Testimony

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

In the Matter of:)

) File No. FW-02973-A

STANFORD GROUP COMPANY) Amended: 2/6/2009

WITNESS: Michael J. Zarich

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PLACE: Securities and Exchange Commission

801 Cherry Street, 19th Floor

Fort Worth, Texas

DATE: Friday, January 30, 2009

The above-entitled matter came on for hearing, pursuant to notice, at 11:38 a.m.

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APPEARANCES:

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C O N T E N T S

P R O C E E D I N G S

MR. KELTNER: We're now in the record, Mr. Zarich. I'd just like to go through a few preliminaries very quickly.

I know you've had a chance to talk to Terry about testimony and how it works -- you know. We'll try to follow Terry's admonitions -- you know, no non-verbal responses, all that kind of stuff.

But just real briefly, I'm Tom Keltner. With me today are Kevin Edmundson and Michael King of the Enforcement Division. Mr. King has stepped out. He'll be back briefly. David Reece is also here, and also Craig Ellis from our Reg staff.

We've requested your testimony as part of a formal inquiry in the matter of Stanford Group Company. We'll go ahead and get you under oath at this point, if you're okay with that.

MR. ZARICH: Okay.

MR. KELTNER: Could you please raise your right hand?

Whereupon,

MICHAEL J. ZARICH

was called as a witness and, having been first duly sworn, was examined and testified as follows:

EXAMINATION

BY MR. KELTNER:

Q Thank you. Could you please state and spell your full name for the record.

A Michael Joseph Zarich.

Q How do you spell Zarich?

A Zarich is Z, as in zebra, a-r-i-c-h.

Q Before we went on the record, I gave you and your counsel a copy of the Formal Order in this matter, including an amendment, a couple of amendments, that added myself and Michael King to the Formal Order, as well as a copy of the Commission's Form 1662, which you also should have received a copy of with your subpoena?

A Yes, that's correct.

Q Do you have any questions regarding those documents at this point?

A I do not.

Q Okay. They will be available throughout your testimony, if you choose to reference them, or if you have questions at a later date. I'll be happy to answer those questions. Mr. Zarich, are you represented by counsel today?

A Yes, I am.

MR. KELTNER: And would counsel please identify himself?

MR. CRAINE: Patrick Craine from Bracewell Guiliani, here on behalf of Mr. Zarich.

BY MR. KELTNER:

Q Okay. Mr. Zarich, you're here under subpoena today. After you received the subpoena, could you tell me what you did to look for documents and other responsive materials?

A I did. I checked per our previous phone conversation. I checked for some files that I thought I might have, and it turns out I did, and then Patrick has submitted those to you all today on a floppy disk.

Q Okay, and the computer that you pulled these documents from, that was a personal computer?

A It was. It was a home desktop computer.

Q Okay, and just generally, how did those documents end up on that computer? Was it a computer you used for work, from home, logging in, that kind of thing?

A It was. It was -- and I should backtrack. There were some on a floppy as well. There were some disks on a floppy. But yeah, it would be downloaded probably from e-mail and looking at files, so forth and so on.

Q Okay, and these are all documents that would have been on there for quite some time? They weren't recently added or anything like that?

A No. It's been -- I left Stanford a year and a half ago, so at least a year and a half.

Q Okay. Were there any -- so did all the documents that you're producing today come from that computer?

A Yes, or the floppy.

Q Okay, and when you say the floppy, what is that?

A Oh, the disk. I still call them floppies.

Q Like CDs?

A A CD, I'm sorry.

Q Okay.

A And they were on a floppy. I had a work computer, the laptop that I turned into Stanford, that frequently crashed. So I think over time I had compiled some files on that disk.

Q Okay. You transferred some files over from time to time?

A Yes.

Q Okay. What about e-mail? Did you do any review for e-mail?

A I did not, because I don't have access to the Stanford Exchange server. There wouldn't have been any on hotmail or anything like that.

