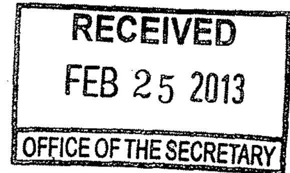
ADMINISTRATIVE PROCEEDING
FILE NO. 3-15006

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 REPLY BRIEF

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## I. INTRODUCTION

Respondents Raymond J. Lucia Companies, Inc. ("RJL") and Raymond J. Lucia, Sr. ("Lucia") submitted a 70-page post-hearing brief that largely sidesteps the fundamental questions presented by this case. The questions to be decided are straightforward, as are the facts that answer them:

- *Did Respondents claim that they had "back-tested" the BOM strategy to 1966 and 1973 in slideshows presented to thousands of prospective clients over several years?*

Yes. Respondents used the term "back-test" to describe two calculations they presented at seminars that purported to show the performance of the Buckets the Money ("BOM") strategy from 1966 to 2003, and from 1973 to 1994. In the 1966 calculation, Respondents claimed that $1 million invested in a BOM portfolio (using REITs) in 1966 would have provided inflation adjusted income through 2003 and the portfolio value would have increased to $4,719,741. In the 1973 calculation, Respondents claimed that $1 million invested in a BOM portfolio in 1973 would have produced inflation adjusted income through 1994 and the portfolio value would have increased to $1,544,789. (Govt. Ex. 1 (BOM slideshow).)

- *Did Respondents have any factual basis for their claims that they had back-tested the BOM strategy to 1966 and 1973?*

No. Respondents admit that they did not perform any back-tests, and in an effort to avoid liability for making those false claims, Respondents contend that the numbers they presented as "results" of their self-described "back-tests" are mere "illustrations." While Respondents produced spreadsheets that they said were support for their claimed back-testing, Respondents admitted at trial that the 1973 spreadsheet did not support their claimed 1973 back-test presented on a slide titled "Back Tested Buckets." Respondents also admitted at trial that the 1973 "Back Tested Buckets" slide contained various mathematical errors, they had no documentation for how they arrived at the numbers presented, and disclaimers on the 1973 slide were false.

- *Were Respondents' false claims that they had back-tested the BOM strategy material?*

Yes. Respondents offered the results of their self-described back-tests as proof that the BOM strategy provided inflation adjusted income for life and sustained portfolio growth to support their efforts to sign up clients for RJL's advisory services.

- *Did Respondents present misleading information, or omit material facts, when they presented the results of their purported back-tests in the slideshow?*

Yes, in a number of ways. First, for their claimed 1973 and 1966 back-tests, Respondents claim that they disclosed an assumed 3% inflation rate, even though they knew that inflation over the periods tested was higher and that using actual inflation would have resulted in their BOM portfolios going bankrupt before the end of the test periods. Second, for their claimed 1973 and 1966 back-tests, Respondents claim that they disclosed that they were using an assumed REIT rate of return, but failed to disclose that their assumed rate of return, and undisclosed assumptions about REIT liquidity and lack of risk, materially increased the performance results of their BOM portfolios. Third, for their claimed 1973 and 1966 back-tests, Respondents failed to disclose the material effect that fees would have had on their reported results of their BOM portfolios, or even that they had failed to account for fees. Fourth, for their claimed 1973 and 1966 back-tests, Respondents failed to disclose that they did not follow a diversified, or "bucketized" BOM strategy, and instead calculated their portfolio results by investing 100% of the portfolios in stocks during the majority of the test periods. And finally, for their claimed 1973 back-test, Respondents failed to disclose that they did not have any basis for their claimed results, the material effects of any inflation assumption (which was not disclosed in the slideshow but they claim was 3% annual inflation), material and unrealistic assumptions about REITs, the effect of fees, and that they failed to follow a BOM strategy.

- *Did Respondents act with scienter?*

Yes. Respondents knew, or were reckless in not knowing, that their inflation assumption and their REIT rate of return assumptions materially altered the results of the purported back-tests. They also knew, or were reckless in not knowing, that the inclusion of fees would have a

material effect on these results. And they made a conscious decision to concentrate the BOM portfolios 100% in stocks for the majority of the time covered even though that was contrary to Respondents' stated investment strategy.

- *Should the Court impose the requested sanctions*?

Yes. Any assurances by Respondents that they have, or will, voluntarily cease and desist must be viewed with a high level of skepticism because Respondents offered similar assurances after a 2003 examination, but were found to be engaging in the same violative conduct after a 2010 examination.

Instead of addressing these fundamental questions directly, Respondents' post-trial brief attempts to re-frame the relevant facts and the applicable law. For example, in their brief, they propose that their repeated claims in investor seminars that they "back-tested" the BOM strategy should instead now be referred to as mere "illustrations." Respondents even try to eliminate the evidence of the faulty models that had formed the bases for their purported "back-tested" performance calculations, by simply dismissing as irrelevant the spreadsheets that they had produced as support for the 1966 and 1973 performance results.

In a further effort to divert attention from their actual conduct, Respondents argue they cannot be held liable for knowingly or even recklessly violating the Investment Advisers Act of 1940 (the "Advisers Act") because, they claim, a 2003 examination of Respondents had "concluded" that they were not engaged in performance advertising. But that examination never reached such a conclusion – indeed the 1966 back-test slide that is the subject of this action was not even part of that examination. And even if the examination had come to such a conclusion, it could not have had any bearing on Respondents' scienter because they never even received a copy of the examination report until after this proceeding was commenced. Moreover, there is ample legal precedent for holding Respondents liable as fiduciaries under Section 206 of the Advisers Act for their false "back-test" performance claims, and so any argument that they had no "notice" that they could be held liable under these provisions simply has no merit.

Moreover, although they presented these so-called "illustrations" at countless investor seminars as empirical proof that their BOM strategy produced inflation adjusted income and sustained portfolio growth, Respondents now urge the Court to disregard these performance claims. They even argue that they were not engaged in performance advertising and did not have a model portfolio. However, the evidence establishes that Respondents did, in fact, create and use a model of their BOM strategy – the 1966 and 1973 spreadsheets. (Govt. Exs. 12 & 13.) The spreadsheets allowed Respondents to run different tests, if they chose to do so, with different inputs over different time periods to generate results that would show how their strategy performed, in terms of inflation adjusted income and portfolio value. It is undisputed that Respondents used the results of these performance models in their slideshow and called them "back-tests" of the BOM strategy.

Therefore, despite what they may claim now, there should be no dispute that Respondents created a model BOM portfolio, purported to use that model to "test" the BOM strategy, and presented the "results" in the slideshow seminars to show how their BOM strategy would have performed over defined historical periods. In fact, Respondents presented specific values for their BOM portfolios in their slideshow, not just in general terms, but to the dollar – a BOM "portfolio" allegedly increased in value to $4,719,741 over the period from 1966 to 2003, and a BOM "portfolio" allegedly increased in value to $1,544,789 over the period from 1973 to 1994.

These claims were materially misleading. The Division presented uncontroverted expert testimony at the hearing that when actual historical inflation rates are used in Respondents' model of the BOM strategy, Respondents' 1966 model does not produce inflation adjusted income and a portfolio with a value of $4,719,744 in 2003, as Respondents claims in their investor slideshow, but instead the portfolio's assets are fully depleted by 1986. Likewise, contrary to what Respondents claimed in the slideshow, their 1973 model does not generate inflation adjusted income through 1994, but instead is fully depleted by 1989. The Division also presented uncontroverted evidence that using actual REIT rates of return and making an allowance for fees materially reduces Respondents' claimed results for their BOM strategy.

Based on Respondents' spreadsheets showing the model they used for their BOM strategy, Respondents' claimed performance results were achieved not by following their diversified, "bucketized" strategy, but rather by concentrating 100% of the portfolio in high-risk equities for the majority of the test periods.

In addition, Respondents argue that the "purpose" of what they now refer to as their "illustrations" was merely to compare various "withdrawal strategies" to show that taking income from safe investments before taking income from riskier investments makes a "big difference." But their effort to re-cast their BOM strategy as a "withdrawal strategy" has no evidentiary basis. That strategy is, and has always been, focused on "asset allocation," as they conceded in their Answers to the OIP. Moreover, their contention is belied by Respondents' 1966 "back test," which did not compare withdrawal strategies, but instead purports to compare a BOM portfolio invested only in stocks and bonds to a BOM portfolio invested in stock, bonds, and REITs.

As yet another example of how they have stretched the record in their post-trial brief, Respondents claim that the "BOM portfolio without REITs" grows to a value of only $1.2 million, while the "BOM portfolio with REITs" grows to over $4.7 million. However, when historical REIT returns are used for the "BOM portfolio with REITs" in place of Respondents' assumed REIT rate of return of 7%, then the "BOM portfolio with REITs" grows to a value of only $1.2 million – the same value reported for the "BOM portfolio without REITs." There is no difference in value between "BOM without REITs" and "BOM with REITs," when historical rates of return are used in Respondents' model. Given Respondents' claimed knowledge of finance, the material impact of their assumed REIT rate of return cannot be accidental, or negligent.

In fact, the only difference between these two "BOM portfolios" is the addition of an asset sold by Respondents – non-traded REITs. Nowhere in their post-trial brief do Respondents even acknowledge that they generated millions of dollars in fees and commissions from the sale of these non-traded REITs to individuals who became RJL clients after attending

BOM seminars. These commissions and fees were paid to Lucia because Respondents understood they were not selling the underlying products, but instead were selling, and clients who attended BOM seminars were buying, the BOM strategy.

Furthermore, Respondents argue in their post-trial brief that they introduced evidence of an "industry standard" based on advertisements issued by investment companies American Funds and Fidelity. However, advertisements by investment companies are regulated by Commission Rules 482 and 156, among other rules. Those rules make clear that an investment company that complies with the rules may still be liable for violations of the antifraud provisions of the federal securities laws. To the extent Respondents now suggest that they be held to the same standard as investment companies, it is clear that they failed to comply with that standard.

Having concocted this new hypothetical factual record that ignores the relevant evidence, Respondents propose a restrictive interpretation of the antifraud provisions of the Advisers Act to their revised version of the facts. The Commission respectfully asks the Court to reject Respondents' hypothetical version of the facts, to rely on the actual facts as established at the hearing, and to apply the applicable law to find that Respondents are liable for the violations alleged in the OIP. Accordingly, the Division requests that the Court issue findings that Respondents committed the violations alleged in the OIP, and impose the remedies described in the Division's opening brief.

## II. ARGUMENT

### A. Respondents Base Their Defense On Several Unsupported Or Inaccurate Factual Statements, Which Result In A Flawed Legal Analysis

Respondents base their defense on several factual assumptions or inaccurate factual statements that permeate their legal arguments and result in a flawed legal analysis. These include re-defining their claimed back-tests as "illustrations"; re-defining the BOM strategy as "only" a "withdrawal strategy;" making unfounded claims about a pre-recorded webinar Respondents produced just days before the start of the hearing; and dismissing as irrelevant the spreadsheets that Respondents said supported the claims made in their investor slideshow. The

Court should reject these efforts to re-define and re-interpret what Respondents actually said and did.

### 1. There Can Be No Dispute That Respondents Claimed They Had "Back-Tested" Their BOM Strategy

The evidence establishes that Respondents repeatedly claimed to have "back-tested" the BOM strategy to 1966 and 1973, and that these claimed back-tests were presented to validate the BOM strategy. Respondents actually used the term "back-test" and presented the results of these claimed "back-tests" in their seminar slideshow. (*See* Govt. Exs. 1, 12, 13, 66; Resp. Ex. 30.) As even their expert acknowledges, "back-testing" is a test of how a strategy would have performed over a specific historical period. Having conceded at trial that these performance claims were ***not*** back-tested at all, in their post-trial brief, Respondents now call these claims "illustrations"[1] – presumably because it may sound less like an admission to acknowledge that they are not "back-tests." (*E.g.*, Resp. Br. pp. 31-35.) But the evidence shows that Respondents chose to use the term "back-test" in their seminar slideshows, and did so for years. That conduct cannot be erased by using a different word now.

Indeed, Respondents never really dispute that they repeatedly made the claim that they had "back-tested" the BOM strategy at hundreds of seminars, to thousands of clients and prospective clients, over a period of several years. (*See* Div. Br. pp. 8-9.) Respondents showed the 1973 "Back-Tested Buckets" slide at seminars beginning around 2003, through at least 2010. Respondents began showing the 1966 back-test slides around 2006, and continued to show those slides at seminars through at least 2010. (Trial Tr. (Ochs) 585:6-9.) Respondents' admittedly unsupported claims that they had back-tested the BOM strategy were a mainstay of their efforts to sell RJL's advisory services and the BOM strategy to clients and prospective clients.

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[1] During the hearing, Respondents also used the terms "so-called back-test," and "forward looking back-test," and "hypothetical," where they had previously just used their chosen term "back-test."

Respondents began using the term "back-tested buckets" to support their claim that BOM was a proven strategy. (Trial Tr. (Lucia) 1319:16-23.) Respondents made a deliberate choice to make the claim that they had back-tested the BOM strategy from 1973, and then a few years later, to claim that they had performed a second back-test from 1966, and to put the results of these purported back-tests forward as proof that the BOM strategy worked. (Trial Tr. (Lucia) 1191:10-13.)

Respondents' long-time employees testified that Lucia verbally reinforced Respondents' back-testing claims repeatedly at the seminars. Lucia Jr. testified that he attended hundreds of BOM seminars, and that during those seminars he heard Lucia use the term back-test. (Trial Tr. (Lucia Jr.) 1687:12-17.) Plum testified that he attended hundreds of BOM seminars and he "most definitely" recalled that Lucia used the term back-tested. (Trial Tr. (Plum) 358:21-359:8.) Similarly, Ochs, Respondents' Chief Compliance Officer, confirmed that Respondents "advertised" that they back-tested the BOM strategy. (Trial Tr. (Ochs) 536:20-537:7.)

The webinar provides additional evidence of how Respondents used their back-testing claims to validate the BOM strategy in their effort to sell it and RJL's services to clients and prospective clients. When Lucia puts up the 1973 "Back Tested Buckets" slide during the webinar, he states:

> 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.
>
> Had you done the Buckets of Money strategy as outline[d], you would have taken 60,000 dollars out over the first six year[s], 71.5 over the next six years; 85.5 over the next six years; 96,000 dollars over the next six years, and in twenty-one years – remember when that balanced Buttafucco portfolio was worth zero – this portfolio, using the identical returns for the stock market, would have been worth 1,544,000 dollars and change. Quite a difference. Zero versus a million-five.

(Govt. Ex. 66 at 46:16-47:6; Resp. Ex. 30.)

