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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
FILE NO. 3-15006

In the Matter of

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

Respondents.

THE DIVISION OF ENFORCEMENT'S MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO PETITION FOR REVIEW FILED BY RAYMOND J. LUCIA COMPANIES, INC., AND RAYMOND J. LUCIA, SR., AND IN SUPPORT OF CROSS-PETITION FOR REVIEW

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Dated: April 23, 2014

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I. INTRODUCTION

The Division of Enforcement ("Division") opposes the petition for review filed by Respondents Raymond J. Lucia Companies, Inc. ("RJLC") and Raymond J. Lucia, Sr. ("Lucia"), and respectfully requests that the Commission affirm the Initial Decision on Remand dated December 6, 2013 ("IDOR") as to the issues raised in Respondents' petition for review, and adopt the sanctions imposed by the Administrative Law Judge ("ALJ"). The Division also respectfully requests that the Commission review the finding that the challenged slideshow was not an "advertisement" under Commission Rule 206(4)-1(a)(5), and find that the slideshow is an advertisement that is covered by and violated the Rule because it is false and misleading.

After nine days of testimony and extensive post-hearing briefing, the ALJ issued an Initial Decision ("Initial Decision") on July 8, 2013, which found that Respondent RJLC violated Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. §§ 80b-6(1), 80b-6(2), and 80b-6(4), by misrepresenting the validity of purported backtesting in seminars for prospective clients, and that Respondent Lucia aided and abetted RJLC's violations. The Initial Decision ordered RJLC and Lucia to cease and desist from further violations of the Advisers Act, revoked Lucia's and RJLC's investment adviser registrations, imposed a civil penalty of $50,000 on Lucia and $250,000 on RJLC, and barred Lucia from associating with an investment adviser, broker, or dealer. Four days after the Initial Decision was issued, on or around July 13, 2013, Lucia voluntarily resigned his association as an investment adviser with RJL Wealth Management, a successor to RJLC managed by Lucia's son, Ray Lucia, Jr. The Commission subsequently remanded the Initial Decision for additional findings, and the IDOR was issued on December 6, 2013, which made additional findings and confirmed the findings in the Initial Decision.

In their petition for review, Respondents focus their arguments on the appropriateness of the associational bar imposed on Lucia and the third-tier civil penalties ordered by the IDOR. Respondents do not challenge the revocation of their registrations. Respondents argue that their violations are so minor that an associational bar is not warranted, and that a censure with some undefined undertakings is a more appropriate sanction. (Respondents' Opening Brief ("Resp. Br.") at 27.) Respondents contend that the violations do not warrant any civil penalty against Lucia, and RJLC is a "dormant corporate shell" since Lucia sold its assets to RJL Wealth Management. (*Id.* at 28.) Finally, Respondents make a cursory argument that the ALJ erred in finding that they violated the Advisers Act at all. (*Id.* at 28-30.)

The Commission should reject Respondents' arguments because the ALJ's findings and conclusions are well supported by the facts and justified by the applicable law. The facts conclusively establish that Respondents violated the Advisers Act by making materially false and misleading claims about their purported backtesting, and omitted material information from their slideshow. The record contains abundant evidence that Respondents acted with a high level of scienter. The public interest supports imposing an associational bar on Lucia, and the imposition of third-tier penalties.

In their petition, Respondents do not challenge most of the findings in the IDOR. The record shows that Respondents claimed in a slideshow presented at seminars to prospective clients that they had "backtested" Lucia's proprietary "Buckets of Money" ("BOM") strategy over two historic periods of time, the "Grizzly Bear" market from 1973 to 1994, and the "flat market" from 1966 to 2003. The backtests were the "grand culmination" (IDOR at 40) of the slideshow presented to convince prospective clients through empirical evidence that the BOM strategy "really does work" to provide inflation-adjusted income for life and portfolio growth, and the 1966 backtest was the slideshow's "pinnacle." (IDOR at 28.) While Respondents argue that the backtests were essentially irrelevant (*see, e.g.*, Resp. Br. at 1-3), the evidence shows that Respondents used the claimed backtests to validate and sell the BOM strategy and RJLC's advisory services to prospective clients.

The ALJ correctly found that Respondents' backtesting claims were false and misleading in numerous ways. There is no dispute that Respondents did not perform backtests of the BOM strategy using historical data over the periods claimed. In fact, at the hearing Respondents did not even attempt to defend their 1973 "Back Tested Buckets" results. Respondents admitted that the disclosures about the 1973 backtest were false, their calculations were incorrect, and they had no documentary support for the 1973 backtest. Nonetheless, Respondents now argue that the disclosures in the slideshow negate any finding of fraud (Resp. Br. at 5-7), but never acknowledge that the disclosures about the 1973 backtest were false, or explain how false disclosures are legally sufficient. Respondents never explain how their use of an admittedly false backtest to validate their BOM strategy was not in any way false or misleading.

Respondents argue that disclosure of an assumed 3% inflation rate negates any finding of fraud (Resp. Br. at 10-13), but fail to address their knowledge of the material impact that assumption had on their purported backtests, and their failure to disclose that information. For example, Respondents claimed that their backtest of a $1 million BOM portfolio over the period from 1966 to 2003 showed it would have provided inflation-adjusted income over the entire period from 1966 to 2003, *and* that balance would have grown to a value of $4,719,741 in 2003. In fact, when historical inflation rates are used in the backtest, the BOM portfolio completely runs out of money in 1986. Moreover, Respondents knew that the BOM portfolio would go bankrupt if they used historical inflation rates, but nevertheless they failed to disclose the material impact of their inflation assumption. Respondents do not deny that they knew the material impact their assumed inflation rate had on their purported backtests, and do not address their failure to disclose the crippling impact that using historical inflation rates would have had on their backtests. Respondents' argument misses the point, which is that they failed to disclose known, material information about the impact of their assumptions.

Similarly, there is no dispute that Respondents made a conscious decision not to follow their BOM strategy in the backtests, even as they used the results of the so-called backtests to validate and tout the BOM strategy. Yet Respondents argue that it was not misleading in any way to fail to disclose this material fact, and rationalize that if they had followed the BOM strategy, this would have exposed them to criticism from the Division. (Resp. Br. at 14-15.) The spreadsheets produced by Respondents as support for the backtests show that Respondents concentrated 100% of the portfolio in equities for over half of the respective test periods, notwithstanding that Respondents and the BOM strategy advocated never being 100% invested in equities. It was grossly misleading to present the backtests as validation of the BOM strategy, when Respondents consciously did not follow the BOM strategy to achieve the touted results. It is well established that presenting the results of the performance of a model or strategy, when one does not follow that strategy, is highly misleading.

The record supports the findings in the IDOR that Respondents acted with a high level of scienter. The ALJ found that on a number of occasions, Lucia offered testimony that was inconsistent, contradictory, or knowingly false. (IDOR at 43-47.) Respondents do not challenge any of these findings. Instead, Respondents argue that Lucia was not put on notice by his supervising broker-dealers that the slideshow was misleading (Resp. Br. at 16-17), and contend that they could not have scienter because a 2003 examination by OCIE did not find any violations. (*Id.* at 18-20.) Rather than accepting responsibility for their conduct, Respondents point the finger at others. These arguments fail to acknowledge critical facts, such as the fact that the 1966 backtest was not created until after the 2003 examination and was not part of that examination, or that Respondents had a fiduciary duty to assure that the information in the marketing materials they presented was accurate and not misleading.

Respondents argue that Lucia has left the industry, even as they acknowledge that he continues to seek work offering advice and consulting on "retirement planning and other topics." (Resp. Br. at 25.) Respondents also argue that Lucia never recommended any securities, although the ALJ correctly found that the purpose of the seminars was to tout BOM and REITs, and in fact, Respondents' main source of income was commissions from the sale of REITs to persons who signed up as advisory clients with RJLC. (IDOR at 4-7.)

Thus, the facts in the record support a finding that Respondents engaged in egregious, recurrent violations with a high level of scienter. Respondents' arguments demonstrate that they have failed to acknowledge the wrongful nature of their conduct. The public interest supports imposition of an associational bar on Lucia, and imposition of third-tier penalties.

Finally, the Division requests that the Commission review the finding in the IDOR that the slideshow was not an "advertisement" and did not violate Rule 206(4)-1(a)(5), 17 C.F.R. § 275.206(4)-1(a)(5). The ALJ found that Rule 206(4)-1(a)(5) applies only to "traditional media," which did not include electronic publication of the slideshow at a seminar aimed at convincing prospective clients to sign up for Respondents' advisory services. However, Commission and court precedent establishes that the antifraud statutes apply to electronic media. The construction of the Rule in the IDOR is too narrow in a world in which new forms of advertisement and media are being created every day. Accordingly, the Division respectfully requests that the

Commission find that the slideshow is an advertisement within the scope of Rule 206(4)-1(a)(5), and that it violated the antifraud provisions of the Rule.

