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HEDGE FUNDS AND INDEPENDENT ANALYSTS: HOW INDEPENDENT ARE THEIR RELATIONSHIPS?

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

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WEDNESDAY, JUNE 28, 2006

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The Committee met, pursuant to notice, at 9:32 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Committee, presiding.

Present: Senators Specter, Hatch, and Schumer.

OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman SPECTER. Ladies and gentlemen, the Judiciary Committee will now proceed with this hearing to inquire into the adequacy of the Federal criminal statutes to deal with the potential issues for fraud on the investments of hedge funds in collaboration with so-called independent analysts. This is a subject of enormous importance to the United States economy, with hedge funds now having $1.2 trillion in assets and having stock transactions which involve some 30 percent of what goes on in the trading market.

There have been some high-profile civil cases which have been brought with allegations, among other things, that hedge funds are collaborating with the so-called independent analysts to rig the information to make it appear that some companies are weaker than they really are, with short-selling and the potential for very, very substantial profits.

The Judiciary Committee has been intimately involved in the regulatory process to the extent that it involves criminal prosecutions in the legislation captioned "Sarbanes-Oxley," so much so that Senator Leahy, when he was Chairman of this Committee, and Representative Sensenbrenner, the Chairman of the House Committee, were conferees. The Banking Committees obviously have primary jurisdiction on the regulation of hedge funds. It is squarely within their purview. The issue of the adequacy of the criminal laws are a matter for the Judiciary Committee, and that is why we are making this inquiry today.

Our focus will be on the adequacy of the provision of Sarbanes-Oxley, which was reported out of this Committee since it dealt with a criminal law, making it a violation for anyone who knowingly executes a scheme or an artifice to defraud any person in connection with any security or to obtain by means of false or fraudulent pretenses any money in connection with the purchase or sale of any security.

We have a representative of the Department of Justice and we have the Attorney General of the State of Connecticut to give us their thinking on this subject.

We are dealing with a subject matter which has enormous potential to have a very, very major impact on the markets. The case involving the Long-Term Capital Management Company was one which illustrates the potential problems. In 1998, when LTCM was on the verge of collapse, the New York Fed stepped in and undertook what we call a "facilitation," a rescue package of some $3.6 billion in cash contributed by 13 private financial institutions. You have a situation where this company, LTCM, with $3 to $4 billion in assets, was able to leverage some $80 to $100 billion, and if there had been a fire sale of their assets, it would have had an enormous impact on the market, and the Fed stepped in.

Well, that is fine if the Fed can find 13 companies to step in to stabilize the market. But it raises some very, very important questions, especially in the context where the District of Columbia Circuit Court has held that the SEC does not have jurisdiction for some of the rulemaking. That is a matter, obviously, for the Banking Committee to take up. But the backdrop here of the applicability of the criminal laws is very, very important.

Since this hearing was scheduled, the subject matter has attained substantial additional notoriety with the termination of a senior SEC lawyer, who will testify here today. We have had the decision by the Court of Appeals for the District of Columbia, and we have quite a heavy focus on these hedge funds. They had been attracting investors who were very, very wealthy, in the range of $400,000, and now we are finding people in the $10,000 to $20,000 category. So it is a matter of great concern, and it is very important that there be adequate investigation and oversight by the Department of Justice and oversight on the Department of Justice by this Committee if we need any new laws.

My red light just went on, so I will yield to my distinguished colleague, the former Chairman of the Judiciary Committee, Senator Hatch.

STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM THE STATE OF UTAH

Senator HATCH. Well, thank you, Mr. Chairman. I want to thank you for holding this hearing today. I know there has been some discussion about our Committee's jurisdiction here, and I want you to know that, in my opinion, our jurisdiction is clear. We have oversight responsibilities for the Department of Justice. Ultimately, the Senators on this Committee are the ones responsible for writing and amending our Nation's criminal law.

In 2002, the President created a Corporate Fraud Task Force. It is chaired by the Deputy Attorney General and includes U.S. Attorneys, the heads of DOJ's Criminal and Tax Divisions, and representatives from the law enforcement community and government agencies, including the SEC. That task force is responsible for investigating corporate fraud, and we are responsible for determining whether DOJ is doing its job and whether we have provided them with the tools to do their job.

Unfortunately, because of my schedule this morning—we have markups in both the HELP and Finance Committees, and one of my bills is being marked up this morning. Of course, I am a member of both of those as well, and I will not be able to attend all of this hearing, as much as I would like. But if I leave early, I do not want anybody to mistake that I am doing that for a lack of commitment to investigating this issue. I think that it is critical that we do so.

I am pleased that Mr. Friedrich is here to testify today about the structure of the Corporate Fraud Task Force and its past successes. I think that the many successful prosecutions that he details are testament to the priority that the President and the attorneys at DOJ have given these cases. Market confidence and ultimately the health of our economy depends on them. There is no denying those successes.

Now, I know that he cannot speak to ongoing investigations, but in reading your testimony, it seemed to me that there was a general reluctance to discuss, even in a general way, the Department's capability to investigate and prosecute what we are here today to discuss: the relationship between hedge funds and so-called independent analysts.

We all know that hedge funds are a powerful force in our financial markets. It is critical that the power and influence that hedge funds have attained be exercised responsible, and we need to be sure that our laws that we give to the law enforcement authorities are effective and adequate to ensure that the substantial power of hedge funds is not abused. This is of particular concern because hedge funds are so lightly regulated and operate largely in secrecy.

I am not necessarily calling for new regulations here. In fact, I have real questions about whether we should. But we need to monitor this field and make that our markets have the integrity that our investors need to continue investing and maintain our vibrant economy.

DOJ has an important role to play here. Mr. Friedrich, as you explain in your testimony, the Corporate Fraud Task Force maps out a strategy and identifies best practice. I have a number of questions. Do you have the tools that you need? How often do you meet? Are you incorporating U.S. Attorneys only from major financial centers or also from nontraditional locations? After all, we are going to hear today about an alleged fraud that began not in New York but in Arizona. And I know that in my State of Utah, the issue of hedge funds and corporate fraud has become such an issue that the State legislature went into a special session to address the issue. And as you know, DOJ and SEC work closely in these cases, but sometimes, as I read the testimony today, I get the impression that if somebody asked both agencies who was ultimately responsible for initiating these investigations, they might just point fingers at each other.

Now, I want to be clear about what we are not trying to get at through this hearing. This is not a hearing about naked shorting. It is most certainly not a hearing to drag anyone's name through the mud. And this is not a hearing that challenges hedge funds as a whole or the practice of naked shorting in general.

As our friends in the press have continually reminded us since the hearing was called, there is nothing wrong with short-selling. We do not need to be reminded again. The market trend is upward, and it is good to have some pessimists around who keep prices honest and help to maintain market balance. We also know that shorters were well ahead of anyone in discovering that there were problems at Enron. And nobody is attacking this activity in general.

As Mr. Kasowitz has noted, though he does represent a number of clients who alleged harm through market manipulation and short-selling, he does represent hedge funds in a variety of matters. These are legitimate investment vehicles, and I do not doubt that, for the most part, they are acting on the up and up. Yet hedge funds are the Wild West of our financial markets. There are 11,500 hedge funds. They are highly profitable to their managers and largely unregulated, more than all the stocks listed on the Stock Exchange, as I view it. They may be a small piece of the market, but they are growing. And because of their volume of trading and the commissions that they represent, they are an increasingly powerful member of the financial community.

Well, there is a lot more I have to say, but my time is up. Let me just put the record of my statement in the record, Mr. Chairman.

Chairman SPECTER. Without objection, Senator Hatch's full statement will be made a part of the record.

Senator SCHUMER. Mr. Chairman?

Chairman SPECTER. Who is seeking recognition?

Senator SCHUMER. I am, Mr. Chairman.

Chairman SPECTER. Well, in that event, I will ask you if you would care to make an opening statement.

Senator SCHUMER. I would indeed, Mr. Chairman.

Chairman SPECTER. Proceed.

STATEMENT OF HON. CHARLES E. SCHUMER, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator SCHUMER. I thank you, Mr. Chairman. Good morning, Mr. Chairman and members of the Committee. As the only member of this Committee also on the Banking Committee, I would like to bring a different perspective to today's hearings.

First of all, Mr. Chairman, as you said, I support the jurisdiction of this Committee to hold hearings on legal issues raised by any industry, including the investment industry. But the very title of this hearing—"Hedge Funds and Independent Analysts: How Independent Are Their Relationships?"—raises a yellow flag of caution.

From the written testimony submitted by many of the witnesses, it is clear that this hearing will focus on a broad range of regulatory issues facing the hedge fund industry. For starters, what are hedge funds? Just last week, the U.S. Court of Appeals negated the SEC's hedge fund registration rules because the agency's definition of a hedge fund was not adequately supported.

Experts continue to disagree over what it is or is not, what a hedge fund is or what a hedge fund is not. Should hedge funds be regulated?—an issue we have discussed at great length in the Banking Committee. And a separate issue, does short-selling benefit markets?

The bottom line, in my judgment, Mr. Chairman, as one who sits on both Committees, is that many of these issues are best addressed in the Banking Committee. The Banking Committee has exclusive jurisdiction, as they have asserted in a letter sent to the Committee yesterday afternoon. I am going to read the letter and ask unanimous consent it be added to the record.

Chairman SPECTER. Without objection, the letter will be made a part of the record.

Senator SCHUMER. Thank you. This is a letter—short—from Chairman Shelby and Ranking Member Sarbanes.

"Dear Senators Specter and Leahy: We understand that the Judiciary Committee will hold a hearing tomorrow on hedge fund advisers and independent equity research analysts. While we appreciate your interest in these important participants in the capital markets, we are writing today to note that the operation and regulation of both hedge funds and stock analysts fall within the exclusive jurisdiction of the Banking Committee. Furthermore, our jurisdiction over these areas is well established and clearly delineated by Senate rules. This Committee"—the Banking Committee—"has held numerous oversight hearings in the past year on both hedge funds and Wall Street analysts, and we intend to continue this active oversight for the remainder of the 109th Congress and beyond."

Not only do the Banking Committees—and the letter is now in the record. Not only does the Banking Committee have exclusive jurisdiction, but it also has the critical expertise needed to examine these very complicated financial market issues. I worry that today's hearing will not afford us the benefit of the views and expertise of many of the critical Federal agencies charged with overseeing and enforcing our Nation's security laws. I understand that Mr. Blumenthal, my friend and a man I have great respect for, will be making claims that there should be additional regulation of hedge funds. Those arguments should absolutely be heard, but they should be heard before the Banking Committee, which has exclusive and relevant jurisdiction. And we should hear the views of the relevant regulators and the people in the industry who might disagree with those views so we could come to a fair and adequate conclusion.

Though the Department of Justice undoubtedly plays an important role in securities enforcement, without the expert views of the SEC as principal regulator or other members of the President's Working Group on Financial Markets—Treasury, Federal Reserve, CFTC—this Committee is not likely to get a full and complete picture, complete view of the way in which participants in the capital markets operate legally and ethically.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator Schumer.

We turn now to our first witness, Matthew Friedrich, Principal Deputy Assistant Attorney General and Chief of Staff of the Criminal Division of the Department of Justice; previously had been an Assistant United States Attorney in the Eastern District of Virginia; served as a member of the Enron Task Force and co-counsel in the first two criminal cases tried as part of the Enron investigation; a graduate from the University of Virginia, the University of Texas School of Law; clerked for District Judge Royal Ferguson in the Western District of Texas.

Thank you for coming back to testify before this Committee, Mr. Friedrich, and we look forward to your views.

STATEMENT OF MATTHEW FRIEDRICH, PRINCIPAL DEPUTY ASSISTANT ATTORNEY GENERAL AND CHIEF OF STAFF, CRIMINAL DIVISION, DEPARTMENT OF JUSTICE, WASHINGTON, D.C.

Mr. FRIEDRICH. Thank you. Good morning, Mr. Chairman and members of the Committee. On behalf of the Department of Justice, I want to thank you for inviting me here today to testify about the Department's ongoing efforts to combat corporate and investor fraud. The Justice Department appreciates the Committee's concerns, and I look forward to discussing this issue with you today.

Prosecuting corporate and investor fraud is more than just enforcing the rules. It is about protecting the reliability, integrity, and transparency of American markets. Investing, after all, is a measure of trust. Investors generally will not put their money into companies or markets that they do not trust. Thus, in the global competition for investor dollars, market integrity is essential to the strength of our economy. It is a competitive edge that can bring with it new investment, new capital, and new jobs.

Conversely, and as we were all reminded during the corporate scandals of 2001 and 2002, instances of corporate fraud put us at a disadvantage in that competition because, simply put, fraud is bad for business. Lack of investor confidence leads to weak markets and job loss. I am sure that concerns like these were paramount in the minds of members of this Committee in passing the landmark Sarbanes-Oxley legislation in 2002. You gave those of us in the front lines of prosecution new tools to use in our efforts against corporate fraud.

We have utilized the tools which you have given us, and we are grateful to you for them. For example, since the inception of Sarbanes-Oxley, more than 53 defendants have been charged with securities fraud under Section 1348 of the Act. Additionally, through fiscal year 2005, we have issued five indictments involving violations of the certification provisions of Section 1350.

I would note that the importance of the certification provision of Sarbanes-Oxley, however, is not measured solely by indictments. Section 1350 has had an enormous deterrent effect on corporate fraud, which ultimately is one of the primary purposes of this powerful law.

As you know, and as Senator Hatch referred to earlier, the focal point of the Department's efforts in this arena is the President's Corporate Fraud Task Force. The task force is chaired by the Deputy Attorney General and includes members from the U.S. Attorney community, the head of the Criminal Division, and a broad array of Federal law enforcement and regulatory agencies, including the FBI and the SEC.

From its inception in 2002 through this past December, the task force has obtained over 1,000 corporate fraud convictions. As to corporate officers, the task force has convicted 92 corporate presidents, 82 CEOs, 40 chief financial officers, and 17 corporate counsel or attorneys. In the Enron investigation alone, 34 individuals were charged, and 25 convictions to date have been obtained. Two of those recent convictions came last month. On May 25th, a Houston jury found Enron's top two executives, Kenneth Lay and Jeffrey Skilling, guilty of committing one of the largest financial crimes in history.

As you know, in December of 2001, Enron, which was then one of the ten largest companies in the United States, collapsed into bankruptcy. Thousands of employees lost their jobs, investors and retirees lost billions of dollars in savings, and the investing public began to seriously question the integrity of our financial markets. During the 4-month trial earlier this year, the Department presented 22 witnesses, including many former top Enron executives who pled guilty to Enron-related crimes. These executives testified that at an Enron run by Lay and Skilling, the company's image and stock price were valued above anything else at any cost. The defense presented over 25 witnesses of their own, which included weeks of testimony from both Lay and Skilling.

The jury ultimately found that Lay and Skilling orchestrated a conspiracy to inflate profits artificially, to hide millions of dollars in losses, and misrepresent the true nature of the company's finances through misleading statements, omissions, half-truths, and lies.

As one newspaper reported on the eve of trial, "The implications of the outcome of this case are sure to be felt far beyond the courtroom. Most people in the white-collar world would agree that Enron is the Granddaddy of all frauds in the last two decades. How this comes out is a test of the limits of what the corporate community will tolerate in business practices."

The verdict also had a closer and more personal impact on the victims, some of whose reactions were carried by the press.

"Justice has been served," said Roger Boyce, who worked in Enron's plant building business. "I'm satisfied with the verdict, but I'm happy for all of us employees and retirees that a just verdict has been reached." And, Mr. Chairman, for our prosecutors and agents who labored in bringing that trial, I am sure that there is no more fitting reward than comments like that from a victim.

In summary, I can tell you that our work in combating corporate fraud is both continuing and vigorous. We are working with our law enforcement colleagues at State, local, Federal, and international levels. We are partnering with the SEC and the FBI, and we are doing many of those things using the impressive arsenal of new laws contained within Sarbanes-Oxley. Our corporate citizens are stepping up to the plate to follow the new rules created by Congress.

Mr. Chairman, on behalf of the Department of Justice, I would like to again thank you for having the opportunity to testify today, and I will be happy to answer any questions which you may have.

[The prepared statement of Mr. Friedrich appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Friedrich.

We turn now to the distinguished Attorney General of the State of Connecticut, Richard Blumenthal. Previously he had been in the Connecticut State Senate and the State House of Representatives and the United States Attorney for Connecticut. He served as a law clerk to Supreme Court Justice Blackmun, was an assistant to former Senator Abraham Ribicoff and an aid to then-Presidential Assistant Daniel Patrick Moynihan; Phi Beta Kappa graduate from Harvard University and from the Yale Law School, where he was an editor of the Yale Law Journal, a prestigious position. Thank you for again joining us, Attorney General Blumenthal, and the floor is yours.

STATEMENT OF RICHARD BLUMENTHAL, ATTORNEY GENERAL, STATE OF CONNECTICUT, HARTFORD, CONNECTICUT

Mr. BLUMENTHAL. Thank you very much, Mr. Chairman, and to you, Senator Hatch, and to Senator Schumer, for being here today and for your leadership in having us address this critically important topic. I speak today as a former prosecutor, as United States Attorney, former Federal prosecutor, and I want to congratulate and thank the Department of Justice for the prosecutions that have just been discussed by my co-panelist and for its initiative and intense and successful action in that area.

Let me address the precise question that has been raised by this Committee. I strongly urge and believe that penalties should be strengthened for the kind of manipulation that has been alleged involving hedge funds, in effect, shorting and distorting, using supposedly independent analysts that are really independent in name only. Right now the penalties, in my view, are inadequate. They are inadequate in a monetary sense, certainly, and in my testimony, I have recommended that there be a civil penalty of treble damages imposed for this kind of manipulation and deceptive practice as well.

I believe that the susceptibility of the markets is particularly acute where hedge funds are involved and supposedly independent analysts because hedge funds can engage in short-selling, unlike other institutions, they operate in secret, and the supposedly independent analysts may be beholden to them as a result of very substantial fees that they receive in connection with the supposed custom reports that are meant to be unbiased but may not be. And I want to stress, borrowing a phrase from Senator Hatch, that there is nothing wrong with short-selling. It can be a very constructive and positive technique in the market. There is nothing wrong with hedge funds. By and large, they are operated honestly and effectively, and Connecticut is home to many of them.

But there is a need for stronger scrutiny and oversight, and the *Goldstein* decision, which I think brings us to a turning point, a really critical juncture in this area, really makes absolutely certain the need for some kind of Congressional action. And it should be to establish a new framework of regulation that encompasses hedge funds, which previously had been unregulated. The *Goldstein* decision turns on a very narrow and technical point—namely, the definition of "client"—that could be easily clarified by the Congress or perhaps by the SEC. But the point is that States will fill the void that the court of appeals has created. Right now hedge funds are in a regulatory void without any disclosure or accountability. The absence of transparency and Federal inaction or inertia will invite State action. And under our State statutes in Connecticut, which track the Federal statutes, we could easily amend our laws, as could other States.

Federal action and regulation is vastly preferable because the Federal Government can bring to bear the expertise as well as authority and uniformity that is so important in this area to assure credibility and trust in the markets. But States must consider their own regulatory standards, perhaps modeled on the SEC rules, achieving the same goals of disclosure and accountability. And if Federal agencies abandon the field, as they have done at other points in history, in other areas of regulation, then States will join forces, as we have done in joint legal action, to act separately or together to proactively protect our consumers.

Let me conclude simply by saying that the recommendations that I have included are simply an opening shot or a beginning shot in this debate that post-*Goldstein* I think will be very much in the fore. And whether it is in this Committee, which I believe has clear authority over the criminal areas that are involved, or in the Banking Committee, I hope that the States are given a role in this debate.

Thank you.

[The prepared statement of Mr. Blumenthal appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Attorney General Blumenthal.

Senator Grassley could not be here this morning. He is Chairman of the Finance Committee and is otherwise engaged. But he asked that this statement be put into the record.

Senator Grassley says, "Chairman Specter, I am pleased that you are holding this oversight hearing on hedge funds and independent analysts. I share the Chairman's concern regarding corporate fraud and integrity in the marketplace. The allegations we are hearing today remind me of the Enron debacle where positive accounting information was fabricated and disseminated about the company to increase the value of its stock. This Committee held hearings on Enron's fraudulent partnership and accounting practices, and we passed legislation included in Sarbanes-Oxley that strengthened the criminal prosecutions of persons who defrauded investors in publicly traded securities. The Sarbanes-Oxley law also included a provision that I offered"—Senator Grassley—"with Senator Leahy providing whistleblower protection to individuals who raised concerns about fraudulent activity."

"All in all, I felt the Sarbanes-Oxley law had done much to assist Federal regulators to prosecute illegal activity and to keep our financial markets on the up and up. But maybe we did not go far enough. The wholesale fabrication of information and collaboration with market players to pull down the price of stock sounds suspect to me. In my mind, this kind of market manipulation seriously distorts the integrity of the financial marketplace, and everyone—that is, everyone except the bad actors—loses."

"So what is independent analysis? Is research ever independent? Is there enough scrutiny of this kind of activity, or do we need more disclosures and safeguards in the trade? I want to make sure that the Department of Justice and SEC are being aggressive in their investigations of alleged wrongdoing. I want to make sure that they are doing everything in their power to protect investors and the public from fraudulent activity and manipulation of the marketplace. I want to find out whether the Department of Justice has a need for more tools or resources to get the job done. The stakes are high because so many are impacted by fraudulent market information—pension plans, small investors, seniors, ordinary workers, and their families. So we need to support our enforcement agencies in their efforts to clean up the market and make sure that we have enough tough laws in place, not just to punish but to deter these bad actors."

Mr. Friedrich, starting with you on the 5-minute round of questions, we are not looking at the regulatory approach. That is for others, and regulations obviously are very important. But there is nothing like a criminal prosecution. Criminal prosecutions may have a questionable effect on violent criminal conduct or barroom killings or a variety of street crimes where motivations are hard to understand. But when you deal with the corporate community, when you deal with white-collar crime, criminal sanction is very, very effective, much more effective in a regulatory scheme which may or may not be imposed. When it is imposed, not a whole lot happens except filing of a report or perhaps a civil proceeding or perhaps a fine within the regulatory scheme. But a jail sentence means a lot, especially to thoughtful white-collar criminals.

You went over a litany of corporate fraud convictions that you have had. How about on hedge funds? Have there been any convictions by the Department of Justice on hedge funds or the so-called independent analysts going to the allegations which are current now about collusion and market manipulation?

