:14-1152:17.)

Respondents' responses to questions about the assumed 3% inflation rate also shows a high level of scienter. 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. (Trial Tr. (Bennett) 91:2-7.) The examination staff pointed out that historic inflation data is readily available from the U.S. Department of Labor,

Bureau of Labor Standards (“BLS”), on the Internet. (*Id.* 93:11-23.) Respondents’ personnel then gave two other 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%. (*Id.* 91:8-22.) Thus, after first providing an excuse that lacked any substance, Respondents admitted that they knew they were materially altering the results of their back-tests by using an assumed inflation rate. *See In the Matter of Monetta Financial Services, Inc.*, 2000 SEC LEXIS 574, *63 (2000) (noting lack of candor and attempt to hide misconduct supports finding of intent to deceive); *In the Matter of G. Bradley Taylor*, 2002 SEC LEXIS 2429, *35 (2002) (noting efforts to conceal conduct demonstrate consciousness of guilt and support finding of intent to deceive). Indeed, at the hearing, Respondents’ efforts to re-characterize their statements that they had back-tested the BOM strategy, to suggest that they were doing “forward looking back-tests,” also demonstrates a lack of candor which shows a high level of scienter.

Similarly, Lucia admitted that not re-bucketizing the 1966 and 1973 back-tests was a conscious decision. (Trial Tr. (Lucia Sr.) at 1130:8-12.) Lucia also admitted that in the 1966 back-test, rather than having a safe bucket of short-term assets to cover short-term liabilities, Respondents drained the stock portfolio (Bucket # 3) for income. (*Id.* at 1327:2-5.) In other words, Respondents made a conscious decision to concentrate 100% of the so-called “real” BOM portfolio in stock – following a strategy that Lucia categorically rejects. (*See* Govt. Ex. 35 (“I would never – NEVER – advocate being 100% invested in stocks.”).) It is also indisputable that Respondents never disclosed that conscious decision in the slideshow or the seminars. Again, Respondents’ lack of candor in the slideshow and to seminar attendees about how they achieved the 1966 and 1973 results is strong evidence of an intent to deceive.

With respect to the 1973 “Back Tested Buckets” slide, Respondents admittedly have no documentary support to show how they arrived at the numbers on the slide, even though they used the slide at seminars for several years. At some point after 2003, Respondents put a disclosure on the slide which purported to inform seminar attendees how they had performed the

calculations – using actual S&P 500 returns and actual T-Bill rates of return – but Respondents only realized that disclosure was false a few days before the hearing commenced. Indeed, Respondents’ Chief Compliance Officer admitted that Respondents did not have any procedure for checking the accuracy of the slides used in the seminars. (Trial Tr. (Ochs) 668:5-9.) Such conduct is highly reckless, particularly for an investment adviser who owes a fiduciary duty to clients and prospective clients.

Respondents’ conduct in failing to even examine the accuracy of the challenged slides until, apparently, days before the hearing, shows a lack of candor that supports a finding of an intent to deceive. From the time that the examination staff first raised issues with Respondents’ back-testing claims in December 2010, through the filing of answers and a lengthy pre-hearing brief on November 5, 2012, Respondents never disclosed to the Commission’s staff all of the various errors on the 1973 “Back Tested Buckets” slide. Instead, Respondents denied any wrongdoing and Lucia posted a video in which he dismissed the Division’s charges. (Govt. Ex. 75 (September 6, 2012 video posted by Lucia).) According to Lucia’s testimony, Respondents repeatedly denied any wrongdoing without even investigating the accuracy of their back-testing claims. (See Trial Tr. (Lucia) 1205:24-1208:5, Resp. Ex. 7, 8, & 10.) According to Respondents’ witnesses, it was only on the eve of trial that they suddenly realized the 1973 “Back Tested Buckets” slide was riddled with errors. Indeed, at the hearing, Lucia resisted admitting that he knew there was an error in the calculation of the inflation adjusted income on the slide, even though Respondents’ expert, Hekman, testified that Lucia informed him of the error while Hekman was preparing his report. (See Trial Tr. (Lucia) 1080:8-1081:25; Trial Tr. (Hekman) 1537:22-1538:1.)