Lucia then introduces the slides for the 1966 back-test by claiming that they are the results of a back-test he did for Ben Stein. (*Id.* at 47:22.) Lucia explains that the results of his

1966 back-test were so compelling that they convinced Stein that BOM "really does work" if a portfolio uses a BOM allocation strategy and invests in real estate:

> Now, I said, Ben, let me show you the real live Buckets of Money strategy. Let's assume we put forty percent in T-bills, twenty percent in direct ownership in real estate -- and I'm talking about big stuff, billions of dollars here; and forty percent in the stock market, and we drained the dividend yield from the real estate along with the T-bill money first, then tapped into the real estate second, then tapped into the stock market money third. How would this portfolio have looked in 2003 using the Ray Lucia Buckets of Money strategy? Try 4.7 million dollars.
>
> Same assumptions, just simply draining the right buckets in the right order. And at that point Ben said -- not only did he say wow, he said, when can we get started telling the world about this. . . .
>
> But even someone as brilliant as Ben didn't realize that having a safe bucket of money from which to live, while you allowed your riskier stocks to grow, would have that significant of a difference. Well, he knows now, because he's written about it many, many times in Yahoo and the New York Times and Barron's and all that stuff, because he's drunk the Kool-Aid, he's got religion. Buckets of Money. And it works. It really does work.
>
> So there you have it. A sixty-forty mix. The standard, you know, allocation that most advisors show you, would have had 30,000 bucks by 2003, after thirty-eight years. The regular sixty-forty mix, draining the bonds first and the stocks second, a pseudo Buckets of Money strategy, 1.2 million dollars. But the real Buckets portfolio, using real estate, 4.7 million dollars.

(Govt. Ex. 66 at 50:2-51:19; Resp. Ex. 30.)

Documentary evidence also shows that Respondents repeatedly used their purported back-testing to validate the BOM strategy. For example, in a March 2008 letter written by Lucia to RJL clients, he claimed that he "back-tested "Buckets of Money" to 1966, 1973 and 1987."[2]

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[2] Other than Lucia, Respondents' long-time employees had no knowledge of any 1987 back-test. Ochs testified that she did not recall seeing any documentation on any 1987 back-test. (Trial Tr. (Ochs) 537:8-538:19.) Plum testified that he had never discussed a back-test to 1987 with Lucia, seen any documents reflecting a back-test to 1987, heard from anyone that a back-test to 1987 had been performed, performed such a test himself, and was not aware of anyone else doing such a test. (Trial Tr. (Plum) 855:19-856:8.) There is no dispute that Respondents have

(Govt. Ex. 35.) In training materials for RJL advisers, Respondents claimed "Buckets of Money has back tested to the bear market of 1973-1974." (Govt. Ex. 50.) Similarly, as alleged in the OIP, Lucia's 2007 book, *Ready...Set...Retire!* also claimed that Lucia had "back-tested the strategy over several decades, that it works in good times and bad. In fact, I back-tested it over several bear markets, including the dismal period beginning in 1966."[3] (Govt. Ex. 68 at SEC-LA3937-04102.)

### 2. Respondents' Contention That BOM Is Only A "Withdrawal Strategy" Is Contrary To The Evidence That The BOM Strategy Focus Is On Asset Allocation

Respondents essentially base all of their legal arguments in their post-trial brief on their characterization of the BOM strategy as only a "withdrawal strategy." They use this new characterization to argue they cannot be found liable for violations of any provision of Section 206 of the Advisers Act because they contend this so-called "withdrawal strategy" was not presented as performance advertising (Resp. Br. pp. 27-30), did not present results of a model portfolio (*id.* pp. 30-31), and was not materially misleading. (*id.* pp. 37-52.) Respondents also argue that their claimed back-testing of the BOM strategy complied with a purported "industry standard" for "withdrawal strategies." (*id.* 57-59.) Respondents further rely on BOM being a

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never produced any documentation to support any back-test to 1987. Respondents' unsupported claim to have back-tested the BOM strategy to 1987 is additional evidence of how Respondents used the term "back-test" to validate the BOM strategy.

[3] In their post-hearing brief, Respondents cite generally to the three books in support of broad statements about the BOM strategy (*see* Resp. Br. at pp. 8-9) and point out that there is no allegation that the books violate the federal securities laws. (Resp. Br. at p. 8 n. 9.) The Division did not pursue charges based on statements in Lucia's books because those books arguably fall within an exclusion from coverage of the Advisers Act for the publisher or any *bona fide* publication of general or regular circulation. *See, e.g., Lowe v. SEC*, 472 U.S. 181 (1985); 15 U.S.C. § 80b-2(a)(11)(D). However, the statements in the book corroborate the Division's claims that Respondents used their alleged back-testing to validate and prove that the BOM strategy worked.

"withdrawal strategy" to urge the Court to ignore the common sense guidance set forth in the *Clover Management* no-action letter. (*Id.* pp. 27-30.)

The Court should reject Respondents' efforts to re-characterize the BOM strategy as only a "withdrawal strategy," and should reject Respondents' legal arguments premised on BOM being only a withdrawal strategy. The evidence, as well as Respondents' admissions, clearly show that Respondents did not use the term "withdrawal strategy" in their slideshows, but rather presented the BOM strategy as an asset allocation strategy – that is, one in which a client ***allocates*** their assets among several buckets. (*See* Govt. Ex. 1, Govt. Ex. 66 (webinar) at 29:2-12, 44:15-45:13.) That fact is consistent with Respondents' Answers in this proceeding. In their Answers to the OIP, Respondents admitted that BOM "is an overall asset allocation and withdrawal strategy." (RJL Answer ¶¶ 13, 14, 15; Lucia Answer ¶¶ 13, 14, 15.) Respondents provide no reason why the Court should disregard their admissions in their Answers that BOM is more than a withdrawal strategy, that it is also an "asset allocation" strategy. Indeed, the Division relied on Respondents' admissions in preparing its trial strategy. Respondents are bound by their admissions in their Answers, and for this reason alone the Court should reject Respondents' efforts to re-characterize BOM as "only" a withdrawal strategy.

Moreover, during the hearing, Lucia himself admitted, albeit reluctantly, that the BOM strategy involved asset allocation. (Trial Tr. (Lucia) 1050:8-13.) Lucia agreed that the purpose of the seminars was to market the BOM strategy, and agreed that BOM was an asset allocation strategy: "Q: And an asset allocation strategy, correct? A: Eventually, yes." (Trial Tr. (Lucia) 1072:25-1073:6.) While there is no question that Respondents' tactics at trial were to re-define the BOM strategy as only a withdrawal strategy, their admissions at trial to the contrary should not be disregarded – particularly since those admissions are consistent with the admissions they made in their Answers.

The Division also introduced evidence that Respondents consistently described BOM as an asset allocation strategy and a portfolio strategy in 2007, 2008, 2009, and 2010. Lucia agreed that in his 2010 book, he described BOM as being an asset allocation approach: "The science of

asset allocation, in particular the BOM approach, has been time tested." (Trial Tr. (Lucia) 1050:14-17.) Lucia agreed that Respondents' brochures accurately described the BOM strategy as one that "allocates a portfolio to generate inflation adjusted retirement income for life with minimal risk. The Buckets of Money strategy's goal is to help you create a plan for both income and growth during your retirement." (Trial Tr. (Lucia) 1055:10-24; Govt. Ex. 8.) Lucia agreed that the BOM strategy, in simplest terms, used three buckets and advised "clients to allocate their assets among these three buckets." (Trial Tr. (Lucia) 1056:5-11.)

The Division introduced other evidence dating from 2008, 2009, and 2010 that describes BOM as an asset allocation strategy. (*See, e.g.*, Govt. Ex. 16 at SEC-LA3937-00024 (describing BOM as "a different kind of asset allocation and retirement distribution methodology" and explaining that "[i]nstead of using the traditional asset allocation models found at other financial websites and institutions, with Buckets of Money individuals divide their money into three 'buckets' for income, safety and growth, rather than lumping them all into one."[4]); Govt. Ex. 20 at SEC-LA3937-00276 ("The Buckets of Money philosophy segments a client's retirement portfolio into three general Buckets: Income, Safety and Growth."); Govt. Ex. 35 (letter written by Lucia in 2008) ("They're the callers who have followed my 'Buckets of Money' strategy, people who are properly diversified, who have their Buckets filled with the proper allocation of cash, bonds, balances funds, real estate, and yes, stocks."); Govt. Ex. 38 at SEC-LA3937-00366 ("The Buckets of Money strategy allocates your portfolio into 'buckets' with varying degrees of risk and investment time horizon."); Govt. Ex. 41 at RJL-SEC-0000553 ("Buckets of Money is a retirement planning strategy that allocates a portfolio with the goal of providing inflation adjusted income for life." )

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[4] Respondents' Chief Compliance Officer recalled that in 2007, 2008, 2009, and 2010, Respondents generally described the BOM strategy as one that divided a client's assets among three buckets. (Trial Tr. (Ochs) 593:17-594:14.) That is, an asset allocation strategy.

Also, although Respondents repeatedly point to the webinar as the "best evidence" of what was presented at the BOM seminars, they cannot cite to any portion of the webinar where Lucia described BOM as a "withdrawal strategy." During the webinar, Lucia explained how the BOM strategy instructed investors to "fill" their various buckets. (Ex. 66 at pp. 58, 69.) Lucia states: "If you'd like us to help you fill the buckets with nontradable [sic] real estate and all the safe buckets we've talked about, and show you the money managers that we use, happy to help you." (*Id.* at 69:15-20.) Thus, the webinar does not corroborate Respondents' post-trial effort to re-define the BOM strategy as only a withdrawal strategy. *See also infra*, at Section II.A.4 (also addressing Respondents' webinar).

Finally, Lucia's 2010 book, *The Buckets of Money Retirement Solution, The Ultimate Guide to Income for Life* (Govt. Ex. 69), also shows that Respondents' claim that its strategy was just a "withdrawal" strategy should be rejected. In that book, Lucia explains the BOM strategy in Chapters 3 through 5, and discusses refining that BOM strategy in Chapters 6 through 9. (Govt. Ex. 69 at SEC-LA3937-03811-812.) Finally, the last chapter in the book is entitled: "Craft a Workable Withdrawal Strategy." (*Id.* at SEC-LA3937-03813.) Lucia devoted approximately 135 pages in Chapters 3 through 9 explaining that the BOM strategy involves the allocation of assets, and only one chapter of 15 pages to "crafting a withdrawal strategy," which is done after one's assets are properly "bucketized." Thus, as late as 2010, Lucia did not describe the BOM strategy as a "withdrawal strategy" and, in fact, the concept of a withdrawal strategy was just an after-thought in his book.

### 3. Respondents Make Inaccurate And Unsupported Claims About A 2003 Commission Examination of RJL

Respondents repeatedly, and incorrectly, claim that a 2003 examination by the Commission examination staff "concluded" that they were not engaged in performance advertising. They also contend they cannot be held liable under Section 206 of the Advisers Act because this examination raised "no alarms" about the 1973 "Back Tested Buckets" slide. (Resp. Br. pp. 30-31.) Respondents argue that the 2003 examination generally estops the Division from

bringing this enforcement action on a variety of grounds, including that their conduct did not violate Section 206 generally, lack of materiality, lack of scienter, due process, and statute of limitations. (*See, e.g.*, Resp. Br. pp. 4, 18-20; 30-31, 32, 49, 55-57, 62-63, 68-69.) For several reasons, Respondents' arguments about the 2003 examination lack any merit and should be rejected.

First, this argument conveniently ignores the fact that the Respondents themselves informed the examination staff in 2003 that they were not engaged in performance advertising. The examination staff specifically asked for all documents about performance advertising. (Resp. Ex. 15.) Respondents stated "not applicable." (Resp. Ex. 16.) Thus, far from "concluding" that Respondents were not engaged in performance advertising, the examination staff merely accepted as true Respondents' statement that they were not engaged in that kind of advertising. That the staff chose to rely on this statement has no legal bearing here.[5]

Second, Respondents ignore the explicit, cautionary language of the 2003 deficiency letter:

> We are bringing the deficiencies and/or violations of law described above to your attention for immediate corrective action, without regard to any other action(s) that may result from the examination. **You should not assume that the Registrant's activities not discussed in this letter are in full compliance with the federal securities laws or other applicable rules and regulations.** The above findings are based on the staff's examination and are not finding or conclusions of the Commission.

(Resp. Ex. 13 at pp. 9-10 (emphasis added.) Respondents not only ignore this language, but also fail to provide any cogent reason why the Court should ignore this explicit, cautionary language that refutes Respondents' reliance on the 2003 examination.

Third, Respondents repeatedly but incorrectly suggest that all of their back-testing slides were examined during the 2003 examination. (*See, e.g.*, Resp. Br. 4, 10, 18-20, 55-57, 69). But

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[5] In 2010, Respondents provided information on their performance advertising to the examination staff in response to requests for such information. While Respondents seek to rely on the 2003 examination, an equally pertinent question is why Respondents did not identify their performance advertising to the Commission's examination staff in 2003.

there is no dispute that the 1966 back-test was not created until 2005 or 2006, so the slideshow that was actually reviewed in the 2003 examination could not have included the 1966 back-testing slides. In fact, Respondents' long-time employee, Dotson, testified that she provided a slideshow marked at Govt. Ex. 21 to the examination staff in 2003. (Trial Tr. (Dotson) 1484:12-25.) Govt. Ex. 21 does not contain the 1966 back-testing slides. Respondents also claim the examiners in 2003 "did not request copies of the slides with the issues now complained of in the OIP." (Resp. Br. p. 19.) But since the 1966 slides were not part of the slideshow, that argument is meaningless. Therefore, the Respondents' repeated references to "slides" in their discussion of the 2003 examination (such as their statement that the Commission expressed "no concern regarding the slides during the 2003 examination" (*id.* p. 4.)) misrepresent what information was actually provided to the examination staff in 2003.

Fourth, Respondents misstate the contents of the 1973 "Back Tested Buckets" slide as it was examined in 2003. (*See, e.g.*, Resp. Br. pp. 19, 30-31.) For example, the 1973 "Back Tested Buckets" slide provided to the examination staff in 2003 contains a different disclaimer than the slide that is the subject of the OIP. In the 2003 slideshow, the "Back Tested Buckets" slide contained this disclaimer: "Rates of return are hypothetical in nature and are for illustrative purposes only. An investors results may vary." (Govt. Ex. 21 at SEC-LA3937-01094.) In contrast, by 2010, Respondents were using a much different disclaimer that explicitly states that performance results were being presented on the slide. (Govt. Ex. 1 at SEC0LA3937-00200.) Respondents never address this change in the disclaimer language, and ignore their admissions during trial that the disclaimer that appears on the "Back Tested Buckets" slide in 2010 was factually incorrect. Similarly, Respondents assert that the "2003 slides also assume a 3% inflation rate for a historical time period commencing in 1973, a 7.75% REIT dividend yield for the same period, do not deduct advisory fees and do not reallocate assets." (Resp. Br. pp. 19 (twice), 56.) But even a cursory review of the 1973 "Back Tested Buckets" slide shows that these assumptions do not appear on the "Back Tested Buckets" slide in 2003. (*See* Govt. Ex. 21 at SEC-LA3937-01094.)

Fifth, Respondents rely on statements made in the 2003 examination report. (*See, e.g.*, Resp. Br. pp. 18, 20, 22, 49.) The 2003 examination report was not provided to Respondents until after the OIP was instituted, in response to their request for production of the document. Respondents had no knowledge of the contents of the 2003 examination report and cannot make any credible claim that they in any way relied on any statement in that report.