Mr. FRIEDRICH. Senator, I am not aware of any closed cases that deal—or publicly reported cases that deal with that specific issue as between hedge funds and analysts. The Department has done some prosecutions in the area of hedge funds. Two I can think of offhand. In September 2005, the Southern District of New York had a couple pleas—

Chairman SPECTER. You have done some prosecutions on hedge funds?

Mr. FRIEDRICH. YES.

Chairman SPECTER. Have there been jail sentences?

Mr. FRIEDRICH. My understanding is that as to the one closed case, there was a jail sentence.

Chairman SPECTER. Well, would you please provide that information to us? On a hearing dealing with Department of Justice enforcement of criminal actions against hedge funds, I would have thought that would have been at the top of your agenda to tell us what you have done.

Mr. FRIEDRICH. Senator, the case that I was referring to involved the prosecution of two executives, I believe it was Bayou Capital Management in the Southern District of New York. If you would give me a moment, I can give you some more detail on that.

Chairman SPECTER. Well, provide it in writing. There is a limited amount of time, and I want to turn to Attorney General Blumenthal. But give us the detail, if you will, please, as to what prosecutions have been brought in this field. And I do not want to ask you in open session about investigations, but we have oversight authority on pending matters. Would you please provide us on a confidential basis what the Department of Justice is doing on current investigations?

Mr. FRIEDRICH. I can provide you information as to the cases that are publicly reported as to closed cases. I am not aware that I am free to provide, even in a confidential format, information about pending cases.

Chairman SPECTER. Well, take a look at the testimony in the confirmation of Deputy Attorney General McNulty and our discussion about our authority to get into pending cases and give me a response on that.

Mr. FRIEDRICH. Yes, sir.

Chairman SPECTER. Attorney General Blumenthal, you say you would like to see some treble damage cases. I would be interested in your evaluation of the efficacy of treble damages against wealthy companies or wealthy individuals contrasted with a tough jail sentence behind bars?

Mr. BLUMENTHAL. Well, clearly, Senator, I agree with you wholeheartedly that incarceration has a much stronger impact, both in terms of deterrence and also a message to the public, than does any fine or monetary penalty. The case that involved the Bayou group, in fact, I think illustrates that idea because the two individuals there, Samuel Israel and Daniel Marino, might not have engaged in the massive fraud that caused the criminal prosecution by the Department of Justice. Excellent work done by the FBI and the Department of Justice. But the kinds of sentences in these cases, Bayou and—

Chairman SPECTER. What were the sentences?

Mr. BLUMENTHAL. Well, I don't know that they have been sentenced yet. The prosecutions themselves, as Mr. Friedrich said, resulted in guilty pleas in December of 2005. Bayou is a Connecticut case, and I think that certainly the kinds of deterrent effect that you have discussed have much greater weight if there are criminal penalties. And that is true generally in the white-collar crime area, in my view.

Chairman SPECTER. Well, my red light is on so I would yield now to Senator Hatch.

Senator HATCH. Well, thank you, Mr. Chairman.

Mr. Friedrich, as you know, the Sarbanes-Oxley Act defined a new Federal crime—securities fraud. It was designed to get past a patchwork set of laws under which securities fraud has previously been prosecuted. Now, that section codified at 18 U.S.C. Section 1348 gave the Department of Justice a strong and important tool for combating illegal securities fraud, something that they did not have before.

Now, what steps has the Department of Justice taken to ensure that hedge funds and corrupt securities analysts do not commit securities fraud in violation of Section 1348?

Mr. FRIEDRICH. I would say generally, Senator, obviously this is an area that we are aware of. There have been prosecutions, as I mentioned before, against principals of hedge funds. As to the use of that new statute, that is a statute that we train on in our securities fraud training at the National Advocacy Center. It is a tool that has been used, and I think it is a tool—as I mentioned, there have been 53 indictments under that statute to date. I think it is a tool that will be used with increasing frequency in the area of hedge fund fraud or other types of securities fraud.

Senator HATCH. Thank you.

Mr. Blumenthal, in your testimony, you recommend specifically new regulation of hedge funds, and I agree with my colleague from New York, Senator Schumer, that such civil regulations would be the exclusive jurisdiction of the Banking Committee.

Now, I did watch you on "60 Minutes" on that program a few weeks ago where you were addressing the relationship between independent analysts and various hedge funds. As I recall, you indicated that criminal investigation and prosecution of these is very, very difficult. Now, in your testimony, you just suggested that we need new tools for criminal enforcement, and that is within the jurisdiction of this Committee.

So I have basically two questions for you, Mr. Blumenthal, and basically, that is, what new tools would you like us to come up with for criminal enforcement? And what tools would you like to see us investigate and come to a conclusion on with regard to all of these matters?

Mr. BLUMENTHAL. I think the new tools, Senator—and I am happy to respond, although obviously Federal jurisdiction is not within my purview. New tools should include stronger penalties, but also stronger protections for whistleblowers, stronger penalties against retaliation for individuals who are doing their job honestly and forthrightly and who may be victims of retaliation, either as whistleblowers or as public officials, as staff members of any of the agencies involved, whether criminal or civil, and perhaps some consideration of criminal penalties for that kind of retaliation. Obviously, obstruction of justice is one possibility, but there should be consideration of protection for whistleblowers and deterrence against retaliation.

But, also, as you are obviously very well aware, Senator, resources are key in this area. And when I mentioned before that these cases are very complex and challenging, they are also very resource intensive. And my hope is that the resources for the criminal justice prosecutions will be provided by Congress so that both the Department of Justice and the SEC can exercise their criminal jurisdiction to investigate and prosecute.

Senator HATCH. You mentioned in your testimony that the number and financial power of hedge funds, now reportedly more than 13,000 hedge funds—I had 11,500; it goes up all the time—with assets exceeding $24 trillion, I believe you said, provide fertile opportunity for potential fraud based on false or deliberately misleading stock analysts' reports. And I have to say that this is a matter of great concern to me, and you mentioned at least a couple of cases in here where there have been real allegations of collusion between hedge funds and analysts that may be corrupt or may be cooperating or may be conspiring to do wrong here.

My time is up, but I just want to thank both of you for the work that you do do, and we are concerned about this. I believe that the vast majority of hedge funds are honest people and doing a good job, but there are literally, literally thousands of them, and I am really concerned about if there is widespread collusion and conspiracies to knock down the price of shares in various corporations, that could really discombobulate our whole market.

I think my time is up, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator Hatch.

Mr. Friedrich, to what extent does the Department of Justice monitor the civil suits which have been brought? For example, Biovail, a pharmaceutical company, has alleged in a suit brought in New Jersey State courts, alleging that several hedge funds, an independent stock research firm, and a research analyst had participated in market manipulation to harm Biovail's stock. The lawsuit further contained allegations that similar executions were orchestrated on other companies, Calgene and Biowaste Technology, Incorporated.

Are such lawsuits of assistance to the Department of Justice to followup to make a determination as to whether those allegations are true or whether they would support a criminal prosecution?

Mr. FRIEDRICH. I think the best way to answer that question, Senator, good criminal chiefs in every district make a practice of reading the newspapers and looking for lawsuits of the type that you describe. I think the best way to put it would be that is an indication that further questions may need to be asked. That is something that can tip us off that there may be some irregularity.

Chairman SPECTER. Well, are you following up on Biovail's contentions?

Mr. FRIEDRICH. Unfortunately, Senator, I cannot comment as to any pending matter that the Justice Department might have. I can comment as to closed matters, and if I may just add to what Senator Hatch asked a moment ago, as to Section 1341, I can tell you that there was a Section 1341 complaint that was filed recently in the Northern District of Georgia as against the operators of a hedge fund.

Chairman SPECTER. And what is the status of that matter?

Mr. FRIEDRICH. There has been a public complaint filed, and there has not been any other public actions so far as that case itself.

Chairman SPECTER. Attorney General Blumenthal, have you initiated any criminal prosecutions in the State of Connecticut against hedge funds?

Mr. BLUMENTHAL. We have not, Senator, and they have been, as Mr. Friedrich has indicated, rare at the Federal level as well. But I think it is an emerging area of interest, and I know that State criminal as well as civil authorities are monitoring and following closely those actions involving Biovail and Overstock.com because they reflect on the need for greater disclosure. If there were disclosure, for example, of the relationships between the hedge funds and supposedly independent analysts, it would have a very positive effect in preventing perhaps the kind of collusion or manipulation that is alleged. Again, these claims are only allegations at this point. So we are following them to determine whether there is evidence and whether, in fact, they will ever go to trial.

Chairman SPECTER. Attorney General Blumenthal, do you know if there are any actions brought by other State Attorneys General? The New York Attorney General, Mr. Spitzer, has been very active in the market area. Do you know if his office or any other Attorneys General have initiated either criminal or civil lawsuits in this area?

Mr. BLUMENTHAL. There have been none, Senator, so far as I am aware. But I know that there are very strong interests on the part of States like Connecticut, New York, and others in this potential area of manipulation or fraud, and certainly there is no reluctance to use existing State criminal authority, as we have done before.

Chairman SPECTER. I was interested in a speech which Fed Chairman Ben Bernanke made recently where he says, "The primary mechanism for regulating excessive leverage and other aspects of risk-taking in a market economy, referring to hedge funds as the discipline provided by creditors, counterparties, and investors. And Chairman Bernanke is against regulation but looks for the market to handle it itself.

Now you have the circuit court decision limiting what the SEC can do, and in an area where there is so much opportunity for manipulation and such enormous profits reported that two individuals last year made in a hedge fund market $1 billion, listen, free economy, earn what you can. But where there is such enormous public impact, we ought to be looking at tough enforcement matters, especially with the void which we have at the moment with the most recently court ruling until the Banking Committee has an opportunity to provide the answers and the Federal legislation comes up and whatever is done with the SEC, which needs to be done.

So I would urge you, Mr. Friedrich, to take a close look at this area and tell us if the existing laws are adequate or if you need tougher sanctions, if you agree with Mr. Blumenthal that there ought to be some civil treble damage penalties. My inclination would be against it. I would not want to give you that option. I would rather have you use the criminal statutes if you have crimes, if you have allegations of crimes, and especially serious ones.

Senator Hatch, before we move on to panel two, would you care to ask anything further?

Senator HATCH. Well, if I could. I did not particularly want to make this hearing one about naked shorting, but I might have a question for both of you on that.

Let me just ask you this: How does your group work? How many meetings do you have with your particular regulatory group, the CFTF? Who do you invite as U.S. Attorneys? Are they all from the financial districts of the country, or are they from across the country? And where do you go with that? How often do you meet?

Mr. FRIEDRICH. It is a mix of representatives. There are representatives—the Deputy Attorney General chairs it. There are people from the Deputy's office who basically administer the task force on a more hands-on basis. There are a range of U.S. attorneys. Some are from the major districts. Some are from smaller districts. There is representation by the FBI, the SEC, the CFTC, and other relevant Federal agencies. Really, there is a lot of, I would say, sort of strategic direction, making sure people have the right resources, exchanging ideas about best practices, and items of that nature. In terms of—

Senator HATCH. How often do you meet?

Mr. FRIEDRICH. I believe since Deputy Attorney General McNulty has been in, I believe there has been one meeting. I am not sure of the frequency of the meetings before he got here.

Senator HATCH. OK.

Mr. FRIEDRICH. And I know they are planning another.

Senator HATCH. Is this issue on your agenda? How do issues get on the agenda?

Mr. FRIEDRICH. I think really that is driven by what people—sort of items of current interest, either things that the regulators or the law enforcement folks or the Bureau want to put on the table, new trends that they are seeing. We are constantly looking for new trends and making sure that the resources that we have are arrayed in a logical way with respect to those trends. New types of corporate fraud, exchanging best practices, exchanging ideas about new court rulings—that type of thing.

Senator HATCH. Maybe either or both of you could answer this question: As I understand it, with regard to naked short—well, shorting in general, naked shorting in particular, within 3 days after the date of sale, you have to register that with the—what is it called? The Depository Trust and Clearing Corporation? It is the DTCC, I believe. But it is my understanding that, at least last time I heard about it, there were about $6 billion per day in failure to deliver stock under the naked shorting situation.

Are you both familiar with that? That to me is startling, and I have also heard from various sources that sometimes some of these companies will register the stock over in, say, Europe, like Germany, so that they do not have to meet that requisite of reporting to the DTCC.

Mr. BLUMENTHAL. Clearly, this is an area—this area is one that ought to be a focus for the Securities and Exchange Commission, and I hope it will be. It is largely beyond the purview of State authority, but it opens new opportunities and very fertile ground for manipulation and fraud and is tied, again, to hedge fund activities and illustrates the need for the deterrent effect of strong criminal penalties and stronger enforcement. There is no question that the penalties themselves will be dead letter unless they are enforced, like any criminal statute.

Senator HATCH. Are both of you aware that that is going on?

Mr. FRIEDRICH. I am aware that that is a practice which is occurring, and I agree with you in terms of your statement of what the legal requirements are in that area. I know that the SEC as well as both major exchanges have taken public positions in terms of naked shorting, what it means and what it does not mean.

Senator HATCH. Well, how can we allow $6 billion a day not to be reported? I mean, that is a lot of money, especially over a year, to not be reported and accounted for. And as we all know, naked shorting is where there is not enough stock to cover the short.

Mr. BLUMENTHAL. And it poses a danger to the markets, the health of the markets and their integrity.

Senator HATCH. That is my point. It could really kill the marketplace if this is widespread. Now, I do not believe it is, but there may be some instances where it will. If it is $6 billion a day, which is what I have been told, then there have got to be a lot of instances where this is being violated, and it ought to be stopped. Do you both agree with that?

Mr. FRIEDRICH. Respectfully, that is an area where I would really have to defer to the SEC in terms of answering a question like that.

Senator HATCH. Do you agree?

Mr. BLUMENTHAL. I agree, but I would probably also have to defer to the SEC.

Senator HATCH. You would defer also. I will defer it to the SEC, too, and I am suggesting that they better get on the ball and start checking on this type of stuff.

Thank you both. I really appreciate it.

Chairman SPECTER. Thank you very much, Senator Hatch, and thank you, Mr. Friedrich and Attorney General Blumenthal. We very much appreciate your coming in.

We will now turn to our second panel: Mr. Aguirre, Mr. Kasowitz, Mr. McLaughlin, Mr. Blickenstaff, Mr. Lamont, Mr. Anifantis, Mr. Schilit, and Mr. Boersma.

Our first witness is Mr. Gary Aguirre, formerly senior counsel with the Division of Enforcement at the Securities and Exchange Commission; nearly 40 years of litigation experience, including the areas of construction disputes, environmental regulations, securities litigation, and criminal defense; has published a number of scholarly legal articles, including one on the litigation arising out of the Enron debacle and the application of Section 10(b) of the Securities Act related to fraud; bachelor's degree in politics and a law degree from the University of California, Master of Fine Arts from UCLA.

Mr. Aguirre, we very much appreciate your joining us here today. We have a copy of a lengthy letter which you have sent to the Chairman and Ranking Member of the Banking Subcommittee on Securities and Investment, which will be made a part of the record, and we look forward to your testimony.

STATEMENT OF GARY J. AGUIRRE, FORMER INVESTIGATOR, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D.C.

Mr. AGUIRRE. Thank you, Mr. Chairman. I deeply appreciate the opportunity to offer some views on this critical issue.

I would like to say preliminarily that I have forwarded your letter inviting me to testify today to the Securities and Exchange Commission, and yesterday I was informed by the Securities and Exchange Commission in a letter that it is their view that existing regulations prohibiting the disclosure of nonpublic information applies to my testimony today. So since there are various penalties that are applicable to disclosure of nonpublic information, I redrafted my testimony yesterday and submitted it so that it was intended to only disclose matters that have already been made public. Among those sanctions are criminal sanctions.

I would like to offer this perspective: I believe that—

Chairman SPECTER. Well, Mr. Aguirre, just a comment. I take issue with what the SEC has said to you. This is an oversight hearing on Federal criminal statutes, and there is a constitutional responsibility in this Committee, and we need to know the facts. And it may be that we will take some of your testimony in closed session, but I would have thought that had the SEC had some concern about the invitation, they would have communicated it to this Committee, to the Chairman. And this is the first that I have heard about it. I have just been handed a letter on the subject.

Mr. AGUIRRE. I had actually suggested—my counsel suggested to them that if they did have some objections to my testimony, that they pass it along to this Committee. It is also my view that my testimony before this Committee is protected by the Lloyd-LaFollette Act. But given the contention of the SEC, I had prepared written testimony that I submitted that merely included what was public. I will do the best I can to answer your questions. I will do the best I can.

Chairman SPECTER. Well, that is all you can do, but I think it is particularly problemsome when the information which you have heretofore disclosed and has been in the public domain raises questions about the propriety of what the SEC has done. This is not a matter of some comment about some third party. This is a matter about the propriety of what the SEC is doing.

Mr. AGUIRRE. I agree with you 100 percent, Senator. Chairman Specter. We will start your time at 5 minutes so we can give you the substantive on substance without talking about these collateral matters, not to take it out of your time.

Thank you, Chairman.

I think that it helps to begin any analysis of the hedge fund potential for abuse on the financial markets by discussing three classes of those types of abuses:

First is the long-term capital risk, and I am really not going to discuss that. It is more the subject, I think, of someone familiar with several different agencies.

The second class of hedge fund abuse is hedge fund fraud on their own investors, and that class of fraud has been the subject of most of the cases that have been brought by the SEC and the Department of Justice. It has been the subject of cases for approximately 10 years. It is probably the SEC's strongest suit. And I am not sure to what extent it is going to require any form of regulation.

The third area is the type of fraud that injures ever other market participant. The type of fraud we are talking about today or the potential type of fraud we are talking about today is one class of that. But there are multiple sub-classes of this type of fraud, for example, insider trading, different forms of market manipulation, the recent use of market timing and late trading by hedge funds to effectively siphon funds from the accounts of small investors. These are all classes of this type of fraud.

Now, this fraud derives from the amount of trading that hedge funds do. We know that at this point that trading amounts to something in the area of 30 percent or more of the New York Stock Exchange and a larger percentage of the trading in other forms of securities. That can only be expected to significantly increase as we move from $1.3 trillion in hedge funds to $6 trillion in hedge funds over the next 9 years.

I believe the impact and the cause of that is the significant funds that are generated in fees and commissions to the various brokerage firms and investment banks that deal with hedge funds.

If we look at the extent of scrutiny of hedge funds in this area, this third class of fraud, over the last 25 years, we will find that there was effectively no scrutiny until 2004. And I am not quoting my own research. I am quoting comments in recent SEC publications.

In 2004, the SEC did not discover any of this class of fraud; rather, it was discovered by a State Attorney General—Mr. Spitzer. That class of fraud, hedge fund abuse of mutual funds, was costing small investors somewhere in the vicinity of several billion a year over several years.

Now, there has been over the last year a second class of fraud discovered, this second class impacting the market participants in general, and that is the PIPE cases. I discuss those to some extent in my written testimony.

Now, aside from those two classes of fraud, you will have to search long and hard to find any enforcement by the Securities and Exchange Commission of any other class of hedge fund abuse against other market participants. I am talking about insider trading. I am talking about market manipulation. I am talking about the class of fraud that we are talking about today. The case that I handled, which I believe was perhaps one of the largest, if not the largest, or the broadest investigation of a hedge fund involved both market manipulation and insider trading. What I found there is that most of these referrals from the New York Stock Exchange and SROs had been coming into the SEC for years and had not been acted upon.

It appears that my time has run out, Senator.

[The prepared statement of Mr. Aguirre appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Aguirre. We will come back to you and give you an opportunity to amplify your statement during the question-and-answer session.

Mr. AGUIRRE. Thank you.

Chairman SPECTER. Our next witness is Mr. Marc Kasowitz, senior partner of Kasowitz, Benson, Torres & Friedman, representing large multinational corporations. "American Lawyer" has included Mr. Kasowitz on its list of the top 45 lawyers under 45. That is kind of precarious category to be in, Mr. Kasowitz, subject to leaving it involuntarily.

Mr. Kasowitz. That was 9 years ago when I was 45.

[Laughter.]

Chairman SPECTER. You are not one of the top 54 under 55, are you?

Mr. Kasowitz. Well, but today is my birthday, Mr. Chairman.

Chairman SPECTER. Well, happy birthday. Cum laude from Yale, law degree from Cornell, editor of the Cornell Law Review. He is testifying today on behalf of the Alliance for Investment Transparency.

Thank you very much for coming in today, Mr. Kasowitz, and we look forward to your testimony.

STATEMENT OF MARC E. KASOWITZ, SENIOR PARTNER, KASOWITZ, BENSON, TORRES & FRIEDMAN LLP, ON BEHALF OF THE ALLIANCE FOR INVESTMENT TRANSPARENCY, NEW YORK, NEW YORK

Mr. KASOWITZ. Thank you for inviting me, Mr. Chairman.

Our firm has developed a considerable expertise and experience in the subject that the Committee is addressing today. We represent a number of clients who have been severely harmed by the market manipulation activities of certain extremely powerful hedge funds and certain supposedly independent securities analysts. Those clients have joined together to form the Alliance for Investment Transparency, on whose behalf I appear today.

Our law firm has filed a lawsuit on behalf of one of our clients against some of those hedge funds and analysts, and we are currently investigating and analyzing claims on behalf of other clients. But I want to make clear at the outset that this is in no way a vendetta against hedge funds in any way. In fact, our firm represents many hedge funds in a variety of matters. The concerns I am addressing today have nothing to do with all those hedge funds which engage in perfectly legal and legitimate investment activities, and they have nothing to do with truly independent securities analysts.

However, what our clients and other companies have experienced is truly shocking. These companies have been targets of a pattern of egregious collusion between certain influential hedge funds and certain supposedly independent analysts, including analysts at major Wall Street firms whose research, in effect, was bought and paid for by the hedge funds as part of illegal market manipulation schemes, typically involving short-selling.

We are not talking about short-sellers who are making an honest bet that a company's stock is about to fall. We are talking about short-sellers who manipulate the market to cause a drop in a company's stock price by engaging in schemes to disseminate false and distorted research and other disinformation.

The schemes those hedge funds engage in are strikingly simple but frighteningly destructive. They often target high-tech, biotech, and pharmaceutical companies. Here is one of the ways in which those schemes work.

The short-selling hedge fund selects a target company. The hedge fund then colludes with a so-called independent stock analyst to prepare a false and negative research report on the target. The analyst firm agrees not to release the research report to the public until the hedge fund accumulates a substantial short position in the target company's stock. Once the hedge fund has accumulated that substantial short position, the report is disseminated widely, causing the intended decline in the target stock price.