Q Any recent e-mail correspondence you had with people from Stanford?

A I have some friends there, lunch -- you know, Super Bowl, who's going to win. Some friends in Antigua and the Houston office that I keep in touch with.

Q Sure. Anything related to the investigation that's going on now?

A No.

Q Okay. So no e-mails that say things like, call me, and then led to discussions about --

A No.

Q Since you brought it up, who are you still close with at the company?

A And I don't know if we want to differentiate my time in Houston or Antigua, but Houston I still talk to Brent Hennings. He's in commissions. Mark Grosebeck is a financial advisor in Houston.

Willie North and Ben Simiski. I believe that's S-i-m-i-s-k-i. That's kind of our every other week lunch crowd. Mark and Ben work together, and then in Antigua, Sasha Mercer is probably my most frequent, and it is usually by e-mail we communicate.

Q And what's Sasha's role?

A She's the -- they call her the protocol officer, which is really the kind of concierge. She's responsible for organizing trips to the bank, clients, prospects, hotel accommodations, airfare. Kind of runs the tour, if you will.

Q Okay. So did you interact with her quite a bit when you were down in Antigua?

A Yeah, very much so.

Q Okay. At this point, just to kind of set the stage -- obviously, we've spoken before. We did an informal

interview, and we're probably going to go back over some of that ground now, since now we've got a court reporter.

So we may -- you know, don't get frustrated if we're going back over stuff we talked about before.

A Okay.

Q So just kind of starting from the beginning, how did you come to work at Stanford Group?

A I was hired in 1999, June-July in Denver, Colorado, as an asset management analyst, in what was then the Private Client Services Group, which is the advisory arm or the Advisory Department of Stanford Group Company, the broker-dealer/RIA.

I was hired to create and promote a mutual fund allocation program called MFP. The PCS, Private Client Services Group, had an array of fee-based products, separate account managers, this program and a few others. So that was while I was hired. Do you want me to kind of run through the whole quick history of --

Q Yeah, that would be great.

A I worked there in 2002, the beginning of 2002, end of 2001-2002, that Denver office was essentially closed, and I was luckily offered a job in Houston, in which case Chip McNeil and myself moved to Houston to still run that group in 2002.

He left the company, I believe late that year, and

it basically became my group. At some point in there, it was redefined as the Investment Advisory Group, which I ran right up until December 31 of 2005, which then -- and then I was transferred down to Stanford International Bank in Antigua, as the role of senior investment officer, until my resignation in July 2007.

Q Okay. Who hired you initially?

A It was joint, Chip McNeil that I mentioned, who was technically my supervisor, and we both reported to Bob Glenn, who ran that whole department, the Private Client Services Group.

Q Okay, and then did your reporting chain stay pretty much the same until you moved to Houston?

A Yes, yes. In Denver it did, and then in Houston, it was Chip McNeil and then Jay Comeaux and Alvaro Trullenque. I had a few reports over the years, but --

Q Sure.

COURT REPORTER: Can I get the spelling of that last name?

THE WITNESS: Oh, yeah. Al Trullenque, T-r-u-l-l-e-n-q-u-e.

BY MR. KELTNER:

Q Okay, and after you got to Houston, who was in the -- I guess, we'll call the Investment Advisory Group. I know it changed names over time.

A We got there, it was the two of us, Chip and myself, and we hired an assistant.

Q What was his or her name?

A Her -- I'm afraid it's sad to say I'm going to have to say I don't remember. I could come up with it.

Q Yeah. Is that Jurika, or is that a different assistant?

A No. Susan, no. She's gone. She was with us maybe nine months, six to nine months. I do know Susan, though.

Q Okay. In what ballpark was she? What year would you say that nine months fell in?

A Oh, that would have been 2002, probably into a little bit of 2003.

Q Okay, and since we're talking about her, what was her job?

A She was an assistant, an administrative assistant, filing, phones. That could be just fairly low level administrative stuff. Some projects here and there.