Finally, Respondents produced an exhibit that Dotson identified as a copy of all the documents that the examination staff requested in 2003. (Resp. Ex. 20, Trial Tr. (Dotson) 1492:24-1493:6.) Two of the pages are partially obliterated, but appear to be comments about disclosures and changes that need to be made to a slideshow. Among the changes requested is the inclusion of disclosures that: "Past performance is not indicative of future results. Fees and expenses have not been included in this illustration. If included, performance values would be lower." (Resp. Ex. 20 at p. 15 (at the third and fifth bullet points).) Another comment pertains to disclosure of the claimed yield of a REIT, and reads: "Slide 130 should include a basis for the 7.75% dividend quoted for the REIT investment ...[if using historical returns of the S&P REIT index], the material should be revised to accurately reflect this return." (Resp. Ex. 20 at p. 15 (last bullet point on page, which is cut-off in Respondents' production).) Another comment on the slideshow in this 2003 document concerns claims about the success of the BOM strategy, where Respondents are told to revise a statement because it "implies a profit and the success of the strategy." (Resp. Ex. 20 at p. 28 (ninth bullet on page).) Thus, since at least since 2003, Respondents have been on notice that they had to disclose if fees were not included in an illustration, disclose the basis for any assumptions about REIT yields, and be careful about making claims concerning the success of their BOM strategy.[6]

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[6] Respondents' Chief Compliance Officer, Ochs, testified that while at Securities America in 2003 she had been responsible for reviewing RJL's slideshows, and recalled that Securities America had a number of revisions, including disclosure of the basis for REIT returns and regarding past performance when showing historical performance. (Trial Tr. (Ochs) 565:7-567:7.)

### 4. The Webinar Is Evidence Of A Single, Unique Presentation That Supports The Allegations In The OIP

Respondents produced a copy of a pre-recorded webinar weeks after the OIP was instituted, and urge the Court to rely primarily on this webinar as the "best evidence" of what was said at every seminar Lucia conducted. (*See, e.g.*, Resp. Br. 2, 16, 30, 33.) Specifically, Respondents rely on a single passage from the webinar, in which Lucia used the term "pretend," to argue that the slideshow was not misleading. (*See, e.g., id.* pp. 12, 17, 33, 39.) But the evidence does not support giving such weight to this unique, one-time, abbreviated version of the seminar presentations. In fact, far from being the exculpatory piece of evidence Respondents claim, the webinar actually corroborates and supports the allegations in the OIP. Indeed, the webinar provides the true context of the BOM seminars, showing that they were sales presentations and advertisements for the BOM strategy and RJL's investment adviser services.[7]

Respondents did not produce a copy of the slideshow used in the webinar, which presumably is maintained in Respondents' books and records and so should be readily available. Moreover, Respondents' failure to produce the webinar during the examination process or in response to Division subpoenas shows that it was not properly maintained in Respondents' books and records.[8]

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[7] Respondents seek to gain some advantage by pointing to the Division's objections to the admission of the webinar because of its last minute production and questions about its authenticity (*see, e.g.*, Resp. Br. p. 2), although the Division was well within its rights to seek evidence concerning the authenticity of the webinar.

[8] Respondents never offered a satisfactory explanation why this pre-recorded webinar, which would have been subject to special compliance review, was not in RJL's books and records; was not produced to the examination staff, was not produced in response to subpoenas during the Division's investigation, and was not produced during the Wells process. Oddly, given Respondents' testimony that a pre-recorded webinar went through special compliance review, Respondents did not elicit testimony from their Chief Compliance Officer about the webinar. When the Division questioned its authenticity, Respondents did not produce any compliance documents authenticating the pre-recorded webinar. If the webinar had been properly vetted by compliance and maintained in RJL's records, its existence should have been well known and it should have been produced years ago.

Testimony about the contents of the webinar established that it is not, and cannot be viewed as, a definitive statement of what occurred at every seminar. The content of the pre-recorded webinar is not identical to the seminars. Lucia testified that "[t]he content of the webinar was an abbreviated version of the seminar." (Trial Tr. (Lucia) 1225:24-1226:5.) The webinar was recorded and edited (Trial Tr. (Lucia Jr.) 1248:16-25), and Respondents did not retain an unedited version of the webinar. (Trial Tr. (Lucia Jr.) 1249:2-4.) The webinar proceeded in a substantially different manner than the seminars. The seminars begin with a question and answer period, while the webinar did not. (Trial Tr. (Lucia) 1226:7-21.) Moreover, Lucia testified that they changed the slides in the slideshow and the content of the seminars depending on current events and other circumstances. (Trial Tr. (Lucia) 1064:7-1065:12.) Thus, what was said at any seminar might well vary from all other seminars, and might also vary from the edited version of the seminar that became the webinar.

To the extent that the verbal presentation of a seminar was driven by the slideshow, the slideshow in the webinar was unique and Lucia believed that particular version of the slideshow was only used for that webinar. (Trial Tr. (Lucia) 1315:10-14.) During the hearing, the Division elicited testimony that there were differences between the content of the slideshow that is the subject of the OIP – Govt. Ex. 1, and the content of the slides in the webinar, including that some slides in Govt. Ex. 1 did not appear on the tape of the webinar and that disclaimers were missing or altered on other slides. (Trial Tr. (Lucia) 1308:9-1315:14.)

Respondents did not keep a record of the webinar in the books and records of RJL, and it was found "three or four levels down in a folder structure" on a hard drive of Lucia's entertainment company. (Trial Tr. (Lucia Jr.) 1240:22-1241:8.) While Respondents claimed that they had searched for and found all the documentation that would have authenticated the webinar, such as compliance documents and communications with First Allied (Trial Tr. (Lucia Jr.) 1252:14-24), Respondents did not produce a single compliance document about this pre-recorded webinar. Respondents' Chief Compliance Officer, Ochs, purportedly searched for and found such documents (*id.*), and would have been uniquely qualified to testify about the webinar,

but Respondents did not ask Ochs any questions to establish the webinar's authenticity or compliance.[9] Respondents could not identify when they found the webinar. (Trial Tr. (Lucia) 1222:10-1223:14 ("It was sometime after the OIP….").) It was not produced during the examination or in response to subpoena during the Division's investigation, and Respondents could not answer why. (Trial Tr. (Lucia Jr.) 1255:9-1256:20.)

### B. Respondents' Arguments That They Did Not Violate Section 206 Because They Were Not Engaged In Performance Advertising Of A Model Portfolio Lack Merit And Should Be Rejected

Respondents argue they cannot be found liable for violation of any part of Section 206 of the Advisers Act because they were not engaged in performance advertising of their so-called "withdrawal strategy," and because they did not present a model portfolio of this "withdrawal strategy." Respondents also argue that the considerations stated in the *Clover Management* no-action letter are inapposite, and rely on the decision *In the Matter of FXC Investors Corp., et al.*, 2002 WL 31741561 (Dec. 9, 2002), to suggest that there is no authority for sanctioning false statements about a "withdrawal strategy" under any part of Section 206. (Resp. Br. pp. 27-31.) Respondents then admit that they did not actually back-test the BOM strategy to 1966 and 1973 as they explicitly claimed in their slideshow and seminars, but argue that the Court should instead look at the "context" of their false back-testing claims in order to find that such false statements likewise did not violate Section 206. (*Id.* pp. 31-35.) As discussed below, all of these arguments are unavailing.

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[9] Respondents were proffering the webinar and had the burden of proof concerning its authenticity. Yet Respondents let witness after witness testify without eliciting any evidence to authenticate the webinar. Finally, Lucia testified that Lucia Jr. found it, and then Lucia Jr. testified that "Uncle Joe" found it. Respondents did not call Uncle Joe to testify.

### 1. Section 206 Covers Fraud Whether It Is Styled Performance Advertising Or A Model Portfolio Of A Withdrawal Strategy

Respondents argue that there is no precedent for holding them liable for false or misleading statements because they were not engaged in performance advertising as defined by Rule 206(4)-1(a)(5), and that *Clover Management* is inapplicable to their withdrawal strategy. (Resp. Br. pp. 27-31.) Respondents' argument ignores the plain language of Section 206 and relevant case law.

The plain language of Section 206 broadly prohibits an investment adviser from employing "***any*** device, scheme, or artifice to defraud any client or prospective client," Section 206(1) (emphasis added), and from engaging in "***any*** transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206(2) (emphasis added). Section 206(4) prohibits an investment adviser from engaging in "***any*** act, practice, or course of business which is fraudulent, deceptive, or manipulative." Section 206(4) (emphasis added). The clear proscriptions of Section 206 provide ample notice that fraudulent, deceptive, or manipulative conduct is prohibited. There is nothing in the statutory language that limits its coverage to performance advertising as defined in Rule 206(4)-1(a)(5), or excludes conduct that is not covered by Rule 206(4)-1(a)(5).

Respondents, however, argue that there is no reported decision, rule, or other authority concerning "advertising related solely to an investment withdrawal strategy . . . ." (Resp. Br. pp. 28, 68.) This argument and narrow construction of Section 206 is contrary to well-established case law. The Supreme Court has held that Section 206 should be interpreted "not technically and restrictively, but flexibly to effectuate its remedial purposes." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). It has long been recognized that under the Advisers Act, "'fraud' must be interpreted broadly to effect the remedial purposes of the Act." *SEC v. Lindsey-Holman Co.*, 1978 WL 1129 (M.D. Ga. 1978); *see also SEC v. Fife*, 311 F.3d 1, 10-11 (1st Cir. 2002); *SEC v. Van Horn*, 371 F.2d 181, 185-86 (7th Cir. 1966); *SEC v. Gruss*, 859 F. Supp. 2d 653, 663 (S.D.N.Y 2012). Indeed, *Gruss* recognized that Section 206 was

intended to be "a very broad remedy" and is "even broader than Section 10(b) of the Exchange Act." *Gruss*, 859 F. Supp. 2d at 663.

Moreover, Section 206 has been interpreted to impose a fiduciary duty on investment advisers, to act in good faith, to disclose fully and fairly all material facts to its clients and prospective clients, and to employ reasonable care to avoid misleading clients and prospective clients. *See Capital Gains Research Bureau,* 375 U.S. at 194; *SEC v. Chiase*, 2011 WL 6176209, at *5 (D.N.J. Dec. 12, 2011). The Commission has stated that "high standards of truthfulness and disclosure must also govern the propriety and legality of investment advisers' efforts to induce others to purchase their services." *In the Matter of Spear & Staff, Inc.*, 42 S.E.C. 549, 1965 WL 88746 at * 3 (1965). Respondents' arguments concerning the scope of Section 206 must be viewed in the context that RJL and Lucia were investment advisers subject to these high standards of truthfulness and disclosure.

Also, Respondents cannot credibly claim that they were not on notice that advertising is subject to Section 206 of the Advisers Act. There is ample case law that Section 206 applies to fraudulent claims made by an investment adviser in advertising, or other statements, to clients and potential clients. *See, e.g., SEC v. C.R. Richmond & Co.*, 565 F.2d 1101 (9th Cir. 1977); *SEC v. Locke Capital Management, Inc.*, 794 F. Supp. 2d 355 (D.R.I. 2011); *SEC v. Lauer*, 2008 WL 4372896 (S.D. Fla. 2008); *In the Matter of F.X.C. Investors Corp,. et al.*, Release No. 218, 2002 WL 31741561 (2002); *SEC v. Valicenti Advisory Services, Inc.*, 198 F.3d 62 (2d Cir. 1999); *In the Matter of Meridian Investment Management Corp., et al.*, Release No. 1779, 1998 WL 898489 (1998); *SEC v. Lindsey-Holman*, 1978 WL 11 29 (W.D. Ga. 1978).

For example, in *SEC v. C.R. Richmond & Co.*, 565 F.2d 1101 (9th Cir. 1977), the appellate court affirmed liability under Section 206 for false and misleading statements by an investment adviser in a book and newsletters. The advisers in *C.R. Richmond* argued that their newsletters and books were not advertisements under Rule 206(4)-1(b). *Id.* at 1104. The Ninth Circuit recognized that the term "advertisement" is broadly defined in the Rule, and that conduct with respect to the rules must be measured from the viewpoint of a person "unskilled and

unsophisticated in investment matters." *Id.* The Ninth Circuit held that "[i]investment advisory material which promotes advisory services for the purpose of inducing potential clients to subscribe to those services is advertising within the Rule." *Id.* at 1105. Thus, Respondents' slideshow presented at seminars were used to generate clients for RJL and falls within Rule 206(4)-1.

In *C.R. Richmond*, the Ninth Circuit also considered the defense that every sentence used throughout the course of the advertising "in and of itself is accurate and truthful." *Id.* at 1106. The Ninth Circuit rejected that defense, because the "advertisements were 'deceptive and misleading in their overall effect even though when narrowly and literally read, no single statement of material fact was false.'" *Id.* at 1106-1107 (*quoting Spear & Staff*, 42 S.E.C. 549). That reasoning is applicable to Respondents' defense here that they disclosed their assumed inflation rate, assumed REIT rate of return, and did not reallocate because they were comparing three versions of taking safe money first.[10] Even assuming that Respondents fully disclosed those assumptions, they did not disclose the material effect that their 3% inflation adjustment had on their results or that they knew that using actual inflation would result in their BOM strategy also going "bankrupt" before 2003. There is also no question that Respondents did not disclose the basis for their assumed REIT rate of return and the material impact that their assumed REIT rate of return had over historic data – which was to add $3.5 million to the portfolio value.

### 2. Respondents' "Due Process" Arguments Also Fail

In their post-trial brief, Respondents also make a "due process" argument, contending the Commission has "never issued any guidance as to performance advertising." This contention

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[10] As discussed elsewhere, Respondents' argument that the "1966 Illustrations" were only to compare taking safe money first is belied by the fact that when historic REIT returns are used, both BOM portfolios produce almost identical results of $1.2 million, rather than $1.2 million compared to $4,719,741.

essentially repeats their argument that there is no precedent for holding them liable under Section 206. (*See* Resp. Br. pp. 66-69.)

This argument that they have somehow been unfairly surprised by this enforcement action is not a new argument, and it has been soundly rejected. For example, in *Marketlines, Inc. v. SEC*, 384 F.2d 264 (2d Cir. 1967), an adviser appealed from a Commission order revoking its registration for, among other things, violations of Section 206 by publishing misleading advertisements soliciting subscriptions to its market letters. *Id.* at 266. In affirming the Commission's order, the Second Circuit held that the "Commission could properly conclude that the entire content and tone of the advertisements was designed to whet the appetite of the unsophisticated." *Id.* The adviser argued that it was "unfairly surprised" by the Commission's position since almost all of the challenged advertisements appeared before the Commission's decision in *Spear & Staff*, which the adviser claimed was the first decision "giving notice as to what would be considered improper investment advisory material." The Second Circuit rejected that argument finding that the Commission's position had "been made well clear" well before Marketlines committed its violations. *Id.* at 266 n.5. This Court should do the same here.