The report that is disseminated—and this is also very important—contains no disclosure that the analyst was paid to prepare the report, no disclosure that the hedge fund participate in the preparation of the report, and no disclosure that the hedge fund had a substantial short position in the target stock. Once the false and negative research report has had its intended effect, the hedge fund then closes its position and makes an enormous profit, and it makes that profit at the expense of the proper functioning of the markets, at the expense of innocent investors, and at the expense of the target company and its employees.

There are a number of other ways that hedge funds and analysts illegally manipulate the market as well. They engage in organized campaigns to drive down stock prices by spreading rumors and falsehoods in the financial press, on Internet chat boards, in investor conference calls, at analyst presentations, and at industry conferences. There are orchestrated campaigns to communicate egregiously false information directly to a target company's board of directors, larger shareholders, principal banks, and outside auditors.

We are aware of instances in which the perpetrators of such campaigns have sought to instigate regulatory investigations based on disinformation in order to cause more adverse publicity about the targeted companies. The effects of these campaigns have been devastating to the companies, their employees, and everyday investors.

You heard Mr. Aguirre talk about Pequot, at least in his correspondence to this Committee. Those allegations, if proven, are outrageous and illegal. The same is true here. The conduct that I have described today is egregious and illegal.

Underlying both of these situations is the fact that this industry has grown so large, so powerful, and with so little transparency that the potential for gross fraud and abuse is stunning. In fact, based on the testimony of witnesses before this very Committee today, no one even knows within $1 trillion how large the hedge fund industry actually is. One witness estimates $2.4 trillion; another estimates $1.5 trillion; another says it is $1.2 trillion. The fact that we do not even know how big the industry is within a trillion dollars—which is real money, even in Washington, D.C.—proves the incredible lack of transparency.

There is a pervasive pattern of illegal conduct. Civil remedies exist to address it on an individual basis. But it is critical that law enforcement utilize all of the tools at its disposal to assure that that conduct is uncovered, punished, and deterred.

Thank you.

[The prepared statement of Mr. Kasowitz appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Kasowitz. We now turn to Mr. Joseph McLaughlin, a partner at Sidley Austin, a practice focusing on securities regulation and enforcement; had been a member of the New York Stock Exchange Legal Advisory Committee to the Board of Governors; currently a member of the Subcommittee on Market Structure; a law degree from Columbia and a bachelor's degree also from Columbia. He is testifying today on behalf of the Managed Funds Association.

Thank you for coming in, Mr. McLaughlin, and the floor is yours.

STATEMENT OF JOSEPH MCLAUGHLIN, PARTNER, SIDLEY AUSTIN LLP, ON BEHALF OF THE MANAGED FUNDS ASSOCIATION, NEW YORK, NEW YORK

Mr. MCLAUGHLIN. Thank you, Mr. Chairman. Good morning. The Managed Funds Association is a global membership organization based in the United States. It serves the needs of the professionals who specialize in the alternative investment industry. It has over 1,000 members who include professionals in hedge funds, funds of hedge funds, and managed futures funds. Its members manage a substantial portion of the estimated $1.2 trillion or more invested in these vehicles.

On behalf of its members, MFA has worked with committees of the House and the Senate on hedge fund matters and with the President's Working Group on Financial Markets and that group's constituent departments and agencies.

As members of this Committee are aware, hedge funds are more easily defined in relation to what they are not. They are essentially investment companies that are not publicly offered. The hedge fund universe is characterized by a wide variety of strategies with different risk characteristics and different return expectations.

To the extent that hedge funds engage in short-selling as part of their investment strategy, they tend to dampen what may be irrationally positive market perceptions. They contribute to liquidity and price formation. To the extent that they target companies whose financial positions or whose accounting may be suspect, short-sellers try to identify the bad actors in our marketplace.

As for short-selling, as I am sure you are aware, Mr. Chairman, the SEC was given by Congress plenary authority to regulate short-selling. It has done so. It recently adopted Regulation SHO to deal with the market operational problems that short-selling can create and to deal with the potential manipulative effects of short-selling.

Mr. Chairman, whether investment managers are investing on the short side or the long side, they have a fiduciary duty to their investors to consider all reasonably available information that might bear upon the advisability of their decisions. And where available information leads some investors to take significant short positions in a public company's common stock, it sometimes occurs that the public company will allege that the short seller has been assisted by third parties and is seeking to profit from the short position.

For example, companies frequently allege that investors established a short position in a company stock while feeding reports to the financial press, analysts, or other third parties that criticize the company's accounting or financial conduct. These allegations are not new. In my experience, they have been around since the 1960's when I started practicing law. They may well go back much more into the distant past. This does not involve just hedge funds, but other investors as well. The fact is these allegations on the part of public companies have seldom been substantiated.

As discussed previously, short-sellers often turn out to be right in their conclusions about public companies. MFA believes it would be a serious policy mistake to inhibit short-sellers from continuing to perform the essential contrarian function I have described and that would raise serious constitutional issues to attempt to chill short-sellers' communications with third parties.

Mr. Chairman, if an investor knows its allegations about a company are untrue, then existing law and SEC rules provide ample means for dealing with this conduct. As we have seen from the pump-and-dump schemes, which essentially involve the reverse situation from what we have here, the SEC has ample and enforcement authority under Rule 10(b)(5) and other provisions of the securities laws.

Of course, unlike the pump-and-dump schemes, it is sometimes difficult to identify the source of negative information, except by requiring the recipient of the information to reveal his or her sources, a step that enforcement authorities are often understandably reluctant to take.

At the same time, Mr. Chairman, persons who receive adverse information have their own responsibility to treat it with a degree of healthy skepticism. We believe the financial press has been increasingly diligent over the past few years in identifying possible sources of bias of persons whom they quote as having positive or negative views on a stock.

In this connection, independent analysts are not subject to rules of the New York Stock Exchange or the NASD aimed at revealing conflicts of interest and otherwise enhancing the integrity of an analyst's research. The views expressed or reported by independent analysts are still part of the relevant mosaic, however, and users of independent research must make allowances for the fact that independent research is not subject to the same internal and external scrutiny and standards as research produced by securities firms.

Mr. Chairman and Senator Hatch, MFA unequivocally condemns the intentional spreading of false or misleading information. At the same time, there will be many cases where the facts in the law are not clear, and MFA believes that the remedy in such cases should be not to chill speech but, rather, to encourage more speech. And we urge that the Congress and the regulators follow this principle in their further deliberations.

Thank you.

[The prepared statement of Mr. McLaughlin appears as a submission for the record.]

Chairman SPECTER. Thank you, Mr. McLaughlin.

Our next witness is Mr. Kim Blickenstaff, co-founder, Chairman, and Chief Executive Officer of Biosite, Incorporated; 25 years' experience in health care financing, market management, sales and strategic planning; previously held various financial operations and marketing positions with Baxter Health Care, National Health Laboratories, and High-Tech Incorporated; a master's degree in business administration from University of Chicago, and a bachelor's degree from Loyola, a certified public accountant.

We welcome you here, Mr. Blickenstaff, and look forward to your testimony.

STATEMENT OF KIM BLICKENSTAFF, FOUNDER, CHAIRMAN, AND CHIEF EXECUTIVE OFFICER, BIOSITE, INCORPORATED, SAN DIEGO, CALIFORNIA

Mr. BLICKENSTAFF. Thank you, Chairman Specter and Senator Hatch. I really appreciate you inviting me to this Committee. Obviously, my name is Kim Blickenstaff. I am a founder and Chairman and CEO of Biosite, Incorporated, and I think the only CEO on the panel today, so I think some of my perspective may be interesting.

Just briefly, Biosite is a San Diego-based medical diagnostics company. We do utilize biotechnology techniques within our company to develop rapid diagnostic tests to improve the diagnosis of time-critical diseases. I should note that the company actually went public on the Nasdaq back in 1997.

My testimony today is going to relate to a period in 2002 in which Biosite experienced a rise in its stock price accompanied by highly negative independent research coverage that contained inaccuracies and speculation, so I will show you a lot of details in my comments. Also, I should note that during this same period the company's short position increased six-fold. In many cases, the distributions of these independent reports seemed to be timed to offset positive business developments that the company was reporting on a number of fronts. Due in large part to our experience during this period, we believe that the unregulated activities of independent research firms and their possible links to hedge funds merits further investigation by your Committee.

Just to provide context, I will share some specific situations that influenced my perspective.

In the spring of 2002, Biosite's business had upward momentum following reports of several financial and scientific developments. The stock had increased from $13 a share in January of that year to approximately $19 in February, and by May it had reached $36 a share on the Nasdaq. Much of the enthusiasm was fueled by the investment community and their believe that the market for a new test that we had introduced, our Triage BNP Test, which was the first test for congestive heart failure in the marketplace, could be a very substantial market opportunity. And I believe the rapid rise of our share price over that period of time and the opportunity to speculate—or negative speculation about the entry of potential competitors into the rapidly growing marketplace set the stage for what we experienced next with the independent research community.

Just to give you background, in the 10 months from February to December 2002, the number of shares controlled by short-sellers increased from 690,000 shares to 7.1 million shares, which represented nearly 50 percent of our outstanding stock, and we have the unfortunate distinction of being the most highly shorted stock on any of the exchanges here in the United States.

During this same period, Sterling Financial Investment Group, which is a Florida-based research firm, issued at least seven negative research reports on Biosite, each carrying a "sell" or "sell short" recommendation and an $11 target price in contrast to our $36 market price. Contrary to standard industry practices, no author was listed on the reports, and we believe these reports contain numerous inaccurate or false and misleading statements, which ultimately lent volatility to the stock's performance, thereby harming many of our long-term, fundamentally based investors.

Just to give you an example, in a number of reports issued in the summer and fall of 2002, Sterling predicted the failure of our BNP test due to the expected entry of a competitive test into the marketplace. In several of these reports, Sterling included outright inaccuracies regarding the competitive advantages that supposedly favored the competitive test. The reports also included inaccuracies and misstatements about our own test performance, which were also construed to be an advantage for our competitors.

On September 11, 2002, the same day that Biosite announced positive news, a column was written by Sally Yanchus which appeared on a website called RealMoneyPro.com. The column, which was critical of Biosite, was posted to Yahoo's Biosite message board, so it got onto the Internet.

Ms. Yanchus previously participated on our quarterly conference calls under the affiliation Nightingale and Farber, and we were subsequently able to link Ms. Yanchus to Sterling Research through an NASD Disciplinary Panel Decision, dated April 15, 2005, which refers to her admission of knowingly including inaccuracies in reports on another health care company while working on behalf of Sterling Financial. And I should note that this all happened during the same timeframe that she was involved in these postings on Biosite.

So, on November 18, 2002, members of my management team, including myself, met with the analyst from Sterling Research at the American Heart Association meeting. During our discussion the Sterling analyst told us her research at the conference—she was doing specific research on our products—had elicited positive feedback on our BNP test. She also acknowledged that certain reports that they had previous released did contain inaccuracies, but indicated that what her research director wanted written was not necessarily in line with her own views from her own research. She further maintained that she felt our company would continue to do very well in the marketplace and expressed surprise as to why her managers felt the stock continued to be a good short target. When we asked her why she was writing negative material about the company, she said that her role was research and that the reports were, in fact, written by someone else who was at liberty to revise her research. She also said she was considering leaving Sterling because of the way they were operating and her discomfort about these operational processes on the research writing.

So during this entire period, I should note our BNP test was, in fact, gaining market momentum. Sales grew from $3.4 million in 2001 to $38 million in 2002, despite the competition. Despite all the progress being made by Biosite, our investors continued to see their investments compromised by the volatility in our stock that was created by the dissemination of these reports through various methodologies.

Finally, I should note that in the fall of 2002, we attempted to independently investigate the activities of the short-sellers and their links to Sterling. Unfortunately, the lack of visibility into these trades made it impossible for our investigators to definitively produce a link between Sterling's activities—

Chairman SPECTER. Mr. Blickenstaff, how much longer would you need?

Mr. BLICKENSTAFF. Just 2 seconds. It failed to produce a link between Sterling's activities and the resulting increase in our short position. Nevertheless, we believe the parallels between the magnitude and the timing of Sterling's research activity and Biosite's short position increase was more than a mere coincidence.

I will conclude and go to questions when you have them at the end of the presentations.

[The prepared statement of Mr. Blickenstaff appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Blickenstaff.

Our next witness is Professor Owen Lamont, Professor of Finance and Senior Associate Dean for Faculty Affairs at the Yale School of Management; previously had been an associate economist and research associate to the Boston company Economic Advisers; also served as assistant professor of economics at Princeton University and assistant professor of Finance at the University of Chicago Graduate School of Business; a bachelor's degree with honors from Oberlin and a Ph.D. in Economics from MIT.

We welcome you here, Professor Lamont, and the floor is yours.

STATEMENT OF OWEN A. LAMONT, PROFESSOR OF FINANCE, YALE SCHOOL OF MANAGEMENT, NEW HAVEN, CONNECTICUT

Mr. LAMONT. Thank you very much, Mr. Chairman. I am honored to have this opportunity to testify today.

As an economist, I am concerned with prices, the need to get the prices right. When the prices are wrong, investors are hurt and resources are wasted. In order to get prices right, we need to have all information, both the positive information and the negative information, get into the market. Just like in the world of politics, free speech is essential in the world of finance.

Unfortunately, U.S. financial markets have a substantial optimistic bias built in. The good news is accepted, but the dissemination and discovery of bad news is suppressed. This bias happened for two reasons. One is it can be difficult technically to short-sell, and short-selling is today primarily done by hedge funds and is an important channel for negative information to get into the market. A second component of this bias is retaliation through legal means and other means against any public criticism of the company, whether it be from journalists or short-sellers or analysts.

What happens when negative information is suppressed? Stocks can become overpriced, and we have already mentioned an example of that today, which is Enron. To prevent future Enrons from occurring, we need to make sure that pessimistic voices are heard in the market.

Our current financial system is not set up to encourage short-selling. We have many institutions set up to encourage people to go long, but few institutions set up to encourage people to go short. And there are technical issues with short-selling relating to our system of lending equities. Our system is just not designed to facilitate short-selling of equities, and for some stocks it can be just difficult or impossible to short them.

In the case of analysts, part of the optimistic bias of our system comes from sell-side analysts—not independent analysts, but sell-side analysts from investment banks. These analysts have an incentive to curry favor with the issuing firms in hopes of gaining future underwriting business, and there is substantial evidence that these analysts have in the past been corrupt and intentionally issued overoptimistic forecasts.

The antidote to this problem is independent analysts unaffiliated with any investment bank, and that antidote was mandated in the 2003 settlement between investment banks and securities firms and the Government.

In the case of Enron, for example, independent analysts were substantially less optimistic than the analysts from investment banks. So independent analysts can help detect problems. Unfortunately, independent analysts also have an incentive to be overoptimistic because if they issue negative reports, they may be sued or otherwise harassed by the companies that they cover. And these lawsuits are a particular threat to independent analysts because they are typically small companies that lack the resources to withstand lawsuits.

So I think there is a variety of evidence from academic studies that when you cannot short-sell, stocks can get overpriced. One example I have studied is battles between short-sellers and firms. These are cases in which firms sue short-sellers or otherwise take actions to prevent short-sellers from shorting their stock. And consistent with the idea that when it is hard to short a stock it gets overpriced, firms that are fighting with short-sellers tend to have their stock price decline a great deal in subsequent years, suggesting that it was overpriced to begin with, either because of excessively optimistic investor expectations, because of a problem at the company, or just plain fraud on the part of management.

A notable feature of the data that I studied is that many of the firms that fight with short-sellers are subsequently revealed to be fraudulent, and a variety of other evidence suggests that short-sellers are good at detecting and publicizing fraud, not just overpricing but fraud on the part of firms. I think the SEC and the other regulators cannot be our only line of defense against corporate fraud. We also need a vibrant short-selling community.

In the case of Enron, I think that illustrated many of the benefits of short-selling. Executives from Enron in their recent trial in Houston claimed short-sellers had caused the demise of the company, Enron. I think that claim is nonsense. The jury did not buy that story, and neither should you.

So my opinion is that we need to make the system less lopsided and more hospitable to short selling. We might also want to consider ways of protecting independent analysts from lawsuits from companies. We do not want these analysts to be cheerleaders. We want them to be able to express their honest opinions.

Congress and the SEC are going to continue to hear complaints from companies about short-sellers. An example that I think is useful about who tends to be right in these situations comes from hearings in 1989 when the House Committee on Government Operations had hearings about the alleged evils of short-selling, featuring testimony from supposedly victimized firms. Officials from three firms testified at these hearings. Subsequent to this testimony, the presidents of two out of these three firms were charged with fraud by the SEC. So when you hear companies complain, keep in mind that short-sellers are often the good guys.

Thanks very much for this opportunity to testify. I would be happy to answer your questions.

[The prepared statement of Mr. Lamont appears as a submission for the record.]

Chairman SPECTER. Thank you, Professor Lamont.

Our next witness is Mr. Demetrios Anifantis, manager of Small Business Relationships at J.P. Morgan Chase, formerly client relation manager with Camelback Research Alliance; previously held positions with Thompson Financial, Chase Manhattan, and Skyy Spirits; bachelor's degree in economics from the University of San Francisco and a master's in economics from Fordham.

We welcome you, Mr. Anifantis, and the floor is yours.

STATEMENT OF DEMETRIOS ANIFANTIS, FORMER CLIENT RELATIONSHIP MANAGER, CAMELBACK RESEARCH ALLIANCE, INC., SCOTTSDALE, ARIZONA

Mr. ANIFANTIS. Thank you so much, Mr. Chairman, Senator Hatch. I am pleased to be called to testify before this Committee this morning.

As you mentioned, I did work for Camelback as a client relationship manager performing services for Camelback subscribers for approximately 1 year. I was in the trenches, so I am basically speaking from experience today on exactly what took place at one of these independent research firms. I do work for J.P. Morgan Chase right now as a small business banker.

During my tenure at Camelback, I became well acquainted with Camelback's business model and its management team and staff. It was a relatively small operation while I was there.

Camelback touted itself as supplying "independent research" for a fee to subscribers. It was in the business of publishing reports on public companies, and it also sold some software to subscribers that would rank public companies according to their financial performance and prospects. Basically this was a firm that touted itself on forensic accounting analysis, taking tax returns and financial statements and analyzing those tax returns and financial statements.

I worked most closely with Donn Vickrey, who was one of Camelback's two principals. Vickrey and the other principal, James Carr Bettis, were the individuals who founded Camelback and had control of Camelback's operations.

Vickrey was directly in charge of this independent analyst group, and Carr was more of a head figure of the company. Vickrey's key function was to oversee the research and writing that went into the reports covering publicly traded companies.

Another manager, Jeff Mindlin, had the primary responsibility of engineering as well as managing the financial models that ranked each company.

There were approximately 18 to 20 analysts during my tenure at Camelback; at any given time, approximately 10. These analysts had responsibility to research and write reports on publicly traded companies. The analysts were all recent graduates of universities with 4-year degrees in business-related disciplines, yet management instructed employees to share with clients that the analyst team was comprised of CFAs and/or CPAs with advanced degrees, even though it appeared to me that none but Camelback's top management had such designations. All these individuals who were analysts at Camelback were graduates, recent graduates, recent undergrad graduates, with no certifications at all.

Camelback advertised analytical reporting services on companies whose securities were publicly traded on various exchanges, the three major exchanges here in the United States.

At the time I worked for Camelback, Camelback's client base consisted almost exclusively of large hedge funds and a couple mutual funds. My responsibilities included working with the clients to see that their requests were being met with a view toward keeping them satisfied so they would retain their subscription to Camelback's publications.

The price for Camelback's subscription varied, but commonly there was an annual base subscription of approximately $25,000 to $30,000 per year. For this fee, the client would receive access to all of Camelback's published reports and access to all historic reports on publicly traded companies. So all the reports that were written during Camelback's tenure were available to any client, even new customers or new clients.

Camelback published these reports on several websites that clients did have access to.

Camelback's promotional material and its actual sales practices included selling a yearly "Base Subscription" service to its research reports. Included in this package that I just referred to, between $25,00 and $30,000 a year, also came two custom reports, and these were reports that any of the customers could come and request from Camelback on a specific company.

Typically, Camelback's subscribers would call Camelback and request these reports. That was usually who they called. They usually called me, either through myself or Vickrey. All report requests would be drafted by an analyst and turned over to Vickrey for final approval.

These reports were represented to be qualitative analysis and were essentially more subjective in their coverage than quantitative, which was the models I was referring to earlier. In Camelback's qualitative reports, the company covered would receive an alpha score from "A" to "F," "A" being a strong company, "F" being a very weak firm.

Frequently, the subscribing client of Camelback requesting the custom report would actually supply Camelback with information on the companies that were the subject of the requested report, with instructions to consider and include such information in the report. Usually, the client would instruct Vickrey and other Camelback personnel involved in the intake of the request and the research and writing of the report to generate either a positive or negative report on the company that was the subject of the request.

When a request came in to me, one of the three questions—or two of the three questions that I would always ask of each client that was requesting a report was: Do you currently hold a position in the stock? And if you do hold a position, is it long or short? And this as information that Donn Vickrey wanted prior to beginning the research of any one of these companies.

Just to wrap up here, since I am running out of time, I really truly believe that Camelback is built on deception, corruption, and a complete non-independent model. Independence to me means that all opinions and interpretations are not influenced by any third party or outside source. Camelback also held reports for specific clients, as mentioned by Mr. Kasowitz, where a customer would request that a report not be disseminated to the general paying subscriber base due to the fact that that requesting client, the client who requested the report, could gain some form of position in that stock. As the panel knows, it is oftentimes difficult to build a sizable short position—

Chairman SPECTER. Mr. Anifantis, how much longer will you require?

Mr. ANIFANTIS. Just a minute, Mr. Specter.

The other thing in regard to the deception, Camelback mentioned to all of its employees and professed that it did not run money or did not operate any hedge funds or did not co-manage any funds, which they did.

They would offer joint attacks with media personnel. Within days, even hours of releasing a report, a journalist individual would publish a report that was negative on the same firm.

To wrap up, I believe that this type of thing I saw at Camelback is more common in the industry than regulators believe. The independent analysts feel it is virtually unregulated and lacks meaningful disclosure. I hope my testimony here today results in change in this area, both in enforcement and regulation, that will benefit America's public companies and their shareholders.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Anifantis appears as a submission for the record.]