II. FACTS

A. Respondents' Background

At the time of the hearing in December 2012, Lucia was registered as an investment adviser with RJL Wealth Management. (Tr. 1024.) Lucia had formed RJLC in 1994, and it was a registered investment adviser from September 2002 through December 2011. From 2006 through 2010, RJL did business under the name "RJL Wealth Management." (Tr. 1026:15-1027:9.) Lucia was the sole owner of RJLC, and also owned Lucia Financial, LLC ("Lucia Financial"), a registered broker-dealer. (Tr. 73, 516, Div. Ex. 2, IDOR at 3-5.)

RJLC earned investment adviser revenue by collecting fees for assets under management, hourly fees, fixed-fee consulting arrangements, and other management fees. (Div. Ex. 2, p. 7; Tr. 492-93, 517, 1656.) Lucia also collected commission income through a sole proprietorship, Raymond J. Lucia, Sr., sole proprietor. (Tr. 517.) Respondents' main income generator was commissions from the sales of non-traded REITs to RJLC clients through dual-registered investment advisers of RJLC, who recommended the REIT investments and then transacted the sales through Lucia Financial. Between January 1, 2009 and January 31, 2010, RJLC clients invested more than $143 million in non-traded REITs and Lucia's companies collected approximately $12.4 million in gross commissions on the sales of securities, of which $8.7 million was paid to Lucia as commissions on the sale of non-traded REITs. (Div. Ex. 2, p. 7; Div. Ex. 4, p. 8; Tr. 104, 506, 1349.) In contrast, during the same period RJLC generated advisory fees of approximately $1.7 million. (Div. Ex. 4, p. 8; Tr. 1660.) There is no dispute that the sale of non-traded REITs generated a high percentage of the revenue for Respondents. (Tr. 1347-48.)[1] (*See generally* IDOR at 3-7.)

B. Respondents' Promotion of the BOM Strategy and Backtesting Claims

Lucia created the BOM retirement planning strategy, which involves allocating a client's assets among three "buckets" to provide "inflation-adjusted income for life and sustained portfolio growth." (Div. Exs. 8, 27, 31; Tr. 626, 1024, 1082-83, 741-42.) Respondents described BOM as being "science, not art," and claimed the BOM strategy was "proven," "time-tested," and based on "empirical evidence." (IDOR at 8.)

Respondents promoted the BOM strategy nationwide at BOM seminars conducted by Lucia. At the seminars, Lucia published the slideshow presentation which consisted of three main parts: the first part debunked other investment strategies; the second part explained how the BOM strategy allocated assets among three buckets and compared to BOM to three alternative allocation strategies;[2] and the third part proved that BOM would have provided

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[1] Respondents complain that the IDOR "devoted inordinate attention to RJLC's sale of REITs" (Resp. Br. at 11 n.3), and that Respondents did not recommend any specific securities at the seminar. (*Id.* at 2.) The OIP alleged that Respondents held seminars promoting their BOM strategy to obtain advisory clients who would be charged fees for Respondents' advisory services. (OIP ¶ 14.) The evidence established that Respondents generated substantial fees from sales of REITs promoted at the BOM seminars, by signing up clients with RLJC for the BOM strategy, and then selling REITs to those clients. (IDOR at 4-7.) The facts about RJLC's sale of REITs is relevant to the issues raised in this proceeding, and the ALJ properly devoted an appropriate amount of attention to these relevant facts.

[2] At the hearing and in post-hearing briefing, Respondents adamantly denied that BOM involved asset allocation and argued that it was only a "withdrawal" strategy. (IDOR at 7 n.8.) The ALJ found Lucia's testimony at trial that BOM was purely a "withdrawal" strategy was "knowingly false." (*Id.* at 47.) In their appeal, Respondents concede that BOM is an asset allocation strategy that involves diversifying assets among three buckets. (*See, e.g.*, Resp. Br. at 1.) Respondents do not provide any explanation for Lucia's false testimony at the hearing on this point, or why they have abandoned this argument.

inflation-adjusted income for life and portfolio growth using purported backtests of BOM from 1966 and 1973. (Div. Ex. 1.)

The representations and omissions in the third part of the slideshow – the purported backtests of the BOM strategy from 1973 and 1966 – are the subject of this action.

1. The 1973 "Back Tested Buckets" Slides

To prove that BOM works, Respondents presented the results of a purported backtest beginning on January 1, 1973 through 1994, or over the "Grizzly Bear" market of that period. (IDOR at 10-11.) Lucia introduced this historical test as key: "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." (Div. Ex. 66 at p. 46.) The first slide asks the question: "But Can Buckets Stand Up To The Test Of The '73/'74 Grizzly Bear?" (Div. Ex. 1 at 199.) The next, captioned "Back Tested Buckets," answers the question by showing the results of a backtest of a portfolio beginning on "1/1/73," with a $1 million value, which "includes 20% REIT," and draws inflation-adjusted income from 1973 through 1994. Respondents show that the portfolio has produced inflation-adjusted income from 1973 through 1994, and the portfolio has grown to a "Balance in 21 Years" of "$1,544,789." This "Back Tested Buckets" slide includes a disclaimer that, among other things, Respondents used "actual treasury rates of return to calculate fixed income/bond returns and actual S&P 500 returns to calculate growth returns." (Div. Ex. 1, at 200.) However, the slide does not disclose the rate of return used for the REIT investment. (IDOR at 10-11.)[3]

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[3] Respondents defend the 1973 backtest in their petition to the Commission, but fail to address their admissions at the hearing that the disclosures concerning the rates used are false, or that the numbers on the slide are incorrect, or that they admittedly have no documentary support for the 1973 backtest. Respondents did not offer any expert economic testimony on the 1973

2. The 1966 Backtest Slides

The slideshow then culminates by presenting the results of Respondents' purported 1966 backtest of BOM, which is the "pinnacle" of the slideshow. (IDOR at 11-12, 28, 40.) Lucia introduces the 1966 backtest by claiming that his friend Ben Stein asked him how BOM would perform if he started in 1966, and Lucia states: "Well, I did a backtest for Ben." (Div. Ex. 66 at p. 47.) The slideshow presents "Notes & Assumptions," which states that "actual market returns" are used for the periods listed, with bond returns based on U.S. Treasury returns, stock returns based on S&P 500 returns, "REIT returns are based on a 7% annual return," and "inflation is based at 3% annual." (Div. Ex. 1 at 204.) The slideshow then presents the performance results of three portfolios over the period from 1966 to 2003. Each portfolio started with $1 million in 1966 and paid inflation-adjusted income from 1966 to 2003: (1) "60-40 Portfolio. Income from stocks & bonds (pro rata)" (Div. Ex. 1 at 205-206); (2) "60-40 Portfolio. Buckets of Money (Without REIT)" (*id.* at 207-208); and (3) "Buckets of Money Portfolio. (40-20-40) (With Real Estate Investment Trusts)" (*id.* at 209-210.) Finally, Respondents present a summary page that states that the "Buckets' Portfolio" which is 20% REITs, 40% bonds, and 40% stocks, has a "Value" of "$4,719,741" in 2003. (*Id.* at 211.)

III. LEGAL DISCUSSION

A. The ALJ Correctly Found That Respondents Violated Sections 206(1), 206(2), and 206(4) of the Advisers Act

The AJL issued an exhaustive and well-reasoned IDOR that found Respondents violated Sections 206(1), 206(2), and 206(4) of the Advisers Act by making material misrepresentations,

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backtest, and did not provide evidence to support use of a 7.75% REIT rate of return over the period 1973 to 1994.

and omitting material facts, in their slideshow presentation about claimed backtests of their BOM strategy, and that Respondents did so with a high level of scienter.

The ALJ's factual findings and conclusions of law concerning material misrepresentations and omissions are extensive:

- Respondents represented that they had backtested the BOM strategy from 1966 and 1973, and that the backtests proved that BOM worked, when in fact Respondents had performed no such backtests. (IDOR at 25-29, 39-40, 42-43.)
- Respondents disclosed that they used an assumed 3% inflation rate, but failed to disclose that they knew historical inflation rates were higher and that using those actual rates would have had a "crippling" impact resulting in their BOM portfolios going bankrupt. (IDOR at 32-35, 42-43.)
- Respondents disclosed that they used a REIT investment at a 7% rate of return, but failed to disclose material information about the unavailability of REITs, the reasonableness of the assumed rate of return, or how they used the REIT investment to time the market and enhance their results. (IDOR at 29-32, 42-43.)
- Respondents failed to deduct fees or disclose their impact, even though Respondents knew that fees materially affect a portfolio's returns. (IDOR at 35-37, 42-43.)
- Respondents did not disclose that they did not follow the BOM strategy in their backtests, even though they made a conscious decision not to rebucketize and the portfolio was 100% invested in equities for the majority of the test period. (IDOR at 37-39, 42-43.)