Q Okay. So how does your staff change after that? I mean, kind of -- what are the significant changes going forward?

A And forgive me for dates, but my next -- Chip was let go, I want to say fall of 2003, I believe. Then I essentially then had the reins myself, and then it was a small department at the time. But the growth was starting to

ramp up, and I made my first hire, I believe, in 2004. 2003 or 2004 was Jason D'Amato.

Q Okay, and how did you know Mr. D'Amato?

A A resume that came in through our Human Resources Department.

Q So you hired D'Amato in, you think early '04, '03, somewhere in that time frame?

A Yes.

Q And so he --

Was he kind of your number two?

A Yes, yes.

Q So he comes in --

I guess MFP is established at this point.

A Yes.

Q Okay, and were there other senior people, or is it mostly you and Mr. D'Amato at this point?

A It was us. We reported. We did report to Jay now, as I mentioned, and then there was a period in there we switched over to Ben Finkelstein. F-i-n-k-e-l-s-t-e-i-n.

Q Okay. Was he in the Fixed Income group?

A I believe he's still there. He's an institutional Fixed Income trader/transacter.

Q And then just to -- since we're on the path, let's go ahead and walk through how -- both up and down, how the management chain changes. Because I know at some point Stys

comes in and Parrish comes in. Could you kind of sort that out for us?

A Yes. Let's just go to the beginning. Bob Glenn, Chip McNeil, and I'd say Jay and Alvaro together, because they're a team. That's Jay Comeaux and Alvaro Trullenque. Ben Finkelstein and then Eddie Rollins, and then really Danny Bogar would be my last report.

Q And just for the record, who is Danny Bogar?

A He was -- I think he's still there, the managing director over Stanford Group Companies, which would be the broker-dealer. I guess anything really under the broker-dealer, Investment Banking, Coins and Bullion. There's actual BD itself.

Q And would you include the investment advisor in that, or no?

A We were under that, yes.

Q Okay, and so I know at one point --

A Oh, go ahead.

Q At one point the investment advisor spins out to a new company?

A Yes.

Q Okay, and that was --

A Then that was after -- the talks were starting when I was still there in 2005, but I think the ultimate spinout was beyond after I left the bank. I want to say 2006, and

then it did spin out to Stanford Capital Management.

Q Okay, and the business unit that you managed became Stanford Capital Management?

A Correct, correct.

Q Okay, and so were you still in that group when Stys and Parrish come into the picture?

A No.

Q Okay. So did Parrish largely replace you, is that correct?

A Yes. Jason did, I don't know if de facto is right. Jason did technically replace me.

Q Okay, Jason D'Amato.

A D'Amato when I left for the bank, and then I think Zach Parrish came in shortly after and Jason reported to Zach. Then Mark Stys came in after that. I think it's kind of in between Zach and Jason, I believe.

Q Then during this time frame, you're down in Antigua?

A Correct.

Q So you have probably have some picture in what's going on up in Houston that you're not directly involved?

A Yes, and I will say I did not live full time in Antigua. I essentially did a rotation mostly there, but maybe a week a month I was still in Houston, in which case I was officed at the 5050 location, which is where the

broker-dealer is.

So yes, I was in loose contact. I was mostly in contact with the financial advisors, and not so much that group.

Q I'm just trying to get context. Are you single or married at this time?

A In between.

Q Okay. Well, I was just trying to figure out where your family would have been?

A They were there in Houston.

Q Did you have kids in Houston?

A Kids in Houston.

Q Okay, so you're rotating back, spending time with your family?

A That was -- exactly.

Q Was that part of your deal, that you'd get to come back from time -- frequently to see family and all that?

A Yes. That was certainly a caveat to accepting that position as senior investment officer, was that I would not move down there. They tried to get me to move, with my family to move down there, but I did not.

Q Okay, and just since we're kind of going through the time line at this point, was it around the end of '05, early '06 when you made the move to Antigua?