Chairman SPECTER. Thank you, Mr. Anifantis. Has Camelback changed its name?

Mr. ANIFANTIS. Yes, it has. It is now Gradient Analytics.

Chairman SPECTER. Thank you.

We now turn to Mr. Howard Schilit, founder and Chairman of Center for Financial Research and Analysis; previously an accounting professor at American University; author of the book "Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports;" a Ph.D. and MBA in accounting and finance from the University of Maryland, master's in accounting from Binghampton, and bachelor's degree from Queens.

Thank you very much for coming in today, Mr. Schilit, and we look forward to your testimony.

STATEMENT OF HOWARD SCHILIT, CPA, FOUNDER AND NON-EXECUTIVE CHAIR, CENTER FOR FINANCIAL RESEARCH AND ANALYSIS (CFRA, LLC), ROCKVILLE, MARYLAND

Mr. SCHILIT. Thank you, Senator Specter and other esteemed members on the Committee. I am grateful to have this opportunity to participate in this important hearing.

The perspective that I would like to share based upon the background first as a professor and author about topics on ethics and a founder of an independent research firm is about the independent research industry itself. I was one of the pioneers in the industry back in 1994 and observing the behavior of research firms and our clients, and I will have a series of recommendations on how to improve the behavior and eliminate some conflicts.

I would first like to mention briefly one or two things about the investment management profession, and then I will move on to the research side.

Investment managers can be segmented into two groups; those that own stocks on the long side only, and those that can short stocks. And it is important to recognize good or bad behavior can and does occur in both of those groups. I think in terms of the focus of this Committee, look more broadly, not just at a subset of investment managers, the hedge fund community, but more broadly at the behavior of investment managers in general.

Moving to what is referred to as the independent research profession or organizations, perhaps as many as 500 investment research organizations are now selling a wide variety of products and services to investment managers. While most are still one- or two-person "mom-and-pop" operations, some have grown to generate tens of millions of dollars in revenue.

Some research firms have well-thought-out conflict-of-interest policies while others may demonstrate little or no scruples.

I believe the most important result of this Committee's work would be to move the investment research profession to establish policies and procedures to eliminate both real and perceived conflicts of interest.

I have half a dozen specific recommendations that perhaps you would like to consider.

For firms selling a prescription product, all subscribers should receive the product at the same time and in the same form. No subscribers should be given advance copies, nor should they ever be tipped off of an upcoming report.

Second, research firms should refrain from using nonpublic information to trade in their own accounts, particularly in advance of disseminating a report to subscribers.

Third, research firms that make recommendations for stock purchase or sale should not be permitted to also manage an investment fund. While this may sound self-evident, today some research firms are also investment firms, either long-only or hedge funds.

Four, fees received from investment management clients should never contain a percentage of profits earned from the research. Becoming a partner with a client would immediately strain the objectivity and independence of the research analyst.

Five, research firms that also provide investment banking services should be prohibited from ever using the label "independent."

Six, company-sponsored research creates a special conflict-of-interest problem and should generally render the research firm as "not independent."

And, finally, just as an oversight board exists for auditors, the Public Company Accounting Oversight Board, and many other professionals, such a board is needed to review policies, procedures, and practices of independent research firms.

While this list is far from complete, I think it may be a good starting point.

A few words about the relationship between the independent research firm and the investment managers.

Today, pressure can be brought to bear on research firms by investment managers, such as hedge fund professionals, to write or not write on certain companies, and perhaps even to provide non-public information to a high-paying client. My experience in running a large research center for over a decade is that by establishing transparent and verifiable rules for both clients and employees, rarely will clients push the research firm to act unethically. It is critical that at the beginning of a relationship with a client, he or she knows the rules of the game and also knows that they will always be enforced. That means occasionally firing a client who is unwilling to play by the ethical rules established by the research firm.

A few concluding thoughts. While there may be only isolated cases of bad behavior by investment managers or research providers, the need exists for a careful review of the practices of each group and how they interact. For sure, from time to time investment managers will act badly and try to pressure research providers to act unethically, to the detriment of clients and investors in general. This problem is not too different than the one we all face as parents, as our usually wonderful children sometimes act badly and try to pressure us to do things we later regret doing. The absence of rules or failure to enforce them not only emboldens children to misbehave, but also investment managers.

I hope these thoughts and recommendations were helpful. I look forward to answering any questions.

[The prepared statement of Mr. Schilit appears as a submission for the record.]

Chairman SPECTER. Thank you, Mr. Schilit.

Our final witness today is Mr. Jonathan Boersma, Director of Standards of Practice, Centre for Financial Market Integrity, CFA Institute; responsible for managing and directing the development of the institute's Code of Ethics and Standards of Professional Conduct; previously worked in the investment management industry; bachelor's degree in economics from the University of Wisconsin.

We appreciate your coming in, Mr. Boersma, and the floor is yours.

STATEMENT OF JONATHAN A. BOERSMA, DIRECTOR, STANDARDS OF PRACTICE, CFA CENTRE FOR FINANCIAL MARKET INTEGRITY, CHARLOTTESVILLE, VIRGINIA

Mr. BOERSMA. Thank you, Mr. Chairman, and thank you for the opportunity to speak with you today.

For more than 40 years, CFA Institute has administered the Chartered Financial Analyst, or CFA, examination and awarded the CFA charter, a designation I share with nearly 70,000 investment professionals worldwide.

The hallmark of membership in CFA Institute is adherence to our Code of Ethics and Standards of Professional Conduct. Each of our members, as well as more than 100,000 candidates in the CFA program, must abide by and annually attest to their adherence to our Code and Standards. Among other things, our Code and Standards require our members to maintain their independence and objectivity, prohibit them from engaging in market manipulation, require that they perform their research with diligence and rigor, and require that they disclose any conflicts of interest.

The term "independent research" can have different meanings. It is not simply the product of a firm lacking an investment banking department. Research can be influenced internally, through investment banking, or externally, by the company the analyst is covering or by an investor. Client-sponsored or even issuer-paid research, whereby a company with little or no research coverage hires a firm to write a report on their company, is certainly not independent.

The key question is whether this research is objective. Research that is by its very nature dependent can still be objective. Our Code and Standards mandate all research must be conducted with integrity, thorough analysis, and care. There must be a reasonable and adequate basis to support and substantiate recommendations. This applies to positive and negative ratings. Analysts must not rely on hearsay or rumors, but must conduct careful investigations and rigorously test their hypotheses.

Conflicts of interest are often present and must be managed appropriately—all with the mandate that investors' interests must come first. In order to maintain trust and confidence in our capital markets, it is critical that such conflicts are minimized to ensure that investors' interests are protected. Thorough disclosure is key here. This means, for example, letting investors know whether the research report has been funded by a third party.

Another conflict that has been raised is whether analysts should be allowed to own, or short, shares in the companies that they cover. While some argue that analysts should be prohibited from taking such positions, others maintain that analysts should be required to because it aligns their interests with those of their clients. Our view is that this is indeed a conflict of interest and, like any other conflict, needs to be managed carefully—through blackout periods, pre-approval of trades, or other means. Further, this conflict must be disclosed in order to help investors fully evaluate analysts' recommendations.

Last year, CFA institute issues the Asset Manager Code of Professional Conduct. This voluntary code is to be used by asset managers, and hedge funds in particular, as a template for developing procedures that protect investors and promote ethical behavior. We believe that asset managers have a responsibility to act with integrity and, relevant to our discussion here today, refrain from market manipulation. Under the code, asset managers must not knowingly spread false rumors or attempt to influence analysts to rate or recommend a security in a way that benefits the asset manager or their clients.

Asset managers are not prohibited from hiring outside research firms to supplement or validate their own research. Such research may be positive or negative, and asset managers should be free to take investment actions as a result of their own negative views or as otherwise confirmed by an outside research provider.

Finally, let me say a word about corporate issuers, because they also have a role to play here. In December 2004, CFA Institute and the National Investor Relations Institute issued joint best practice guidelines dealing with the relationship between analysts and corporate issuers. These guidelines, which have been endorsed by the New York Stock Exchange and Nasdaq, outline the duties and responsibilities of analysts and corporate issuers with the goal of reducing retaliation and improving the integrity of research.

As I stated at the beginning, all analysts have a responsibility to act with integrity and to publish only honest, thorough research. Market manipulation of any kind must be dealt with appropriately. Yet analysts must be free to state their opinions and be protected from pressures or threats from the companies when they do so. Not every stock is a "buy," and analysts must have the freedom to say so. Corporate issuers must refrain from trying to influence analysts because that is market manipulation as well.

In closing, I would like to thank you, Senator Specter, for the opportunity to speak with you, and we offer our assistance as you examine these issues further.

[The prepared statement of Mr. Boersma appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Boersma.

For the record, I want it noted that a number of key prospective witnesses declined to participate or cooperate with the Committee. We had sought representatives from SAC Capital, from Rockner Partners, and from Camelback Alliance. And we had sought the testimony of Mr. James Chanice. It was the thought of the Committee that they all had important testimony to add. We have compulsory process, as you know, if necessary, and we may call upon those people in the absence of coming in today to respond for the record. So let the record show that those matters are under consideration by the Committee.

Beginning with Mr. Aguirre, to what extent did your work with the SEC involve referrals to the Department of Justice on any matters which might have had criminal overtones, such as those we are discussing today with hedge funds and so-called independent analysts?

Mr. AGUIRRE. No, it did not. It did not involve independent analysts. We did—

Chairman SPECTER. How about hedge funds?

Mr. AGUIRRE. Well, yes. The case that I was investigating when I was discharged was referred to the U.S. Attorney's Office in New York, and I met with the U.S. Attorney and the FBI on the case in June—

Chairman SPECTER. Well, that matter is under active investigation by the U.S. Attorney and the FBI?

Mr. AGUIRRE. I understand that it is not. But that information has been—I picked that up from the media, which I understand was passed along to them by the SEC.

Chairman SPECTER. I did not follow that. You say it is not under active investigation, but you had consulted with the U.S. Attorney and the FBI?

Mr. AGUIRRE. I did, in June of 2005.

Chairman SPECTER. And what happened after that?

Mr. AGUIRRE. Well, in June of 2005, we basically presented the facts of the G.E.-Heller investigation to the U.S. Attorney.

Chairman SPECTER. And what were those basic facts?

Mr. AGUIRRE. That the CEO of Pequot had appeared to obtain a tip from the CEO of an investment bank.

Chairman SPECTER. And would you define what a "skip" means?

Mr. AGUIRRE. Pardon?

Chairman SPECTER. Would you define what a "skip" means?

Mr. AGUIRRE. I said "tip," sir.

Chairman SPECTER. Tip, oh. Well, I know what a tip means.

Mr. AGUIRRE. Yes.

Chairman SPECTER. Go ahead.

Mr. AGUIRRE. We provided that information to the U.S. Attorney and the FBI.

Chairman SPECTER. I know what a tip means, but you mean a tip which would be relevant to some inside information?

Mr. AGUIRRE. Yes, regarding the pending acquisition. I had done a good deal of the background research through millions of e-mails, searching through calendars, credit card receipts, telephone records, and had basically come up with one significant lead as the possible tipper. We provided that information—after meeting with my supervisors and getting their approval, I provided that information to the U.S. Attorney and the FBI.

Nine days later, I believe that investigation was essentially stopped when the investment banker—there was a newspaper article in the Wall Street Journal on June 23, 2005. That newspaper article announced that Morgan Stanley was considering rehiring Mr. Mack. And until that point, June 23rd, this investigation had the solid approval of my supervisors. I had received accolades for it. I was told by my assistant director that he had given me a personal award, said that he was not sure he had ever given this award to anyone else. It was the highest one of his personal awards. And 9 days later, the investigation was stopped.

Chairman SPECTER. Do you know why the investigation was stopped?

Mr. AGUIRRE. Well, I can tell you my conclusion from all of the evidence. I received a phone call from Morgan Stanley on June 23rd, from the head of their compliance. He had this question: Are you going to proceed against Mr. Mack? Because if you proceed against Mr. Mack, we are going to have problems in having him step in as CEO. We do not want him to step in as CEO if there is going to be a securities case brought against him by the SEC. Until that point, this case was, as I said, supported by everyone.

Over the next 7 days, I saw the investigation come to a grinding halt. Essentially I was left out of meetings. High-powered attorneys contacted my supervisors. I was present when my assistant director spoke with the person who had called me from Morgan Stanley.

Chairman SPECTER. You were present during that conversation?

Mr. AGUIRRE. The assistant director, after I informed him of the question from Morgan Stanley, called the compliance attorney from Morgan Stanley to corroborate what he had told me.

Chairman SPECTER. Well, are you talking about a conversation which you overheard?

Mr. AGUIRRE. Yes, I am. He was on speakerphone.

Chairman SPECTER. And who were the participants in the conversation?

Mr. AGUIRRE. Mark Kreitman, Assistant Director Mark Kreitman; Eric Darnell, who was the head of compliance at Morgan Stanley. Also in the room were Robert Hanson, my branch chief.

Chairman SPECTER. Those were all the people present?

Mr. AGUIRRE. Yes.

Chairman SPECTER. And what was said?

Mr. AGUIRRE. Assistant Director Kreitman asked Mr. Darnell to confirm his question that he had addressed to me, which was, essentially, Are you guys going to go on Mr. Mack? Because we have got a problem if you do, and we want simply want to know if you are serious about proceeding against him.

At the end of the phone conversation, Mr. Kreitman said, "I think we have got to let them know that we probably will." And then he said, "But, first, I am going to call Associate Director Paul Berger and let him know."

So Mr. Kreitman called Associate Director Paul Berger, and the conversation went something like this—

Chairman SPECTER. Were you a party—you overheard the conversation?

Mr. AGUIRRE. It was on speakerphone.

Chairman SPECTER. Go ahead.

Mr. AGUIRRE. Mr. Kreitman said to Mr. Berger, "Paul, this case is coming along pretty well now. We got this phone call from Morgan Stanley, and I think they want to know whether we are serious about it. I think we are going to go on this, and I think we ought to say something now."

Mr. Kreitman was cutoff in mid-sentence by Mr. Berger, and it was rather sharp. Mr. Berger said, "I don't think we are, and we shouldn't say anything."

Now, the problem was that Mr. Berger knew very, very little about the investigation that I had conducted.

Chairman SPECTER. How do you know he knew very little about the investigation?

Mr. AGUIRRE. Well, the information that I passed along—customarily, when Mr. Berger was apprised, I would be asked to prepare something. Mr. Berger had not participated in any meetings. Most of the conversations I had were verbal. And I think he said something during the phone conversation that implied that he was not that familiar with the facts of the case. And the facts that I am talking about had been developed in the last, oh, 3 or 4 weeks.

After the conversation with Mr. Berger, there was an abrupt reversal by my supervisors in their support for this investigation. I wrote two extensive e-mails to Mr. Kreitman outlining for him the facts suggesting that Pequot had acted on insider information and the facts at that point that suggested that Mr. Mack was the most likely—I shouldn't say "most likely." At that point I gave several possibilities, and I put Mr. Mack at the top of the possibilities.

Chairman SPECTER. Top possibility for what?

Mr. AGUIRRE. Being the tipper.

Now, Mr. Kreitman would not discuss the case with me. He was angry. He refused my request that we take Mr. Mack's testimony.

Chairman SPECTER. You say he was angry. That is conclusory. What evidentiary base do you have to say that?

Mr. AGUIRRE. I had provided him with two e-mails and two spread sheets. The tone of his voice. He threw one of the spread sheets at me physically. He was unwilling to discuss the case.

I walked out of his office. I sent him an e-mail confirming what had just happened. Now, that was—

Chairman SPECTER. You sent an e-mail contemporaneously with the event?

Mr. AGUIRRE. Yes.

Chairman SPECTER. Could you provide that to this Committee, please?

Mr. AGUIRRE. I will, sir.

Chairman SPECTER. Thank you.

Mr. AGUIRRE. That e-mail essentially stated that what he was doing in stopping the issuance of the subpoenas was frustrating the investigation. I did not receive a response from that for almost 4 weeks, and I did not—in fact, I provided him with two e-mails, two spread sheets supporting what I saw as the next logical step in the investigation.

Chairman SPECTER. Could you provide this Committee with those spread sheets?

Mr. AGUIRRE. I will, sir.

Chairman SPECTER. Thank you.

Mr. AGUIRRE. Now, there was no response to any of these e-mails—the nine-page e-mail, the six-page e-mail, the spread sheets, or the e-mail confirming his refusal to allow these subpoenas to be issued.

Now, before this, I probably issued something between 90 and 100 subpoenas in the case. On one occasion, I sent an e-mail recommending that we take 27 different—we use 27 subpoenas for 27 different witnesses. And it was unquestioned. Most of the discussions would be fairly brief. In this case, there were no discussions.

On approximately June 23rd, my branch chief—now, this is just about the same time that the newspaper article came out. When I brought up the possibility of issuing a subpoena with him, he told me that Mr. Mack—that this would be very difficult, Mr. Mack had very powerful political connections. He would not authorize it and I would have to speak with Mr. Kreitman.

In July, I sent an e-mail to Associate Director Berger informing him that my branch chief had told me that it would be very difficult to take Mr. Mack's testimony because of his political connections.

Chairman SPECTER. Will you supply us a copy of that e-mail as well?

Mr. AGUIRRE. I will.

Chairman SPECTER. Thank you.

Mr. AGUIRRE. Mr. Berger did not respond. I had a similar conversation with him shortly before I sent him the e-mail. When I did not get a response from Mr. Berger, I sent an e-mail to the Director of Enforcement, and I told her that—I reminded her that she had been present at a going-away party for a senior SEC official who had worked with me on the case. He was probably the most experienced person at the SEC in conducting investigations of insider trading. He taught insider trading to new enforcement staff. He taught insider trading to foreign officials.

At his going-away party, he had told Director Thomsen that the most important case that he had worked on in his 30 years with the SEC was the case that I was heading. He told her that in my presence.

In the e-mail I sent to Director Thomsen on August 4th, I informed her that—or reminded her of the statement that this senior staff person had made, and told her that the case was not moving in circles and could I speak with her about it. I did receive an e-mail and she did say, "Well, bring in the team."

The next day, August 5th, in an e-mail and a face-to-face discussion, my branch chief advised me that they were going to reconsider my request, that they would vet my facts and then make a decision. He suggested that we would do this after we were both back from vacation. He was going on vacation the next day. As soon as he got back, I would be on vacation. So that meant the facts would be vetted in September.

I notified the Director of Enforcement that it would not be necessary to meet with her because the matter had—the facts had changed. They were going to reconsider this issue.

I went on vacation, and on approximately August 30th I received a phone call to call the office. I called the office and spoke with Associate Director Mark Kreitman, Branch Chief Hanson, and they told me that I was being discharged.

Chairman SPECTER. Anything to report after that? Before you do, I have asked you specifically for a number of e-mails, but I did not interrupt you on some of the others. But please provide all the e-mails you have referenced, or any others which are relevant.

Mr. AGUIRRE. I have provided a sworn statement—

Chairman SPECTER. Will you provide those e-mails?

Mr. AGUIRRE.—and 46 exhibits to the Finance and to the Banking Committee and to the Office of Special Counsel. Are you asking for those e-mails, Mr. Chairman?

Chairman SPECTER. With the Banking Committee of the Senate?

Mr. AGUIRRE. Yes.

Chairman SPECTER. Oh, no, that is fine. They are in the jurisdiction of the Senate. You need not provide anything which would be duplicate. We can access those.

Anything further to say on this subject, Mr. Aguirre?

Mr. AGUIRRE. Well, all of my evaluations through the moment that I was discharged were positive. My pay raise went into effect 11 days before I was fired. After I was fired—I think I have said enough.

Chairman SPECTER. Well, I have gone considerably over the 5-minute limit here because I did not want to interrupt your testimony on this matter. And we will work with the Banking Committee, and all the documents which you have provided them we will have access to. And we may discuss this with you further.

We are running late so I will not pursue the matter now, but we will review the documents, as I say, and doubtless have questions for you at the staff level beyond today.

Mr. AGUIRRE. Sure.

Chairman SPECTER. Thank you.

Mr. AGUIRRE. Thank you.

Chairman SPECTER. Senator Hatch?

Senator HATCH. Well, this has been an interesting hearing, and I think it is an important hearing because if some of the allegations are true—and I presume you are all testifying truthfully, and your statements are pretty dramatic—then we have got some work to do up here on Capitol Hill.

Mr. Anifantis—am I pronouncing that right?

Mr. ANIFANTIS. Yes.

Senator HATCH. When did Camelback change its name?

Mr. ANIFANTIS. Camelback changed its name I believe in—it was shortly before I was actually let go, I believe October.

Senator HATCH. Was it before or after the "60 Minutes"—

Mr. ANIFANTIS. Much before that.

Senator HATCH. Before that.

Mr. ANIFANTIS. Yes, about a year and a half before that.

Senator HATCH. And they changed the name to Gradient Analytics?

Mr. ANIFANTIS. That is correct.

Senator HATCH. OK. Mr. Kasowitz, a few years back, we saw successful prosecutions in what are called pump-and-dump cases, as I understand it. In my view, what you are describing, it seems to me, in your testimony is a slam-and dam case, if the allegations are true. To me, talking down a good stock in order to benefit a hedge fund's short position is just as damaging to the markets as almost anything you could do if the talking-down is false.

Now, if this activity is widespread, it certainly has the potential to destroy investor confidence. I would like you to flesh out for us what the full ramifications of these alleged assaults on your clients really were.

Mr. KASOWITZ. Well, the ramifications are that there is damage at almost every level. There certainly is damage for the process of orderly markets because in the circumstances that I have described that our clients have experienced, clearly the hedge fund that is engaged in an improper manipulation, according to the way I have described it, is gaining a significant benefit not only in knowing about and being able to analyze a particular company and its operations, but, in fact, in damaging the company, damaging the value of its stock through the dissemination of false information, which the hedge fund controls. It writes the false information. It controls when that false information is disseminated. It controls the dissemination of that false information through an analyst firm that is supposed to be independent but, in fact, is not. And then it reaps great benefits from it. The shareholders of the company that is attacked in that way are damaged dramatically because the value of their equity holdings are substantially diminished. The employees of that company and the management of the company are damaged dramatically because the company, being under such attack, then faces business problems. The kinds of problems that it faces are problems with business partners, problems with its own banks and lending institutions who either terminate or redo the financing vehicles and the like.