Finally, after telling prospective clients for years that they had back-tested the BOM strategy through 1973 and 1966, Respondents now cannot decide whether they performed back-tests, or not. Lucia adamantly claims that he back-tested the BOM strategy although he did not keep any documentary evidence to support his claims, while Respondents’ expert – in response to questions from Respondents’ counsel – opined that Respondents did not perform back-tests.

Respondents describe their back-tests now as hypotheticals or so-called back-tests, or other terms, but the slideshow does not use such equivocal terms; instead, in the slideshow Respondents claimed they had back-tested the BOM strategy, and as the webinar shows, they used their tests as evidence that the BOM strategy “really works.” Respondents’ continuing lack of candor on this point at the hearing also supports a finding of scienter.

B. RJL Violated Section 206(4) Of The Advisers Act And Rule 206(4)-1(a)(5) Thereunder

Section 206(4) of the Advisers Act states:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly –

- (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

Section 206(4) of the Advisers Act prohibits any investment adviser from engaging in “any act, practice, or course of business which is fraudulent, deceptive, or manipulative,” and authorizes the Commission to prescribe rules designed to prevent such conduct. The elements of a violation of Section 206(4) are similar to those for Section 206(2), and like Section 206(2), scienter is not an element of a violation of Section 206(4). *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)). Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder prohibit essentially the same type of conduct. *See United States v. Naftalin*, 441 U.S. 768, 773 n.4 (1979); *SEC v. Pimco Advisors Fund Mgmt. LLC*, 341 F.Supp.2d 454, 469-70 (S.D.N.Y. 2004).

Rule 206(4)-1(a)(5) makes it a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Advisers Act for a registered 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.” 17 C.F.R. § 275.206(4)-1(a)(5). For the purposes of the Rule, 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 (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.” 17 C.F.R. § 275.206(4)-1(b). The courts look from the viewpoint of an unskilled and unsophisticated person to whom advertisements are aimed in determining whether or not they are fraudulent or deceptive. *See, e.g., C.R. Richmond & Co.*, at 1105; *SEC v. Lindsey-Holman Co.*, 1978 WL 1129, *2 (M.D. Ga. Aug. 16, 1978); *Marketline, Inc. v. SEC*, 384 F.2d 264 (2d Cir. 1967).

Respondents’ seminar slideshow is an advertisement within the meaning of the Rule because it was a “written communication” that when presented at the seminars was “addressed to more than one person,” and through the slideshow, Respondents offered “any other investment advisory service with regard to securities,” specifically, the investment advisory services of Respondents’ representatives to use the BOM strategy. During the webinar, Lucia is heard several times encouraging listeners to contact RJL to consult with their advisers. (Resp. Ex. 35; Govt. Ex. 66.) In addition, Respondents distributed cards to seminar attendees who may have wanted additional information about BOM. Indeed, Lucia Jr. testified that Respondents maintained an extensive database of seminar attendees.

As demonstrated above, Respondents’ back-testing claims were false and misleading for several reasons. It is well established that the dissemination of false or misleading performance information by an investment adviser violates Section 206(4) and Rule 206(4)-1(a)(5) thereunder. *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.

False and misleading claims about back-testing by registered investment advisers have been found to violate Section 206(4) and Rule 206(4)-1(a)(5). *See, e.g., In the Matter of William J. Ferry*, Investment Adviser Release No. 1747 (August 19, 1998) (failure to disclose that performance results did not reflect the strategy and inherent limitations on strategy violated Act); *In the Matter of LBS Capital Management, Inc.*, Investment Adviser Release No. 1644 (July 18, 1997) (failure to adequately disclose use of a model found to be materially misleading); *In the Matter of Meridian Investment Management Corporation, et al.*, Investment Adviser Release No. 1779 (December 28, 1998) (investment adviser materially misstated its investment performance results by not deducting fees in performance results, even though materials disclosed fees would be charged); *Clover Capital Management, Inc.*, (No Action Letter - File No. 801-27041, October 28, 1986) (stating staff’s 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.”).