The ALJ made extensive factual findings that Respondents acted with a high level of scienter, both in failing to disclose known, material information, and in failing to testify frankly at the hearing. (IDOR at 43-49.) The ALJ found that Lucia knew if actual historical inflation were used in the 1966 and 1973 backtests, then the BOM portfolios would have been depleted more quickly, and Lucia knew that disclosing such information would not be helpful in attracting clients. (*Id.* at 44.) Lucia deliberately chose not to follow the BOM strategy and rebucketize, instead leaving the entire balance of the portfolio in the stock market for the majority of the test periods, and Respondents deliberately did not disclose this material information. (*Id.* at 45.) Lucia was aware of the material impact of fees and discussed them when it suited his message, and Respondents' failure to disclose their impact or account for them in the backtests demonstrated an intent to purposefully exclude fees to strengthen the returns of the backtests. (*Id.*) Lucia recklessly departed from the standards of care by not ensuring the accuracy of the information he presented in his backtests. (*Id.* at 46.) Lucia departed from the standards of care "in an extreme way" by failing to inform seminar attendees of the risks of REITs, knew that REITs were not available as represented in the 1966 backtest, and had a financial motive to misrepresent the facts about REITs. (*Id.* at 46-47.)

The ALJ found yet more evidence of scienter based on statements made under oath at the hearing, which findings Respondents do not contest.[4] The ALJ found that Lucia offered inconsistent and contradictory testimony about why Respondents chose 3% for an inflation rate. (*Id.* at 44.) Lucia gave conflicting testimony about why Respondents did not deduct for fees.

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[4] Considerable weight and deference are given to credibility findings of an initial fact finder because such findings are based on hearing the witnessess' testimony and observing their demeanor. *Joseph J. Vastano, Jr.*, 57 S.E.C. 803, 811 (2004); *Anthony H. Barkate*, 57 S.E.C. 488, 499 (2004).

(*Id.* at 45.) Respondents did not give a "plausible" explanation for why they did not follow the BOM strategy and re-bucketize. (*Id.*) Lucia knew that the BOM strategy had not been backtested, and in an apparent effort to avoid liability claimed the backtests were "forward-looking" even though the 1966 backtest uses a mix of historical and assumed data. (*Id.*) Lucia's testimony about the discovery of errors in the 1973 "Back Tested Buckets" slide was "knowingly false." (*Id.* at 46.) The ALJ found it "utterly implausible" that Lucia, who determined the contents of the slides and gave every BOM seminar, would not be aware of false information in the 1973 "Back Tested Buckets" slide. (*Id.*) Lucia testified "disingenuously" about the errors in the 1973 "Back Tested Buckets" slide. (*Id.*) Finally, Lucia's testimony that BOM is solely a "withdrawal" strategy that did not involve asset allocation was "knowingly false." (*Id.* at 47.)

The ALJ found that the misrepresentations and omissions were material. (IDOR at 49-52.) Seminar attendees testified that the discussion of REITs in their seminars was important in their decision to purchase non-traded REITS through RJLC. (*Id.* at 49.) The omissions concerning the inflation rate were material because investors would not be interested in engaging RJLC if they were told that the backtested portfolios went bankrupt and did not provide "inflation-adjusted income for life." (*Id.* at 49-50.) It was materially misleading not to disclose that advisory fees were not deducted, and seminar attendees testified that information would have been important. (*Id.* at 50.) The failure to disclose that the backtested portfolios were not rebucketized and did not follow the BOM strategy being validated by the purported backtests was material. (*Id.*)

Thus, the extensive record supports the ALJ's detailed factual findings. While Respondents downplay the breadth of their fraudulent conduct, the IDOR sets forth extensive factual findings that establish Respondents cynically claimed to have backtested the BOM strategy to convince investors to sign up as clients with RJLC, when in fact Respondents had performed no backtesting and had no basis for their claims. Instead, Respondents cherry-picked favorable data and created unrealistic assumptions to rig their purported backtests to make it seem that their proprietary BOM strategy was a scientifically tested, empirically proven strategy that "really does work." Indeed, Respondents were not shy in claiming that they had backtested BOM in their seminar slideshows, in webinars, and in other media, until they were found out and their backtesting claims were challenged by the examination staff in 2010. Now, on appeal, as they did during the hearing, Respondents seek to avoid liability by pretending that they never made their false backtesting claims. The record amply supports the ALJ's findings, which should be affirmed and otherwise adopted.

1. The Legal Standard for Violations of Section 206(1), 206(2), and 206(4)

Section 206 of the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) Those fiduciary duties require advisers to exercise "an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading his clients." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 194, 201 (1963). As fiduciaries, investment advisers are required "to act for the benefit of their clients," "to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients." *SEC v. Moran*, 922 F. Supp. 867, 895-96 (S.D.N.Y. 1996)), *aff'd*, 587 F.3d 553 (2d Cir. 2009).

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

The elements of a claim for a violation of Section 206(2) and 206(4) are similar, except that scienter is not an element of a claim under Section 206(2) or 206(4). *See SEC v. Steadman*, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992) ("a violation of § 206(2) of the Investment Advisers Act may rest on a finding of simple negligence"); *SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1105 (9th Cir. 1977) (scienter not an element of Section 206(4)).

Respondents do not dispute the findings that Respondents were registered as investment advisers, or that they utilized means of interstate commerce in publicizing and presenting the slideshow.

2. Respondents Made Material Misrepresentations and Omissions in the Slideshow About Purported Backtests

a. Respondents Falsely Claimed They Had Backtested the BOM Strategy

Respondents falsely claimed to have backtested the BOM strategy over the historical period from 1966 to 2003, and from 1973 to 1994. Respondents used their purported backtests as "empirical" proof that BOM worked in their slideshow that was presented repeatedly, over a period of years, to tens of thousands of prospective clients, in an effort to obtain clients and generate fees for RJLC. (*See, e.g.*, IDOR at 27-28.) Respondents do not challenge the ALJ's finding that the backtest slides are the "capstone of the slideshows, and the '66 Backtest is the pinnacle." (*Id.* at p. 28.) These findings are supported by substantial evidence. (*See, e.g.*, Tr. 358-59, 536-37, 880, 1191, 1319, 1686-87; Div Exs. 1, 35, 50, 68, 66.)

Respondents, who hold themselves out as knowledgeable and experienced in the securities industry, chose to use the term backtest and present the results of two purported backtests in their slideshow to validate their BOM strategy. Ample evidence establishes that Respondents claimed that they had backtested the BOM strategy (IDOR at 25-27), the backtests were of "central importance" to the slideshow (*id.* at 28-28), the historical context of the backtests was deliberate and critical to the presentation (*id.* at 39-40), and the backtests were offered as scientific findings (*id.* at 40). Respondents do not offer any evidence to contradict these factual findings.

Respondents do not dispute the findings and evidence that they did not perform backtests. Indeed, Respondents abandoned any defense of the 1973 "Back Tested Buckets" slide at the hearing because of its numerous errors. (IDOR at 11 n.11, 42-43; *see also* Div. Ex. 70.) Even Respondents' experts agree that Respondents did not perform backtests of the BOM strategy. (IDOR at 23.)

Respondents also do not argue that false claims about backtesting and performance are not material. (*See* Resp. Br. at 15-16.) Such an argument would not withstand the factual record. Lucia admitted that the purpose of the slideshow and the backtests was to validate the BOM strategy to prospective clients so they sign up with RJLC. (Tr. 1097-98.) As a legal matter, it is well established that false and misleading claims about backtesting and performance are material. *See, e.g., William J. Ferry*, Investment Adviser Release No. 1747 (August 19, 1998); *LBS Capital Management, Inc.*, Investment Adviser Release No. 1644 (July 18, 1997); *Meridian Investment Management Corporation, et al.*, Investment Adviser Release No. 1779

(December 28, 1998). *See also Clover Capital Management, Inc.*, (No Action Letter - File No. 801-27041, October 28, 1986) (stating staff's position that the use of model or actual results in an advertisement would be false or misleading, and in violation of Rule 206(4)-1(a)(5), "if it implies, or a reader would infer from it, something about the adviser's competence or about future investment results that would not be true had the advertisement included all material facts.").

(1) The ALJ correctly rejected Respondents' after-the-fact arguments that they meant to say "hypotheticals" rather than backtest

Respondents do not take responsibility for their false claims that they backtested the BOM strategy. Instead, Respondents argue, as they did to the ALJ, that they only used the word "backtest" once or twice in the entire slideshow and the ALJ erred by not crediting their arguments that they meant to present "hypotheticals" rather than backtests. (Resp. Br. at 2, 5-8.) The ALJ considered their arguments about "hypothetical forward-looking" scenarios," "simulations," and "forward-looking hypotheticals," and properly rejected them for a number of reasons. (IDOR at 27, 40, 45.)