It is just problems up and down the spectrum, both on a macro level with respect to the market and on a micro level with respect to this particular company and its investors.

Senator HATCH. Mr. Anifantis, how did Camelback make its money? I mean, did they have people subscribe to their analytical monthly letters or weekly letters, whatever it is? How did they make their money?

Mr. ANIFANTIS. Senator Hatch, thanks for the question. Camelback predominantly made their money through the qualitative service, which is the research service, which is the analyst reports. They were priced, as mentioned, between $25,000 and $30,000. Also, there were—

Senator HATCH. They would pay $25,000 or $35,000 for the report or for all of the reports that they did?

Mr. ANIFANTIS. For an annual subscription to all of the pieces that would be published by the firm during that year, by Camelback during that calendar year, or during that contract year.

The other way they made money, there were a couple customers that did only have packages that were based on custom reports. For example, a customer would sign up to the service to receive six custom reports, and six custom reports only.

There was another set of customers that used what they sold, which was a quantitative model. It was basically a mathematically driven model which spat out scores based on accounting statistics.

Senator HATCH. Was this a subscriber list or did you have salespeople go out and get these customers or how—

Mr. ANIFANTIS. The customers were predominantly acquired via outgoing calls by a staff of sales folks.

Senator HATCH. OK. Mr. Blickenstaff—Mr. Chairman, I am a little bit over. Could I have a few more questions?

Chairman SPECTER. Go ahead.

Senator HATCH. Mr. Blickenstaff, you described Sterling's approach to you and how it really affected your company detrimentally. How did they charge for their services? Do you have any idea?

Mr. BLICKENSTAFF. No. In fact, I was just looking at the disclosure. There is a fine print at the bottom of this research report. The one thing they did disclose is that they had no shares of Biosite's stock, so nobody owned our shares. It also said they never had a banking relationship, so we never paid them. And then it went on to say that we were not paying them for this research. I mean, of course we would not pay them for this kind of negative research. So who actually paid for the research is not disclosed in this sort of letterhead, and I think that is one key thing. If you could tell who actually was financing this, what firms were involved, that would be a big step toward saying this is paid advertisement.

Senator HATCH. It would seem to me that ethically, Mr. Boersma, that there should be a disclosure of who is financing the research and whether or not there is a connection between the financing and the actual outcome of the research.

Mr. BLICKENSTAFF. I would agree. On the sell side, sell-side analysts have to disclose whether there is a banking relationship with the firm, and obviously, you know, all the sell-siders that were covering us had not done underwriting, so there was not a banking relationship.

Senator HATCH. You felt, though, even though your product was proving to be very beneficial and that you had gone up from, what $13 million to $38 million in just a short period of time, that here were all these negative reports that kept stultifying your stock.

Mr. BLICKENSTAFF. Absolutely. In fact, to give you a good example of the kind of research report, we actually had—in the third quarter of 2002, we beat expectations on our guidance on the ramp of BNP, and yet the headline is we beat expectation, but all the BNP risk remained of competition and—so it seems to turn good news into bad news, and all the reports then turn bad news into even worse news. So there is—

Senator HATCH. We in the Congress fully understand that.

[Laughter.]

Mr. BLICKENSTAFF. Believe me, I know what a negative campaign is all about. I have lived through it.

Senator HATCH. I think we understand it maybe even better than you do.

Mr. BLICKENSTAFF. I think you might.

Senator HATCH. Mr. McLaughlin, you are a very important person and I have a lot of respect for you, and I am sure you have heard this story before. Hedge funds get access and they get information because the number of trades they order in a given day is so lucrative, or at least they want it to be lucrative. What do you make of this assessment? Just how much power do these funds have over the marketplace? If there are 11,500 of them, or more, what kind of power is that in the marketplace? I am not finding fault with the hedge fund business because I know there are a lot of honest, decent hedge funds out there, but it is a tremendous amount of power, isn't it? And I have heard that up to 30 percent of the marketplace happens to be short-selling, which I believe is essential to keep the marketplace honest. But what about that?

Mr. MCLAUGHLIN. Well, Senator Hatch, I cannot confirm whether 30 percent of the volume on a given day is short or not. I am sure there is someone who can do that.

Senator HATCH. Sure.

Mr. MCLAUGHLIN. Any large customer or group of large customers tend to have some influence with the firms that execute their orders. It would be suicide, however, for a broker-dealer firm, because of the importance of the order flow from one or a group of hedge funds, to jeopardize its standing with its customers, clients, and with the enforcement agencies to step over the line and provide information, for example, where there was a duty of trust and confidence not to provide that information.

Senator HATCH. I agree that is true with regard to broker-dealers. What about analytical firms?

Mr. MCLAUGHLIN. Well, independent firms, as I stated earlier, may not be subject to the same considerations, the same controls as firms that are members of the NASD or the New York Stock Exchange. I notice that the firm that Mr. Blickenstaff is referring to here is a member of the NASD and, therefore, of course, is subject to that organization's rules about having a reasonable basis for research and disclosing sources of bias. So when a report like this is published, it would be subject to that full range of controls and safeguards designed to promote the integrity of research.

At the same time, there are many other firms providing information that would be relevant to investment decisions. And I hasten to add, as I stated earlier, it is very hard to draw the line here between independent analysts who are not subject to the same safeguards, sell-side analysts who are, and then you have the financial press, bloggers, and other people who publish information as well. And to deal with this problem, to the extent it is a problem, you have to consider what you might be doing that would have the effect of chilling communication, legitimate debate about companies and their prospects.

Senator HATCH. Well, let me ask you this: I have no doubt that most of these funds, these hedge funds, are operating within the law. But would you agree—at least I assume that hedge funds are equally subject to the anti-fraud provisions of the Federal law.

Mr. MCLAUGHLIN. Of course.

Senator HATCH. And I assume that hedge funds worry that the accusations that we have been hearing today could spoil the industry's reputation if they are true. So I wonder if you could provide us with some examples of self-regulatory steps that the hedge fund industry has taken to make sure that we do not have fraud or insider trading through short-selling like some have described here today.

Mr. MCLAUGHLIN. Well, each hedge fund is required by—each investment adviser, at least registered investment adviser, is required by law to have procedures in place to prevent violations of law arising from that type of activity. In addition, the MFA, on whose behalf I am appearing here today, recently published a set of best practices in this area. To the extent that hedge funds on the trading side and analysts on the analyst side are members of organizations—and, of course, the CFA Institute does in its area just what the MFA does in its, to try to raise the standards of conducts of its members. Neither organization has the ability to require people to become members or to follow these best practices.

Senator HATCH. Can research that is paid for by a hedge fund with a large short or long position in a particular stock be later published as "independent" research without some kind of disclosure?

Mr. MCLAUGHLIN. Under the 1933 Act—and this has been true since 1933—if research is paid for by a company, it must be disclosed. If research is paid for by a client, in my view it ought to be disclosed, but it would depend on the reliance of a particular analyst's customers and the marketplace's reliance on that analyst whether there would be a fraud violation if it were not disclosed.

Senator HATCH. What is your estimation of how well the industry is complying across the board with reporting on especially naked shorts to the Depository Trust and Clearance Corporation? The DTCC, I guess it is.

Mr. MCLAUGHLIN. The hedge fund industry?

Senator HATCH. Yes, let's limit it to that.

Mr. MCLAUGHLIN. Again, I have no statistics on that subject, but I would like to point out that the SEC did adopt Regulation SHO just 2 years ago.

Senator HATCH. They have regulations, but they are not enforced. Wouldn't you agree?

Mr. MCLAUGHLIN. I think the SEC understood when it adopted SHO that it is impossible to prevent every short sale from taking place without a borrow.

Senator HATCH. Well, it is my understanding that the SEC responded to the problem of naked short-selling by enacting SHO, and that was enacted in, if I recall, January 2005. And that was to limit—SHO was enacted to limit market distortion caused by naked short-selling. But I think you would have to admit it falls pretty short of the goals that they set.

Mr. MCLAUGHLIN. I don't know whether I am in a position to admit that, but I think the SEC is certainly concerned about trying to further reduce the extent of naked short-selling.

Senator HATCH. I would think so. First, the Regulation SHO grandfathers in all failures to deliver that occurred prior to January 3, 2005, exempting a large portion of liabilities that will never be delivered. And, second, while Regulation SHO requires that the SEC publish a list of companies that have been targets of predatory short-selling, those for which brokerage firms have failed to deliver a large number of stocks, this seems only to have served as an identification list for further targeting of those firms. And, you know, I think that Regulation SHO also has failed to require either the disclosure or the aggregate failures to deliver in the marketplace or a number of failures to deliver of a particular company's stock. And, finally, despite the apparent widespread continuation of naked short-selling in the marketplace, there are no serious regulatory or criminal consequences for brokers repeatedly failing to deliver. Are you aware of all that?

Mr. MCLAUGHLIN. Yes, I am, Senator Hatch. I go back on the regulation of short-selling for a good many years. I do not mean here to defend the practice of naked short-selling—

Senator HATCH. I have not interpreted you as defending it. I think your testimony has been very straightforward and good.

Are you aware that some of these companies actually go and register over in, say, Germany?

Mr. MCLAUGHLIN. I have to say, Senator Hatch, that remark confused me when you said that earlier. I really—

Senator HATCH. That is what my understanding is. I may be wrong on that. I would be happy to be corrected.

Mr. MCLAUGHLIN. I certainly have clients that are going to public abroad these days instead of in the United States.

Senator HATCH. My understanding is they do that in order to avoid having to report within the 3 days required here. Now, I may be wrong on that, but I would sure like to—would you mind looking at that and helping us understand—

Mr. MCLAUGHLIN. I would like to look at that. I am very curious about it. I have not heard about that happening.

Senator HATCH. If that is so, then that is a very serious charge that I know has been made to me personally and to others here on the Committee.

Mr. Chairman, I have taken too much time, I understand, and I certainly appreciate your forbearance and your kindness in allowing me to do so.

This has been a very important hearing. We acknowledge that the Banking Committee has the vast majority of control and jurisdiction here, but we do have the Justice Department jurisdiction, and that is pretty significant. And some of the things that I have heard here today really have alarmed me, especially from you, Mr.

Aguirre. I have to say that I am very concerned, because if we do not get to the bottom of some of these things and make sure that things are straight, honest, and decent, we could have some really, really serious difficulties in our society.

So I just want to thank you all for being willing to come in and testify and to help us to understand this better, and hopefully we can get through it and figure out what needs to be done. We appreciate your suggestions as well.

Chairman SPECTER. Well, thank you, Senator Hatch, for the work you did while you were Chairman of the Committee and for your suggestion on holding this hearing today. It is past noon, and we have run way over time, but I want to ask just a few more questions.

Mr. Kasowitz, you have outlined in some pretty strong language factual matters suggesting criminal conduct. have you relayed those to the Department of Justice?

Mr. KASOWITZ. That was directed to me, Mr. Chairman?

Chairman SPECTER. Yes. Mr. Kasowitz.

Mr. KASOWITZ. We have included certain of the matters that I have discussed today within a civil lawsuit brought under a State RICO statute in New Jersey. That complaint is a matter of public record. Our focus has been with respect to that, and we certainly are here in cooperation with the Committee and stand prepared to cooperate with all regulators.

Chairman SPECTER. Well, the allegations in your lawsuit are allegations of fraud?

Mr. KASOWITZ. That is right.

Chairman SPECTER. Wouldn't they fit within the statute which I cited earlier, knowingly executes a scheme or artifice to defraud a person in connection with any security, et cetera?

Mr. KASOWITZ. Section 1348?

Chairman SPECTER. Yes.

Mr. KASOWITZ. I believe they would.

Chairman SPECTER. Well, why don't you report it to the U.S. Department of Justice?

Mr. KASOWITZ. Well, we certainly—

Chairman SPECTER. Let me make a suggestion to you, instead of asking you why you have not, make a suggestion to you that you do. They have investigative resources, but not unlimited. You have factual materials. Tell them about that.

I would also like you to take a look at the statute and give the Committee your judgment as to whether it ought to be expanded, whether the penalties are sufficient, what you think of Attorney General Blumental's testimony about civil penalties as well.

And, Mr. Blickenstaff, you have testified about an employee of a so-called independent analytical firm telling you that the information published was false and erroneous, but she had no power or recourse but to let it stand. Correct?

Mr. BLICKENSTAFF. That is correct.

Chairman SPECTER. Did you consider reporting that to the Department of Justice?

Mr. BLICKENSTAFF. Well, given the fact that we could not actually tie the hedge funds to these activities by the research firms, we came to the conclusion that it was a very small matter that, you know, probably was not reportable to a higher level.

Chairman SPECTER. Well, it was a matter which seriously prejudiced your firm. Didn't it?

Mr. BLICKENSTAFF. Yes, it did, sure.

Chairman SPECTER. It sounds to me like it comes within the context of the statute as scheme or artifice to defraud in connection with the sale of a security.

You are a citizen. You are a businessman. You do not have the resources to conduct a criminal investigation.

Mr. BLICKENSTAFF. That was part of the problem. I think we spent several hundred thousand dollars trying to investigate this whole matter, and that was the only piece of this that really we could point to that we felt was, you know, borderline. But—

Chairman SPECTER. Well, that is why we have a Department of Justice. I used to be a district attorney. People brought me information of this sort. If it sounded to me like a violation of law, we had detectives to go out and investigate.

Mr. BLICKENSTAFF. Well, at the time there was not a lot of focus on this whole hedge fund activity and these research firms that we are talking about today, and, you know, we were advised by Kroll & Associates that there just was not a groundswell in any of the major Justice Departments or the SEC that really would, you know, look at this matter. So we just sort of—

Chairman SPECTER. Well, maybe we are creating a groundswell.

Mr. BLICKENSTAFF. We would be willing to cooperate.

Chairman SPECTER. How long ago did this conversation occur?

Mr. BLICKENSTAFF. That conversation was in 2002. I think we do still know where that person is located.

Chairman SPECTER. Well, I think you probably have a 5-year statute of limitations here, so consider making an official report on it and let the Committee know if you do, and we will pursue it and followup. OK?

Mr. BLICKENSTAFF. We will do that. Chairman Specter. Professor Lamont, you talk about

investment bankers who like to secure favoritism with their customers and may exaggerate their report about their customers' stock. Does that come within the kind of language here, knowingly executes a scheme or artifice to defraud with the sale of a security, do you think?

Mr. LAMONT. I could not—

Chairman SPECTER. I know you are a professor of economics.

Mr. LAMONT. Yes.

Chairman SPECTER. How does that sound to you?

Mr. LAMONT. I could not give you any legal advice. I can tell you that in 2003 the SEC and other regulators had a settlement with the underwriters and the securities firms, a $1.5 billion settlement, so there must have been some legal basis for that settlement.

Chairman SPECTER. Well, I am always suspect on civil settlements which are designed to go halfway. They are usually accompanied by a statement that there is no admission of liability or responsibility, disclaimers of every sort, but it has the effect of terminating a matter. And that does not really utilize the real power of criminal prosecution on white-collar crime, which I described earlier.

Mr. Schilit and Mr. Boersma, you have testified about and we have heard other testimony about the lack of professionalism among so-called independent analysts and lack of training. Mr. Anifantis went into some detail on that. Where you have a real estate broker, there are State laws which require the real estate brokers to take tests and to maintain certain standards, and a real estate broker deals with very small sums—relatively small sums of money for limited clients. Is this a matter which ought to be the subject of State laws? If you practice law without a license in Pennsylvania, you are subject to a criminal prosecution. What of that, Mr. Schilit? How about some sanctions which would be analogous to those considerations?

Mr. SCHILIT. Well, the recommendation I was making is you have an industry, the investment and research industry, which has grown dramatically, and there are not standards. So if you wanted to leave your position in the Senate and form a research company, there are no prohibitions for you to do that and label yourself as an independent research company.

Chairman SPECTER. Well, I could not become a real estate broker.

Mr. SCHILIT. Correct. And so, you know—

Chairman SPECTER. Maybe it is more—

Mr. SCHILIT. Well, the recommendation—

Chairman SPECTER. Maybe I can do more harm as a real estate broker than as a research analyst. I doubt it.

Mr. SCHILIT. But I think the spirit of what you are suggesting I certainly would agree with, that there has to be standards before you enter that field.

Chairman SPECTER. Mr. Boersma, what do you think about that? I am trying to get a few more opinions here and draw this hearing to a close?

Mr. BOERSMA. There is an examination for—

Chairman SPECTER. We are about to interfere with tomorrow's hearing.

Mr. SCHILIT. There is an examination for those that work in a broker-dealer setting, but there is not any certification required for independent analysts, and we certainly think the CFA program and designation is a mark of good standing for analysts. But they are not required to do that.

Chairman SPECTER. Well, after listening to the testimony today and after reviewing a lot of documents in this field, it is my judgment that we are dealing with a matter of enormous importance, $1.2 trillion, maybe more, as Mr. Kasowitz says, maybe double, and it is on its way to a lot more than that. And although it is only 5 percent of the market from the statistics I have seen, it has 30 percent of the transactions. And you had the case in 1998 where the company with assets of $3 to $4 billion leveraged it to $80 to $100 billion. And had they collapsed, it would have had enormous repercussions. And you have potential for $1 billion a year, which is fine if it is done legally, but with only limiting it, as the Chairman of the Fed says, to pressures within the industry, it has enormous potential for abuse. And regulation is fine. That is up to the

SEC and up to the Congress generally and the Banking Committee. But the Department of Justice and State prosecutors have a very important role to play here. And prosecutions for white-collar crime and jail sentences have a tremendous deterrent effect. And this Committee intends to push the Department of Justice to do that.

If you have information, Mr. Kasowitz, Mr. Blickenstaff, others, pass it on.

Senator HATCH. Mr. Chairman, can I just ask one more question?

Chairman SPECTER. Are you serious?

[Laughter.]

Senator HATCH. Yes, I am serious.

Chairman SPECTER. I know you are serious, but I mean about one more question.

Senator HATCH. It might be more than one. But I will try and keep it to one. I just want to ask Mr. Kasowitz, I mentioned to Mr. McLaughlin—and this is something I understand is done, but I may be wrong on it. I would just like to know.

These folks on these naked shorts are supposed to file with the Depository Trust and Clearing Corporation within 3 days. SHO was to try and make sure that they do that. But it is my understanding that some of these companies, to avoid doing that, go and register a stock in a foreign country. I will use Germany as an illustration. And then they can avoid it for months on end. Where there is not any stock to go get, which is the definition of "naked shorting."

Are you aware of that?

Mr. KASOWITZ. The case that we have filed for our client, Biovail, does not involve that situation. I have heard reports similar to the ones that you have read about, Senator.

Senator HATCH. Well, I would appreciate—Mr. Aguirre, have you heard about this?

Mr. AGUIRRE. No, I have not.

Senator HATCH. OK. Well, I would appreciate any information anybody on this panel, or otherwise, can give us on that, because if that is true, that I think may be very well constitute fraud. It may not, but it may very well constitute fraud that we are concerned about here under this particular statutory section, in order to evade reporting because they know that they are naked shorting and they cannot cover the stock.

These are matters that I think are very important. Mr. Schilit, do you have any awareness of that?

Mr. SCHILIT. I do not.

Senator HATCH. Anybody else have any awareness of that?

[No response.]

Senator HATCH. OK. Well, then, I just wanted to ask that, and I would appreciate, Mr. McLaughlin, Mr. Kasowitz, if you can help us to understand that process. And if we are wrong, I would like to know. I would just like to know what is right here. I don't have any axes to grind here. I would just like to do what is right, and I am real concerned, as you can see the Chairman is, about some of the things we have heard here today and that we have been studying. We do not want to hurt anybody. We just want to make sure that our markets are not ruined because of the fraud.

Chairman SPECTER. Thank you, Senator Hatch and thank you all.

[Whereupon, at 12:15 p.m., the Committee was adjourned.]

[Questions and answers and submissions for the record follow.]

[Additional material is being retained in the Committee files.]

QUESTIONS AND ANSWERS

Senator Specter
Questions for Gary Aguirre
Former SEC Investigator
June 28, 2006

1. In criticizing federal enforcement efforts against hedge funds, your written testimony states that the Department of Justice "merely shadows the SEC's meager scrutiny of hedge funds." Can you elaborate on this point?

In my testimony, I tracked the history of the SEC's enforcement actions against hedge funds from 1979 to the present.[1] That history demonstrates the SEC has consistently failed to appreciate the growing risk of one specie of hedge fund fraud and manipulation--that which victimizes other market participants. This class of victims includes individuals and institutions that invest and trade by the rules, small investors who believed their assets were safely tucked away in mutual funds, and public companies decimated by illegal forms of short selling. The fraud and manipulation comes in various forms: insider trading, wash trades, naked short sales, short sales combined with phony analysts' reports, late trading and market timing of mutual funds and, more than likely, other forms of fraud yet undetected.

To the extent that the DOJ has initiated criminal prosecutions against hedge fund principals, it has generally ridden on the SEC's coattails. It has therefore, in my opinion, shadowed "the SEC's meager scrutiny of hedge funds."

I offer one caveat regarding my comments below. Tracking SEC enforcement cases against hedge funds, at least for me, is a far simpler task than tracking DOJ prosecutions of hedge funds. I have a service that collects SEC case filings and dispositions. I have no similar service for collecting DOJ filings. In making the comments blow about the DOJ track record of prosecuting hedge fund fraud and manipulation, I have relied on information obtained by conducting searches through Lexis news and reported case sources. In doing so, I would expect that I have missed some cases. But that caveat does not apply to the *patterns* of DOJ prosecutions discussed below.

A) 1979--October 2003

1) SEC: The SEC pursued and recognized only one type of hedge fund fraud during this period: fraud by hedge funds that victimized their own investors.[2] The SEC

[1] *Hedge Funds and Independent Analysts: How Independent Are Their Relationships? Hearing before the U.S. Senate Committee on the Judiciary, 109th Cong.* (2006) (statement of Gary J. Aguirre, Esq., pp 10-14).