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.” *Clover Capital Management, supra*. In the *Clover* letter, the staff stated its view that any performance information that fails to disclose the effect of material market or economic conditions on the results portrayed would violate Rule 206(4)-1, as would any 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. In addition, in *Clover*, the staff stated its view that the Rule would also be violated if an adviser used performance results but failed to disclose that the investment strategies of the model portfolio changed materially during the period portrayed, and the effect of such changes.

The evidence shows that Respondents violated Section 206(4) and Rule 206(4)-1(a)(5). Respondents presented their back-testing of the BOM strategy from 1966 and 1973 as showing how a BOM portfolio would have performed over those time periods. However, while Respondents disclosed that they assumed 3% inflation, they failed to disclose how that deviation from historical data materially altered the results of their back-tests. Respondents consciously chose not to disclose that they did not follow a BOM strategy in their tests, and instead concentrated the portfolio's assets 100% in stocks for the majority of the period tested.

In addition, Respondents used REITs in their 1973 and 1966 back-tests, but failed to disclose that REITs were not readily available for a portion of the period tested. Respondents used assumed REIT returns, which they disclosed, but failed to disclose that using actual REIT returns would have materially depressed the performance of their BOM portfolios. Respondents also did not disclose that they assumed the REITs were a risk-free investment that was perfectly liquid, although such an investment does not exist in the real world. Finally, although Respondents' strategy would incur fees, Respondents failed to take fees into account in calculating their results, which substantially overstated the performance of their BOM portfolios during the period tested.

C. Lucia Aided And Abetted RJL's Violations Of Sections 206(1), 206(2), 206(4), And Rule 206(4)-1(a)(5)

There can be little dispute that Lucia aided and abetted RJL's violations of Sections 206(1), 206(2), 206(4), 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).

The evidence establishes that there was a primary violation of the Advisers Act by Respondent RJL. The evidence also establishes that Lucia had knowledge of the fraudulent acts and provided substantial assistance to RJL. In fact, Lucia was the primary actor for RJL who committed the violations. Lucia was responsible for the content of the slideshows, and he personally delivered the seminars at which the back-testing was presented. Indeed, it was Lucia who, finally, at the hearing, disclosed in detail the numerous errors in the 1973 “Back Tested Buckets” slide, as well as the fact that Respondents failed to investigate the accuracy of that slide until the eve of trial – despite the fact that Lucia presented that slide at seminars for several years. Lucia is the sole owner of RJL, and was the individual primarily responsible for RJL’s violations of the Advisers Act. There can be no dispute that Lucia aided and abetted RJL’s violations of the Advisers Act.

D. RJL Did Not Maintain Books And Records In Violation Of Rule 204-2(a)(16) Of The Advisers Act

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).

The evidence establishes, beyond any dispute, that RJL does not have any documentation to support the “calculation of the performance” of the BOM portfolio presented on the 1973 “Back Tested Buckets” slide to thousands of people at various seminars. The evidence also shows that RJL did not produce the 1966 spreadsheet (Govt. Ex. 12) during the 2010 examination conducted by the Commission’s examination staff, when asked to produce all support for their back-testing, which establishes that Respondents had not properly maintained this record.