The ALJ correctly found that Respondents used the 1966 and 1973 backtest start dates to provoke sentiment in audience members, and that these historical start dates were not arbitrary. (IDOR at p. 39.) The ALJ found that characterizing the claimed backtests as hypotheticals discounts the Respondents' calculated use of specific historic dates, and that if the only purpose was to demonstrate BOM's performance under any set of market conditions, then no specific historic start dates would be required. (*Id.*) Testimony from investor witnesses confirmed that they understood the backtests to be evidence that the BOM strategy held up under difficult historical market conditions. (*Id.* at p. 40.)

The ALJ also found that a backtest is, by definition, a realistic hypothetical. (*Id.*) Respondents contend that Lucia's statement in a webinar that he is going to "pretend" that inflation was 3% "from that point forward," although "[w]e knew it was more," conclusively warns audiences that the backtests are hypotheticals, and that the ALJ improperly ignored this evidence. (Resp. Brief at p. 6.) In fact, the ALJ carefully considered Respondents' arguments and evidence that a reasonable investor would have understood that the slideshows did not present backtests, and were "hypotheticals with a forward-looking mentality." (IDOR at 27, 29.) The ALJ found that Respondents were providing "inconsistent, after-the-fact descriptions" of what the slideshow portrayed, and rejected that evidence. (*Id.* at p. 27.) The only two seminar attendees to testify understood that the backtests were presented as historically accurate. (*Id.*)

After carefully weighing the evidence, the ALJ properly found that Respondents' arguments on this point were not persuasive, and that "a reasonable investor would have understood that the '66 and '73 Backtests' data and assumptions were factual, historical, and realistic." (*Id.*) This finding is not erroneous and is supported by evidence in the record.

(2) The ALJ correctly rejected Respondents' arguments that the term backtest has no definition

Respondents argue that the ALJ erred in failing to find that there is "no legal meaning to the word 'backtest'" and it has no "standard industry definition." (Resp. Br. at 11, 2.) However, Respondents did not let that claimed lack of a standard definition stop them from claiming to have backtested the BOM strategy in the slideshow. In fact, the ALJ considered the evidence and Respondents' arguments, and correctly found that the only consistent definition of the term "backtest" is "using historical data to test a particular investment strategy." (IDOR at 25-27).

The ALJ considered the testimony of the Division's expert, an OCIE examiner, and Respondents' chief compliance officer, who all had the same understanding that a backtest used actual historical data to test the performance of a particular investment strategy. (IDOR at 26.) Respondents' two experts, Gannon and Hekman, provided similar definitions. Indeed, Respondents' expert Hekman testified that an average investor would understand the term, in this context, to mean "using historical data to test a particular investment strategy." (*Id.*) The seminar attendees who testified provided similar evidence about the meaning of a backtest. (*Id.* at 26-27.)

The ALJ also considered Lucia's testimony which disputed the definition given not just by the Division's expert, but also by Respondents' own experts. (*Id.* at 26.) Lucia claimed that his definition was an industry standard that was "almost uniformly used." However, none of the experts, including Respondents' experts, corroborated Lucia's testimony. Respondents submitted brochures from various large companies, including one from American Funds, which also undercut Lucia's testimony. For example, the American Funds brochure states that actual "historical index returns" were used for backtests. The ALJ correctly found that the other brochures relied upon by Respondents also used factual, historical data. (*Id.*)

Lucia's testimony about how he used the 1966 backtest to convince Ben Stein that BOM worked likewise contradicts Respondents' argument. (IDOR at 45.) Lucia asserted that he satisfied Stein by doing a backtest from 1966 to 2003. Lucia was not telling Stein that he had created some hypothetical with no connection to historical data, but rather Lucia was claiming to have performed an actual backtest using historical data from the relevant period to prove that BOM worked over the actual market conditions that existed during that period. (*Id.*)

Additional evidence in the record contradicts Respondents' assertion on this point. Lucia testified that the purpose of going back in time to a specific historical date was to test how BOM would have performed under "historical circumstances."[5] (Tr. 1097.) Respondents do not dispute that Lucia deliberately chose to present the backtest slides and language, the historical contexts of the backtests, the span of years of the backtest, and the initial start date of the 1966 backtest five years before REITs were available. (IDOR at 44.) Respondents chose to claim that they had backtested the BOM strategy, used that term freely, and offered the backtests as validation of the superiority of BOM. It is not a defense to fraud to argue after-the-fact that the term they chose to use is ill-defined and incapable of definition. The ALJ properly weighed all the evidence and correctly concluded that Respondents' argument in this regard lacked merit.

(3) Respondents' arguments about disclosure lack any factual support

Respondents argue that disclaimers in the slideshow conclusively establish that they were merely presenting "hypothetical" illustrations. (Resp. Br. at 2, 5-7.) Respondents' argument is not supported by facts in the record.

The record establishes that the 1966 backtest slides do not include any disclaimers that they are hypotheticals and, in fact, do not include the word "hypothetical." (*See* Div. Ex. 1 at SEC-LA3937—00203-211, IDOR at 12.) Instead, the slideshow claims the 1966 backtest results are based on "actual market returns for the period(s) listed." (Div. Ex. 1 at 204, IDOR at 12.) The ALJ correctly noted the lack of the usual disclaimers on the 1966 backtest slides, in contrast to virtually every other slide in the slideshow. (IDOR at 12.) Respondents have never explained

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[5] In the webinar, Lucia introduced the 1973 backtest as "key" empirical evidence of the validity of the BOM strategy: "But the key here is can Buckets of Money strategy stand up to the true test of the 1973/74 Grizzly Bear market? Well, let's see." (Div. Ex. 66 at 46.) This is further evidence that at the time of the challenged conduct, Respondents were presenting the backtests as reliable, empirical "test" data that validated how the BOM strategy performed under particular and difficult historical conditions.

that deficiency. Thus, Respondents' argument about disclaimers is not supported by the evidence – the 1966 backtest slides do not contain disclaimers.

As for the 1973 "Back Tested Buckets" slides, Respondents admit that the disclosures were false. (IDOR at 11 n.11.) Respondents do not explain how false disclosures are a sufficient disclosure of material information. Respondents fail to reconcile the fact that they have admitted the disclosures about the 1973 backtest were false with their argument that the disclosures somehow remedied any misrepresentations or omissions.

(4) Respondents' arguments that BOM would provide "superior" performance are irrelevant and not supported by the record

Respondents contend that the misrepresentations about backtesting are not material because BOM would have provided "superior" performance to other strategies. (Resp. Br. at 2-3, 15-16.) These arguments are irrelevant for a number of reasons. First, the Division did not challenge the merits of the BOM strategy, so its purported "superiority" is not at issue. Second, the Division produced uncontroverted expert evidence that BOM runs out of funds in a properly conducted backtest. (Div. Ex. 70.) Third, Respondents did not introduce any credible evidence that BOM provides "superior" performance over any historical period because Respondents did not backtest BOM over any historical period. Fourth, Respondents provide no support for the proposition that running out of money is a "superior" retirement strategy. The ALJ considered Respondents' arguments on this point and found them to be factually inaccurate. (IDOR at 35.)

Respondents continue to assert that the BOM strategy is "superior" in some way. The record shows that Respondents did not backtest the BOM strategy over any historical period, and Respondents do not point to any facts in the record of empirical evidence of a valid comparison of BOM to any strategy. In fact, the record shows that when Respondents purported to backtest

BOM beginning in 1966 and 1973, they failed to follow the BOM strategy for the test period. Instead, for the majority of the test period, Respondents concentrated 100% of the portfolio assets in equities, which is admittedly not a BOM strategy. (*See* Div. Ex. 70.) At the hearing, Respondents argued that BOM went broke later than other strategies, in an apparent concession that BOM does not provide "inflation-adjusted income for life and portfolio growth." Respondents did not offer any testimony from investors or experts that a retirement strategy that failed to provide for retirement is a good strategy, much less a "superior" strategy.

Moreover, it is well established that false claims about performance are material. *See, e.g., SEC v. Lauder*, Case No. 03-80612-CIV, 2008 WL 4372896, at *20 (S.D. Fla. Sept. 24, 2008) (representations about performance with no material basis in fact are material); *SEC v. Batterman*, Case No. 00-CIV-4835, 2002 WL 31190171, at *8 (S.D.N.Y. Sept. 30, 2002) (misrepresentations about performance "would undoubtedly have been material to an investor); *SEC v. Scott*, 565 F. Supp. 1513, 1527 (S.D.N.Y. 1983).

b. Respondents Omitted Material Inflation That the Assumed Inflation Rate Impacted the Results of Their Backtests

The ALJ considered all the evidence and arguments and found that Respondents' use of an assumed 3% inflation rate, and failure to disclose that a historical rate would have depleted the back-test portfolios after a short period, was materially misleading. (IDOR at 32-35, 49-52.) The ALJ found that the slideshow did not disclose that the inflation rate used by Respondents "was far below historical numbers and that use of even modified historical rates, accounting for biases, would have caused the backtest portfolios to drop to a zero balance years prior to 2003." (*Id.* at 32.) The ALJ considered various arguments made by Respondents to support their use of a 3% flat rate, but ultimately found that Respondents never disclosed "the crippling impact historical numbers would have had on the backtests." (*Id.* at 34.) Respondents do not, and cannot, dispute the fact that using historical rates would have destroyed their backtest claims because in both cases, the BOM portfolio would have run out of funds before the end of the test period. Thus, using actual inflation would have shown that BOM could not provide "inflation-adjusted income for life" or portfolio growth.