[2] As late as September 2003, the SEC staff report on hedge funds described its efforts to police hedge funds: it identified thirty-eight enforcement actions brought by the SEC from 1999 to September 2003. Staff Report to the U.S. Securities and Exchange Commission, Implications of the Growth of Hedge Funds, at 90 (September 2003). Available at http://www.sec.gov/news/studies/hedgefunds0903.pdf. All of those cases involved the same type of hedge fund fraud: fraud by hedge funds that victimized their own investors. But 1999 is an arbitrary cut off date. In searching through Lexis from the present to the past, the first case I could find where the SEC had filed an enforcement action against a hedge fund for causing injury to anyone other than hedge fund investors was *SEC v. Howard Associates et al.,* 1979 SEC LEXIS 2362.

brought no cases against hedge funds for victimizing other market participants, e.g., insider trading, wash trades, and late trading or market timing.[3]

2) DOJ: The DOJ has the same track record. Searching through Lexis news and federal decisions, I could only find DOJ cases against hedge fund principals involving fraud against hedge fund investors. In most cases, the DOJ appeared to be tracking an SEC investigation. However, I came across three cases during 2000 and 2001 where the DOJ apparently investigated and prosecuted hedge funds without the participation of the SEC.[4] I did not find any case in the last five years where that had occurred. There may be a valid explanation for the DOJ's failure to prosecute these cases without SEC help. During my tenure with the SEC, I was told that the DOJ's available resources to investigate financial crimes had been restricted as a consequence of September 11. In this regard, Assistant Director Kreitman told me--the day before I met with the US Attorney and FBI on the Pequot investigation--that I would have to "spoon feed" everything to these officials.

B) September 3, 2003: Attorney General Spitzer announces the settlement with Canary Capital Management, a hedge fund, for $40 million for late trading and market timing. This triggers a catch-up effort by both SEC and DOJ. Later, the GAO and Congress would be critical of the SEC for failing to detect the existence of this widespread fraud.

C) Post September 2003: SEC and DOJ upgrade their scrutiny of hedge funds, brokers and mutual funds for market timing and late trading.

1) SEC: After the Canary Capital settlement, the SEC pursued hedge funds, brokers, and mutual funds for their part in the late trading/market timing fraud. By January 2005, according to The Wall Street Journal, "The SEC...found nearly 400 hedge funds that engaged in illegal late trading or improper short-term trading of mutual funds."[5] Although by my count the SEC has brought over 100 market timing/late trading cases, it brought very few against hedge funds. In fact, I could find only two.[6] Yet, by all accounts, hedge funds committed the lion's share of the fraud. The SEC releases involving settlements with brokers and mutual funds repeatedly emphasize the involvement of hedge funds. The SEC case against Bear Stearns is

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[3] *Id.*

[4] *U.S. v. Natale;* see *Broker Pleads Guilty in New Jersey to Fraud Involving $40 Million*, N.Y. TIMES, March 6, 2000 at C13; *U.S. v. Higgins;* see *Fund Manager Admits Role in Securities Scam*, The San Francisco Chronicle, July 7, 2000, at A 20; and *U.S. v. Trainer,* see *Trainer Brothers Plead Guilty to Fraud over Looting of Hedge Fund; Prosecutors Say Matthew Trainer Lost $1 Million Through Stock Market Trading*, St. LOUIS POST-DISPATCH, April 27, 2001, at C8.

[5] Gregory Zuckerman and Ian McDonald, *The Wild West Of Hedge Funds Becomes Tamer,* WALL ST. J., Jan. 24, 2005, at C1.

[6] The SEC brought actions against Millennium Partners and one of its traders in *In the Matter of Millennium Partners, L.P., Millennium Management, L.L.C., Millennium International Management, L.L.C., Israel Englander, Terence Feeney, Fred Stone, and Kovan Pillai.* Investment Advisers Act Release No. 2453 (Dec. 1, 2005) and *In the Matter of Steven B. Markovitz.* Investment Advisers Act Release No. 2180 (Oct. 2, 2003), and against three hedge funds managed by the same advisor in *In the Matter of Veras Capital Master Fund, VEY Partners Master Fund, Veras Investment Partners, L.L.C., Kevin D. Larson, and James R. McBride.* Investment Advisers Act Release No. 2466 (Dec. 22, 2005).

an excellent example. Bear Stearns agreed to pay $250 million dollars for permitting market timing and late trading. The SEC release observes: "At BS&Co., certain brokers in the Private Client Services Division ("PCS") facilitated illegal mutual fund trading by knowingly processing large numbers of late trades for certain market timing customers, *predominately large hedge funds* ...(emphasis added)" So, where are the cases against these large hedge funds?[7]

2) The DOJ follows a similar pattern. It began pursuing mutual funds, brokers and hedge funds for market timing and late trading a few months after the Canary Capital settlement. The first case--against three executives of a *broker-dealer*--was filed in March 2004.[8] I believe the first conviction was also against a *broker* in July 2004.[9] I have been unable to find a DOJ conviction involving a hedge fund principal, trader, or employee. The only conviction of a hedge fund principal arising out of late trading and market timing appears to be a case brought by Attorney General Spitzer.[10]

D) The PIPEs cases:

1) The SEC: I discussed in my testimony how the SEC learned about these violations. They were detected by a $100 billion mutual fund and the evidence was then handed over to SEC officials.[11] The SEC has settled three of these cases and is continuing to investigate twenty-four others, [12] including one against Pequot. These cases have cookie-cutter facts.[13] One question bubble to the surface: Why are there only three SEC enforcement actions against hedge funds arising out of PIPEs transactions?

[7] *In the Matter of Bear, Stearns & CO., Inc., and Bear, Stearns Securities Corp.* Investment Company Act Release No. 27262 (March 16, 2006).
[8] *U.S. v. Sapio*, see Kara Scanell and Tom Lauricella, *Fund Scandal: Criminal Charges—Federal Prosecutors File their First Such Motions, Hit Three at Broker-Dealer*, WALL St. J., March 16, 2004, at D9.
[9] *U.S. v. Sharma*, see Matthew Goldstein, *Rare Criminal Conviction in Market-Timing*, TheStreet.com, July 30, 2004.
[10] *People v. Markowitz*, see Gregory Zuckerman, *Top Hedge-Fund Trader Admits to "Late" Trades*, WALL ST. J., October 3, 2003, at C1.
[11] "The focus on Pipes was prompted in part by complaints from a large mutual fund whose traders had noticed a pattern in which small-company stocks would decline in advance of a company's announcement of a Pipe deal, according to people familiar with the matter." Susan Pulliam, Stock-*Trading Cheats Are in the Cross Hairs,* WALL ST. J., July 8, 2004, at C1. "For Bradley, who gave the SEC a list about 18 months ago of companies whose stock might have traded irregularly after a PIPE deal, said there appeared to be a concerted effort to spread information in the market in an unaudited way." Herbert Lash, *Hedge Fund Instant Messaging Should Be Scrutinized*, Reuters News May 24, 2005.
[12] "The investigation is believed to involve more than two dozen investment funds and already has resulted in some scalps. Regulators are looking into allegations of stock manipulation by hedge funds, which are big investors in PIPEs." Neal St. Anthony, *Deep Haven among Funds in SEC Investigation*, Star Tribune (Minneapolis, MN), July 6, 2005, at 1D. "[T]he U.S. Securities and Exchange Commission is investigating 20 instances in which hedge funds may have used insider information to profit from upcoming stock offerings, according to people familiar with the matter." Susan Pulliam, *SEC pumps up hedge funds probe,* WALL ST. J., July 8, 2004, at B10.
[13] *Hedge Funds Hearing, supra* note 1, at 10-11.

2) The DOJ has obtained at least one guilty plea to insider trading arising out of a PIPEs transaction. It was from the former director of Cowen Securities, a *brokerage firm*[14] The SEC also simultaneously brought an enforcement action against the same individual. I have found no DOJ case resulting in the conviction of a hedge fund principal, trader or employee. I did come across one case where the SEC and a US Attorney are jointly conducting a PIPEs investigation.[15]

E) Other cases: I mentioned in my testimony that the SEC has brought several other cases, of relatively minor importance, which do not involve PIPEs or mutual fund abuse. The DOJ has been involved in two of those matters: 1) *U.S. v. Tom* and 2) *U.S. v Schmidt* and *U.S. V. Sacane*, who are both principals of Durus Capital.[16]

F) The Pequot Capital Investigation. The heavy lifting on this case was going to be done by the SEC: taking testimony, subpoenaing records, and mining evidence such as emails, phone records, and credit card statements. As relevant evidence was developed, it would be provided to the US Attorney and the FBI.

G) Other DOJ cases. I found no other pattern of DOJ cases involving this species of hedge fund fraud or manipulation--that which victimizes other market participants. In fact, I could find no other DOJ prosecutions for this species of fraud, but my research was pressed for time.[17]

2. During your tenure at SEC, do you know whether the Department of Justice actively investigated the trading activities of hedge funds without the help of SEC? I would not have known about this.

No.

3. On page 4 of your written statement you say that hedge funds "by no means dominate the capital markets." But you later say in the same statement on the next page that "hedge fund trading now dominates the nation's capital markets." How do you reconcile these statements?

These two statements use different metrics to measure the economic muscle of hedge funds in relation to the broader capital markets. I believe this process is a critical step in comparing the relative risks the two species of hedge fund fraud--fraud victimizing hedge fund investors and fraud victimizing other market participants--pose to the capital markets.

The first statement quoted above (hedge funds "by no means dominate the capital markets") focuses on the relatively tiny amount of assets that hedge funds collectively manage compared

[14] *S.E.C. Accuses Former Official at SG Cowen in Fraud Suit, N.Y. Times April 22, 2005, at C5.*
[15] *Business Briefing*, Sun-Sentinel (Fort Lauderdale, FL) October 26, 2005 at 1D.
[16] *Information Issued by U.S. Attorney's Office for Massachusetts on Feb. 16: Global Capital Manager Pleads Guilty to Insider Trading Charges*, U.S. Fed News, Feb. 16, 2006; *Fund Manager Pleads Guilty*, N.Y. Times, December 23, 2005, at C4; and *Hedge Fund Operator Sentenced for Filing False Statements*, Associated Press, March 6, 2006.
[17] This of course does not include DOJ prosecutions of hedge fund principals for fraud on their own investors.

with other bench marks. When the economic power of hedge funds is measured by this metric alone, their economic power--$1.2 trillion--is relatively inconsequential. From this perspective--the amount of assets hedge funds control, they dominate no markets. In its context, this statement reads:

> Of course, wealthy individuals and institutions have entrusted $1.2 trillion to hedge funds. That is a big chunk of money, but it is only a tiny fraction of the total assets that individuals and institutions have invested in the capital markets. For example, mutual funds collectively manage $9.2 trillion. The bond and equity markets are more than $40 trillion. Globally, $90 trillion of financial assets are under management. Thus, by any measure, hedge funds have significant assets, but by no means dominate the capital markets. No amount of fraud by hedge funds against their own investors could cripple the capital markets. It is too little money.[18]

The second statement quoted ("hedge fund trading now dominates the nation's capital markets") focuses on the *trading* hedge funds do as a percentage of the total trading done by institutions and individuals. In this case, I believe hedge funds now collectively dominate trading on the capital markets. In its context, this statement reads:

> The potential harm that hedge funds can inflict on other market participants has no real limits. *Hedge fund trading now dominates the nation's capital markets.* The $1.2 trillion under hedge fund management are on steroids. They recycle at high velocity through the markets. With that $1.2 trillion, hedge funds execute up to fifty percent of daily trading on the $21 trillion New York Stock Exchange. They also do seventy percent of the trading in the US distressed debt market, US exchange-traded fund market and the convertible bond market. The same picture is emerging in the derivative markets (emphasis added).[19]

This process--using two different metrics to measure hedge fund muscle--is a key step, in my opinion, in distinguishing and thus grasping the real risks hedge funds pose to the capital markets. There are two recognized species of hedge fund fraud: that which victimizes hedge fund investors and that which victimizes other market participants.

The first specie--fraud that victimizes hedge fund investors-- is limited by the *amount of assets* investors have entrusted to hedge funds, now approximately $1.2 trillion according to the last SEC testimony before the Congress. As discussed above, this is a tiny faction of the assets invested in the capital markets. As discussed at length in my testimony, it is unlikely that this specie of fraud could ever cripple the capital markets.[20]

The second specie of fraud victimizes other market participants. It includes late trading and market timing of mutual funds, insider trading, wash sales, and the use of short sales combined

[18] *Hedge Funds Hearing, supra* note 1, at 3.
[19] *Id.* at 5.
[20] *Id.* at 3.

with phony analysts' reports. *It is all carried out through trading.* I have suggested in my testimony that this specie of fraud poses the greatest risk of delivering a severe financial crisis.[21]

4. Has the issue of hedge fund short selling and their activities with so called independent research analysts been a matter of investigation for the SEC?

I never heard of such an investigation when I was with the SEC.

5. Please identify by name the Assistant U.S. Attorney for the Southern District of New York and Federal Bureau of Investigation ("FBI") agents you met with on June 15, 2005 to discuss your investigation of Pequot Capital Management ("PCM"), Arthur Samberg ("Samberg") and John Mack ("Mack") in connection with allegations of insider trading of General Electric Company and Heller Financial Inc. stocks.

David Anders, Assistant United States Attorney, 212-637-1029.

David Markel, FBI, 718-286-7385. I do not recall the name of the second FBI agent.

6. If you were accompanied by other Securities and Exchange Commission ("SEC") staff during your June 15, 2005 meeting with the Assistant U.S. Attorney and FBI, please identify any SEC staffers accompanying you by name and title.

Eric Ribelin, Branch Chief, Office of Market Surveillance, Division of Enforcement, office phone: 202-551-4984; home phone: 703-524-0154.

Nancy Miller, summer intern, Division of Enforcement, whereabouts unknown.

7. You testified that despite the fact you briefed the U.S. Attorney's office and the FBI, you did not believe that they had an active, ongoing investigation of insider trading by PCM, Samberg and Mack. (Tr. 89-90). Who informed you that the U.S. Attorney and FBI had called off any investigation?

I would like to pickup from the question and answer at the hearing and then offer an answer. The transcript reads:

> SEN. SPECTER: Well, that matter is under active investigation by the U.S. attorney and the FBI.
>
> MR. AGUIRRE: I understand that it's not. I -- that's -- but that information has been -- I picked that up from the media, which I understand was passed along to them by the SEC.

I need to provide some background to put my statement above in context. In the meetings with the FBI and the US Attorney, we discussed two complementary approaches to advancing the GE Heller investigation. One approach involved the FBI convincing a former associate of

[21] See in particular *id.* at 5-6.

Samberg to become an informant. In searching through the Pequot emails, I had found a possible candidate. The FBI's initial role was to try interview this person, show him incriminating emails he had exchanged with Samberg, and then "be his best friend." The success of this approach was a long shot. I understand that the FBI made several attempts to interview the potential informant during my tenure with the SEC, but had been unsuccessful.

The second approach was longer term. SEC staff--primarily me--would cobble together evidence from emails, phone records, credit card statements, calendars and similar evidence to build a convincing circumstantial case. It was my understanding that any further investigation by the FBI and the U.S. Attorney would be dependent on the flow of this information from the SEC. As a practical matter, the SEC had subpoena power; the U.S. Attorney and the FBI did not. Further, the mining of relevant evidence from millions of documents is extremely time-consuming. It was my understanding that neither the FBI nor the U.S. Attorney was prepared to devote such time to the investigation. Accordingly, if the SEC dropped the GE-Heller investigation--and that seemed to be the case in the summer of 2005, the information flow to the FBI- U.S. Attorney would dry up and their investigation would also be dropped.

Turning to the information from the media, I found an article on Lexis that had been published in Street.com several months ago. It described a hedge fund investigation, which--in my opinion--had to be the Pequot investigation. The article stated that the SEC had stopped the investigation last year. I had received a similar impression from one of the reporters who contacted me. After my testimony, Barron's published an article (*Roundtable Rascals*) in its July 3 edition in which it stated: "In a letter sent to Pequot clients last week, Samberg said the SEC had ended the investigation because the suspicions were unfounded." Since the SEC appears to have been dropped its GE-Heller investigation, the information flow to the FBI's and US Attorney's investigation has been cutoff and thus that investigation must have stopped as well.

Mr. Demetrios Anifantis
Hedge Funds and Analysts: How Independent are Their Relationships?
June 28, 2006

Dear Mr. Chairman,

I appreciate the opportunity to continue discussions on the matter of "Hedge Funds & Independent Research." I also thank you for the time given to this matter by the committee.

I will answer your questions in order as listed in your inquiry.

1. In regard to my firing and explanation to pursue a platform asking for change in the unregulated Independent Research and Hedge Fund industries.

Months prior to my firing I raised many issues with the founders in regard to ethics violations and what I believe to be, including approaching Donn more than once about holding reports for specific customers, obviously allowing them to take positions prior to the release of the report to the general client base and Wall Street.

I believe Gradient (Camelback) was in violation of the SEC's Security Exchange Act of 1934 in 6 ways:

1. Often speaking to clients prior to a report being published or released to the general client community (Sometimes client is given report prior to publication)
2. Reports are written in same suite that Pinnacle Investment Advisors is operating out of.
3. Bigdough.com, a database used for prospecting financial institutions and managers (incl. Hedge Funds) had Pinnacle in its database as well as James Bettis and Donn Vickrey (editor in chief as well as CFO of Camelback) listed as Portfolio Managers. After showing Jeff Mindlin both names were removed within 24 Hours. Coincidently a member of Bigdough's staff was hired shortly after. As you can see below James Bettis is mentioned as a Portfolio Manager of Pinnacle many times. I have a copy of the web page before it was changed if requested.

Imagine Robert E. Stansky of Fidelity's Magellan fund writing and marketing so called, "Independent Research," while managing the world's largest mutual fund without the knowledge of Wall Street. Completely Illegal!

4. Jeff Mindlin and Carr "James" Bettis have built all Models sold under the Camelback name (Earnings Quality Model, Fundamental X-ray Model and Technical Model) with some direction from Donn Vickrey. Jeff Mindlin built the Tech Model and uses a portion of it as part of his strategy to manage the Hallmark Fund.
5. Jeff Mindlin is instrumental in the sales of Camelback's models including the manipulation/mining of data often presented to prospects and clients. He is the Model Product expert and visited prospects and clients in NYC on Camelback business. Sales staff has no knowledge of the models; Jeff is responsible for any Model related

discussions with prospects and clients. He told me recently that he has to be very careful that his signature in his email is correct and he answers the phone under the appropriate company name.

6. John Markman w/ Jeff Mindlin run a newsletter out of Camelback's offices. Markman is also listed as a Pinnacle PM and writes for CNBC.com.

SEC VIOLATION CITINGS:

Section 15D -- Securities Analysts And Research Reports

1. To foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts, by--

    A. Restricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff; ← **OBVIOUS FROM ABOVE**

2. To define periods during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities; ← **Pinnacle/Camelback may be bundled into this**

3. to establish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision; and ← **DOES NOT EXIST**

a. **Disclosure**

The Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section [enacted July 30, 2002], rules reasonably designed to require each securities analyst to disclose in public appearances, and each registered broker or dealer to disclose in each research report, as applicable, conflicts of interest that are known or should have been known by the securities analyst or the broker or dealer, to exist at the time of the appearance or the date of distribution of the report, including--

2. whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the securities analyst, from the issuer that is the subject of the appearance or research report, subject to such exemptions as the Commission may determine appropriate and necessary to prevent disclosure by virtue of this paragraph of material non-public information regarding specific potential future investment banking transactions of such issuer, as is appropriate in the public interest and consistent with the protection of investors; ← **Sounds like Camelback may have had to disclose its relations to Pinnacle and possible report leaks (in the event any of the PM's of Pinnacle saw the report before its distribution to the entire client paying community)**

Gradient (Camelback) built a business on lies, misinformation and deception.

Look at the piece, "Earnings Quality Analytics Analyst Team." NONE of the analysts possess CFA's, CPA's or any other certification. 8-10 are direct hires recently graduating from ASU with no prior or relevant work experience before employment at Gradient (Camelback). This group has absolutely NO Wall Street Experience or Analyst experience prior to employment at Camelback. As the document reads it appears this group is made up of much more than a group of recent ASU grads with an average age of 24. Prior to the version of the document enclosed herein Mr. Vorhauer was listed as carrying a CFA designation that is also false.

2. In regard to the question about Camelback's record on issuing positive reports (A,B grades). Positive grades were a rarity, less than 5% of total reports written. Of all reports known as "Customer Requests," none to my knowledge were given a positive grade. Please know that Camelback asked questions of client's when a report was requested and prior to any research. These questions included but are not limited to; Do you currently hold a position in the stock?, Are you long or short the stock?, What company irregularities would you like us to concentrate our research efforts on? 100% of clients were negative thus resulting reports received a D or F grade. The research process done by the analysts was closely coordinated with the client requesting the report. Often times, in coordination with the client. It's evident that "Independence" did not describe Gradient's (Camelback's) research. I understand Independence to be.

Independence: Free from the influence, guidance, or control of another or others.

Disclosures of any nature did not describe the behaviors discussed above. The requesting client was the only client aware of the origins, influence and "custom nature" of the final report but never ever was a distinction made between "custom report" and purely Camelback inspired writing to the client base.

Another example of Gradient's (Camelback's) reliance on manipulation and falsification was the data for the models. I recall once having one of the financial engineers run the numbers as we had been for months for the current month to send to a client. Well I emailed the new results/numbers/data out to a prospective client, carbon-copying Bettis. Well, Bettis shortly appeared irate and completely disgusted with the data forcing the financial engineer to run the numbers based on a new standard developed to make the results/numbers/data (returns) appear much better than they were. This is a blatant example of Gradient's (Camelback's) unethical behavior.

3. Gradient (Camelback) owners and officers were involved in investing money. No disclosure was ever furnished to employees as far as I recollect regarding trading and investing in stock, as was the case when I worked at Thomson and JP Morgan Chase. As described above, officers and owners ran Pinnacle Investment Advisors, a money management firm that actively managed several funds and monies. This money also included $2 Million of Bettis's own money, commonly known among employees. Bettis' was the owner of Pinnacle and Gradient (Camelback) during my tenure.

No disclosure of this activity was ever made. To the contrary, employees of Gradient (Camelback) were specifically told when prompted, "Does Gradient (Camelback) manage money?" to say, "We do not manage money." When asked, "How do you compare to Behind the Numbers[a competitor in the Independent Research space who discloses he manages money]?" the team was instructed to say, "They Manage Money! Not only is this a lie and unethical answer but also the truth about another business is being brought to the forefront in order to defame and discredit a competitor.

Yes, to my knowledge and limited abilities to locate information I was able to put together this regarding a single fund Pinnacle managed.