Respondents also argue, in support of their purported due process defense, that the *Clover Capital Management* no-action letter "is not the law." (Resp. Br. pp. 28-30.) In support, they rely on the decision in *F.X.C. Investors*, where the court recognized that staff interpretations in opinion letters are not binding on courts and "have no value beyond their own persuasive weight." *Id.*, 2002 WL 31741561 at *11. However, as explained in the Division's post-trial brief, the *Clover Capital Management* no-action letter presents compelling reasons to hold Respondents liable in this proceeding. (*See* Div. Br. pp. 40-42.) Nowhere in *F.X.C. Investors* is it suggested that this Court cannot conduct its own independent analysis of the evidence and reach a conclusion that is consistent with the considerations stated in the *Clover Capital Management* letter. *See New York City Employees Retirement Syst. v. SEC*, 45 F.3d 7, 12-13 (2d Cir. 1995) ("Even when district courts have ruled in accord with no-action letters, they almost always have analyzed the issues independently of the letters.").

For example, in *SEC v. Locke Capital*, 794 F. Supp. 2d 355, the court found that advertising violated Sections 206 and 204 of the Advisers Act without any citation to *Clover Management*. In *Valicenti*, the advisers argued that because the Commission "has not promulgated regulations articulating specific standards for performance advertising," the advisers had not received fair notice and asserted a due process defense. *Valicenti Advisory*, 198 F.3d at 66. The *Valicenti* court stated that "due process requires, however, only that 'laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited.'" *Id.* (*citing Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972)). The Second Circuit summarily rejected this argument, holding: "Neither VAS, a registered investment adviser, nor Valicenti, who has worked in the investment industry since 1967, can credibly claim lack of fair notice of the proscription against defrauding investors." *Id.* Lucia testified that he has been involved in the retirement planning industry for 38 years, and similarly any claims that he was unaware of the antifraud provisions are not credible.

Moreover, the decision in *F.X.C. Investors* supports the Division's allegations. In that case, the court found that the advisers were liable for distributing a series of advertisements which, "taken as a whole, created the impression that, during specified periods of time, FXC had achieved a remarkable success rate." *Id.*, 2002 WL 31741561 at *12. Some of the violations "were not particularly subtle," including "the implication that clients remained fully invested in the market at all times, and the failure to disclose that advisory fees had not been deducted from the results portrayed in the advertisements." *Id.* The court found each of these representations highly inaccurate and material to prospective clients. *Id.* In addition, in *F.X.C. Investors*, the Division claimed the advertisements involved hypothetical returns of model portfolios, while the advisers claimed they were not model results. *Id.* The court found that the advertisements showed what respondents believed '"could have happened' if a client had traded in accordance with its recommendations at the instant [respondent] made the recommendations." The court concluded such claims depicted the performance of a model portfolio. *Id.* It also found that the

advisers also violated Section 206 by failing to disclose the limitations of their model results. *Id.* * 13. This is similar to what the Division is asking the Court to do here.

### 3. The Factual Record Does Not Support Respondents' Legal Argument

In addition to having scant legal support for their arguments regarding Section 206, the factual record also does not support, and actually contradicts, Respondents' argument that they never engaged in false and misleading performance advertising. As discussed above, Respondents chose the term "back-test" and used it in the manner in which it is generally understood – as a test of how a strategy would have performed over a specific historical period. Respondents created a model of their BOM strategy, which is contained in the spreadsheets. (Govt. Exs. 12 & 13.) They used their model of the BOM strategy to test how it performed over certain historical periods. Respondents had the ability to change the inputs used, the times covered, and all the other parameters of their model of the BOM strategy. Indeed, Respondents' expert, Hekman, was provided with the model of the BOM strategy and performed additional tests over the 1973 and 1966 time periods using different inputs and assumptions, and generated results of how the BOM strategy performed. (*See* Resp. Ex. 35 (Hekman Report) Appendices 4, 7, 10, 11.) The Division's expert, Grenadier, recreated Respondents' BOM strategy model and also performed additional tests over the 1973 and 1966 time periods, and generated more results about how the BOM strategy performed. (Govt. Ex. 70 (Grenadier Report) Exs. 2a, 2b, 3a, 3b, 5a, 5b, 6a, 6b, 9a, 9b.) The Division introduced a chart that showed some of these different results, specifically how changing the inflation assumption by small amounts resulted in materially different results in the test of the period 1966-2003. (Govt. Ex. 77.)

In general, Respondents began with a $1 million portfolio that was allocated using their BOM strategy among different asset classes, and then calculated what would have happened to the value of that portfolio by using actual historical rates of return for stocks and T-Bills, and an assumed rate of return for REITs. Respondents' model of the BOM strategy created results in the form of inflation adjusted income needs met and ending portfolio values, and there is no

dispute that Respondents presented the results of their tests of the BOM strategy in their seminar slideshow to show how the BOM strategy would have performed. (Govt. Ex. 1 at SEC-LA3937-000200-011-02; 000209-210.) Indeed, with respect to the claimed 1966 back-test, Respondents specifically used the term "the results" before presenting the data from their model of the BOM strategy. (*Id.*) Respondents reported the results of their claimed back-tests as evidence that the BOM strategy performed as they claimed, and provided inflation adjusted income and sustained portfolio growth. (*See* Govt. Exs. 1, 12, 13, 66; Resp. Ex. 30.)[11]

Therefore, the evidence establishes that Respondents advertised these performance results in their slideshows at seminars. Respondents' "back-tests" at the time purportedly showed what would have happened if a client went back to 1966 or 1973 and followed their BOM strategy. When such claims are misleading or involve failure to disclose material information, they are fraudulent under Section 206. *F.X.C. Investors*, 2002 WL 31741561, at *13. In this case, if a client could have gone back to 1966 or 1973 and implemented the BOM strategy set forth in the spreadsheets, that client would have experienced the actual inflation rate from 1966 or 1973, just as they would have realized the historic T-Bill and S&P 500 returns. *Id.* Rather than using readily available historic inflation data, Respondents assumed a rate of inflation that they knew was below the actual inflation rate, and by so doing materially altered the results of their model. Moreover, while Respondents admittedly knew that their model would go bankrupt before the end of the test period if they used actual inflation, they failed to disclose that material information to investors.

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[11] Notably, Lucia advised individuals to run several projections to get an idea of the range of possible outcomes, doing calculations "year by year with actual returns rather than the average return for the period," assuming that one will live to be 100. (*See* Govt. Ex. 69 at SEC-LA3937-03997.) Lucia also advised individuals to run projections at different rates of inflation. (*See* Govt. Ex. 67 at SEC-LA3937-04386 (providing factors for calculations at inflation rates ranging from 3% to 10%, and 12%).) Respondents did not follow that advice in preparing or presenting their claims of how the BOM strategy performed in their claimed back-tests.

In addition, Respondents argue that the "purpose" of their claimed back-tests "was to show that with identical returns on bonds, identical returns on stocks, identical inflation rate and identical distributions, changing one factor – taking income distributions from safe money instead of volatile money – makes a big difference." (Resp. Br. p. 43.) If that was their purpose, then again their assumptions created materially misleading results. Specifically, in the so-called "1966 Illustrations," Respondents described two "BOM portfolios," and the sole difference was that one included an investment in a REIT with an assumed 7% rate of return. The evidence is uncontroverted that if Respondents had used historical REIT rates of return, then both "BOM portfolios" would have ended with virtually identical values: $1.2 million. (Compare Govt. Ex. 1 at SEC-LA3937-00207-208 and Govt. Ex. 70 (Grenadier Report) Ex. 5a.) However, Respondents' assumed REIT rate of return materially changed that to show that the BOM portfolio with REITs performed almost three times better than one without REITs. Respondents concede that REITs are risky investments, so a reasonable investor most likely understood that the "1966 Illustrations" showed that adding a REIT to their retirement portfolio would add substantial value to their retirement portfolio. There is no dispute that the majority of Respondents' fees and commission earned in 2009 and 2010 were from the sale of non-traded REITs. (*See* Govt. Exs. 2, 4.) Thus, either Respondents' statement of purpose is not credible, or they recklessly failed to create an "illustration" that met their purpose.

**4. Respondents' Argument They Complied With An "Industry Standard" And Thus Are Not Liable Under Section 206 Lacks Merit**

Respondents also argue in their post-trial brief that they complied with an "industry standard" in presenting back-tests of their withdrawal strategy which insulates them from liability under Section 206. (*E.g.*, Resp. Br. pp. 3, 48, 57-59, 68.) The Respondents' attempt to use this self-serving "industry standard" evidence to refute their scienter is addressed in more detail below. *See infra*, Section II.D.4.

In making this argument, Respondents point to advertisements by investment companies American Funds (Resp. Ex. 46) and Fidelity (Resp. Ex. 47) as setting the industry standard.

Performance advertising by investment companies is governed by Commission Rules 482 and 156. 17 C.F.R §§ 230.482, 230.156. As discussed below, Respondents do not contend that they complied with those rules. To the extent that the conduct of investment companies sets the industry standard that Respondents claim to have followed, then they cannot claim lack of notice of those rules and their provisions. A cursory examination of Respondents' claimed "back-test" slides demonstrates that they did not comply with Rules 482 and 156. Moreover, Rule 482 expressly states that advertising that complies with the rule is still subject to the antifraud provisions. Therefore, Respondents' industry standard argument does not provide any defense to the Division's allegations.

### 5. Respondents' Arguments Concerning The Context Of The Back-Testing Claim Are Factually Unsupported, And The Context Supports Finding A Violation Of Section 206

Respondents assert several variations on the argument that the Division has ignored the "context" in which the slideshow was presented, and criticize the Commission because neither the examination staff nor the Division attended a seminar. (*See, e.g.*, Resp. Br. pp. 1-4, 12-15, 21, 29-36, 46, 60.) However, Respondents' arguments about context ignore the evidence.

#### a. The Context Of The Slideshow Was A Sales Presentation For BOM and RJL's Advisory Services

The context of the seminars and the slideshow was to generate business for RJL by selling the BOM strategy. Respondents claim that the BOM seminar "is educational in nature" "setting forth factors and risks relative to retirement planning." (Resp. Br. p. 11.) However, Respondents conceded that the "goal of the BOM seminars is to attempt to match up a potential investor with a financial advisor…." (*Id.* p. 10.) Lucia agreed that for the most part, at the BOM seminars one of the things he was selling were the services of RJL. (Trial Tr. (Lucia) 1067:4-11.) The purpose of the seminars in the first instance was to market the BOM strategy. (Trial Tr. (Lucia) 1072:25-1073:6.)

The context of the slideshow and the seminars was a sales presentation for the BOM strategy and RJL's advisory services, and the goal was to generate commissions and fees for RJL and Lucia. The evidence established that Respondents were quite successful in generating fees and commissions. (Govt. Ex. 4 at SEC-LA3937-05032.) Lucia testified that before he sold the business to his son, he made money when someone who attended one of his BOM seminars subsequently went to RJL and the adviser sold that person some BOM-approved products, because Lucia would then realize some of those commissions. (Trial Tr. (Lucia) 1067:20-1068:3.) Although Lucia did not have advisory clients, his arrangement with RJL was that RJL's registered advisers signed over to Lucia the commissions generated from sales of BOM-approved products to people who came to RJL after attending a BOM seminar. (Trial Tr. (Lucia) 1073:21-1074:3.) Lucia and others in his employ approved the products that RJL advisers could offer to people who attended BOM seminars. (Trial Tr. (Lucia) 1076:16-24; Trial Tr. (Ochs) 573:20-24 (Lucia had particular products that he approved to be used by RJL advisers selling the BOM strategy).)

While Respondents suggest the slideshow and seminars can be viewed in a variety of contexts, the two relevant contexts are the purpose of the seminars to generate clients for RJL and the BOM strategy, and the context of Respondents' claims that they had back-tested the BOM strategy in the slideshow.

#### b. The Slideshow And Seminars Were A Sales Presentation To Generate Leads For RJL

RJL drew its client base from Lucia's activities as a media personality. (Govt. Ex. 4 at SEC-LA3937-05031.) Lucia admitted that he "encouraged people to set up an appointment to do their own custom buckets plan with a financial advisor that's been trained in the art of bucketization." (Trial Tr. (Lucia) 1281:14-22.) At the end of the slideshow, there is a slide that says "Response Cards." (*See* Govt. Ex. 1 at SEC-LA3937-00214.) There was a sign-in table at the seminars where attendees would be given a response card, and if an attendee were interested in the BOM strategy, they would fill out a response card. (Trial Tr. (Lucia) 1053:4-16.) Lucia's

long-time employee, Stripe, also testified that seminar attendees were provided with response cards. (Trial Tr. (Stripe) 1559:4-25.) Respondents' "scheduling team" enters the information from the response cards into a database, and calls individuals to schedule an appointment with one of Respondents' financial advisers. (Trial Tr. (Lucia Jr.) 1609:3-18.)

Respondents argue that they never offered to sell a particular security during the seminar. However, according to Respondents, "clients are buying the Buckets of Money strategy and not the individual underlying products. As such, the potential sale is generated by Mr. Lucia and not the advisor/registered representative." (Govt. Ex. 4 at SEC-LA3937-05032-33.) During the 2010 examination, Respondents informed the examination staff that clients were buying the BOM strategy, not individual securities. (Trial Tr. (Bennett) 215:15-23.) Lucia agreed that he supplied all sales leads to RJL through his activity as a media personality and seminar presenter: "I was the rainmaker for the firm, no doubt about that." (Trial Tr. (Lucia) 1075:20-25.) Lucia admitted that clients were buying the BOM strategy and not the individual underlying products. (*Id.* 1076:1-8.)

The seminars were very successful in generating fees and commissions for Respondents, and particularly for Lucia. Lucia stressed non-traded REITs as a critical part of a BOM strategy in the slideshow, and during a twelve-month period ending December 31, 2009, Lucia received $8.7 million in commissions based on the sale of non-traded REITs. (Govt. Ex. 2 (2010 RJL Examination Report) at LA-SEC3937-005808.) For the period from January 1, 2009 through January 31, 2010, Respondents' broker-dealer, Lucia Financial LLC, generated approximately $12.4 million in commissions, and approximately 72.3% of that amount was directly related to the sale of non-traded REITs, and in excess of $143 million was invested in REITs during that period. (Govt. Ex. 4 (2010 Lucia Financial Examination Report) at SEC-LA3937-05033.)

**c. Respondents' Pre-Recorded Webinar Shows Lucia Was Drumming Up Business For RJL And The BOM Strategy**

Respondents argue that the webinar provides context for the slideshow. The webinar shows that Respondents' BOM seminars were a sales pitch for the BOM strategy and RJL's

advisory services. At the outset of the webinar, Lucia states that it is "very important" for viewers to contact RJL by clicking on a link on the screen, and he promised that one of Respondents' "salaried financial advisors" would provide assistance, including "your own personalized, complimentary, Buckets of Money retirement analysis." (Govt. Ex. 66 at 3:7-19; Resp. Ex. 30.) At least eight additional times during the webinar, Lucia urged viewers to click on the link on the screen to contact RJL so that one of Respondents' salaried advisors could provide, among other things, a "complimentary" BOM strategy. (*See id.* at 5, 37-38, 51-52, 69, 71, 74-75, 77, 82.) For example, at around the mid-point of the webinar, Lucia stated:

> So what's the summary? Get your buckets of money strategy right. I will do it for you. Through my salaried advisors, all around the country, they will do a Buckets of Money strategy for you. Just click on the little icon, and you can get a Buckets of Money strategy complimentary, no arm twisting, no nothing. These guys get paid salaries, whether you do business or not.

(*Id.* at 51:20-52:3.)