The Division presented undisputed evidence that using historical inflation rates materially affected the results of Respondents' purported backtests. (Div. Ex. 70 at ¶¶ 13-18, Exs. 2a, 2b, 2c.) When historical inflation rates are used, the 1966 backtest does not produce inflation-adjusted income for decades and grow to a value of $4,719,741 by 2003, but rather declines to a value of zero in 1986. (*Id.* at Ex. 2a.) The 1973 portfolio does not have a value of $1,544,789 in 1994, but rather declines to zero in 1989. (*Id.* at Ex. 2b.) Respondents' long-time employee ran the 1966 calculations using an average inflation rate and found that it ran out of money before 2003. (Tr. 816-17.) The evidence that using historical inflation rates results in the BOM backtest portfolios going to zero before the end of the test period is undisputed.

Respondents argue that because they disclosed that they were using an assumed inflation rate, the backtests could not be misleading. (Resp. Br. at 10-11.) The ALJ considered and rejected this argument. (IDOR at 32-35.) Indeed, Lucia admitted that he knew using higher inflation rates would have made the results of the backtests look much worse. (Tr. 1202-03.) Respondents knew that using actual inflation would result in the 1966 and 1973 backtests reaching a zero balance before the end of the test period. (Tr. 91, 863-69.) Lucia conceded that it would be self-defeating to say that the BOM strategy would end up with the client going broke. (Tr. 1151-52.) Respondents cite no authority for the proposition that where a defendant has actual knowledge of material information and fails to disclose it, such conduct does not violate the antifraud provisions.[6]

Respondents also argue that the use of hypothetical inflation rates was consistent with industry practice, and point to testimony of their expert, Hekman, that using a 3% inflation rate for hypothetical, forward-looking retirement planning was "universally recognized," and to a brochure from American Funds.[7] (Resp. Br. at 11-12.) However, Respondents' expert Hekman testified that the examples he gave in his report involved retirement planning in the future, when inflation rates are unknown. (Tr. 1445-48.) Hekman could not provide any examples where an assumed 3% hypothetical inflation rate was used in a backtest. (Tr. 1448.) The brochure from American Funds used a 4% inflation rate. (Resp. Ex. 46.) In fact, the ALJ considered these arguments and properly rejected them. (IDOR at 35.)

Neither Hekman's testimony, nor the American Funds' brochure, stand for the proposition that failure to disclose known material information about an inflation assumption is not misleading. Lucia admitted that the backtests were used to show how BOM performed over specific historical periods. Respondents do not dispute that there was no disclosure about the

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[6] Indeed, such evidence satisfies any scienter requirement in a material omission case where the defendant has actual knowledge of material information and fails to disclose it. *See, e.g, Fenstermacher v. Philadelphia Nat'l Bank*, 493 F.2d 333, 340 (3d Cir. 1974); *Thomas v. Duralite Co.*, 524 F.2d 577, 584 (3d Cir. 1975), *aff'd*, 559 F.2d 1209 (3d Cir. 1977) (knowledge of material facts and failure to disclose provide adequate bases for culpability for violation of the antifraud provisions of the Exchange Act).

[7] This argument also relies on Respondents' argument that BOM is solely a "withdrawal" strategy and not an asset allocation strategy – an argument that the ALJ properly rejected. (IDOR at p. 47.) Respondents concede in their brief that the BOM is not only a "withdrawal" strategy as they argued to the ALJ, but also involves the "concept of diversifying holdings among 'buckets' of varying risk." (Resp. Brief at p. 1.) Thus, Respondents have abandoned the rationale they advanced at the hearing to support the relevance and applicability of this evidence.

material impact the inflation assumption had on the results of the purported backtests. (*See* IDOR at 34.) The ALJ did not err in finding that failure to disclose material information about the impact of Respondents' inflation assumption was misleading.

c. Respondents Omitted Material Information About Their Use of an Assumed REIT Investment

The ALJ found that the REIT rates of return and usage were unreasonable and misleading. (IDOR at 30-32.) The ALJ found that use of an assumed 7% dividend rate for the 1966 backtest and 7.75% for the 1973 backtest was misleading, based on the testimony of both the Division's expert, Grenadier, and Respondents' expert, Gannon. (*Id.*) The ALJ found that the REIT returns for 1966 to 1971 used in the 1966 backtest were "made up out of whole cloth." (*Id.* at 30-31.) The ALJ further found that 1973 and 1974 produced significant losses for the REIT market as a whole, but Respondents' assumptions arbitrarily eliminated those substantial losses. (*Id.* at 31.) Moreover, Respondents "liquidated" the REIT investment arbitrarily after ten years, which allowed Respondents to time the stock market perfectly to enhance the results of their purported backtests. Respondents failed to disclose the length of time the REITs were held, the ending principal amount, or the material impact that their fortuitous timing had on their purported backtest results. (*Id.*)

Respondents contend that the use of an assumed rate of return for REITs of either 7% or 7.75% could not be misleading because they were "laid out in black and white on the 'Notes and Assumptions' slide." (Resp. Br. at 10-11.) The ALJ expressly considered that Respondents disclosed the assumed REIT rate of return. Indeed, the Division did not allege that Respondents failed to disclose their assumptions, but rather they failed to disclose the material impact of their assumptions on the backtests. Respondents do not contend that they disclosed the material impact that their assumed REIT investment had on their backtest results.

There is also no question that the impact of the assumed REIT rate of return was material. Indeed, adding the REIT was the only cause for the increase in the value of the BOM portfolio as of 2003 from $1,297,771 to $4,719,741 in the 1966 backtest. (Div. Ex. 70 ¶¶ 20-26, Exs. 5a, 5b, 5c.) Thus, Respondents' use of the assumed REIT investment was the sole cause of a $3.5 million increase in the claimed value of the BOM portfolio in the 1966 backtest. Respondents were not just selling the BOM strategy, but were also setting the stage for RJLC and Lucia to reap large profits in the form of commissions from the sale of non-traded REITs to persons who signed up for the BOM strategy.

Respondents point to the testimony of their expert, Gannon, that a 7% rate of return for REITs for the period 1966-2003, and 7.75% for 1973-2000, was reasonable. (Resp. Br. at 12.) However, Gannon did not opine that 7.75% was reasonable. Moreover, Gannon testified that it was not appropriate to use a hypothetical 7% return for REITs in a backtest, and that a backtest would use actual historical data on REIT returns. (Tr. 1387.) The ALJ properly found that Gannon's testimony supported his finding that Respondents' use of REITs was unreasonable and misleading.

d. Respondents Failed to Disclose the Impact of Fees

There is no dispute that Respondents did not deduct management fees in their backtests, and failed to disclose the material impact fees would have had on their results. The ALJ properly found that fees can reduce, and at times eliminate, the benefits of a strategy, and seminar attendees were not informed of how significantly the costs would eat away at the backtest results. (IDOR at 35-37.) Respondents do not dispute that advisory fees materially affect a portfolio's returns. (*Id.* at 36, Tr. 1199, 1203, 1285.)

Respondents argue that the failure to deduct fees "would be neutral across strategies," and that it was error to not consider this. (Resp. Br. at 13.) In fact, the ALJ specifically considered this argument and correctly found that "it is a misleading oversimplification to assume, as Respondents essentially did, that the effect of fees is a wash." (IDOR at 37.) Respondents did not offer any expert testimony to support their arguments on fees. (*Id.* at 24.)

Respondents contend that the Division failed to introduce evidence concerning the impact of fees "for any of the alternative strategies." (Resp. Br. at 13.) This argument is a red herring, because the Division did not allege that the hypotheticals involving the "Balanced Buttafuccos," the "High Rolling Hendersons," or the "Conservative Campbells" were misleading. Instead, the Division introduced expert testimony that extensively addressed the issue of fees and their impact on the purported backtests. (IDOR at 23-24, Div. Ex. 70.) In contrast, Respondents did not offer any expert testimony on the issue of fees in backtests. (IDOR at 24.) In fact, there is no evidence in the record to support Respondents' argument that fees are a wash across the various strategies.

e. Respondents Failed to Disclose That They Did Not Follow Their BOM Strategy and Did Not "Rebucketize" in Their Backtests

The ALJ found that it was misleading for Respondents not to disclose that they did not adhere to the BOM allocation strategy in their backtests. (IDOR at 37-39.) Respondents assert that this finding was in error because rebucketizing would have been speculative and could have exposed Respondents to criticism from the Division. (Resp. Br. at 14-15.) Respondents did not offer any expert testimony to support their arguments on the issue of rebucketizing. (IDOR at 24.) Again, Respondents' arguments lack any merit.