A Yes. Jim Davis approached me with a position in I

want to say August of 2005. I accepted, and then that fall really was a training period, getting ramped up for that position, for a January 1, 2006 start date.

Q Okay. When you say "a training period," what did that involve?

A It was mainly working with Laura Pendergast in Memphis on what my duties would be. We talked about a big part of my responsibility would be essentially facilitating in the sales process of the CD Products of the bank, and how to communicate with financial advisors and their clients and their prospects. Go ahead.

Q So it sounds like -- how long were you in Memphis?

A I was there a lot. Not every week, but quite frequently for those three or four months that I was training. So let me -- there was a previous rotation as well to Memphis, even back to the Investment Advisory Group days, with the intention of getting synergies with that research group. We were already on a rotation basis. So I had previously been spending time in Memphis.

Q Okay, and roughly when was that?

A That would have been in that '05, '04-'05 period.

Q Okay, and I know we've talked about a lot of this, but just to get the context. When you say "that research group," can you tell me who you're talking about?

A Yes. Laura Pendergast is the chief investment officer of the Stanford Financial Group, and among her duties she has, I want to say, 20 or so research analysts that handle sectors and kind of macro research on currencies, regions. They're responsible for Asia, Latin America, whatever.

So they put out reports that the financial advisors would use to educate themselves and their clients, interest rates and markets, where they're going.

So it made sense for the Investment Advisory Group to meet with them, to give us ideas how we're going to allocate portfolios and strategies.

Q So you interacted with them on MFP-related issues; is that correct?

A Right.

Q Okay. Advice on investment strategy, which sector they should be in, which parts of the world, those kinds of things?

A Yes, yes.

Q Was it also part of the responsibilities or work flow of this group in Memphis to consult on the management of the assets of the bank?

A Yes. I would say from a monitoring standpoint, the 20 analysts in Memphis were responsible for overseeing a portion of the assets of the bank. As we've discussed, the assets of the bank is an investment portfolio on a loan

portfolio. So --

Q Right.

A Go ahead.

Q So let's talk about that for a minute. So you say it's not a loan portfolio. Are you saying as opposed to a conventional bank, where they take money in and they loan it out, they've got a loan portfolio, SIB is a little different. Can you tell me how it's different?

A Correct. Yeah, the model is different, in just that first of all, there's no loans at the bank. There's just one chartered bank in Antigua, and the only product they have is a certificate of deposit with maturities from one month to five years.

So the depositor puts their money on. They get a guaranteed rate, whatever percent. That money -- like traditional banks would loan that money out to create a spread.

This bank would invest it and try to create a spread over the returns that they would make in those investments to obviously be profitable and be able to pay the liabilities of the depositors and give them their money back in maturity.

Q And then just big picture, since we're talking about it. What types of assets would they invest in?

A Stocks, bonds, commodities, currencies, alternative

investments such as hedge funds, funded funds.

Q Okay, and what's your basis for saying this? Are you basing this on your time in Memphis or on your time in Antigua? I mean, how do you know?

A It was certainly part of my training, and this is the educational process at Stanford in general. I mean, I knew that even from day one about the bank and this is how it works. But I was -- while I was at the Investment Advisory Group, I was asked to go on some trips to Europe, which is where a lot of the money managers and banks and institutions are domiciled that run the money for the bank in Antigua.

So I met a lot of them, a lot meaning like ten, maybe eight. I had never -- the literature, and I don't want to say literature, but the training is that there's 25 or 30 of them, private banks.

Q And you think you met around ten?

A I'd say ten.

Q Okay, and in terms of seeing documentation or statements, do you think there were 25 or 30, or how many did you actually see? What was your sense based on your actual experience, as opposed to what the training material said?

A No, I did not see statements that indicated that there were 30 or 25. I was never forwarded statements direct anyway. I did receive statements in Antigua. I think just by being there I would receive statements, but always one

here and there, or a piece, never the whole picture.