A few minutes later, Lucia again pitched RJL's services during the webinar:

> Folks you need to get bucketized. Click on that little icon at the bottom right hand side of your screen, and get bucketized by one of my highly-trained advisors. I've got them all around the country. I've personally trained them. It'll be my eyeballs and my staff's eyeballs that look over these plans.
>
> And whether you choose to do this on your own, certainly your prerogative, or through your own advisor, fine and dandy. If you'd like us to help you fill the buckets with the nontradable real estate and all the safe buckets that we've talked about, and show you the money managers that we use, happy to help you.
>
> But please, if you do nothing, at least get your Buckets of Money strategy done today. We're offering you an opportunity to do that. Complimentary, at no cost, for having sat through this presentation.

(*Id.* at 69:5-25.)

Just a few minutes later during the webinar, Lucia again urged viewers to contact RJL:

> Once again, if any of these situations apply to you, if you want information on nontradable real estate, and as I said, get your own personalized Buckets of Money strategy, then click on the icon at the bottom right, and you should be able to get one, lickety-split, without any cost, and of course, without obligation. As I said, everybody that's working on these plans are salaried employees. They're not incentivized one way or the other, to help you. I'm doing this to help you, my radio listeners and people that watch me on television all around the country, so that you can get bucketized, you can get financially organized.

(*Id.* at 74:18-75:9.)

Thus, the webinar shows that the context of the seminars was to sell the BOM strategy and to encourage prospective clients to get a "complimentary" and "personalized Buckets of Money strategy" from RJL.

#### d. The Context Of The Back-Testing Claims In The Slideshow Was To Prove That BOM Provides Inflation Adjusted Income And Sustained Portfolio Growth

There can be little dispute that a reasonable investor would understand that the context of Respondents' back-testing claims in the slideshow was to provide evidence that a BOM strategy provides inflation adjusted income for life and sustained portfolio growth. Indeed, in the slideshow, the 1973 "Back Tested Buckets" slide and the 1996 back-test are the last slides before the end of the slide presentation. (Govt. Ex. 1 at SEC-LA3937-000200-211.) The purpose is to validate the BOM strategy to prospective clients, so that they contact RJL. (See Trial Tr. (Lucia) 1097:5-1098:8.). To the extent that context is not clear from the slideshow itself, the webinar corroborates that the claimed back-tests are used as a tool to sell the BOM strategy and RJL's services.

Respondents, however, contend that the context of the back-tests is much more involved, and present a lengthy explanation of their view of the purpose and context of the back-testing claims as well as their view of how a "reasonable investor" would have understood the slideshow. (Resp. Br. pp. 10-16.) Respondents' explanation should be viewed with skepticism

by the Court for several reasons, including the fact that Respondents need to go far afield from the slideshow, and even from the webinar, to support their view of context and purpose.

In their Answers, Respondents each admitted that "the 'slideshow' speaks for itself." (Lucia Answer ¶¶ 17, 18, 23; RJL Answer ¶¶ 17, 18, 23.) However, in their effort to provide "context," Respondents also include extensive additions to the slideshow from the pre-recorded webinar, including a lengthy quote that does not appear in the slideshow at all. (*See* Resp. Br. pp. 10-16, p. 12.) Beyond the slides and the webinar, Respondents cite to the testimony of the investors who testified for the Division that they found the slideshow misleading – Messrs. Desipio and Chisholm. (*Id.* at pp. 14-15.) However, Respondents later dismiss the testimony of these investors on the grounds that they "demonstrated significant credibility issues." (*Id.* at p. 52.)

Respondents find more "context" in the testimony of Commission examiner Bennett (*id.* at pp. 10, 14) – whom they castigate for not having seen a seminar (*id.* at pp. 1, 21 n. 26, 29), and then in the Commission's internal 2010 examination report, which is not part of any seminar, webinar, or other presentation to investors. (*Id.* at pp. 13, 14.) Respondents cite the OIP in their arguments to add context. (*Id.* at pp. 13-14.) Respondents also use their expert, Hekman, who never attended a seminar, for yet more "context." (*Id.* at pp. 13, 14.) Respondents find context in the report of the Division's expert economist, Grenadier, who opined that their back-testing claims were materially misleading. (*Id.* at p. 14 n. 20.) Finally, Respondents suggest that the context of the seminars is revealed by reference to articles that were not shown to seminar attendees. (*Id.* at p. 11 n. 16 (citing Govt. Ex. 80) and Resp. Ex. 37 (although not by exhibit number).) The Court should reject Respondents' strained efforts to explain away their false and misleading statements by references to information far beyond the slideshow, which Respondents admitted "speaks for itself."

The Division will not take the Court's time with another run through the slideshow. The Division notes briefly that to make their context argument, Respondents relegate the bulk of the slideshow to a footnote. (Resp. Br. pp. 10-16 and p. 11 n. 15.) These are slides where

Respondents first provide a brief cautionary slide, [12] identify and explain various investment risks, and explain why everyone else gets it wrong. After debunking all the places a prospective client might look for information and guidance, Respondents launch into the BOM strategy: "How We Do Retirement, 'Aim to Retire in Comfort & Safety.'" (Govt. Ex. 1 at SEC-LA3937-00146.)

The first thing mentioned are REITs. Respondents explain the "Conservative Campbells," the "High Rolling Hendersons," and the "Balanced Buttafuccos," and how each of these investors may go "bankrupt" in retirement. Respondents present a summary of these strategies, which includes the statement that while the "Balanced "Buttafuccos" have "A better more 'balanced' approach, but when back tested* to 1973-74 even this approach fails." (Govt. Ex. 1 at SEC-LA3937-00170 (asterisk in original).) The asterisk is to a disclaimer that states: "Past performance is not a guarantee of future results. An investors [sic] results may vary." (*Id.*) This is the type of disclaimer required for performance advertising.

The slideshow then explains in detail "the Potential Solution, Buckets of Money, a hypothetical Illustration" that shows how the Bold Bucketeers should allocate their assets to three buckets to get inflation adjusted income for life and sustained portfolio growth. The explanation of the BOM strategy concludes with a slide titled "Buckets Overview," which summarizes a "$1,000,000 Investment Portfolio." (*Id.* at -00198.)

Respondents then ask: "But Can Buckets Stand Up To The Test Of The '73/'74 Grizzly Bear?" (*Id.* at -00199.) This introduces Respondents' two claimed back-tests, from 1973, and then from 1966. The slideshow then ends.[13]

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[12] In the webinar, Lucia generally talks over the slide "A Word From Our Legal Folks," and does not specifically review the disclaimers with the audience. It is unclear whether Lucia was similarly dismissive of these warnings at the hundreds of seminars he gave across the country, although Respondents' view would suggest that he was.

[13] Respondents admitted that they do not have any documentation to support the calculation that appears on the 1973"Back Tested Buckets" slide, there were several numerical errors, and the disclosure on the bottom was incorrect. (Trial Tr. (Lucia) 1078:1-1081:25.) Respondents have

### C. Respondents Made Materially False And Misleading Statements And Omissions In The Slideshow

#### 1. Respondents Are Incorrect That *Goble* Precludes This Action Brought Pursuant To Section 206 Of The Advisers Act

Respondents contend that a recent decision in *SEC v. Goble*, 682 F.3d 934 (11th Cir. 2012), conclusively establishes that information relating to an investor's choice of a broker-dealer is immaterial. (Resp. Br. pp. 35-37.) *Goble* is distinguishable on several grounds. *Goble* involved an action under Section 10(b) of the Exchange Act, and not an action under Section 206 of the Advisers Act. Unlike investment advisers who have a fiduciary duty to clients and prospective clients, the *Goble* court did not consider whether broker-dealers had a fiduciary duty and how that might have altered its analysis.

In addition, *Goble* involved a sham transaction that was only recorded on an internal record, and not, as here, affirmative public statements by Respondents concerning the performance of the BOM strategy. In *Goble*, the Eleventh Circuit held only that "a misrepresentation that would only influence an individual's choice of broker-dealers cannot form the basis for § 10(b) fraud liability." *Goble*, 682 F.3d at 944. Moreover, in *Goble*, the Eleventh Circuit noted that it was adopting a more limited statement of materiality than it had used in prior decisions such as *SEC v. Morgan Keegan & Co*, 678 F.3d 1233 (11th Cir. 2012). *See Goble*, 682 F.3d at 944 n. 5. Indeed, in reaching its result, *Goble* disregarded half of the standard for materiality in the Ninth Circuit, which tracks the Supreme Court's "total mix" language from *Basic v. Levinson*. *See Goble* at 943-44 (quoting half the definition of materiality stated by the Ninth Circuit in *SEC v. Pirate Investor LLC*, 580 F.3d at 240.) In any event, *Goble* did not decide whether a misrepresentation or omission was actionable under Section 206 and its limited statement of materiality should not be applied to this action.

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not pointed to any part of the 1973 "Back Tested Buckets" slide as accurate or correct. Nonetheless, Respondents vigorously defend the 1973 "Back Tested Buckets" slide – or "'73 Illustration," and argue that it is not misleading in any way.

Cases brought under the Advisers Act, as well as Commission releases, establish that materiality under the Advisers Act does not require an investment decision, *e.g.*, the purchase or sale of a security, as *Goble* required under Section 10(b) of the Exchange Act. For example, in *Matter of Valicenti*, a case brought under the Advisers Act, the Court stated: "The standard of materiality is whether or not a reasonable client or prospective client would have considered the information important in deciding whether or not to invest with VAS and Mr. Valicenti." *Matter of Valicenti*, 1997 WL 362000 at *15 (citations omitted.) Courts have recognized that unlike the antifraud provisions of the Securities Act and the Exchange Act, Section 206 does not require the activity be "in the offer or sale of any" security or "in connection with the purchase or sale of any security." *SEC v. K.W. Brown and Co.*, 555 F. Supp. 2d 1275, 1308 (S.D. Fla. 2007) (*citing* Advisers Act Release No. 1092, 6 Fed. Sec. L. Rep. (CCH) ¶ 56,156E, at 44,057-7 to 44,058 (Oct. 8, 1987)). *See also SEC v. Lauer*, 2008 WL 4372896, at *24 (S.D. Fla. Sept. 24, 2008) (same). This is because "the Commission has applied Sections 206(1) and (2) in circumstances in which the fraudulent conduct arose out of the investment advisory relationship between an investment adviser and its clients, even though the conduct does not involve a securities transaction." Advisers Act Release No. 1092, 6 Fed. Sec. L Rep. (CCH) ¶ 56,156E, at 44,080 to 44,081 (Oct. 8, 1987).

Thus, Respondents' reliance on *Goble* is misplaced and it does not apply to Section 206 of the Advisers Act, which does not have the "in connection with" requirement found in Section 10(b) of the Exchange Act.

### 2. Respondents Admittedly Made Materially False Statements That They Back-Tested The BOM Strategy

Other than incorrectly arguing that *Goble* precludes any finding of materiality, Respondents offer little to refute that their back-testing claims were materially misleading. (*See* Resp. Br. pp. 35-37.) The legal standard for materiality is well-recognized. Information is deemed material if there is a substantial likelihood that the misrepresented or omitted facts would have assumed actual significance in the deliberations of a reasonable investor. *See Basic Inc. v.*

*Levinson*, 485 U.S. 224, 231–32 (1988); *see also TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448–49 (1976). An omission is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Levinson*, 485 U.S. at 231–32; *SEC v. DiBella*, 587 F.3d 553, 564 (2d Cir. 2009); *SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992); *SEC v. Pirate Investor LLC*, 580 F.3d 233, 240-41 (9th Cir. 2009). Moreover, not '"every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow.'" *SEC v. True North*, 2012 WL 5471063, at *24 (D. Minn. Nov. 9, 2012) (*quoting Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1097 (1991).) The fact that the allegedly misleading statements are accompanied by true statements does not render them immaterial. *Id.*

Under this standard, there is little question that a reasonable investor would have been misled by Respondents' errors and omissions. Respondents admittedly did not have any basis for their claims that they had "back-tested" the BOM strategy to 1966 and 1973. After re-defining their claimed back-tests as "Illustrations," Respondents admit that they were not back-tests. (Resp. Br. pp. 31-35.) Moreover, the false back-tests were presented as proof of how the BOM strategy would have performed from 1966 and 1973, through particularly difficult market conditions. Performance claims are clearly material. *See, e.g., Matter of Valicenti*, 1997 WL 362000, at *15. Respondents admit that they had no factual basis to claim that they had back-tested the BOM strategy, did not back-test the BOM strategy, admit that the 1973 "Back Tested Buckets" slide contains numerous errors and misstatements, and were not able to explain how they arrived at the numbers on that 1973 "Back Tested Buckets" slide.

Respondents, however, suggest that there is a "disconnect" between the definition of "back-test" used by the compliance departments of RJL, First Allied Securities, and Securities America, and the definition in the OIP. (*See, e.g.*, Resp. Br. at pp. 31-32.) The facts do not support that contention. RJL's Chief Compliance Officer testified that she agreed with the

definition of back-test stated in the OIP. (Trial Tr. (Ochs) 574:20-575:21.) Because Ochs was employed by Securities America in the early 2000s, her testimony directly contradicts Respondents' argument. Respondents did not call any witnesses from either First Allied or Securities America, and did not introduce any evidence to support this argument other than the self-serving testimony of Respondents and their long-time employees.

Moreover, Respondents incorrectly rely on a statement made by Plum to the Commission's examination staff in 2010 that the claimed back-tests were supposed to be a "forward-looking exercise." (Resp. Br. p. 33.) Statements by Plum to the examination staff are irrelevant to Respondents' false back-testing claims. In fact, the "context" of Plum's explanations is in response to the findings of the examination staff that Respondents did not have documentation to support their back-tests, and that using actual inflation rates causes a material change in the calculations of Respondents' 1966 and 1973 claimed back-tests. In any event, it is nonsensical to suggest that purporting to provide the results of a test of a strategy over a historical period using historical data is somehow forward-looking or prospective.

In addition to falsely claiming they had back-tested, Respondents' performance claims were also materially misleading because the difference between Respondents' reported performance results for the BOM strategy using their assumed 3% inflation rate, and the actual inflation rate, are material. In fact, the differences are so significant that Respondents do not try to defend their spreadsheets, but instead urge the Court to disregard the basis for their back-testing claims. For the 1973 back-test, rather than having inflation adjusted income from 1973 to 1994 and a portfolio valued at $1,544,789 in 1994 (Govt. Ex. 1), using actual inflation results in the BOM portfolio going to zero in 1989. (Govt. Ex. 70 (Grenadier Report) Ex. 2b.) For the 1966 back-test, rather than having inflation adjusted income from 1966 through 2003 and a portfolio valued at $4,719,741 (Govt. Ex. 1), using actual inflation results in the BOM portfolio going to zero in 1986. (Govt. Ex. 70 (Grenadier Report) Ex. 2b.)

There is a material difference between the results presented by Respondents, and the results that Respondents admittedly knew would happen if they used actual inflation.

Respondents' failure to disclose the material impact of their assumed inflation rate was an omission of material information that was needed to make the information disclosed not misleading. There should be no dispute that claiming that a strategy will provide income and wealth, when one knows it will not, is a material misstatement of fact under the Advisers Act.