Respondents' purpose in presenting the backtesting claims was to validate the BOM strategy. Respondents were not compelled to include any backtesting claims. If Respondents could not create a legitimate backtest that modeled the BOM strategy, then they should have demurred in making backtesting claims, or should have simply disclosed the relevant and material information. It was grossly misleading to present the backtests as validation of the BOM strategy without disclosing that they did not follow the BOM strategy. There can be no dispute that Respondents' failure to follow their own strategy is material. *William J. Ferry*, Investment Adviser Release No. 1747 (August 19, 1998) (finding that failure to disclose that they were not following the advertised model violated Section 206). The ALJ did not err in refusing to credit Respondents' arguments about the difficulties of rebucketizing, because the arguments lack any merit.

3. Respondents Acted With a High Level of Scienter

As discussed above, the ALJ made extensive factual findings, supported by evidence in the record, that Respondents acted with a high level of scienter. (IDOR at 43-47.) The record fully supports the ALJ's findings. For example, Lucia knew that using a higher inflation rate would be "damaging" to the results of his backtests,[8] (Tr. 1150-51, 1192), yet Respondents did not disclose this fact in the slideshow. Respondents point to a statement in the webinar where Lucia acknowledges that he knew inflation was higher than the assumed rate (Resp. Brief at p. 6), however, Respondents never disclosed to seminar attendees the "crippling" impact that they knew historical inflation rates would have had on the results of their purported BOM backtests. (IDOR at 34; Tr. 870-71, 1581, 1591, 1686-87). Lucia conceded that the purpose of the

[8] Scienter is a knowledge of what one is doing and the consequences of those actions. *See, e.g., SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 77 (D.C. Cir. 1980), *cert. denied*, 449 U.S. 1012 (1980).

seminars was to sign up clients for Respondents' advisory services, so disclosing that the BOM strategy would go bankrupt would not be very helpful. (Tr. 1151-52.) Similarly, Lucia admitted that Respondents made a conscious decision not to rebucketize the backtests and to leave the entire balance in the stock market, and not to disclose either fact. (IDOR at 45.) Respondents do not dispute that they were reckless in not having their own compliance procedure in place to check the accuracy of the numbers presented in the backtest slides. (*Id.* at 46.)

Indeed, that recklessness continued at least up to the hearing: if Respondents are to be believed, they performed no due diligence on their backtest calculations until the eve of the hearing in 2012, yet vigorously contested the deficiencies cited in the 2010 examination, filed an answer denying the allegations of the OIP, posted a video refuting the allegations of the OIP online, and filed extensive pre-hearing briefs that defended the 1973 backtests. (Tr. 1080-81, 1537-38, 1205-08, Div. Exs. 7, 8, 10, 75.) Then, at the hearing, Respondents admitted, in bits and pieces through different witnesses, that Lucia knew the 1973 slides contained errors, Respondents had no support for the 1973 backtests at all, Respondents' expert could not duplicate the 1973 backtest results, and the disclosures on the 1973 "Back Tested Buckets" slide were false. (*See* IDOR at 11 n.11.)

a. The existence of supervisory broker-dealers does not negate a finding of scienter

Respondents argue that they could not have acted with scienter because the seminar slideshow was reviewed by RJLC's supervising broker-dealer and there is no evidence that Lucia was put on notice that there was anything wrong with the claims made in the slideshow. (Resp. Br. at 16-18.) The ALJ carefully considered and rejected Respondents' arguments that the compliance network negated a finding of scienter. (IDOR at 47-48.)

This argument ignores Respondents' fiduciary duty as investment advisers. The Commission has made it clear 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." *Spear & Staff, Inc.*, Advisers Act Release No. 188, 42 S.E.C. 549 (Mar. 25, 1965). Respondents did not meet this duty by waiting for others to spot errors in their advertisements. Evidence in the record established that RJLC did not have any procedures in place to make sure that the slideshow was accurate. (Tr. 668.) Indeed, Respondents were put on notice in 2010 by the examination staff that there were issues with their backtests, yet waited until late 2012, on the eve of the hearing, to check their slideshow for accuracy. (IDOR at 11 n.11.) Respondents did not introduce probative evidence concerning their own efforts to meet the high standards of truthfulness and disclosure they were required to meet, independent of the efforts of any supervising broker.

The ALJ correctly found that the 1966 backtest slides, "unlike virtually every other section of the slideshow, bear no disclaimers at all," which suggested a lack of advertising review. (IDOR at 48, Div. Ex. 1.) Respondents contend that this finding is in error and point to Respondents' Exhibits 25 to 29. (Resp. Br. at 17.) These exhibits do not support Respondents' argument. Respondents' Exhibits 25-28 are not a review of the slideshow, but are reviews of short radio announcements. Respondents' Exhibit 29 shows that Lucia submitted about 150 pages of slides for supervisory review on October 14, 2009, to be used on October 15, 2009, and approval was received on October 16, 2009. This single exhibit is not evidence of robust supervisory review. Moreover, there is no evidence that Respondents provided any documentary support of their backtests to a supervisory broker-dealer. (IDOR at 48.) Indeed, in view of the fact that Respondents concede the 1973 "Back Tested Buckets" slide was riddled with errors, including false disclosures, Respondents' claimed reliance on reviews by supervisory brokers is not credible.

The mere existence of a relationship with a supervisory broker-dealer, without more, does not negate a finding of scienter.[9] The ALJ properly weighed all the evidence and correctly found that that "little significance" can be assigned to Respondents' claim about compliance reviews. (*Id.*) This finding was not error, particularly in view of all of the compelling evidence of scienter.

b. The 2003 examination does not negate a finding of scienter

Respondents incorrectly assert that the SEC examination staff reviewed the backtest slides during the 2003 examination and that the ALJ incorrectly weighed that evidence. (Resp. Br. at 18-20.) Respondents' argument is not supported by the record, and the ALJ properly considered and rejected Respondents' arguments that a 2003 examination of RJLC negated any finding of scienter. (IDOR at 47-49.)

The record shows that the 1966 backtest was not part of the slideshow at the time of the 2003 examination. (IDOR at 49, Tr. 1484, Div. Ex. 21.) Respondents attempt to avoid this fact by arguing that the slideshow contained the "identical representations or omissions." (Resp. Br. at 19.) The ALJ properly rejected this argument because the 1966 backtest is substantively different than the 1973 "Back Tested Buckets" slide. (IDOR at 48-49.) Indeed, the 1966 backtest slides do not even contain the same disclaimers that appear on the 1973 backtest slides. Respondents' argument also ignores their admissions that the 1973 "Back Tested Buckets" slide,

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[9] *See, e.g., Scott Epstein*, Exchange Act Release No. 59328 (Jan. 30, 2009), *aff'd*, 416 F. App'x 142 (3d Cir. 2010) ("We have held repeatedly that a respondent cannot shift his or her responsibility for compliance with an applicable requirement to a supervisor.")

which was reviewed during the 2003 examination, in fact is materially false and misleading in multiple ways.

Further, Respondents ignore the plain language of the deficiency letter issued in December 2003. (Resp. Ex. 13.) Respondents informed the examination staff in advance of the 2003 examination that they were not engaging in performance advertising, (Resp. Ex. 15 at 11; Resp. Ex. 16 at 1), and the deficiency letter does not discuss any performance advertising. (Resp. Ex. 13.) The deficiency letter expressly states: "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 or regulations. The above findings are based on the staff's examination and are not findings or conclusions of the Commission." (Resp. Ex. 13 at 9-10.) Respondents do not provide any legal authority for the proposition that the mere fact that the Commission's examination staff looked at a particular item one year negates a finding of scienter with regard to conduct that occurred years later.

As they do here (Resp. Br. at 19), Respondents cited *SEC v. Slocum Gordon, & Co.*, 334 F. Supp. 2d 144 (D.R.I. 2004), to the ALJ, and the ALJ correctly found it is inapplicable for a number of reasons, including that the defendants in *Slocum* brought specific issues to the attention of the examination staff during two examinations, and relied on advice of counsel. (IDOR at 49.) There is no evidence that Respondents sought any advice from the examination staff concerning performance advertising. To the contrary, in 2010 Respondents vigorously contested the deficiencies found by the examination staff in Respondents' performance advertising.[10] Respondents do not cite any evidence that shows the ALJ erred in any way in rejecting their arguments concerning the 2003 examination.

c. Lucia's testimony about his subjective belief does not negate a finding of scienter

Respondents argue that the ALJ erred by not crediting Lucia's testimony concerning his subjective belief that he was using the term "backtest" correctly to encompass forward-looking hypotheticals. (Resp. Br. at 16.) In fact, the ALJ carefully considered the evidence offered by Lucia, his son Lucia Jr., and long-time employee Richard Plum, concerning their understanding of the term "backtest." (IDOR at 25-29, 39-40, 45.) The ALJ found that in the face of Lucia's "persistent allusions to backtesting his strategy, I do not accept the inconsistent, after-the-fact descriptions of what Lucia and others testified Lucia was actually portraying, instead of a backtest." (IDOR at 27.) The IDOR demonstrates that the ALJ carefully weighed all the evidence, including Respondents' credibility, to arrive at this conclusion.