Q Okay. I mean, one of the things we're trying to do is get our arms around how the bank works. It might be helpful -- you know, somebody with your expertise and your time down in Antigua.

I'm trying to distinguish in my own mind how the investment side of this thing is similar to or different from a hedge fund, because it sounds a lot like a hedge fund in the sense -- you know, you've got your equities, your fixed income, your alternative investments. How would you compare and contrast those to a hedge fund?

A I would say because it is a bank, and it's chartered as such, and the only product is certificate of deposits that they issue, makes it very bank-like. So regardless of what this investment portfolio does, there's still an implied guarantee that has to be paid to the depositor.

So it is a bank. It's chartered as a bank, as banking products. The asset side, I always looked at it more like a mega-endowment. Well, I guess not mega compared to like Yale or Stanford, that it was managed very much in that regard, you know.

They use a lot of private equity, meaning Yale and Harvard. I didn't see a lot of private equity in there, but just kind of a lot of investment vehicles that smaller institutions or individuals can't get, that they were able to put their money with these managers or banks or whatever, to generate this positive spread to keep the bank profitable year-in and year-out.

I was traveled and met enough of these managers -- you know, or it was believable. You know, I met them, and as we spoke on the phone, I mentioned Credit Suisse as a private bank who handles one of the sleeves, let's say the 25 sleeves.

I don't know how much they managed, but they would even go further into the diversification process by having maybe 20 managers -- you know, underlying managers or funds or whatever in there. So a very diverse concept.

Q Okay. Well, I think for now we've got kind of an overview of the bank and how it works. So let's leave that for a moment and then we'll come back to it in a little bit.

So I want to back up to earlier you told us that you were hired to come in and establish a mutual fund wrap program?

A Yes.

Q Okay. Was that pretty much the understanding from day one?

A Yes.

Q Okay. That's what you were hired to do?

A Yes.

Q Okay. Did Stanford have a similar product when you got there? Were they in the business before you got there?

A The mutual fund?

Q Yes. Were they in the business before you got there?

A The mutual fund? Yes.

Q They had a mutual fund allocation?

A Yes. Chip had done -- yeah. There was assets in place, so it wasn't -- it didn't start at zero. It might have had eight million in it.

Q Yeah. I think you told me before seven and a half, so in that ballpark?

A Right. So I should -- that's a good point. I mean, I didn't go from -- I created from zero. I built the models and picked the funds and hired the promoters.

Q Okay. So when you show up, what do you do? How do you get started in establishing this program or growing this program?

A It starts with building models, or --

Q I mean, kind tell me about it. You're building models. I assume there's kind of a piece of it where you're figuring out how do we get clients, how do we market -- you know, that sort of stuff.

A The models start out obviously with kind of a risk tolerance assessment. You want to, and this is modern

portfolio theory, asset allocation 101. You know, you want to create a model that has the -- you know, the right growth objectives, the return objectives with the least amount of risk, and you define an optimal mix of equity bonds and cash. That's what it was back then. Now they have all these other asset classes.

You design a questionnaire to assess a client's risk and investment objectives, and you score it and then you come up with -- you know, this is a young person who's going to stay for 30 years. They're going to be in the growth all the way to conservative. So conservative, moderate growth.

I had nine models, 1 being conservative, 9 being the most growth. The questions in the questionnaire are designed to -- you know, peg the clients on whether --

And then as far as creating the allocations, we were using Ibbotsson at the time as an optimization.

Q Can you spell that for Terry?

A Oh. Ibbotsson is I-b-b-t-o-s-s-o-n.

Q And what's Ibbotsson?

A Ibbotsson is an optimization software, and what it does is take historical information from various asset classes and you find the right mix of the growth model, or conservative or moderate.

Q Okay. So you said when you started out, quickly thereafter you had nine strategies?

A Yes.