### 3. Respondents Omitted Material Information About Their Inflation Rate Adjustment

Respondents claim that the "Division" has changed its position concerning the inflation rate over the past two years by comparing the deficiency letter from the examination staff with the OIP. (Resp. Br. pp. 38-39.) The examination staff is not part of the Division, but is a separate office of the Commission. The examination staff's letter stated that they substituted "actual inflation rates for the 3% assumed inflation rate." (Resp. Ex. 6 at p. 4 (SEC-LA3937-03646).) The examination staff explained also that the actual average inflation rate over the period of Respondents' purported back-tests was 4.8%, which was substantially higher than Respondents' assumed average rate of 3%. (*Id.*) The Division alleged in the OIP that Respondents should have used actual inflation rates, and presented expert testimony supporting that contention. (Govt. Ex. 70 (Grenadier Report).) There has not been any change in position by the Commission's staff.

Respondents point to Lucia's statements in the webinar where he uses the word "pretend" to disclose an inflation rate of 3% for the 1966 purported back-test, and then stated: "We know it was more, but we wouldn't have known that at the time." (Resp. Br. p. 33.) There is no such disclosure concerning the inflation rate used for the 1973 "Back Tested Buckets" slide either in the slideshow or the webinar. Moreover, a statement concerning a projection, belief, or opinion is a factual misstatement if "the speaker is aware of undisclosed facts tending to seriously undermine the statement's accuracy." *SEC v. Currency Trading Int'l, Inc.*, 2004 WL 2753128, at *7 (C.D. Cal. Feb. 2, 2004) (*citing Kaplan v. Rose*, 49 F.3d 1363, 1375 (9th Cir. 1994)). As the Ninth Circuit has recognized, "[s]ome statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors." *SEC v.*

*Currency Trading*, 2004 WL 2753128, at *7 (citations omitted). Thus, the disclosure "required by the federal securities laws is measured not by the literal truth, but by the ability of the material to accurately inform rather than mislead" investors. *Id.* (citations omitted). *See also SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1106-07 (9th Cir. 1977) (finding advertisements "deceptive and misleading in their overall effect even though when narrowly read, no single statement of material fact was false.")

Lucia admitted that he knew that higher inflation rates would have made the results of his purported back-tests look much worse (Trial Tr. (Lucia) 1202:18-1203:9), and Plum testified that Respondents knew that using actual inflation would result in the 1966 and 1973 purported back-tests of the BOM strategy having a zero balance long before the end of the test period. (Trial Tr. (Plum) 863:4-869:17.) Respondents admitted this to the examination staff in 2010. (Trial Tr. (Bennett) 91:8-22; Resp. Ex. 6 (2010 deficiency letter) at SEC-LA3937-03646-647 ("Second, RJL's personnel stated that all of the portfolios, including the Buckets of Money portfolios, would have gone broke if actual inflation rates had been used but that the purpose of the presentations was to show that the Buckets of Money portfolio would have lasted longer than the non-Buckets of Money portfolios.")

Respondents argue that using a 3% assumed inflation rate is not misleading because using a 3% inflation rate for "retirement planning calculations is universally recognized." (Resp. Br. pp. 40-41.) Respondents rely on the conclusion stated on page 14 of Hekman's report that that "use of an assumed 3% inflation rate in hypothetical illustrations of investment strategies, including a systematic withdrawal approach during the periods 1966 to 2003 and 1973 to 2003, was reasonable." (Resp. Ex. 35 at p. 14.)[14] Respondents' expert testified that the examples he gave in his report, which are the bases for his conclusion, involved retirement planning in the future. (Trial Tr. (Hekman) 1445:18-1448:15.) Hekman did not provide any examples where an

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[14] While Respondents claim that the Division's expert concurred (*id.*), they cite instead to testimony of Plum and Lucia, and not to testimony from the Division's expert.

assumed 3% hypothetical inflation rate was used in a back-test. (*Id.* 1448:16-19.) Hekman admitted that he was not aware of any instances where a simulation of historical performance of a retirement strategy used a 3% hypothetical inflation rate. (*Id.* 1450:11-15.) Thus, Hekman's testimony at trial impeaches his opinion that Respondents' use of a 3% inflation rate in their back-tests was reasonable.

Respondents also argue that CPI-U is overstated. (Resp. Br. pp. 41-42.) The simple fact is Plum admitted he could have easily downloaded historical inflation data when he prepared the 1966 spreadsheets, but he chose to assume a 3% inflation rate. (Trial Tr. (Plum) 812:1-7.) Respondents' expert, Hekman, testified that in his experience, it was typical to use historical CPI in back-tests. (Trial Tr. (Hekman) 1463:8-17.) Respondents' arguments about CPI are an after-the-fact attempt to justify their conduct, and should be rejected.

Similarly, Respondents cite to Hekman's calculation using their 1966 spreadsheet in which he reduces CPI-U by 1.2% for bias and another 2%. (Resp. Br. p. 41.) Respondents omit that after making such a reduction in the inflation rate, Hekman calculated that the BOM portfolio would have a value of $6,628,626 in 2003. – almost $2 million more than Respondents' calculation using an assumed 3% inflation rate. (Resp. Ex. 35 at pp. 13-14, Appendix 11 ("Buckets Strategy" calculation).) Hekman agreed that his adjustment of CPI was sometimes referred to as the "CPI minus X approach to indexation," (Trial Tr. (Hekman) 1452:14-24), and to his knowledge, no one used "CPI minus X" in back-tests or for any other reason. (*Id.* 1455:3-24, 1458:6-10, 1458:11-1459:1.) Hekman admitted that he is the only person with expertise in the field of finance and economics who was using an adjusted CPI-U.[15]

Significantly, Respondents' expert, Hekman, testified that he was aware that experts in the field of finance and economics use CPI in back-tests, and to his knowledge, they used

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[15] Respondents refer to the "highly regarded" Boskin report, although Hekman testified that literature in the field of finance and economics criticized the Boskin report. (Trial Tr. (Hekman) 1453:5-10.)

reported CPI (Trial Tr. (Hekman) 1463:8-17), in other words, the historical measure of CPI that the Division alleges Respondent should have used, and that when used by the Division's expert on their spreadsheets, results in both the 1966 and 1973 portfolios going to a value of zero long before 2003 or 1994, respectively.

Finally, Respondents' criticism that the Division asked its expert to replicate Respondents' spreadsheets and calculations using CPI-E, which is the reported inflation rate for the elderly, misses the mark. (Resp. Br. p. 42.) The Division's expert, Grenadier, only used that rate to respond to Respondents' contentions. In their responses to the examination report, Respondents asserted that the elderly experience a lower inflation rate (*see* Resp. Exs. 7, 8, 10), and also make this argument in their brief. (Resp. Br. pp. 42-43.) To test Respondents' argument, Grenadier used CPI-E, the experimental inflation rate for the elderly, and found that even using CPI-E resulted in the 1966 and 1973 back-tests of the BOM portfolio model running out of funds and going to zero before the end of the test periods. (Govt. Ex. 70 (Grenadier Report) Exs. 3a, 3b.)

#### 4. Respondents' Use Of An Assumed REIT Investment Was Materially Misleading

Respondents contend that by disclosing the "assumptions" about REITs to seminar attendees, they could not have misled seminar attendees about REITs.[16] (Resp. Br. pp. 43-46.) Respondents claim that the so-called "1966 Illustrations" were solely to show the effect of taking money from safe income first. (*Id.* p. 43.) In fact, Respondents' assumptions about REITs materially inflated the results of their BOM portfolio with REITs, and provided materially misleading information about the benefits of REIT investments to clients and prospective clients.

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[16] Respondents' argument ignores that some statements that are literally accurate can become, through their context and manner of presentation, devices which mislead investors. *See, e.g., SEC v. Gabelli*, 653 F.3d at 57. Respondents' argument also ignores that not every mixture of the true will neutralize the deceptive. *See, e.g., SEC v. True North*, 2012 WL 5471063, at *25.

While Respondents defend their use of an assumed REIT rate of return in an "illustration," Respondents' told seminar attendees it was a back-test. Respondents' real estate expert testified that he would not use a hypothetical 7% return for REITs in a back-test. (Trial Tr. (Gannon) 1387:6-12.) Respondents' real estate expert testified that he would use actual data in a back-test. (*Id.* 1387:13-15.) Thus, Respondents' expert does not support Respondents' use of a hypothetical REIT rate of return in what they, at the time, told investors was a back-test.

Respondents' use of an assumed REIT rate of return materially changed the results of their test, and they failed to disclose that information. The Division's expert calculated Respondents' 1966 performance numbers using historical REIT rates of return and found that the value of the "BOM Portfolio with REIT" in 2003 decreased from the $4,719,741 that Respondents stated in their slideshow, to a value of $1,297,771 when only correcting for historical REIT data. (Govt. Ex. 70 (Grenadier Report) ¶¶ & Exs. 5a, 5b, 5c.) Thus, Respondents' assumed REIT rate of return increased their claimed results by about $3.5 million – or almost three times.

The $3.5 million impact that Respondents' assumed REIT rate of return has on their "1966 Illustrations" rebuts any credibility that the "purpose" was to show the effect of taking safe income first. In fact, in the slideshow, Respondents purport to compare a "BOM Portfolio without REIT" to a "BOM Portfolio with REIT." The only difference between these two "BOM Portfolios" is the REIT investment at an assumed rate of return. Respondents claimed that "BOM Portfolio" without REIT had a value of $1.2 million, but "BOM Portfolio with REIT" had a value of $4,719,741 at a comparable time in 2003. (Govt. Ex. 1 at SEC-LA3937-00208.) However, the Division's expert showed that when actual historical REIT returns are put into Respondents' model, then the "BOM Portfolio with REIT" has a value of only $1,297,771 – virtually identical to the $1.2 million value reported for the "BOM Portfolio without REIT."

The "big difference" was not produced by a change in where the income came from, but rather only by Respondents' use of an assumed REIT rate of return. Moreover, Respondents present themselves as knowledgeable and experienced in matters of finance. Respondents knew,

or were extremely reckless in not knowing, the material and dramatic effect that their assumed REIT rate of return had on their claimed back-test results. In addition, Respondents should know that the Court will understand that the only difference between the 1966 "BOM Portfolio without REIT" and the 1966 "BOM Portfolio with REIT" was the REIT. Respondents were not comparing how the source of income changes results; in fact, Respondents were promoting and selling non-traded REITs to people who attended BOM seminars and then became RJL clients, and Respondents generated substantial commissions from doing so.

The remainder of Respondents' arguments about their assumed REIT rate of return lack any merit. Respondents claim that the slideshow clearly discloses that their performance calculations "utilize[s] the 'FTSE NAREIT Equity REIT Index" and "specifically references equity REITs and the NAREIT Equity Index." (Resp. Br. pp. 44-45; Resp. Ex. 3 at SEC-LA3937-00149.) This contention is simply not credible. Respondents admit they used an assumed rate of return. This disclosure appears on a slide titled "Diversify to Reduce Risk or Increase Return," is in very small print, and appears 50 pages before the 1973 "Back Tested Buckets" slide. Indeed, because Respondents did not produce the webinar slides, it is unclear whether this disclosure appeared in the webinar or was legible.

There is no disclosure of the assumed REIT rate of return on the 1973 "Back Tested Buckets" slide, which appears 51 pages later in the slideshow. For the 1966 back-tests, Respondents only disclose that they assumed a 7% REIT rate of return. In fact, Respondents did not include a disclosure on the slide about the basis for that assumption. However, as shown by correspondence between RJL and Securities America in 2003, Respondents were on notice that such disclosures were required. (Resp. Ex. 20 at p. 15.) Indeed, Respondents' failure to include disclosures in the 2010 slideshow, that Respondents were informed in 2003 were required, also shows a high level of scienter, and that Respondents' argument about compliance review lacks any merit.

Respondents do not address the Division's evidence that they failed to disclose that they assumed REITs were perfectly liquid and risk-free, or that REITs were generally not available

from 1966 to 1971. Respondents' real estate expert confirmed the Division's allegation that REITs were generally not available from 1966 to 1971. (Trial Tr. (Gannon) 1378:22-1379:12.) Gannon also confirmed that non-traded REITs are "generally considered illiquid securities." (*Id.* 1379:13-1380:2.) Moreover, Gannon confirmed that historical NAREIT index information on REITs was readily available from 1972 onward, and could be accessed readily from Bloomberg. (Id. 1380:3-10.) Using data readily available on Bloomberg, one could easily calculate annual returns for REITs from 1972; in fact, Respondents' expert included that calculation in his report. (*Id.* 1380:11-14.) Respondents attempt to support their assumed REIT rate of return by relying on a model that Gannon created solely for this litigation, but there is no evidence that Respondents used any such model to derive their assumed REIT rate of return. This after-the-fact effort to support their conduct should be rejected.[17]

Respondents argue that in the webinar Lucia stated that Respondents "focus a lot on non-tradable direct ownership in real estate," and distinguish this from REITs. (Resp. Br. pp. 45-46.) In that regard, the webinar represents a significant departure from the slideshow and therefore is not the "best evidence" of the seminars – unless "not-tradable direct ownership in real estate" is a simile for REIT.

In short, just as with Respondents' use of an assumed rate of inflation, they disregarded readily available historical information to use an assumed REIT rate of return, and their assumption had a material impact on their claimed back-test results. For the 1966 back-test, Respondents showed that using REITs tripled a BOM portfolio's value, when all else is kept the same. This fact disproves Respondents' argument that the "purpose" of the "1966 Illustrations" was to show that "changing one factor – taking income distributions from safe money instead of

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[17] The model Gannon created does not reflect any security that was available from 1966 to 1971. Moreover, his model included thirteen assumptions and variables that could be changed. (Trial Tr. (Gannon) 1381:17-24.) Gannon testified that the first runs of the model actually generated returns of 9% or higher, but adjustments to the assumptions brought the returns down to the 7% level. (*Id.* 1384:6-23.)

volatile money – makes a big difference." (Resp. Br. p. 43.) As shown, the big difference was the addition of a REIT that used an assumed rate of return – and Respondents' assumption made a $3.5 million difference in the results they showed.

### 5. Respondents Knowingly Failed To Disclose The Impact Of Fees

Respondents argue that because they were presenting a "withdrawal strategy" and not making any "allocations," deducting a fee would have been "impossible." (Resp. Br. p. 47.) However, the Division's expert testified that it was relatively easy to account for a reasonable fee using Respondents' spreadsheets. (Govt. Ex. 70 (Grenadier Report) ¶¶ 27, 28 & Exs. 6a, 6b; Trial Tr. (Grenadier) 931:22-25.)

Respondents also refer to the slideshow to argue that the slideshow included a disclosure about fees. (Resp. Br. p. 48.) In fact, Respondents refer to the second slide of the slideshow, which includes a general disclosure that there may be fees and expenses involved in investing in mutual funds. (Resp. Ex. 3 at SEC-LA3937-00093.) This is not the same as a disclosure that fees and expenses were not included in the specific illustrations, and more importantly, that if fees had been included, performance values would be lower.