Thus, RJL failed to maintain books and records concerning its back-testing as required by the Advisers Act.¹²

E. 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 the leading case that establishes the standard to be used to evaluate disciplinary sanctions in administrative actions. *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

¹² During the hearing, another potential books and record violation came to light. Respondents produced a recording of a webinar conducted by Lucia. The webinar was not produced to the examination staff or during the Division’s investigation. It was produced after the OIP was instituted, and just weeks prior to the hearing. The testimony concerning that production established that Respondents did not maintain the copy of that webinar in their own books and records, but instead it was maintained at some other company. (See Trial Tr. (Lucia Jr.) 1240:3-9, 1240:22-1241:8 (the webinar was found in the separate offices of RJL Enterprises, and not in the offices of the registered investment adviser.)

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. As shown above, Respondents' actions were egregious and involved a high level of scienter. Respondents deliberately used an assumed inflation rate, which they knew would increase the performance of the BOM portfolio in their back-tests, and failed to disclose the impact of that assumption to seminar attendees or in the slideshow. Respondents knew that if they used actual inflation rates then the BOM portfolio would go broke in their back-tests, but of course, telling audiences that the BOM strategy went broke would not generate many new customers for RJL. Respondents consciously put 100% of the portfolio into stocks for a majority of their back-tests periods, which was contrary to the BOM allocation strategy that promised to minimize risk, and failed to disclose that fact when presenting their back-test results.

Respondents' violations occurred over a long period of time – beginning at least in 2003. Respondents' repeated their misleading back-test claims at hundreds of seminar to thousands of people. This was not an isolated claim.

Lucia is currently a registered representative who continues to put on seminars and speak about the BOM strategy, so that his current occupation presents opportunities for future violations.

The evidence at trial established that the Court should not credit Lucia's assurances that he has stopped the violative conduct. After an examination in 2003, the Commission's examination staff issued a deficiency letter to RJL, addressed to Lucia, about certain advertising practices involving claims about how long RJL had been in business. (Resp. Ex. 13 at p. 3 ("Length of Time in Business").) In a letter dated January 12, 2004, signed by Lucia, Lucia and RJL assured the Commission's examination staff that it would make appropriate corrections. (Resp. Ex. 14 at p. 2.) However, the 2010 examination found that the same conduct had continued. (Govt. Ex. 2 at pp. 16-17 (LA-SEC3937-005817-18).) The December 17, 2010 deficiency letter cited as a deficiency Respondents' inaccurate claims about the duration of RJL's operations, as well as the fact that this had been the subject of a deficiency letter after the

2003 examination. (Govt. Ex. 3 at pp. 809 (SEC-LA3937-00239-40.) In the response in 2011, Respondents took issue with the deficiency and again claimed to have taken corrective action. (Resp. Ex. 7.) Respondents' past conduct in providing assurances demonstrates that their current assurances should be given no weight.

Finally, there is no evidence that Respondents have recognized the wrongful nature of their conduct. To the contrary, Respondents' lack of candor during the hearing demonstrates their continued intent to deceive. Such lack of candor includes Respondents' efforts to re-characterize their back-testing claims as "forward looking back-testing," as well Respondents' efforts to re-define BOM as solely a "withdrawal" strategy, even though they called it an "asset allocation" and "portfolio" strategy in their materials published prior to the hearing. In addition, even as Lucia acknowledged that the information he had been presenting at seminars for years contained numerous errors, he claimed he merely "neglected" to provide the correct information in the slideshow or in his presentation. An individual who recognized the wrongful nature of their conduct – and particularly a fiduciary – might have thought that presenting erroneous and misleading information to thousands of people over several years was more than mere neglect. Nothing in Lucia's testimony at trial shows any recognition by him that he did anything wrong.

Accordingly, the Division requests that RJL's registration as an investment adviser be revoked, 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

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. In this case, the cease and desist order is necessary because the Court cannot credit Lucia's assurances that he has stopped the violative conduct and will not engage in such conduct in the future, because when Lucia made such representations in the past, he did not honor them.

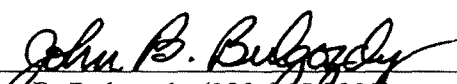
IV. CONCLUSION

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

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