Respondents provide no legal authority for the proposition that a respondent's denial that they acted with scienter outweighs any other evidence in consideration of scienter, and negates a finding of scienter. If that were the law, the Division would never be able to prove scienter. However, scienter may be established that respondent knew or, or recklessly disregarded, the wrongdoing and their role in furthering it. *See Phlo Corp.*, Exhange Act Rel. No. 55562, 90 S.E.C. Docket 1089, 1103 (Mar. 30, 2007). While Lucia disclaimed scienter, the record contains substantial evidence that Lucia knew that the backtests did not present material information – such as that historical inflation rates would cause them to go bankrupt, that the backtests did not

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[10] In *Slocum*, defendants relied on a no-action letter. Here, the 2010 examination staff cited to Respondents the no-action letter *Clover Capital Management, Inc.*, File No. 801-27401 (Oct. 28, 1986). Rather than relying on that advice, Respondents have consistently maintained that that the *Clover* letter does not apply to their conduct.

rebucketize and failed to follow BOM, and that fees would have a material impact on the backtest results. (*See* IDOR at 43-47.) Lucia's after-the-fact denials are contradicted by evidence of his actions at the relevant time.

4. Respondents Misrepresentations and Omissions were Material

As discussed above, the ALJ made extensive, factually supported findings that the misrepresentations and omissions were material. (*See, e.g.*, IDOR at 49-52.) Respondents contend that the ALJ erred because they did not sell securities at the BOM seminars, and cite evidence that the ratio of persons seeking advisory services was "unchanged" after the backtesing slides were removed from the slideshow. (Resp. Br. at 29-30.)

The ALJ expressly considered this evidence and correctly concluded that investment advisers may be held liable under the Advisers Act even without misrepresentations specific to a client investment decision. (IDOR at 51 (citing cases).) Respondents have not argued that the ALJ made a legal error, and have not cited any cases to contradict the ALJ's legal finding on this question.

Moreover, evidence in the record contradicts Respondents' argument. Respondents admit that they were not selling securities at the BOM seminars, but instead were selling the services of RJLC and the BOM strategy. (Tr. at 1067, 1072-73.) According to Respondents, "clients are buying the Buckets of Money strategy and not the individual underlying products." (Div. Ex. 4 at SEC-AL3937-05032-33.)

B. The ALJ Appropriately Ordered a Permanent Associational Bar and Third-tier Penalties

The ALJ considered the public interest and found that it weighs in favor of a heavy sanction in view of the findings that Respondents had violated the Advisers Act, including revocation of registrations, third-tier penalties, and an associational bar against Lucia. (IDOR at

56-61.) Respondents do not challenge the permanent revocation of the registrations of Lucia and RJLC as investment advisers. (Resp. Br. at 20.) However, Respondents contend that a permanent associational bar against Lucia is not in the public interest, and that third-tier penalties are excessive. (Resp. Br. at 20-29.)

The ALJ correctly applied the *Steadman* factors[11] to determine that the public interest weighed in favor of a permanent associational bar. (IDOR at 58-59.) Commission bars are based on a need to "protect the investing public from the respondent's possible future actions." *Gregory Bartko*, Release No. 71666 (Mar. 7, 2014).

As discussed above with respect to the violations, the facts establish that Respondents' violations were egregious, recurrent, and made with a high level of scienter, which are three of the relevant considerations under *Steadman*. These factors support imposition of an associational bar.

The record supports the finding that Respondents "have utterly failed to recognize the wrongful nature of their conduct." (IDOR at 58.) Nonetheless, Respondents argue that because Lucia withdrew the backtest slides after receiving the deficiency letter in 2010, and is no longer associated with any registered investment adviser or broker-dealer, Lucia recognizes the wrongful nature of his conduct. (Resp. Br. at 20.) In fact, Lucia resigned from RJL Wealth Management in July 2013, after the Initial Decision was issued that revoked his registration.

[11] *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). The *Steadman* factors include the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations. The inquiry into the public interest is a flexible one, and no one factor is dispositive. *David Henry Disraeli*, Exchange Act Rel. No. 57027 (Dec. 21, 2007), 92 SEC Docket 852, 875, *petition denied*, 33 F. App'x 334 (D. C. Cir. 2008) (per curiam).

Similarly, Respondents removed the backtest slides after receiving the deficiency letter. These facts are equivocal on the issue.

In contrast, substantial evidence in the record supports the conclusion that Lucia has not recognized his wrongful conduct. The ALJ cited numerous instances where Lucia gave inconsistent, contradictory, or knowingly false testimony at the hearing. (IDOR at 43-47.) Respondents recklessly defended their actions without any due diligence, including posting a video on the Internet categorically denying the allegations in the OIP. Indeed, after discovering that the 1973 "Back Tested Buckets" slide was riddled with errors and was indefensible, Respondents did not proactively provide that information to the hearing officer or the Division, but dribbled it out in contradictory and inconsistent bits of testimony. (IDOR at 11 n.11.) On this appeal, Respondents refuse to concede that they falsely represented to investors that they had backtested BOM, and seek to run away from the term they freely used for years in their advertising materials. Respondents seek to explain away their failure to follow their BOM strategy in the backtests they used to validate BOM. Indeed, Respondents continue to assert that they did nothing wrong. The record supports the conclusion that Respondents have utterly failed to recognize the wrongful nature of their conduct.

Because Lucia has not recognized the wrongful nature of his conduct, he has not provided any credible assurances that he will not engage in such conduct in the future. In addition, after the 2003 examination, Lucia personally assured the examination staff that he would stop making misrepresentations about the length of time he had been an investment adviser, but the 2010 examination found he was again engaged in the same improper conduct. (IDOR at 19, 58.) Respondents point out that Lucia agreed to stop the improper conduct again in

2010. (Resp. Br. at 21.) The record establishes that any assurances Lucia might provide are not credible.

Lucia's occupation presents opportunities for future violations. Lucia wishes to "continue serving as an in-demand public speaker, consultant, and media personality on retirement planning and other topics."[12] (Resp. Br. at 25.) At the time of the hearing, Lucia was under contract with RJL Wealth Management to provide "consulting" services for $300,000 a year, which included providing training for investment advisers on the BOM strategy, among many other things. (IDOR at 6.) Lack of an associational bar would allow Lucia to resume his association with RJL Wealth Management. In view of the fraudulent conduct in marketing RJLC's advisory services and the BOM strategy, allowing Lucia to resume such promotional activities will provide fertile opportunity for future violations. The ALJ properly found that it is in the Commission's interest to deter others from behaving like Lucia. (IDOR at 58.) An associational bar accomplishes that public interest.

Respondents argue that a permanent bar is inconsistent with Commission precedent, and cite to a number of settled actions. (Resp. Br. at 22-24.) However, it is well settled that the appropriate sanctions depend on the particular facts and circumstances presented.[13] The settled actions cited by Respondents are not comparable because they do not present the fuller, more developed record that exists in this litigated matter. Here, the record contains multiple instances

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[12] Commission staff have recently heard advertisements for RJL Wealth Management seminars promoting the "buckets" strategy. At present, it is not known if Lucia is appearing at any RJL Wealth Management seminars in any capacity.

[13] *See Robert L. Burns*, Advisers Act Rel. No. 3260 (Aug. 5, 2011), 101 SEC Docket 44807, 44824 n. 52 ("[I]t is well established that the appropriateness of a sanction 'depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with the action taken in other proceedings.'")

where Lucia provided knowingly false testimony to the hearing officer. (IDOR at 43-47.) None of the settled actions cited by Respondents involve comparable facts.

Respondents argue that Lucia's disciplinary history and lack of customer harm should have a mitigating effect. (Resp. Br. at 1, 22-25.) The Commission has made clear that "lack of disciplinary history is not a mitigating factor for purposes of sanctions because an associated person should not be rewarded for acting in accordance with his duties as a securities professional." *Scott Epstein*, Exchange Act Release No. 59328 (Jan. 30, 2009) (*quoting* Phillipe *N. Keyes*, Release No. 54723 (Nov. 8, 2006) n. 20).[14] Similarly, absence of customer harm is not a mitigating factor for sanctions. *Ernest A. Cipriani*, 51 S.E.C. 1004, 1007 (1994) (rejecting absence of customer harm as a mitigating factor for sanctions).

