Opinion of Commissioner Gallagher and Commissioner Piwowar, dissenting from the opinion of the Commission

Commissioner Daniel M. Gallagher and Commissioner Michael S. Piwowar

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The misdeeds of the respondents in this case have been well established.[1] In making pitches for investment advisory services to large audiences on multiple occasions, the respondents touted an approach called "Buckets of Money," a catchy name for a re-balancing strategy. Unfortunately, the Commission majority has taken a relatively straightforward set of facts and needlessly engaged in "rulemaking by opinion." For that reason, we dissent from the majority opinion.

The respondents claimed that their approach was more likely to produce favorable results when compared to a conservative portfolio of 100% bonds, an aggressive portfolio of 100% stocks, and a hybrid portfolio of 60% stocks and 40% bonds. The respondents tried to demonstrate the superiority of their "Buckets of Money" approach using scenarios from 1973, when the stock market dropped significantly for two years, and from 1966, when the Dow Jones Industrial Average stagnated for a sixteen year period, as compared to the three other portfolios.

The problem for the respondents was that (i) they did not actually utilize the "Buckets of Money" approach in determining the results for in the 1973 and 1966 scenarios and (ii) with respect to the 1973 scenario, they could not even re-construct their supporting calculations. Had the Commission majority simply stopped there, the opinion would have been easy to support.

Instead, the majority opinion creates from whole cloth specific requirements for advertisements that include the word "backtest." Despite the lack of any statutory or regulatory definition of what constitutes a "backtest," the majority opinion finds it fraudulent or deceptive practice if a backtest fails to use actual historical rates — even if the slideshow presentation specifically discloses the use of assumed rates for certain components.

In the context of the respondents' slideshow presentation, the use of the word "backtest" and assumed inflation rates were not misleading. A review of the slideshow reveals that the respondents were making two points: (i) inflation can cause a retiree to exhaust retirement savings; and (ii) stock returns can be volatile and a significant decline in the first year or two of retirement will affect how long retirement savings will last.

To illustrate how inflation can affect retirement savings, the respondents used a 3% assumed inflation rate. The effect of inflation was first presented in connection with the conservative scenario. Using the 3% assumed inflation rate, the respondents created a baseline scenario indicating that the conservative portfolio would be exhausted in 27 years if withdrawals were indexed for inflation.

In contrast, the respondents presented the results of an aggressive portfolio invested 100% in stocks. Using an assumed annual return of 10%, the respondents stated that the aggressive portfolio would never be exhausted. However, the respondents' slideshow presentation repeatedly cautioned that stock returns can be highly volatile and that a significant decline in stocks during the first year or two of retirement could affect whether retirement savings will be sufficient.

The respondents used the 1973 bear market scenario to show the possible effects of stock market volatility on retirement savings and comparative outcomes among the aggressive, hybrid, and "Buckets of Money" portfolios.[2] Using the 3% assumed inflation rate, the respondents claimed in the 1973 scenario that the aggressive portfolio was exhausted in 17 years and the hybrid portfolio was exhausted in 21 years. On the other hand, the respondents asserted that the "Buckets of Money" portfolio would not run out of funds.[3]

It is appropriate to use a consistent, assumed inflation rate when comparing the results among portfolios. Moreover, we find troubling the majority opinion's holding that, notwithstanding the disclosure that the scenarios were determined using assumed 3% inflation, the slideshow presentation was nonetheless fraudulent because a backtest must use historical inflation rates.

The majority opinion emphasizes the testimony of witnesses at the slideshow presentations who thought that the backtests used actual historical inflation rates. But the test for materiality is an objective, not subjective, test of the reasonable investor. Given the clear disclosure of the inflation rate assumptions in the slideshow presentation, we find that a reasonable investor would not have believed that actual historical rates of inflation were used in the backtests.

Finally, the respondents have raised important issues with respect to whether the administrative law judge[4] overseeing the proceeding was appointed in a manner consistent with the Appointments Clause of the Constitution. Even though the Commission is free to express its views on Constitutional issues, we recognize and believe it is appropriate that Article III federal judges ultimately resolve this issue.[5]

[1] *In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.*, Securities Exchange Act Release No. 75837 (Sept. 3, 2015), available at http://www.sec.gov/litigation/opinions/2015/34-75837.pdf.

[2] The respondents asserted that had a person retired in 1973, stock returns for the next two years declined by 41.13%. The respondents showed other slides analyzing similar effects from 1966, when the Dow Jones Industrial Average began and ended for a sixteen year period at around 1,000 points.

[3] As noted previously, the purported results of the Buckets of Money portfolio for the 1973 scenario were fraudulent, but were fraudulent for reasons unrelated to the use of an assumed rate of inflation.

[4] Before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Commission leadership actively sought from Congress expanded authority to seek monetary penalties against individuals through administrative proceedings. The result was Section 929P of Dodd-Frank. *See* SEC's "Wish List" of 42 Changes It Seeks in the Federal Securities Laws (July 16, 2009), available at http://www.securitiesdocket.com/2009/07/16/sec-s-wish-list-of-42-changes-it-seeks-in-the-federal-securities-laws/ (citing Fox Business reports).

[5] *See* Duka v. SEC, 2015 WL 4940057 (S.D.N.Y. Aug. 3, 2015); Hill v. SEC, 2015 WL 4307088 (N.D. Ga. June 8, 2015).

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