Q Okay, and what's on the -- you said it goes from one to nine in terms of risk. I guess what's the most conservative and what's --

A One conservative, and based on the optimization -- you know, you would think of one being the most conservative with the most fixed income, or cash, in the order of cash, fixed income. Then of course even within fixed income, you've got government debt, high yield debt. So you have different risk parameters of debt in there, to nine, being all equity.

Q Okay, and is nine growth?

A Growth. Yeah, that would be there.

Q And as you kind of scale back in the risk profile, I think I've seen growth plus income and different things like that. I mean, what --

A The models for change. After I left from nine to five, and that they were defined, I think. Yes, you're right. I want to say growth, growth plus income. But I think there was five. I think Jason and Seth would -- you know, because I don't recollect --

I recollect we had nine models right up in there, and they switched over to five.

Q And when you say Seth, is that Seth Hare, H-a-r-e?

A Yes, yes. Seth Hare was our third hire, my third hire.

Q Is he an advisor type or an administrative type?

A Analyst.

Q Analyst. And when they went from nine to five strategies, is that the same time they renamed the program SAS?

A Yes.

Q Okay, and what does SAS stand for?

A I believe it's Strategic Allocations -- I don't know actually.

Q Strategic Allocation Strategy or Stanford Allocation Strategy, something like that?

A Yes.

Q And so this change from nine to five and the change in name, does this happen in '06 when you're down in Antigua?

A I believe so, yes.

Q Okay. So we talked a little bit about how you put the strategies together. Then I assume part of it is figuring out how you make this thing attractive to customers, how do you market it. So what was the strategy there?

A The next step, you've got your allocation set, your model set, is the fund selection process. So you have X in large cap growth, X in large cap value, and then you want to fill the best manager or mutual fund manager in the space.

It was my thought, and even at the time in a pretty

commoditized style product, that's where maybe you could differentiate. Because at the end of the day, these allocations are probably what Morgan Stanley's putting out in a variation.

So my thought was to truly add value, would in taking those managers -- you know, that could be -- sorry.

Q That's fine.

A So I know at one time I had this like 13 point manager selection, meaning how long has the manager been there, what's their background, what's the style of consistency, what are the historical returns, the risks, all these kind of 13 steps that you would go through -- you know, to pick a manager. Due diligence, if you will.

Q And you're talking about the managers that manage the mutual funds that end up --

A The mutual funds you put --

Q Into the different wrap programs?

A Right. Like you have a mutual fund in there that's really lagging for a couple of years or whatever, or a manager leaves or something happens where you need to replace that fund manager.

Then you go out to the universe of 8,000, and you start looking for a manager that you feel would be the best one to perform going forward.

You would call them up, maybe talk to one of their

analysts and how do you buy, what's your risk management process and all those kind of things, and make a selection. So that to me was one of the big selling points -- you know, that somebody's always watching it, you know. You've got someone that's watching the allocation that will re-balance it, that will do the fund changes for you, and that are watching these managers.

Whereas, if a broker or a financial advisor is not going to know if -- you know, Joe Blow, the lead manager left the fund. So that's the job of IAG or SCM to manage that process, to oversee it.

Q Okay.

BY MR. ELLIS:

Q Okay. Perhaps I can clarify something here, Tom. Do you have a general sense of how often in these programs you would change the allocation of each model, and there's a second question, how often you might switch out a manager for each piece of the allocation?

A When I was running it, I had a 5 percent -- two points to the question. One, I had a 5 percent band, if you will, on the allocation. So if a client deviated over that 5 percent threshold, you'd re-balance it.

You didn't want to -- you know, you've got transaction costs and potential taxes, so you didn't want to re-balance too frequently. That came out to be probably

about once a year. And similar on the fund side, I don't think you change funds to -- you don't want to change funds too frequently.

In my memory, recollection might have one or two a year you would change a fund out, and not because of performance. You know, I mean, there's -- funds will lag.