Respondents argue that the public interest does not support an associational bar because Lucia may face ostracism from the industry, and they ask for a "bright line" sanction. (Resp. Br. at 26.) Revocation of registration, a cease and desist order, a third-tier penalty, and an associational bar are sanctions that set a very "bright line." Respondents do not identify sanctions that would impose a line that is "brighter," or clearer, than the sanctions ordered by the ALJ.

Finally, Respondents challenge the imposition of third-tier penalties against Lucia and RJLC, and argue that the determination to award third-tier penalties rested "almost entirely on the level of scienter." (Resp. Br. at 27.) The ALJ properly considered not only Respondents' scienter, but also the recurrence of Respondents' deceitful conduct, the need to deter

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[14] *See also Rooms v. SEC*, 444 F.3d 1208, 1214 (10th Cir. 2006) (holding that lack of disciplinary history not a mitigating factor); *Robert J. Prager*, Exchange Act Release No. 51974, 58 S.E.C. 634, 666-67 (July 6, 2005) (finding no mitigation in respondent's "otherwise 'pristine' disciplinary record").

Respondents given Lucia's continued employment in the financial sector, and Lucia's failure to acknowledge the wrongfulness of his conduct. (IDOR at 59-60.) The ALJ considered that Respondents violated the statute hundreds of times, and finally, after properly weighing all the factors, found that a one-time penalty was least prejudicial to Respondents. (*Id.* at 60-61.) Moreover, the ALJ's finding that Respondents enjoyed substantial financial success at their clients' expense is not inconsistent with a finding of no substantial investor losses (Resp. Br. at 27), because the ALJ was referring to the commissions from REIT sales, which in the aggregate were unquestionably substantial for Respondents, but would not necessarily be significant to any single investor. The ALJ properly balanced the appropriate factors and the record supports imposition of a third-tier civil penalty of $50,000 against Lucia and of $250,000 against RJLC.[15]

C. The Commission Should Find That the Slideshow Presentation Was an Advertisement Under Rule 206(4)-1(a)(5) and Violated the Rule

The Division requests that the Commission review the portion of the IDOR that concluded that the slideshow was not an "advertisement" under Rule 206(4)-1(a)(5), 17 C.F.R. § 275.206(4)-1(a)(5), (IDOR at 52-53), and find that the slideshow is, in fact, covered by and violated the Rule. Such a finding is consistent with Commission releases stating that its antifraud provisions are not limited to traditional media, with applicable precedent, and with the ALJ's findings concerning the slideshow.

The ALJ concluded that the slideshow did not qualify as advertising under the Rule because precedent, "outdated as it may be, holds written communication to include only traditional media, including books, newsletters, and newspaper and magazine advertisements." (IDOR at 52-53.) The ALJ reasoned that to be covered by the rule, the written slideshow needed

[15] While RJLC may be defunct, it lives on in RJL Wealth Management, which identified Lucia as "our founder" in at least one investor brochure. (Resp. Ex. 2 at SEC-LA3937-00076.)

to be printed and distributed to seminar participants, "or otherwise published in printed or handwritten form at the seminars." (*Id.*) Thus, while finding that the slideshow was "marketing material," (*id.* at p. 48), the ALJ concluded that the slideshow was not "advertising" covered by Rule 206(4)-1(a)(5).

Section 206(4) of the Advisers Act is an antifraud provision that makes it unlawful for any investment adviser to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." 15 U.S.C. § 80b-6(4). Rule 206(4)-1(a)(5), promulgated under that section, makes it unlawful for a registered investment adviser to "publish, circulate, or distribute any advertisement ....which contains any untrue statement of material fact, or which is otherwise false or misleading." 17 C.F.R. §275.206(4)-1(a)(5). The Rule defines "advertisement" broadly to include "any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television..." 17 C.F.R. § 275.206(4)-1(b). Section 206(4) and Rule 206(4)-1(a)(5) are thus meant to encompass false or misleading advertisements by investment advisers.

The Commission has long expressed the view that the antifraud provisions of the federal securities laws apply to any information delivered electronically, as it does to information delivered in paper. *See, e.g.*, *Use of Electronic Media for Delivery Purposes,* Securities Act Release No. 7233 (Oct. 6, 1995), 60 FR 53458 (Oct. 13, 1995) ("1995 Release"); *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Securities Act Release No. 7288 (May 15, 1996) 61 FR 24644 (May 15, 1996) ("1996 Release"); *Use of Electronic Media*, Securities Act Release No. 7856 (May 4, 2000) ("2000 Release"). In the 1996 Release, the Commission noted:

> the substantive requirements and liability provisions of the federal securities laws apply equally to electronic and paper based media. For

> example, the antifraud provisions of the Exchange Act and Rule 10b-5 thereunder, as well as section 206 of the Advisers Act and the rules thereunder, apply to information delivered and communications transmitted electronically, to the same extent as they apply to information delivered in paper form.

1996 Release at n.4 (citing 1995 Release at n.1.) In the 2000 Release, the Commission explicitly recognized "the potential for electronic media, as instruments of inexpensive, mass communication, to be used to defraud the investing public." 2000 Release at n.4. Thus, the Commission has not limited the definition of the term "advertisement" or "written communications" to traditional media. Indeed, under such a narrow definition, advertising brochures that are sent electronically, rather than sent using traditional paper mail methods, would arguably not be advertising under the Rule.

Here, Respondents delivered the written slideshow electronically to an audience using a computer and a screen to publish the written slideshow to a large number of people. The audience members saw it on the screen – much like a television advertisement. The written information was published to the audience as effectively as if Respondents had distributed a written copy of the slideshow to audience members. The admitted purpose of the seminars and the slideshow was to sell the BOM strategy to prospective clients. The fact that Respondents displayed the pages of the slideshow on a screen while Lucia was standing in the room cannot remove the slideshow from the realm of advertising covered by the Rule. Indeed, such a conclusion is inconsistent with the broad remedial provisions of the antifraud provisions, and gives weight to the form of the communication over the substance that the communication is an advertisement.

In keeping with Commission precedent, the Commission and courts have liberally construed the term "advertisement." In *SEC v. C.R. Richmond & Co.*, 565 F.2d 1101 (9th Cir.

1977), the Ninth Circuit found that Section 206 encompassed false and misleading statements in a book and in newsletters. In response to defendants' arguments that their newsletters and books were not advertisements under Rule 206(4)-1(b), the Ninth Circuit recognized that the term is broadly defined and the conduct at issue must be measured from the viewpoint of a person "unskilled and unsophisticated in investment matters." *Id.* at 1104. The Ninth Circuit concluded that "[i]nvestment advisory material which promotes advisory services for the purpose of inducing potential potential clients to subscribe to those services is advertising within the Rule." *Id.* at 1105. *See also SEC v. Locke Capital Management*, 794 F. Supp. 2d 355 (D.R.I. 2011); *SEC v. Lauer*, 2008 WL 4372896 (S.D. Fla. 2008); *SEC v. Valicenti Advisory Services*, 198 F.3d 62 (2d Cir. 1999); *SEC v. Lindsey-Holman*, 1978 WL 1129 (W.D. Ga. 1978); *Lynn Elgert, Inc.*, Release No. 1339, 52 S.E.C. Docket 1614 (Sept. 21, 1992) (material sent via "electronic hotline" was advertising under the rule; investment adviser consented to entry of permanent associational bar). *Spear & Staff, Inc.*, Advisers Act Release No. 188, 42 S.E.C. 549 (Mar. 25, 1965) (market letters sold to subscribers were advertisements within the rule).

New forms of advertising are being developed every day, over the Internet and various forms of social media. Electronic developments allow people to communicate face-to-face via Skype, and to share documents via the Internet. It is simply too restrictive to limit the coverage of an antifraud provision covering advertising to "traditional" forms of media. The slideshow being published at the seminars was not the most innovative use of modern communication techniques, but it was clearly the publication and distribution of material by an investment adviser to prospective clients in an effort to induce them to subscribe to RJLC's advisory services.

For all those reasons, the Division requests the Commission find that the slideshow is an advertisement covered by Rule 206(4)-1(a)(5). For all of the reasons that the ALJ found the slideshow was false and misleading, the Division requests that the Commission find the slideshow advertisement was false and misleading in violation of the Rule.

IV. CONCLUSION

For all the reasons stated, the Division requests that the Court make findings consistent with, and affirm, the IDOR, and affirm and impose the sanctions ordered therein. The Division further requests that the Commission find that the slideshow is an advertisement under Rule 206(4)-1(a)(5), and violated that Rule.

Respectfully submitted,

DIVISION OF ENFORCEMENT

Dated: April 23, 2014

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Certificate of Compliance

I, John B. Bulgozdy, certify pursuant to Commission Rule of Practice 450(d), that this brief complies with the length limitation set forth in Rule 450(c) because the word count of the word-processing system used to prepare the brief is 12,881 words, excluding tables.

Dated: April 23, 2014

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