Hallmark Fund Holdings [HIIRX]:

CAG	ConAgra Foods	2.79%	6,400	4.04%
IVX	Ivax	2.25%	NA	-5.26%
AFG	American Financial Group	2.18%	-1,500	13.81%
SBC	SBC Communications	2.15%	5,000	1.69%
FST	Forest Oil	2.12%	4,500	6.76%
AET	Aetna	2.06%	NA	40.57%
GTI	GrafTech International	1.98%	-2,000	-31.41%
GRMN	Garmin	1.98%	NA	-8.22%
PVN	Providian Financial	1.92%	NA	33.59%
DUK	Duke Energy	1.75%	5,200	24.73%

CLC	Clarcor	1.75%	2,400	13.07%
JNY	Jones Apparel Group	1.74%	3,000	0.92%
CMVT	Comverse Technology	1.74%	6,000	17.34%
NI	NiSource	1.74%	4,800	2.11%
PRE	PartnerRe	1.72%	NA	2.08%
SLE	Sara Lee	1.72%	4,800	9.96%
MYG	Maytag	1.70%	-2,000	-36.13%
CTB	Cooper Tire & Rubber	1.66%	NA	-7.53%
INGR	Intergraph	1.66%	NA	4.20%
BMY	Bristol-Myers Squibb	1.65%	3,500	-15.20%
TRI	Triad Hospitals	1.65%	NA	-0.72%
RYN	Rayonier	1.64%	2,400	18.55%
BBX	BankAtlantic Bancorp A	1.63%	5,200	26.65%
BDX	Becton Dickinson	1.63%	2,400	28.75%
INFS	InFocus	1.63%	10,200	-33.47%

Camelback writes positive Reports Also (wish I knew exactly when these positions were taken – that is a job for the SEC to determine):

CAG published in April 2004....

IVX published at the end of September 2004

MYG published May 2004

GRMN published in 2003

DUK published in 2003

TRI published in 2003

BMY published in 2003

It is very possible that other work has been done but never made it into a full report (this would fall into a piece referred to as Issue Commentary ie. Watch List, Weekly News, Standouts...etc published and sent to call clients.)

Is it possible that Camelback chooses companies to write on that Pinnacle is currently out of the money in?

It is evident by the above and other information that Gradient (Camelback) did what it took to make client's happy so that they continue paying for a service that displayed no Independence from inside the walls of the firm. Is this why you find a naïve and young research team who doesn't understand or have experience with Wall Street analysis? Possibly. Do we truly believe a SAC or Fidelity would depend on this quality of research knowing the background of the analyst team? No, but many knew and they continued to request research. Is it the reason you find literature and the face of Gradient (Camelback) proclaiming to client's that their analysts are decorated with credentials resembling a WWII soldier? Gradient (Camelback) knew how to play the credibility game with its customers and it was evident when customers stopped asking some of the most important questions posed to Independent Researchers that the game was theirs to play.

I can only ask that you continue to look into this matter and provide the tools that may assist in enforcing such unethical and malicious behavior. It's not the big guy getting hurt on Wall Street; they recover. It's the grandmother and common folk whose wealth is destroyed by such disregard. Our financial systems are our most precious claim to Capitalism. A system allowing such behaviors as discussed above does nothing to separate us from the collusion-taking place between Cartels across the world whose behavior is considered illegal in the United States of America.

I appreciate your time.

Regards,

Demetrios Anifantis

Senator Specter
Kim Blickenstaff
CEO, Biosite Inc.
June 28, 2006

1. **Mr. Blickenstaff, your written testimony indicates that you personally met with a representative from an independent research firm who told you that she was not at liberty to revise her negative report about Biosite despite her own positive findings. Was it your understanding that she could not revise the report because it was being influenced by a hedge fund that was taking a short position on your stock?**

   The analyst, Jolene Furdyk, indicated that in some cases her research yielded conclusions that differed from what was actually published in the report. She inferred that this occurred because whoever was writing the reports took liberties with her research. While she also implied that this was being done for the benefit of a client or clients, she did not explicitly identify that client as a hedge fund shorting our stock.

2. **How much did your company's stock decline in 2002 when the short selling positions increased from 690,000 to 7.1 million shares?**

   During this period Biosite Incorporated's stock price increased ~47% during this time, largely due to some very positive events, including strong earnings growth, positive clinical trial results and the resolution of litigation. However, there was constant downward pressure on the stock that appeared to negate a portion of the positive effect caused by favorable developments. Unfortunately, it would be difficult to quantify that negative effect.

3. **Your testimony indicates that Biosite's attempts to investigate the short selling activities in 2002 proved unproductive because "the lack of visibility into these trades." Can you elaborate on this point?**

   Short selling is a highly unregulated activity. Currently, firms that short stock are not required to submit filings to the SEC identifying those positions. Since the firm shorting a stock is borrowing those shares and has to return them to cover their short position, they are not technically the owner and so don't file for the shares. Also, firms that are short a stock are typically not be willing to communicate this information to the company whose stock they are short for obvious reasons so trying to get updates on a short position are impossible.

RICHARD BLUMENTHAL
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Office of The Attorney General
State of Connecticut

July 26, 2006

The Honorable Arlen Specter, Chair
Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Specter:

Thank you for inviting me to speak on the critical issue of hedge funds and their relationship with stock analysts on June 28, 2006. The hearing provided important information about this relationship and emphasized the need for Congressional action further regulating this relationship specifically and hedge funds generally

Attached are my answers to the four follow-up questions contained in your July 7, 2006 letter. If you need further information or articulation, please don't hesitate to contact me or Special Counsel Rich Kehoe at 860-808-5322.

Very truly yours,

Richard Blumenthal

RB/RFK/sk

**ANSWERS OF
CONNECTICUT ATTORNEY GENERAL RICHARD BLUMENTHAL
TO QUESTIONS POSED BY
THE SENATE COMMITTEE ON THE JUDICIARY
JULY 27, 2006**

1 Elaborate on ways to enhance federal criminal penalties for potential fraudulent short selling practices by hedge funds

There are significant criminal penalties for a stock analyst who issues a fraudulent stock analysis when such fraudulent analysis poses a significant risk of substantial losses to other persons These penalties are a maximum fine of $100,000 per individual and $500,000 for a company violation I urge the committee to consider supplementing these criminal penalties with additional civil penalties, including treble damages.

Effective deterrence should include state civil action as well as criminal prosecution and private civil lawsuits. It is very difficult for victims of stock fraud to bring civil actions against those individuals who perpetuated the fraud. Enormous resources are required to successfully investigate and prosecute such private citizen actions. This financial burden -- on those who have already lost significant sums of money -- often prevents victims of fraud from bringing a civil action As one person testifying before the committee indicated, he spent hundreds of thousands of dollars trying -- and failing -- to bring a civil action against a hedge fund whose illegal activities cost investors millions of dollars

Giving federal regulators the authority to bring civil actions when criminal prosecutions cannot be brought will greatly enhance the deterrent affect of these federal laws Federal antitrust law has long included criminal fines and imprisonment as well as the option for civil penalties and treble damages which can be used when the fraudulent company has financial resources sufficient to compensate those victims harmed by the fraudulent scheme.

2 Is Sarbanes-Oxley an effective enforcement tool?

I agree with the Department of Justice that Sarbanes-Oxley has been a very useful enforcement tool for the federal government. I commend the federal DOJ for their efforts However, as the DOJ representative acknowledged, the DOJ is working with civil law enforcement and other state and local agencies on white collar crime cases, tacitly noting the value of civil enforcement as a supplement to criminal prosecutions. Congress should consider providing law enforcement with a broad range of penalties and enforcement actions to further bolster law enforcement response to investor fraud.

3. What is the Connecticut Attorney General's office doing to combat hedge fund fraud and abuse?

As I indicated to the committee, many state attorneys general lack resources and strong civil and criminal sanctions to bring actions against hedge fund fraud. A federal statute containing strong criminal and civil penalties would increase the likelihood of a joint federal-state task force to effectively root out the causes of hedge fund fraud and abuse. I am also informally conferring with many individuals involved in the hedge fund industry, from managers to consumers, to discuss formulating recommendations for effectively regulating hedge funds while protecting their unique role as an investment alternative.

4 Does the 'retailization' of hedge funds require greater attention to conflicts of interest and improved disclosure? How so?

Seventy years ago, hedge funds were excluded from general securities regulation because they were limited in scope and investors The hands off approach was justified because of the perceived sophistication of those who invested in hedge funds In the past ten years, there has been an explosion in the number of hedge funds and amount of funds in such investment vehicles -- estimated at more than $2 trillion Smaller investors and even pension funds are at risk of losing substantial dollars in hedge fund scams

The original rationale for exempting hedge funds from regulation has been obliterated by the rapid growth and expansion of this investment option.

The committee should consider requiring disclosure of certain financial information to investors as part of any solicitation to invest; defining conflicts of interests between the fund manager and investments of the fund's assets; ensuring proper independent auditing of the hedge fund; and encouraging greater federal/state/local enforcement partnerships.

Senator Specter
Jonathan Boersma
Director
Standards of Practice
CFA Institute
June 28, 2006

1. Has CFA-Institute certified the research firm Camelback Research Alliance or any of its analysts? How about the research firm referenced in Mr. Blickenstaff's testimony, Sterling Financial Investment Group?

CFA Institute is a membership organization comprised of individuals, not firms. CFA Institute does not "certify" firms or individuals, but rather awards the Chartered Financial Analyst ™ (CFA) designation to individuals who have passed the three levels of the CFA exam and met CFA Institute membership requirements. CFA Institute membership is comprised of investment professionals holding the CFA designation, as well as those that do not hold the CFA credential. However, all members and candidates enrolled in the CFA Program are subject to a stringent Code of Ethics and Standards of Professional Conduct. Two CFA Institute members have indicated they are employed at Gradient Analytics, formerly Camelback Research Alliance. Our records do not indicate any of our members are employed by Sterling Financial Investment Group.

2. Assuming the allegations raised by Biovail and Overstock.com against Camelback are true, would this conduct merit de-certification by the CFA-Institute?

The CFA Institute Professional Conduct Program has jurisdiction over all CFA Institute members (charterholder and non-charterholder) and candidates. If the Professional Conduct Program determines a member or candidate may have had involvement in conduct that violated the CFA Institute Code and Standards, an investigation would be initiated. Upon conclusion of the investigation, if there is evidence of a violation, disciplinary action may be imposed. Sanctions include private censure, public censure, and suspension or revocation of the right to use the CFA designation and/or membership in CFA Institute. Although CFA Institute does not have jurisdiction over firms or corporate entities, we are equally concerned with corporate retaliation against analysts when they express negative views.

3. You state that the "CFA Institute maintains a dedicated staff to deal with enforcement" including "stripping the CFA designation from any member we have found to have violated" the rules of ethics. Has CFA Institute experienced an increase in enforcement actions against analysts over the past 5 years? How many enforcement actions have been brought annually against analysts over the past five years?

The CFA Institute membership and candidate base is very diverse in the roles they fulfill in the investment industry. Because the Professional Conduct Program does not keep statistics based upon occupation, we are unable to confirm an increase in enforcement actions involving analysts specifically. We would surmise, however, that the emphasis on analyst ethics and responsibilities over the past five years has increased awareness as well as the likelihood of reported alleged violations to the Professional Conduct Program.

U.S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

September 29, 2006

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Please find enclosed the Department of Justice's responses to questions directed to Matthew Friedrich, Principal Deputy Assistant Attorney General, following Mr. Friedrich's testimony at the Committee's June 28, 2006 hearing entitled "Hedge Funds and Analysts: How Independent is their Relationship?"

The Office of Management and Budget has advised us that from the perspective of the Administration's program, there is no objection to the submission of this proposal. Please do not hesitate to call upon us if we may be of additional assistance.

Sincerely,

William E. Moschella

William E. Moschella
Assistant Attorney General

Enclosure

cc: The Honorable Patrick J. Leahy
Ranking Minority Member

Questions for Matthew Friedrich
Principal Deputy Assistant Attorney General
Department of Justice
Posed by Senator Specter
Following the June 28, 2006 hearing of the Senate Judiciary Committee on
"Hedge Funds and Independent Analysts:
How Independent are Their Relationships?"

1. **Section 1348 of the criminal code, which was enacted as part of the Sarbanes-Oxley Act and makes securities fraud a crime, gives the Department of Justice a strong and important tool. Can you tell me what systematic efforts the DOJ has undertaken to investigate and prosecute instances of securities fraud under Section 1348?**

Shortly after the enactment of the Sarbanes-Oxley Act in July 2002, the Criminal Division of the Department of Justice issued field guidance to federal prosecutors and investigators. This field guidance described the new tools and penalties in the Act, compared those new tools and penalties with existing law and explained how the new laws enhanced the Department's ability to investigate and prosecute corporate and securities fraud. In addition, many United States Attorneys' Offices and Department components provided training on the new Act to their prosecutors and investigators. This training continues to this day on a formal basis at the Department's National Advocacy Center, where provisions of the Act are covered in different courses taught by experienced white collar prosecutors. Furthermore, the application of the Act is routinely discussed at meetings of the Department's Securities & Commodities Fraud Working Group and at meetings of the President's Corporate Fraud Task Force. The Department has also published various memoranda and articles covering the Act, including a web page devoted to the Act on the USABook Intranet site maintained by the Executive Office for U.S. Attorneys, and an article entitled "Sarbanes-Oxley: Broader Statutes - Bigger Penalties" that was published in the *U.S. Attorneys' Bulletin* and distributed to all federal prosecutors. Finally, the Corporate Fraud Task Force has set up a page on the Department's public website that contains, among other things, charging documents filed in significant criminal cases involving corporate fraud.

The purpose of this guidance and training is to inform line prosecutors and agents of the provisions and benefits of the Act so that they will reap the benefits of the Act in investigating and prosecuting their cases. Many securities fraud cases that come to the Department through various sources -- the Securities & Exchange Commission, self-reporting by corporations, press reports, informants or whistleblowers, or through the FBI or other investigating agencies -- can be prosecuted under Section 1348 or other criminal statutes that predate Sarbanes-Oxley. The Department, however, recognizes the benefits of Sarbanes-Oxley and has encouraged its use through continued training. This effort has paid off. The fact that more than fifty defendants have been charged with violations of Section 1348 -- despite the fact that the Act applies only to violations occurring after July

2002 -- shows that line prosecutors recognize the value of Section 1348 and the rest of Sarbanes-Oxley.

2. A number of pending civil lawsuits allege that hedge funds have paid analysts to issue negative reports about publicly-traded companies, causing the value of the company's stock to fall and allowing the hedge fund to profit on short sales of the stock. Do you believe that such conduct would violate Section 1348?

While the Department is aware of press reports and lawsuits that reference these allegations, we are not able to comment on the factual or legal merits of any particular cases or allegations. Thus, the Department offers no view regarding the viability of these allegations under the criminal laws.

As a general matter, many attempts to manipulate securities markets by fraudulent means or through the dissemination of false statements can be criminal acts, assuming all elements of charged crimes are met. For example, the Department historically has been aggressive in prosecuting what is commonly known as "pump and dump" cases in which an actor will buy a position in a thinly capitalized and traded stock which can be manipulated relatively easily; publish false statements touting the stock, which are designed to encourage others to buy the stock and to cause the stock's price to rise; and then sell the stock after the price rises but before the false nature of the published statements is recognized by the market. This conduct, if done willfully and with the intent to defraud, can violate several federal fraud statutes, including Section 1348 if the manipulated stock is a security described in that Section.

3. Do you believe that the DOJ has the tools it needs to prosecute possible fraudulent conduct by hedge funds and independent analysts? If not, what other tools does the Department of Justice need to go after these bad actors?

Given the comprehensive scope and broad penalties in the Sarbanes-Oxley Act (as well as other federal laws such as those prohibiting securities fraud, conspiracy, mail and wire fraud, false statements, falsifying books, records and accounts, and the like), the Department believes it has the tools it needs to prosecute market manipulation schemes, as well as other forms of corporate and securities fraud. The SEC's recent efforts to promulgate regulations for oversight of the hedge fund industry, however, have not survived a recent court challenge.

4. Is it the Department's practice to defer all securities fraud investigations to the SEC?

The Department has a strong partnership with the SEC, which we believe is essential to the successful investigation and prosecution of corporate and securities fraud cases. At the same time, however, the Department has sole authority over federal criminal securities fraud statutes. We cannot and do not defer viable criminal investigations to the SEC. Instead, we will work with the SEC when it brings cases to us for criminal prosecution; when we believe that it is appropriate or useful to have the SEC's expertise; or when we believe that the SEC's abilities to seek and obtain civil remedies, such as injunctions or appointments of trustees, would be helpful. The SEC is also instrumental in obtaining compensation for victims in its civil lawsuits, which complements the restitution and forfeiture remedies in criminal law.

5. Please provide me with a list of the 53 defendants charged with violating 18 U.S.C. § 1348 securities fraud since the enactment of Sarbanes-Oxley. In your response, please list the jurisdiction, case caption, case number, date of filing and current status (e.g. open/closed).

Since the enactment of Sarbanes-Oxley 53 different defendants have been charged with violating 18 U.S.C. § 1348. Attached hereto as Exhibit 1 is a chart containing all of the information requested in Questions 5 and 6, including the district in which the case was filed, the case number and caption, the defendant's name, the date on which the case was filed, the status of the case, the charges brought (including all non-1348 charges), the disposition of the case, if any (reflecting whether the defendant was convicted of or pleaded to an offense other than § 1348), the reason for the disposition, and whether, if convicted, the defendant was sentenced to a period of confinement, fined, or both. The chart contains several codes, as follows:

Disposition Code:

DM	Dismissed without Prejudice
GT	Guilty
NG	Not Guilty
TR	Transfer from District (Rule 20, 21)

Disposition Reason:

DEMD	Dismissed By Defense Motion (District Court)
GWDD	Dismissed By Government from District Court
GWOD	Dismissed By Government from District Court
JTRD	Jury Trial Verdict (District Court)
PLED	Plea (District Court)
RTWD	Rule 20 (District Court)

6. In all the closed cases identified in response to question No. 5, please provide the following information concerning disposition of the case:

a. whether the defendant has been convicted and, if so, whether the court imposed a sentence of confinement or imposed fines;

See response to Question 5.

b. whether the conviction, if applicable, was the result of a plea agreement or jury verdict;

See response to Question 5.

c. **whether the defendant, though charged with § 1348 along with other violations, only pled to or was convicted of a lesser offense.**

See response to Question 5.

7. **To the extent they are not included in your response to question No. 5, please provide the jurisdiction, case caption, case number, date of filing and current status of the "two" cases in which hedge funds or their managers were prosecuted by the Department of Justice (*e.g.*, Bayou Group, Samel Israel, Daniel Marino).**

The Department has prosecuted hedge funds or their managers in the two cases described below.

1. *United States v. Samuel Israel III*, 05-CR-1039, in the Southern District of New York. The information was filed on September 29, 2005, charging the defendant with: a) one count of conspiracy to commit investment advisor fraud and mail fraud; b) one substantive count of investment advisor fraud; and c) one substantive count of mail fraud. Israel pleaded guilty to all counts in the information. His sentencing is pending.

2. *United States v. Daniel E. Marino*, 05-CR-1036, in the Southern District of New York. The information was filed on September 29, 2005, charging the defendant with: a) one count of conspiracy to commit investment advisor fraud, mail fraud and wire fraud; b) one substantive count of investment advisor fraud; c) one substantive count of mail fraud; and d) one substantive count of wire fraud. Marino pleaded guilty to all counts in the information. His sentencing is pending.

(Note: Mr. Friedrich's statement at the hearing that there had been a jail sentence in one of the cases was incorrect. *Bayou Capital Management* was not a hedge fund case.)

8. **Please provide me with the jurisdiction, case caption, case number, date of filing and current status of any indictments of independent analysts who have been charged with § 1348 violations (*e.g.*, *United States v C. Clive Munro*, 4:04-cr-00622-RWS (E.D. Missouri)—defendant only pled guilty to 18 U.S.C. § 875(d), though he was also charged with violating § 1348).**

The Department has charged one independent analyst with § 1348 violations, as follows: *United States v. C. Clive Munro*, 4:04-622-RWS, in the Eastern District of Missouri. The indictment was filed on November 4, 2004, charging interstate threats, 1348 securities fraud, extortion and wire fraud. Munro pleaded guilty to the interstate threats charge - which carries a two-year maximum sentence - on February 10, 2005 and was sentenced to 21 months on July 26, 2005. Munro, an independent analyst, threatened to publish negative reports about CKE Restaurants, a publicly traded company that is the parent of Hardee's, unless CKE hired him as a consultant for $25,000 a month for one year.

9. Please provide the Committee, on a confidential basis if necessary, a summary of what the Department of Justice is doing to investigate and prosecute alleged crimes of market manipulation by hedge funds acting in concert with independent analysts to fraudulently decrease stock value in targeted companies.

The Department takes seriously its law enforcement responsibilities regarding securities and corporate fraud. As stated above in response to Question 3, we investigate all credible allegations and develop cases for prosecution whenever the evidence indicates that a prosecution is viable. Based upon our long-standing policies, we cannot provide non-public information about pending matters.

10. Please provide the Department of Justice's view of Connecticut Attorney General Blumenthal's suggestion that further protecting whistleblowers by criminalizing retaliatory conduct could be an effective deterrent to white collar crime in the hedge fund industry.

The Department believes that the protections contained in Sarbanes-Oxley, including a new criminal provision and comprehensive civil protections for whistleblowers, are effective deterrents. The new criminal provision at 18 U.S.C. § 1513(e) makes it a felony carrying a penalty of up to ten years in prison and a fine of up to $250,000 to take any harmful action to any person in order to retaliate against a person who provides information about possible federal crimes to a law enforcement officer. Section 1514A of Title 18 provides for civil remedies in the event that a publicly traded company takes any action to retaliate against a whistleblower in a securities fraud case. These types of whistleblower protections are essential to ensuring that corporate employees who witness fraud will report it without fear of suffering any kind of retaliation.