If you have a fund manager, I don't want this to get too technical, that their systems are in place and the managers are still there and they're doing what they always say they do. Yet they're lagging

You know, we know the late '90s was a good example of that. That's not a reason to sell them out. You sell them out if there's more of a bigger change in the fund, like they left the firm or they're doing something. They're large caps buying small cap stocks.

Something like that is a reason to change out a manager.

Q How often would you actually change the allocation? Say for example you had a growth allocation that on real basic terms was 60 percent --

A Oh, I see.

Q -- 40 percent allocation. How often would you adjust the model allocation?

A About annually, and it's tweaking.

BY MR. KELTNER:

Q Yes, it's not actively managed. Yeah, it's not tactical would be the word I would use, by any stretch of the imagination, where you're going to go all cash. It would be more like you might -- you know, maybe you have 23 percent in growth and 17 percent in value, and there's a shift in the market.

You know, you may go more in value, 20 percent in value and 18 percent in growth. We'd look at that about --

A Well, we'd look at it all the time, but maybe change it about once a year.

Q And was that usually around year-end, or -- I mean, was it at the end of the year, where you sat down and thought, okay, how are we going to reallocate these things, or was it --

A No, I don't recollect.

MR. CRAINE: Excuse me. I didn't quite hear the question.

BY MR. KELTNER:

Q Was there any rhyme or reason to when in the year you would do the reallocations or --

A I don't recollect it being a calendar year. I think it's more of a fluid process than a set time.

Q Okay, but typically not much more often than once a year would you sit down and make the changes?

A Yes.

Q So the models were relatively static, and they would change from time to time?

A Yes.

Q But it's not like you were going in on a monthly basis and changing allocations or changing managers or funds --

A No.

Q When you first started out, let's take growth for example. Ballpark, how many different assets or funds would you have allocated to?

A I ran about five equity -- generally speaking, a large value, a large growth; a small value, a small growth and an international manager. Then in the fixed income piece, a high yield corporate bond fund and maybe like a government bond fund and then cash.

What is that eight, I guess eight plus cash is nine was about it. Then remember you might have like number 9 model. Wouldn't have any of those fixed incomes. So you're allocating amongst the five equity pieces.

Q Okay, and so were a lot of these, just to characterize them, were they large funds, some index funds, those types of things, or were they --

A No, I believe in the active managed approach. So no index funds, and part of my personal due diligence bias was to steer away from large fund companies, looking for

smaller asset size. Not always, but --

Q Sure.

A I think that's -- you know, more -- you know, staying away from the Fidelities and the Vanguards -- you know. It's like -- I guess it kind of sizzle too in the program, like -- you know, look at us, we're finding these under the radar type mutual funds.

Again, back to -- this is how we're adding alpha. We're picking managers or I'm picking managers that you don't have the time to do.

Anybody can pick Magellan or Vanguard or that, and the theory that larger managers typically underperform. Larger asset-size managers typically underperform over time.

Q Is that just because it's harder to manage a larger portfolio of assets --

A The evidence is, leads to that's one of the theories behind the study, is they're not nimble enough in the market to get out of positions or to get into positions. It's a slower, it just drags it down. That's academic.

Q Sure, and we don't want to get too mired in the academic. So I think we understand the asset fairly well now. The next piece, how do you get this -- how do you present it to clients?

A Really, my first line of clients would be the broker, the financial advisor. When I first started, it was

in a period of just incredible bull market. We all could probably remember Redhead and Qualcom and you're dealing with stocks that are doing 100, 220 percent a year.

I'm trying to promote a program that's targeting 12 percent a year, 14 percent a year. But I'm losing my train of thought. I feel it's slipping. But the idea to go out to the broker is look, you don't want to be picking stocks. You want to be out gathering assets.

Let the Private Client Services Group run those assets for you, you know, to make the trades, to invest the funds, invest it in the MFP, re-balance it, change funds when we need to. So these are the brokers --

Q Monitor it. When you say the brokers, these are the brokers at Stanford Group?

A Yes.