In addition, Respondents ignore that in 2003, Securities America informed Respondents that they were required to disclose whether fees and expenses were included in an "illustration," and the effect of such fees. Specifically, Respondents were told to disclose: "Fees and expenses have not been included in this illustration. If included, performance values would be lower." (Resp. Ex. 20 at p. 15.) No such disclosure appears in the 2010 slideshow. (Govt. Ex. 1.) Moreover, this fact is additional evidence that controverts Respondents' claimed reliance on compliance review.

Respondents also point to an American Funds advertisement as evidence of a purported industry standard. (Resp. Br. pp. 47-48 and Resp. Ex. 46.) However, that same advertisement includes "past results for Class A shares," and in that chart American Funds discloses that results "reflect deduction of maximum sales charge (5.75%)." (Resp. Ex. 46.)

### 6. Respondents' Failure To Disclose That They Did Not Reallocate Was Misleading

Respondents argue that their failure to re-allocate was not raised during the 2003 or 2010 examinations, and claim that it could have "been easily resolved" if it had been. (Resp. Br. pp. 49-50.) During the 2003 examination, Respondents represented that they were not engaging in performance advertising, and there is no evidence that Respondents showed the 1973 spreadsheet (Govt. Ex. 13) to the examination staff in 2003. Respondents are wrong about the 2010 examination, because the failure to follow the BOM strategy was expressly stated as a deficiency in the 2010 deficiency letter. (Resp. Ex. 6 at SEC-LA3937-03648.) Moreover, Respondents rejected the substance of the deficiencies raised in the 2010 deficiency letter – including deficiencies that were raised in the 2003 deficiency letter and which Respondents promised, in 2003, they would correct. (*See, e.g.*, Resp. Exs. 7, 8, 10.)

Respondents argue that the "context" of the presentations renders immaterial their failure to follow the BOM strategy in their 1966 and 1973 claimed back-tests. (Resp. Br. p. 50.) However, the context was that Respondents presented the 1966 and 1973 performance results as results of a test of the BOM strategy. Respondents call them "BOM Portfolios" in the slideshow. (Govt. Ex. 1.) The fact that Respondents did not follow their claimed model is material. *See, e.g.*, *In the Matter of William J. Ferry*, Release No. 1747, 1998 WL 487681 (1998) (failure to disclose that not following advertised model violated Section 206).

Respondents also argue that the "purpose" of the 1973 "Back Tested Buckets" slide was "to compare the BOM withdrawal strategy to the prior PowerPoint illustrations showing the effect of the '73 bear market…." (Resp. Br. p. 51.) Respondents then make the same argument for the 1966 slides. (Id. pp. 51-52.) If the purpose was to compare the BOM strategy, then Respondents' model should have followed the BOM strategy. Indeed, the slide showing the summary of the purported 1966 back-test specifically identifies the "BOM Portfolio" allocated "(40% stocks, 20% REITs, 40% bonds)." (Govt. Ex. 1 at SEC-LA3937-00211.) In fact, as shown by Respondents' spreadsheets (Govt. Exs. 12 & 13), and the Division's expert (Govt. Ex.

70 (Grenadier Report) Exs. 7a, 7b), Respondents did not follow a BOM strategy, but rather were the "High Rolling Hendersons" – 100% invested in the stock market and violating Lucia's rule that one should never draw directly from "Bucket No. 3" because of the risk of a bear market.[18]

### D. Respondents' Arguments Regarding Scienter Lack Merit

The Division presented unrebutted evidence that Respondents acted with a high level of scienter. (Div. Br. pp. 35-39.) To the extent that Respondents' arguments about the "purpose" or the "context" of the slideshow are intended to rebut scienter, as shown above those arguments actually provide additional evidence of scienter. Respondents' arguments highlight how Respondents manipulated the results of their claimed 1966 and 1973 back-tests not to educate, but to provide materially false and misleading information about the benefits of REIT investments and to generate fees and commissions for RJL and Lucia.

#### 1. Lack Of Investor Complaints Is Not Evidence Of Respondents' Scienter

Respondents argue that a lack of investor complaints is evidence of their lack of scienter. (Resp. Br. pp. 52-54.) Respondents presented no legal authority for this argument.

##### a. Investor Complaints Are Irrelevant To Scienter

The Division presented evidence from two individuals who testified that they attended BOM seminars, and each witness testified that they found the seminars misleading. (*See* Trial Tr. (Chisholm) 333:21-385:24; Trial Tr. (Desipio) 245:12-291:8.) Respondents urge the Court to reject this testimony as not credible. These investor witnesses were subject to quite vigorous

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[18] Lucia repeatedly cautioned individuals against concentrating their portfolio 100% in stocks. (*See, e.g.*, Govt. Ex. 35 at RJL-SEC-0000195; (Trial Tr. (Ochs) 535.2-6.) Lucia cautioned that "[i]f you don't rebalance, eventually you'll own almost all stocks and will have abandoned the concept of diversification." (Govt. Ex. 67 at SEC-LA3937-04352.) Lucia also stated his "rule" that "[y]ou don't ever want an *empty* Bucket No. 2. You never want to go directly from growth (Bucket No. 3) to income (Bucket No. 1) because no one knows when the next bear market will occur." (*Id.* at SEC-LA3937-04374 (emphasis in original).)

and, at times, aggressive cross-examination. The Division submits that the Court had the opportunity to judge the credibility of these witnesses and their recollections of the Respondents' seminars. The Division's investor witnesses presented competent and credible evidence that a reasonable investor could be, and was, misled by Respondents' presentations, and that a reasonable investor could, and did, find material Respondents' failure to disclose the effect of the inflation assumption, failure to disclose the REIT assumptions, failure to disclose the effect of fees, and failure to follow the BOM strategy.

However, investor complaints do not establish that Respondents did not have a high level of scienter. The Supreme Court recognized that it would "defeat the manifest purpose" of the Advisers Act "to require proof of intent to injure and actual injury of clients." *Capital Gains Research*, 375 U.S at 195. The Division is not required to prove that any investor actually relied on the misrepresentations or that the misrepresentations caused any investor to lose money. *See SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985); *SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1105 (9th Cir. 1977). In *SEC v. Gruss*, the court addressed at length that the focus of the Advisers Act is on the investment adviser and not the client, and concluded that the Division does not have to prove damages or injury to an advisory client in order to establish a violation of Section 206. *See Gruss*, 859 F. Supp. 2d at 669-670 (citing numerous cases). Therefore, Respondents' arguments about a lack of investor complaints are legally insufficient as any evidence relating to Respondents' scienter.

**b. Respondents' Claims About Reasonable Investors Lack Merit**

Throughout their brief, Respondents purport to cite to evidence about how a reasonable investor would have understood the purpose of their claimed back-testing. (Resp. Br. at pp. 2, 4, 16-17, 34, 41 (Hekman), 46.) However, Respondents chose not to call any investor witnesses, and the only evidence in the record in this regard are self-serving statements by Respondents' long-time employees and "expert" testimony from Respondents' economics expert, Hekman. Respondents' self-serving testimony should be given little or no weight. Moreover,

Respondents' arguments are contradicted by the testimony of two investors who attended the BOM seminar and testified that they considered material the omissions concerning the effect of inflation, the REITs, fees, and the failure to reallocate. (*See generally* Trial Tr. (Chisholm) 333:21-385:24; Trial Tr. (Desipio) 245:12-291:8.)

The opinion of Respondents' expert, Hekman, should be given no weight concerning a reasonable investor's understanding of the meaning or purpose of the seminar slideshow or Respondents' admittedly false back-testing claims. Hekman admitted that he was not relying on anything in his field of finance and economics for opinions he expressed about what a reasonable investor would have understood about the slideshow. (Trial Tr. (Hekman) 1433:15-1434:15, 1440:16-20, 1441:7-11, 1549:15-18.) Hekman did not talk to any investors about the issues in this case, or to anyone who attended a BOM seminar, and never attended a seminar. (*Id.* 1434:16-1435:15, 1439:19-1440:15, 1436:14-25.) Hekman admitted that his opinion on this topic was based on his "feeling" for these types of things. (*Id.* 1547:21-1548:20) Other than in this case, Hekman had never offered an opinion on what a reasonable investor would understand was the purpose of a seminar presentation about a potential investment strategy. (*Id.* 1440:21-1441:2.) Hekman's opinion about what a reasonable investor would have understood about the slideshow or the webinar is based on nothing more than a feeling, is not relevant or admissible opinion testimony, and should be given no weight.[19]

**2. Respondents' Arguments Concerning "Multiple Levels of Compliance Review" Do Not Negate A Finding Of Scienter**

Respondents argue that the testimony of RJL's employees that the seminar slideshow was reviewed by RJL's supervising broker-dealer "for FINRA advertising compliance purposes"

[19] *See, e.g., Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 592 (1993); *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 149 (1999); *Levin v. Dalva Brothers, Inc.*, 459 F.3d 68 (1st Cir. 2006) (recognizing limits on expert testimony). *See also U.S. v. Sayre*, 434 Fed. Appx. 622, 2011 WL 1990589 (9th Cir. 2011) (affirming exclusion of expert testimony about what sorts of information a "reasonable investor" relies upon based on "experience as a teacher and as someone working in this field," and who had not relied on any empirical data or methodology).

negates any finding of scienter. (Resp. Br. pp. 54-55.) However, Respondents did not present any evidence from any current employees of Securities America or First Allied concerning any such compliance reviews. In addition, Respondents also failed to produce any documents showing that they had submitted the seminar slideshow to supervising brokers since at least 2003. (*See* Resp. Ex. 20.) Moreover, the correspondence from 2003 shows that the compliance department required disclosures in 2003, but those required disclosures do not appear in the 2010 slides. For example, there is no disclosure about the effect of fees on "illustrations," or the basis for a REIT rate of return. (Resp. Ex. 20 at p. 15.) Indeed, Respondents may have deleted the disclosure about "illustrations" by 2010 because they were presenting "back-tests," and not "illustrations."

Respondents' Chief Compliance Officer testified that they did not have any procedure in place to review whether there were numerical errors in the seminar slideshow presentations. (Trial Tr. (Ochs) 668:5-9.) Moreover, the Division showed at trial several instances where the webinar slideshow did not include disclosures on slides, even though disclosures appeared on the slideshow provided to the examination staff in 2010. (*See, e.g.*, Govt. Ex. 1 and Trial Tr. (Lucia) 1308:9-1315:14.) Respondents did not produce to the Division or introduce into evidence a copy of the slideshow used at the webinar – most likely because that would make it easier for the Court to identify the missing disclaimers from the webinar slideshow as well as the many differences in the two slideshows.

Respondents also cite no legal authority for the proposition that review of a document by a compliance official negates scienter. Particularly in view of an investment adviser's fiduciary duty under the Advisers Act, that duty would be rendered meaningless if an investment adviser could foist its fiduciary duty off to unidentified persons affiliated with third parties with a vague claim of compliance review.

### 3. Respondents' Claims About The 2003 Examination Do Not Negate Scienter

Respondents place a great deal of weight on a statement in the 2003 examination report (which was not provided to Respondents until after the OIP was instituted in 2012) that Respondents were not engaged in performance advertising. (*See, e.g.*, Resp. Br. pp. 18-20, 56.) Respondents ignore the fact that when asked to produce performance advertising at the outset of the 2003 examination, Respondents informed the examination staff that the request was "not applicable." (See Resp. Ex. 15 at p. 11 of exhibit, requests I.7; Resp. Ex. 16 at p. 1.) The examination staff believed Respondents' statement that they were not engaged in performance advertising.

Respondents' argument that the decision in *SEC v. Slocum*, 334 F. Supp. 2d 144 (D.R.I. 2004), defeats any finding of scienter is flawed. (Resp. Br. pp. 56-57.) Respondents rely on a portion of the *Slocum* decision addressing a claim under Section 207 of the Advisers Act, a technical violation of a provision that requires a showing of willfulness. *Id.* at 180-181. A finding of scienter does not require willfulness, and a showing of recklessness may satisfy the scienter requirement. *See, e.g., SEC v. True North*, 2012 WL 5471063, at *21. Thus, *Slocum* does not automatically negate a finding of scienter for a violation of Section 206(1), and because Sections 206(2) and 206(4) do not require scienter, *Slocum* does not defeat those claims.

Respondents contend that the facts in *Slocum* should compel a finding in their favor, but those facts are distinguishable. Respondents rely on language in *Slocum* that two previous SEC examinations did not find the claimed violation, outside independent auditors did not find the claimed violation during surprise audits, and the advisers testified that they believed they were in compliance with an SEC no-action letter. (Resp. Br. pp. 56-57.) Here, Respondents point to a single examination in 2003, and ignore that the second examination in 2010 found the violative conduct. Moreover, there is some question about Respondents' frankness during the 2003 examination where they claimed that they did not engage in performance advertising in response to the examiners' questions. Here, Respondents do not point to any surprise audits, and provided

no documentary evidence to support their claims of compliance review. Finally, here, Respondents do not contend that they are following any Commission no-action letter or other precedent. Thus, the facts in *Slocum* are markedly different, so for these reasons, too, *Slocum* does not compel a finding that Respondents did not act with scienter.

Finally, in *Slocum*, the court found that the Commission had not offered evidence that the advisers had acted willfully. Here, as discussed at length in the Division's opening brief, there is ample evidence of Respondents' scienter, such as their knowledge that the assumed inflation rate materially altered their claimed back-test results and their failure to disclose that material information. The fact that the Division has offered compelling evidence that Respondents acted with a high level of scienter also compels the conclusion that *Slocum* is not applicable.

### 4. Respondents' Industry Standard Arguments Lack Merit

Respondents argue that the 1966 and 1973 back-tests complied with "recognized industry standards" (Resp. Br. at p. 3) which they further define as "the industry standard for 'back-tests' which illustrate historical returns with hypothetical distributions and inflation rates." (*Id.* at pp. 57-59.) But Respondents' arguments about compliance with an ill-defined and unsubstantiated industry standard do not negate sicenter.

While Respondents offered testimony from two expert witnesses, Respondents did not offer any expert testimony on this so-called industry standard. *See, e.g., Levin v. Dalva Brothers, Inc.*, 459 F.3d 68, 79 (1st Cir. 2006) (expert testimony on industry standards is common). Instead, Respondents introduced into evidence advertisements from two investment companies – American Funds (Resp. Ex. 46) and Fidelity (Resp. Ex. 47), and an investment adviser, Financial Engines (Resp. Ex. 59.) In their brief, Respondents rely primarily on the American Funds advertisement as evidence of their purported industry standard. (Resp. Br. pp. 58-59.)

A cursory examination of the American Funds and Fidelity documents show that they are presenting much different forms of back-testing information – limited to percentages and with very elaborate disclosures. This is because performance advertising by investment companies

such as American Funds and Fidelity are subject to rules issued by the Commission, specifically Rule 482. The Division has not suggested that Respondents are subject to Rule 482. However, to the extent Respondents argue that advertisements by investment companies set the industry standard by which they should be judged, it is obvious that Respondents' very specific claims about performance, which include specific dollar amounts as of specific time periods, do not comply with Rule 482. It is also obvious that Respondents do not include the extensive disclosures mandated by Rule 482. Moreover, to the extent that Respondents suggest that compliance with the industry standard set by Rule 482 would negate scienter, that Rule specifically provides that the "fact that an advertisement complies with this rule does not relieve the investment company, underwriter, or dealer of any obligation with respect to the advertisement under the antifraud provisions of the federal securities laws." Rule 482(a), note to paragraph (a).