Q Okay. So you're talking to the brokers and you're saying put your clients in my asset?

A Correct. So yes. So the first line is to go out to the brokers and promote, almost like an internal wholesaler, to promote your program to raise assets.

And in that process, though, you do end up meeting with clients as well. Hence, why it had to be licensed, with brokers like Gray, I don't understand it. You talked to my client --" you know. So you would sit down and go shoot the proposal.

Q Okay, and would those typically be bigger clients that you would be called in for, was it just kind of off the board? In terms of they had more money to invest?

A That's a good question. Yes, I would say in general, yes.

Q Okay. So if it was an important pitch, you would be brought in?

A Yes, and that's -- I guess as I became more respected in the firm -- you know, after I was -- I guess the advisors were more confident putting me in front of clients.

Q Okay. So when you're talking to the brokers and you know the brokers are then going to have to go out and pitch this to a client, what are you giving them in terms of the tool box? I mean, what do they have to work from? Do they have any materials?

A Well, there's a brochure on the program, that talks about kind of the merits we've been talking about -- you know, actively managed. We're going to pick your funds with this 13-step process, re-balance it when necessary. But you would ultimately present a proposal, and that's really where I would be brought in.

I guess to clarify, it would be like -- you know, and the same thing with the bank, too, at the end -- you know, like to close it. But that proposal process was,

should be the client fills out that questionnaire we spoke about, here's my investment horizons and my risk tolerance.

We scored up, it's a Model 7 and we would generate a proposal which would be like a Model 7 looks like this -- you know, X in bonds and equity and cash and here are the funds we recommend, and we would present it as such to the client, kind of flip through the pages and talk about asset allocation, not having your eggs all in one basket, et cetera.

Q And so what's that proposal look like? What's the client getting?

A The one we worked off for years was a PowerPoint presentation. It was ten pages, maybe 12 pages. The title page. Do you want me to kind of run through what it would look like?

Q Yes.

A The title page. I recollect it was -- it started macro. The first couple of pages talk about the theory of asset allocation and why you would do this, and then your first chart would be the broad allocation, equity, bonds, cash.

Then the next chart would be like let's break down equity value growth, and then let's break down bonds. Then you would lead into the hypothetical page, and the hypothetical page would be, which everyone wants to see,

returns. The hypothetical is just that.

It's like if you invested in this portfolio -- it would be a graph. Like if you had $10,000, if you invested $10,000 five years ago, this is what it would have grown to. You would also, say in those five years it annualized 14 percent. This is what the S&U and maybe compare it to the S&P did whatever, 12 percent.

Q Okay, and again we talked about this a little bit before, but I know there's lots of different ways to present performance, so I want to make sure that we're all on the same page.

A Yes.

Q Explain to me kind of like you would explain to a client what hypothetical performance is?

A Hypothetical is a lookback. This is -- it's a good question. This as if you were here five years ago in these seven funds I'm recommending, this would have been your return.

But Mr. and Mrs. Client, this doesn't mean this is what's going -- you know about the disclosures. That was last three pages probably were disclosures. This doesn't mean this is what you're going to do the next five years.

Q Okay, and it doesn't mean this is what we did the last five years?

A That's correct.

Q So it's not --

A This is what this recommendation did for the last five years.

Q So the recommendation we're giving you today, had you been in it for the last five years, this is what you would have earned?

A Correct.

Q Okay, and again, I'm just trying to clarify this, because there are lots of different terms and we want to make sure we're on the same page. Can you compare that for me to -- you know, model performance, how model performance would be presented?

When I say, do you understand what I'm meaning, or should I define --

A I think I do. I think this to me is model performance, but you want to know like how would those nine models --

Q Well, I think we've seen some other, maybe other groups or other firms, and maybe perhaps Stanford at various times, have presented model performance, as in this is what our model did the last five years -- you know. This is what the models were, this is what the return numbers were for the model.

A Yes.

Q So they're historical in a sense, in that this is