Rule 482 refers to Rule 156 for guidance on the factors to be weighed in determining whether statements, representations, illustrations, and descriptions contained in investment company advertising are misleading. *Id.* Rule 156, titled "Investment Company Sales Literature," sets forth such factors. The Division has not suggested that Respondents' conduct should be measured by Rule 156. However, to the extent Respondents claim that advertisements by investment companies set an industry standard and they complied with it, then they were certainly on notice of Rules 482 and 156, which contain very explicit guidance for performance advertising by investment companies.

Separately, Lucia testified that it was "very, very common within the financial planning industry to view a back-test totally different than the way the Division views a back-test." (Trial Tr. (Lucia) 1271:10-13.) However, Respondents' expert economist testified that Respondents' claimed back-tests were not what he would consider back-tests. (Trial Tr. (Hekman) 1541:24-1542:4.) Respondents' real estate expert testified that he would not use an assumed REIT rate of return in a back-test, but instead would use actual historical data. (Trial Tr. (Gannon) 1387:13-15.) Respondents' long-time employee Plum testified that he understood back-testing used

historical data and returns to test a strategy or model. (Trial Tr. (Plum) 838:17-23.) The Division's expert witness, Grenadier, agreed with the Division's definition of a back-test as alleged in the OIP. (Govt. Ex. 70 (Grenadier Report) at ¶¶ 3-12.) Lucia's self-serving statement is not dispositive of an industry standard, particularly in view of the evidence from Respondents' experts and employees that proved the Division's allegation that a back-test uses historical data to test a strategy or model.

Respondents offered evidence concerning another "industry standard" at trial – using a 3% assumed inflation rate for a back-test; however, the weight of the evidence did not support Respondents' claim. Plum testified the he did not get historical inflation information when doing the calculations Respondents presented as back-tests "because I felt three percent was a reasonable number." Plum described 3% as an "industry standard" and said that "we've been using three percent in the financial planning industry for many, many, many years." (Trial Tr. (Plum) 794:17-795:13.) When Plum was asked by Respondents' counsel the next day about 3% being an industry standard, Plum replied: "In an illustration standpoint. It was a very common illustration standpoint, yes." (Trial Tr. (Plum) 880:13-17.) Plum said "there is either no inflation used or a static, assumed inflation of some number. A typical number would be three percent. It's always – almost always an average, some number." (Trial Tr. (Plum) 880:18-881:1.) Thus, Plum either testified that using a 3% inflation rate in back-tests was the industry standard, or that using "some number" as an inflation rate was an industry standard.

Stripe testified that American Funds used a hypothetical 3% inflation rate which was an industry standard. (Trial Tr. (Stripe) 1572:14-22.) However, Respondents produced one document from American Funds that uses a 4% inflation rate. (Resp. Ex. 46.) Lucia Jr. – who attended the hearing as RJL's representative -- testified that a 4% inflation rate was used in the industry, and pointed to the fact that American Funds used a hypothetical 4% inflation rate over a rolling 25-year period for its back-test. (Trial Tr. (Lucia Jr.) 1629:16-23.) Respondent Lucia testified that American Funds used a presumed 4% inflation rate in its back-tests. (Trial Tr. (Lucia) 1270:8-10.)

To the extent that Respondents are suggesting that American Funds set the industry standard for the inflation rate to use in back-tests, then the evidence establishes that the inflation rate is 4%, and not 3%. Respondents therefore did not comply with this purported industry standard.[20]

To the extent Respondents claim that Resp. Exs. 46, 47, and 59 set industry standards for the inflation rate used for back-tests, then Respondents did not comply with their proposed industry standard. In the Fidelity document, Fidelity discloses in its "Methodology and information for charts" that it used a relatively complex formula to approximate actual inflation:

> Short-term investment asset class returns are based on a historical risk premium added to an inflation rate, which is calculated by subtracting the TIPS (Treasury Inflation-Protected Securities) yield from the 10-year Treasury yield. This method results in what we believe to be an appropriate estimate of the market inflation rate for the next 10 years. Each year (or as necessary), these assumptions are updated, to reflect any movement **in the actual rate of inflation.**

(Resp. Ex. 47 at p. 3 (emphasis added).) Fidelity also disclosed that that the annual returns assumed "no transaction costs, no management or servicing fees, and the rebalancing of the portfolio every year." (Resp. Ex. 47 at p. 3.) On the point of rebalancing, American Funds disclosed that in its back-tests the "portfolio [was] rebalanced annually." (Resp. Ex. 46.) Respondents admittedly did not rebalance or reallocate their purported back-tests.

Respondents cite a document issued by Financial Engines (Resp. Ex. 59) as support for their industry standard. (Resp. Br. at p. 58.) In a lengthy footnote, Respondents also criticize the Financial Engines document on several grounds unsupported by any reference to the record. (*Id.* at p. 58 n. 75.) The Financial Engines exhibit shows that actual inflation was used: "However, in real terms, the payouts decline by 17% due to higher inflation during the period." (Resp. Ex. 59 at 21.) The Financial Engines document also includes a specific caution about back-tests that

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[20] If Respondents had used a 4% inflation rate in their 1966 calculation, the BOM strategy would have gone bankrupt long before 2003. (*See, e.g.*, Govt. Ex. 77 (showing sensitivity of 1966 calculation to different inflation rates.)

Respondents never claim to have included in any of their seminars or slideshows: "As with any back-testing analysis, one must exercise caution in drawing firm conclusions from the results." (*Id.* at p. 22.)

### E. The Division Has Established That Lucia Aided And Abetted RJL's Violations Of Sections 206(1), 206(2), and 206(4) Of The Advisers Act

In their post-trial brief, Respondents argue that Lucia did not aid and abet RJL's Adviser Act violations because Lucia "did not have 'knowledge' of a securities violation." (Resp. Br. p. 61.) But that is not the standard for scienter in an administrative proceeding for aiding and abetting. To establish a claim of aiding and abetting a securities law violation in an administrative proceeding, the requirement that the respondent had "knowledge" of RJL's violation is satisfied if he had a "general awareness" of the underlying violation. *See SEC v. Grendys*, 579 F. Supp. 2d 1, 6 (D.D.C. 2008); *SEC v. Howard*, 376 F.3d 1136, 1142 (D.D.C. 2004). General awareness, in turn, can be established by showing that Lucia exhibited "extreme recklessness," which exists if an aider and abetter "encountered 'red flags' or 'suspicious events creating reasons for doubt' that should have alerted to him to the improper conduct of the primary violator." *Grendys*, 579 F. Supp. 2d at 6; *see also Howard*, 376 F.3d at 1143.

Here, the evidence established that Lucia was aware of numerous "red flags" that should have alerted to him to the improper conduct of RJL, and nothing in Respondent's post-trial brief refutes that conclusion. Indeed, in some sense, Lucia was effectively the primary violator who came up with the back-testing claims and presented them for RJL. He was the sole owner of RJL and he maintained strict control over all facets of the seminar presentations. He was solely responsible for the content of the slides, including the "Back Tested Buckets" slide. He personally presented the seminars, at which he represented that the BOM strategy had been back-tested to 1966 and 1973, and he used those back-tests to show how the BOM strategy would have performed under "historical circumstances" in order to market the BOM strategy.

Lucia made these presentations at hundreds of seminars, to thousands of attendees, over the course of at least seven years, even though he knew that using the actual historical inflation

rate, rather than an "assumed" 3% rate, would have been "damaging" to the results of the back-tests, and in fact would have resulted in the BOM portfolios going bankrupt before the end of the test periods. (Trial Tr. (Lucia) 1192:7-11.) Moreover, Lucia presented the purported results of the 1973 back-test on countless occasions even though he never examined the accuracy of the relevant slide until the eve of the commencement of the hearing in this proceeding, and purportedly did not learn until that time that there was no support for the numbers on the slide and that the disclosure about how the numbers were calculated was wrong. This evidence clearly establishes that Lucia acted with a high level of scienter, and at least recklessness, in aiding and abetting RJL's violations.

### F. RJL Violated Rule 204-2(a)(16) By Failing To Maintain Books And Records Regarding The 1966 And 1973 Back-Tests

As set forth in the Division's post-trial brief, RJL has not maintained any books or records to support the purported performance claims in the 1973 "Back Tested Buckets" slide or the "1966 Buckets of Money Portfolio" slide in its investor seminars. Its failure to do so is a clear violation of Rule 204-2(a)(16), which requires an investment adviser to maintain all books and records that are necessary to form the basis for or demonstrate the calculation of performance or rates of return of any securities recommendations in any advertisement. (*See* Div. Br. pp. 43-44.)

There is no dispute that Respondents do not have any records supporting their performance claims regarding the 1973 and 1966 back-tests.[21] In the OIP, the Division alleged

[21] The 1973 spreadsheet was originally provided to the Commission's examination staff during the 2010 examination as support for Respondents' claimed back-testing in the slideshow. After the examination staff questioned that assertion because the 1973 spreadsheet did not correspond to the 1973 "BackTested Buckets" slide, Respondents changed their story and informed the examination staff that they did not have any documentary support for the 1973 "Back Tested Buckets" slide. (Div. Br. pp. 21-23.) There is a dispute whether the 1966 spreadsheet was also supplied to the examination staff in 2010 as support for Respondents' back-testing claims. Ochs claims it was produced, while the Commission's examination staff testified that it was not produced. Contemporaneous correspondence corroborates the testimony of the examination staff. (*Id.*)

that Respondents had produced two spreadsheets to purportedly validate the slideshow's "back-testing" premise. (OIP ¶¶ B.5, B.17.) In answering paragraph B.17 of the OIP, Respondents admitted that "the 1966 and 1973 Spreadsheets, and numerous other sources, validate the slideshow's central premise – that the BOM investment strategy provides superior outcomes in relation to other investment strategies." (Lucia Answer ¶ 19; RJL Answer ¶ 19.)

Despite this, Respondents now concede that the sole spreadsheet that they produced as supposed support of the 1973 "Back Tested Buckets" slide in their seminar does not, in fact, support that back-test at all. (*See* Div. Br. pp. 23-25.) As for the 1966 back-test performance claims, Respondents never produced any support for these claims or its slide in the 2010 examination. (*See id.* pp. 21-23.) And the spreadsheet that they ultimately did provide in the Division's investigation that led to this proceeding is not a back-test, a fact they concede. (*See id.* pp. 12-14.) There is no dispute that this spreadsheet is the basis for Respondents' claims in the slideshow that they back-tested the BOM strategy to 1966, and it is the model used to generate the "results" and the "portfolio values" set forth in the slideshow.

In their post-trial brief, Respondents do not dispute any of this. Instead, they argue that their so-called "illustrations" – that is, what they had presented as "back-tests" in the investor seminars – are not subject to Rule 204-2(a)(16) and should be disregarded because they do not relate to the performance of any managed account or securities recommendation and were never disseminated to the public. (*See* Resp. Br. pp. 6, 49, 63-65.) But it is disingenuous for Respondents to suggest that the Court should ignore the spreadsheets that they admitted in their Answers "validate the slideshow's central premise." The information about how Respondents calculated their claimed back-testing results is central to the Division's allegations, because the 1973 and 1966 spreadsheets show that Respondents did not follow their BOM strategy for the majority of their calculation and treated REITs as liquid and risk-free investments. Indeed, Respondents' argument that these spreadsheets are irrelevant lacks merit because their own expert, Hekman, undertook to replicate the 1966 spreadsheet and presented various alternative calculations using the 1966 spreadsheet model. (Resp. Ex. 35 (Hekman Report).)

Respondents are also wrong as a matter of law. It cannot be disputed that the Respondents recommended that clients needed to purchase certain categories of securities, including specific non-traded REITs, in order to implement their BOM strategy. They also recommended that clients liquidate the securities in the various buckets in a particular sequence to generate income. These recommendations regarding securities transactions, and the purported performance and rates of return set forth in the slides regarding the back-tests of the BOM strategy, trigger the requirement under Rule 204-2(a)(16) that Respondents maintain true and accurate books and records regarding the purported performance. This interpretation is supported by the Rule's adopting release. In that release, the Commission explained that "[i]f advertised adviser performance consists of performance other than that of managed accounts, the adviser is required to prepare and retain whatever documents are necessary to substantiate performance data." *Recordkeeping By Investment Advisers*, Investment Advisers Act of 1940 Rel. No. 1135, 1988 SEC Lexis 1680, at *4 (Aug. 17, 1988).

Moreover, contrary to Respondents' arguments, Rule 204-2(a)(16) has been applied to analogous situations involving the maintenance of books and records to substantiate performance results achieved by retroactively applying a portfolio strategy to a historical time period. *See In the Matter of Market Timing Systems, Inc.*, Investment Advisers Act of 1940 Rel. No. 2048 (Aug. 28, 2002). Indeed, Respondents' reliance on the *Salomon Brothers* no-action letter in their post-trial brief is misplaced. (*See* Resp. Br. p. 64.) The *Salomon Brothers* letter deals with the unique situation in which an open-end investment company periodically reported the net asset value of one of its managed accounts. In that narrow circumstance, the *Salomon Brothers* no-action letter response explained that maintaining account statements could satisfy the Rule, but it also stated that doing so was not the exclusive method of complying with the rule. *See Salomon Brothers Asset Management Inc. No-Action Letter*, 1999 SEC No-Act. Lexis 644, *7 (July 23, 1999). Accordingly, the guidance of the *Salomon Brothers* letter is meaningless outside the context of reporting the performance of a managed account.

### G. Respondents' Affirmative Defenses Are Without Merit

Respondents assert two affirmative defenses, neither of which is persuasive. (*See* Resp. Br. pp. 66-69.) First, Respondents raise, in essence, a due process defense, arguing that they were not on "reasonable notice" that their conduct violated Sections 204 and 206 of the Advisers Act. (*Id.* p. 66.) As described more fully above, however, Respondents unquestionably were on notice that these provisions apply to fraudulent claims made by an investment adviser in advertisements. *See supra*, Section II.B.1, II.B.2. Moreover, Courts have specifically rejected similar claims in the investment adviser context. *See SEC v. Valicenti Advisory Services, Inc.*, 198 F.3d 62 (2d Cir. 1999).

Second, Respondents' assertion that the action against them is barred by the statute of limitation is also meritless. (*See* Resp. Br. p. 69.) This is not a situation involving a single violation in 2003, as Respondents seem to argue. Rather, the Division alleged in its OIP, and now has proven at trial, that Respondents committed a new violation every time they made a seminar presentation that included the slides regarding back tests of the BOM strategy, which continued into 2010. The statute of limitations, therefore, cannot bar this action.

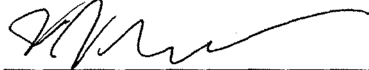
## III. CONCLUSION

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

Respectfully submitted,

**DIVISION OF ENFORCEMENT**

Dated: February 22, 2013



John B. Bulgozdy (323.965.3322)
David Van Havermaat (323.965.3866)
Peter Del Greco (323.965.3892)
Counsel for the Division of Enforcement
Securities and Exchange Commission
5670 Wilshire Boulevard, 11th Floor
Los Angeles, CA 90036
Telephone: 323.965.3998
Facsimile: 323.965.3908