UNITED STATES DEPARTMENT OF JUSTICE
RECORDS OF DEFENDANTS CHARTED WITH TITLE 18 USC 1348 VIOLATIONS

No.	Dist.	Case No.	Case Caption	Def. Name	Date	Status	Charge(s)	Disp.	Reason	Sentence
1	ALN	2002R00919	US v. Scrushy, Richard M. et al.	Scrushy, Richard M.	031104	Closed	15 :00078j(b)	NG	JTRD	
	ALN	2002R00919					15 :00078j(b)	NG	JTRD	
	ALN	2002R00919					18 :00371	NG	JTRD	
	ALN	2002R00919					18 :01001	NG	JTRD	
	ALN	2002R00919					18 :01341	NG	JTRD	
	ALN	2002R00919					18 :01343	NG	JTRD	
	ALN	2002R00919					18 :01348(1)	NG	JTRD	
	ALN	2002R00919					18 :01350	NG	DEMD	
	ALN	2002R00919					18 :01350(c)(2)	NG	JTRD	
	ALN	2002R00919					18 :01512(b)(1)	NG	DEMD	
	ALN	2002R00919					18 :01621	NG	DEMD	
	ALN	2002R00919					18 :01957	NG	JTRD	
2	ARE	2005R00573	United States v. Gary Marcus Smith	Smith, Gary Marcus	060508	Open	15 :00078o			
	ARE	2005R00573					15 :00078o			
	ARE	2005R00573					18 :01348			
3	CT	2004R00674	USA v. Robert R. Ross, et al.	Ross, Robert R.	050629	Open	18 :01348			
	CT	2004R00674					18 :01348			
4	CT	2005R00548	US v. Vought, et al	Vought, Chance M.	051021	Open	18 :00371			
	CT	2005R00548					18 :00371			
	CT	2005R00548					18 :00981a1			
	CT	2005R00548					18 :01341			
	CT	2005R00548					18 :01343			
	CT	2005R00548					18 :01348			
5	CT	2005R00548	US v. Vought, et al	Lucarelli, John M.	051021	Open	18 :00371			
	CT	2005R00548					18 :00371			
	CT	2005R00548					18 :00981a1			

	CT	2005R00548					18 :01341			
	CT	2005R00548					18 :01348			
6	FLS	2004R02165	US vs Eduardo A. Portero	Portero, Eduardo A.	041116	Closed	18 :01341	GT	PLED	Confinement plus fine
	FLS	2004R02165					18 :01341	GT	PLED	
	FLS	2004R02165					18 :013481	GT	PLED	
7	GAN	2003R00187	US VS MOSES (V)	MOSES, TIMOTHY C.	041004	Closed	18 :01348	GT	JTRD	Confinement
	GAN	2003R00187					18 :01348	GT	JTRD	
	GAN	2003R00187					18 :01621	GT	JTRD	
8	MA	2003R00940	U.S. v. Van T. Dinh	Dinh, Van	040107	Closed	15 :00078jb	GT	PLED	Confinement plus fine
	MA	2003R00940					15 :00078jb	GT	PLED	
	MA	2003R00940					18 :00981	DM	GWDD	
	MA	2003R00940					18 :01030a4	GT	PLED	
	MA	2003R00940					18 :01343	GT	PLED	
	MA	2003R00940					18 :01348	GT	PLED	
9	MOE	2004R01236	IN RE: C. CLIVE MUNRO	MUNRO, C. CLIVE	041105	Closed	18 :00875	GT	PLED	Confinement
	MOE	2004R01236					18 :00875	GT	PLED	
	MOE	2004R01236					18 :01343	DM	GWOD	
	MOE	2004R01236					18 :01348	DM	GWOD	
	MOE	2004R01236					18 :01951	DM	GWOD	
10	NYE	2003R00544	U.S. VS. JACOBOWITZ, HERMAN	JACOBOWITZ, HERMAN	040715	Open	15 :00078FF			
	NYE	2003R00544					15 :00078FF			
	NYE	2003R00544					15 :00078MA			
	NYE	2003R00544					18 :00201B1A			
	NYE	2003R00544					18 :00666			
	NYE	2003R00544					18 :00844H			
	NYE	2003R00544					18 :00844I			
	NYE	2003R00544					18 :00981A1C			
	NYE	2003R00544					18 :00982			
	NYE	2003R00544					18 :01341			
	NYE	2003R00544					18 :01344			
	NYE	2003R00544					18 :01346			

	NYE	2003R00544					18 :01348			
	NYE	2003R00544					18 :01349			
11	NYE	2003R00544	U.S. VS. JACOBOWITZ, HERMAN	JACOBOWITZ, VICTOR	040715	Open	15 :00078FF			
	NYE	2003R00544					15 :00078FF			
	NYE	2003R00544					15 :00078MA			
	NYE	2003R00544					18:00002			
	NYE	2003R00544					18 :00201B1A			
	NYE	2003R00544					18 :00666			
	NYE	2003R00544					18 :00844H			
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	NYE	2003R00544					18 :00981A1C			
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	NYE	2003R00544					18 :01348			
	NYE	2003R00544					18 :01349			
	NYE	2003R00544					18 :01350			
	NYE	2003R00544					18 :01512C2			
	NYE	2003R00544					21 :00853P			
	NYE	2003R00544					28 :02461C			
12	NYE	2003R00544	U.S. VS. JACOBOWITZ, HERMAN	JACOBOWITZ, JACOB	040715	Open	15 :00078FF			
	NYE	2003R00544					15 :00078FF			
	NYE	2003R00544					15 :00078MA			
	NYE	2003R00544					18:00002			
	NYE	2003R00544					18 :00201B1A			
	NYE	2003R00544					18 :00666			
	NYE	2003R00544					18 :00844H			
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	NYE	2003R00544					18 :01512C2			
	NYE	2003R00544					21 :00853P			
	NYE	2003R00544					28 :02461C			
13	NYE	2003R00544	U.S. VS. JACOBOWITZ, HERMAN	JACOBOWITZ, AARON	040715	Open	15 :00078FF			
	NYE	2003R00544					15 :00078FF			
	NYE	2003R00544					15 :00078MA			
	NYE	2003R00544					18:00002			
	NYE	2003R00544					18 :00201B1A			
	NYE	2003R00544					18 :00666			
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	NYE	2003R00544					21 :00853P			
	NYE	2003R00544					28 :02461C			
14	NYE	2003R00544	U.S. VS. JACOBOWITZ, HERMAN	BROWN, IRVIN	040715	Open	15 :00078FF			
	NYE	2003R00544					15 :00078FF			
	NYE	2003R00544					15 :00078MA			
	NYE	2003R00544					18:00002			
	NYE	2003R00544					18 :00201B1A			
	NYE	2003R00544					18 :00666			
	NYE	2003R00544					18 :00844H			

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	NYE	2003R00544					21 :00853P			
	NYE	2003R00544					28 :02461C			
15	NYE	2003R00544	U.S. VS. JACOBOWITZ, HERMAN	FEKETE, JACOB	040715	Open	15 :00078FF			
	NYE	2003R00544					15 :00078FF			
	NYE	2003R00544					15 :00078MA			
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	NYE	2003R00544					28 :02461C			
16	NYE	2003R00544	U.S. VS. JACOBOWITZ, HERMAN	LICHTER, NACHMAN	040715	Open	15 :00078FF			
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	NYE	2003R00544					18:00002			
	NYE	2003R00544					18 :00201B1A			
	NYE	2003R00544					18 :00666			
	NYE	2003R00544					18 :00844H			
	NYE	2003R00544					18 :00844I			
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	NYE	2003R00544					18 :01350			
	NYE	2003R00544					18 :01512C2			
	NYE	2003R00544					21 :00853P			
	NYE	2003R00544					28 :02461C			
17	NYE	2003R00544	U.S. VS. JACOBOWITZ, HERMAN	KLEIN, SHOLEM	040715	Open	15 :00078FF			
	NYE	2003R00544					15 :00078FF			
	NYE	2003R00544					15 :00078MA			
	NYE	2003R00544					18:00002			
	NYE	2003R00544					18 :00201B1A			
	NYE	2003R00544					18 :00666			
	NYE	2003R00544					18 :00844H			
	NYE	2003R00544					18 :00844I			
	NYE	2003R00544					18 :00981A1C			
	NYE	2003R00544					18 :00982			
	NYE	2003R00544					18 :01341			
	NYE	2003R00544					18 :01344			
	NYE	2003R00544					18 :01346			
	NYE	2003R00544					18 :01348			
	NYE	2003R00544					18 :01349			
	NYE	2003R00544					18 :01350			
	NYE	2003R00544					18 :01512C2			
	NYE	2003R00544					21 :00853P			

	NYE	2003R00544					28 :02461C			
18	NYE	2003R00759	U. S. VS DANIEL RUBIN, ET AL	RUBIN, DANIEL	050803	Open	18:00002			
	NYE	2003R00759					18:00002			
	NYE	2003R00759					18 :00981(a)(1)(C)			
	NYE	2003R00759					18 :00982(a)(1)			
	NYE	2003R00759					18 :00982(b)			
	NYE	2003R00759					18 :01341			
	NYE	2003R00759					18 :01348			
	NYE	2003R00759					18 :01349			
	NYE	2003R00759					18 :01956(h)			
	NYE	2003R00759					18 :03551			
	NYE	2003R00759					21 :00853(p)			
	NYE	2003R00759					28 :02461(c)			
19	NYE	2003R00759	U. S. VS DANIEL RUBIN, ET AL	NOURANI, DANIEL	050803	Open	18:00002			
	NYE	2003R00759					18:00002			
	NYE	2003R00759					18 :00982(a)(1)			
	NYE	2003R00759					18 :00982(b)			
	NYE	2003R00759					18 :01341			
	NYE	2003R00759					18 :01348			
	NYE	2003R00759					18 :01349			
	NYE	2003R00759					18 :01956(h)			
	NYE	2003R00759					18 :03551			
20	NYE	2003R00759	U. S. VS DANIEL RUBIN, ET AL	SANTHA, GLEN	050803	Open	18:00002			
	NYE	2003R00759					18:00002			
	NYE	2003R00759					18 :00982(a)(1)			
	NYE	2003R00759					18 :00982(b)			
	NYE	2003R00759					18 :01341			
	NYE	2003R00759					18 :01348			
	NYE	2003R00759					18 :01349			
	NYE	2003R00759					18 :01956(h)			
	NYE	2003R00759					18 :03551			
21	NYE	2003R00759	U. S. VS DANIEL RUBIN, ET AL	HALPERIN, SCOTT	050803	Open	18:00002			

	NYE	2003R00759					18:00002			
	NYE	2003R00759					18 :00981(a)(1)(C)			
	NYE	2003R00759					18 :00982(a)(1)			
	NYE	2003R00759					18 :00982(b)			
	NYE	2003R00759					18 :01341			
	NYE	2003R00759					18 :01348			
	NYE	2003R00759					18 :01349			
	NYE	2003R00759					18 :01956(h)			
	NYE	2003R00759					18 :03551			
	NYE	2003R00759					21 :00853(p)			
	NYE	2003R00759					28 :02461(c)			
22	NYE	2003R02196	U.S. V. STEVEN WISE ET AL.	VINDMAN, VLADLEN	040120	Closed	18 :01348	NG	JTRD	
	NYE	2003R02196					18 :01348	NG	JTRD	
	NYE	2003R02196					18 :01349	NG	JTRD	
	NYE	2003R02196					18 :01956(a)(1)(A)(i)	NG	JTRD	
23	NYE	2003R02374	U.S. VS DAN RUBIN, ET AL	SAKSA, ANDREW	040609	Open	18 :01348			
	NYE	2003R02374					18 :01348			
24	NYE	2004R01618	U.S.VS. GARY TODD, ET AL	TODD, GARY	040909	Closed	18:00002	DM	GWOD	
	NYE	2004R01618					18:00002	DM	GWOD	
	NYE	2004R01618					18 :01348	DM	GWOD	
	NYE	2004R01618					18 :01349	DM	GWOD	
25	NYE	2004R01618					18 :01956	DM	GWOD	
	NYE	2004R01618	U.S.VS. GARY TODD, ET AL	PASINKOVSY, ROMAN	040909	Open	18:00002			
	NYE	2004R01618					18:00002			
	NYE	2004R01618					18 :01348			
	NYE	2004R01618					18 :01349			
26	NYE	2004R01618					18 :01956			
	NYE	2004R01618	U.S.VS. GARY TODD, ET AL	PALAZZOLO, SIMONE	040909	Open	18:00002			
	NYE	2004R01618					18:00002			

	NYE	2004R01618					18 :01348			
	NYE	2004R01618					18 :01349			
	NYE	2004R01618					18 :01956(h)			
27	NYE	2004R01618	U.S.VS. GARY TODD, ET AL	SAPOSNICK, MARTIN	040909	Open	18:00002			
	NYE	2004R01618					18:00002			
	NYE	2004R01618					18 :01348			
	NYE	2004R01618					18 :01349			
	NYE	2004R01618					18 :01956(h)			
28	NYE	2004R01618	U.S.VS. GARY TODD, ET AL	SHREYBERG, MARK	040909	Open	18:00002			
	NYE	2004R01618					18:00002			
	NYE	2004R01618					18 :01348			
	NYE	2004R01618					18 :01349			
	NYE	2004R01618					18 :01956(h)			
29	NYE	2004R01693	U.S. V. GUILLAUME POLLET	POLLET, GUILLAUME	050413	Open	18 :01348			
	NYE	2004R01693					18 :01348			
30	NYE	2004R01779	U.S. VS. WEEKS, KENNETH L.	WEEKS, KENNETH L.	041020	Closed	18:00002	TR	RTWD	
	NYE	2004R01779					18:00002	TR	RTWD	
	NYE	2004R01779					18 :01348	TR	RTWD	
31	NYE	2004R01911	U.S. v. AHMAD, ROSHAN ALI	AHMAD, ROSHAN ALI	050815	Open	18 :00371			
	NYE	2004R01911					18 :00371			
	NYE	2004R01911					18 :01001A2			
	NYE	2004R01911					18 :01001A3			
	NYE	2004R01911					18 :01348			
	NYE	2004R01911					18 :03551			
32	NYE	2005R00643	U. S. VS FAISAL ZAFAR	ZAFAR, FAISAL	060503	Open	18:00002			
	NYE	2005R00643					18:00002			
	NYE	2005R00643					18 :01348			
	NYE	2005R00643					18 :01349			
	NYE	2005R00643					18 :03551			
33	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	OCONNELL, TIMOTHY J.	050818	Open	18:00002			

	NYE	2005R00711					18:00002			
	NYE	2005R00711					18 :00371			
	NYE	2005R00711					18 :00981a1c			
	NYE	2005R00711					18 :01001a1			
	NYE	2005R00711					18 :01001a2			
	NYE	2005R00711					18 :01348			
	NYE	2005R00711					18 :01349			
	NYE	2005R00711					18 :01512b1			
	NYE	2005R00711					18 :01512b2a			
	NYE	2005R00711					18 :01512b3			
	NYE	2005R00711					18 :01512k			
	NYE	2005R00711					18 :01952a3			
	NYE	2005R00711					18 :03551			
	NYE	2005R00711					21 :00853p			
	NYE	2005R00711					28 :02461c			
34	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	MAHAFFY, JR., KENNETH E.	050818	Open	18:00002			
	NYE	2005R00711					18:00002			
	NYE	2005R00711					18 :00371			
	NYE	2005R00711					18 :00981a1c			
	NYE	2005R00711					18 :01001a1			
	NYE	2005R00711					18 :01001a2			
	NYE	2005R00711					18 :01348			
	NYE	2005R00711					18 :01349			
	NYE	2005R00711					18 :01512b1			
	NYE	2005R00711					18 :01512b2a			
	NYE	2005R00711					18 :01512b3			
	NYE	2005R00711					18 :01512k			
	NYE	2005R00711					18 :01952a3			
	NYE	2005R00711					18 :03551			
	NYE	2005R00711					21 :00853p			
	NYE	2005R00711					28 :02461c			
35	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	CASBARRO, RALPH D.	050818	Open	18:00002			
	NYE	2005R00711					18:00002			
	NYE	2005R00711					18 :00371			

	NYE	2005R00711					18 :01001A2			
	NYE	2005R00711					18 :01348			
	NYE	2005R00711					18 :01349			
	NYE	2005R00711					18 :01512A3			
	NYE	2005R00711					18 :01512B1			
	NYE	2005R00711					18 :01512B2A			
	NYE	2005R00711					18 :01512B3			
	NYE	2005R00711					18 :01512K			
	NYE	2005R00711					18 :03551			
36	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	GHYSELS, JR., DAVID G.	050818	Open	18:00002			
	NYE	2005R00711					18:00002			
	NYE	2005R00711					18 :00371			
	NYE	2005R00711					18 :00981a1c			
	NYE	2005R00711					18 :01001a1			
	NYE	2005R00711					18 :01001a2			
	NYE	2005R00711					18 :01348			
	NYE	2005R00711					18 :01349			
	NYE	2005R00711					18 :01512b1			
	NYE	2005R00711					18 :01512b2a			
	NYE	2005R00711					18 :01512b3			
	NYE	2005R00711					18 :01512k			
	NYE	2005R00711					18 :01952a3			
	NYE	2005R00711					18 :03551			
	NYE	2005R00711					21 :00853p			
	NYE	2005R00711					28 :02461c			
37	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	MALIN, ROBERT F.	050818	Open	18:00002			
	NYE	2005R00711					18:00002			
	NYE	2005R00711					18 :00371			
	NYE	2005R00711					18 :00981a1c			
	NYE	2005R00711					18 :01001a1			
	NYE	2005R00711					18 :01001a2			
	NYE	2005R00711					18 :01348			
	NYE	2005R00711					18 :01349			
	NYE	2005R00711					18 :01512b1			
	NYE	2005R00711					18 :01512b2a			

	NYE	2005R00711					18 :01512b3			
	NYE	2005R00711					18 :01512k			
	NYE	2005R00711					18 :01952a3			
	NYE	2005R00711					18 :03551			
	NYE	2005R00711					21 :00853p			
	NYE	2005R00711					28 :02461c			
38	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	NWAIGWE, LINUS	050818	Open	18:00002			
	NYE	2005R00711					18:00002			
	NYE	2005R00711					18 :00371			
	NYE	2005R00711					18 :00981a1c			
	NYE	2005R00711					18 :01001a1			
	NYE	2005R00711					18 :01001a2			
	NYE	2005R00711					18 :01348			
	NYE	2005R00711					18 :01349			
	NYE	2005R00711					18 :01512b1			
	NYE	2005R00711					18 :01512b2a			
	NYE	2005R00711					18 :01512b3			
	NYE	2005R00711					18 :01512k			
	NYE	2005R00711					18 :01952a3			
	NYE	2005R00711					18 :03551			
	NYE	2005R00711					21 :00853p			
	NYE	2005R00711					28 :02461c			
39	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	PICONE, MICHAEL A.	050818	Open	18:00002			
	NYE	2005R00711					18:00002			
	NYE	2005R00711					18 :00371			
	NYE	2005R00711					18 :00981a1c			
	NYE	2005R00711					18 :01001a1			
	NYE	2005R00711					18 :01001a2			
	NYE	2005R00711					18 :01348			
	NYE	2005R00711					18 :01349			
	NYE	2005R00711					18 :01512b1			
	NYE	2005R00711					18 :01512b2a			
	NYE	2005R00711					18 :01512b3			
	NYE	2005R00711					18 :01512k			
	NYE	2005R00711					18 :01952a3			

	NYE	2005R00711					18 :03551				
	NYE	2005R00711					21 :00853p				
	NYE	2005R00711					28 :02461c				
40	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	LEONARD, KEEVIN H.	050818	Open	18:00002				
	NYE	2005R00711					18:00002				
	NYE	2005R00711					18 :00371				
	NYE	2005R00711					18 :00981a1c				
	NYE	2005R00711					18 :01001a1				
	NYE	2005R00711					18 :01001a2				
	NYE	2005R00711					18 :01348				
	NYE	2005R00711					18 :01349				
	NYE	2005R00711					18 :01512b1				
	NYE	2005R00711					18 :01512b2a				
	NYE	2005R00711					18 :01512b3				
	NYE	2005R00711					18 :01512k				
	NYE	2005R00711					18 :01952a3				
	NYE	2005R00711					18 :03551				
	NYE	2005R00711					21 :00853p				
	NYE	2005R00711					28 :02461c				
41	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	COUGHLIN, PAUL F.	050818	Open	18:00002				
	NYE	2005R00711					18:00002				
	NYE	2005R00711					18 :00371				
	NYE	2005R00711					18 :00981a1C				
	NYE	2005R00711					18 :01001a1				
	NYE	2005R00711					18 :01001a2				
	NYE	2005R00711					18 :01348				
	NYE	2005R00711					18 :01349				
	NYE	2005R00711					18 :01512b1				
	NYE	2005R00711					18 :01512b2A				
	NYE	2005R00711					18 :01512b3				
	NYE	2005R00711					18 :01512k				
	NYE	2005R00711					18 :01952a3				
	NYE	2005R00711					18 :03551				
	NYE	2005R00711					21 :00853p				
	NYE	2005R00711					28 :02461				

42	NYE	2005R00711	U. S. VS TIMOTHY OCONNELL	DEAKINS, WILLIAM B.	050818	Open	18:00002			
	NYE	2005R00711					18:00002			
	NYE	2005R00711					18 :00371			
	NYE	2005R00711					18 :00981a1C			
	NYE	2005R00711					18 :01001a1			
	NYE	2005R00711					18 :01001a2			
	NYE	2005R00711					18 :01348			
	NYE	2005R00711					18 :01349			
	NYE	2005R00711					18 :01512b1			
	NYE	2005R00711					18 :01512b2A			
	NYE	2005R00711					18 :01512b3			
	NYE	2005R00711					18 :01512k			
	NYE	2005R00711					18 :01952a3			
	NYE	2005R00711					18 :03551			
	NYE	2005R00711					21 :00853p			
	NYE	2005R00711					28 :02461			
43	NYE	2006R00741	U. S. VS BRIAN ROBERT MITCHELL	MITCHELL, BRIAN ROBERT	060424	Open	18 :01348			
	NYE	2006R00741					18 :01348			
44	NYS	2003R02706	US V LUIS COLON, ET AL.	COLON, FILIBERTO	040109	Open	18 :00371			
	NYS	2003R02706					18 :00371			
	NYS	2003R02706					18 :01341			
	NYS	2003R02706					18 :01348			
	NYS	2003R02706					18 :01349			
45	NYS	2003R02706	US V LUIS COLON, ET AL.	COLON, LUIS	040109	Closed	18 :01341			
	NYS	2003R02706					18 :00371	GT	PLED	Confinement
	NYS	2003R02706					18 :01341			
	NYS	2003R02706					18 :01348			
	NYS	2003R02706					18 :01349			
46	NYS	2003R02706	US V LUIS COLON, ET AL.	PIANELLO, ADAM	040109	Closed	18 :01341			
	NYS	2003R02706					18 :00371	GT	PLED	Confinement
	NYS	2003R02706					18 :01341			

	NYS	2003R02706					18 :01348			
	NYS	2003R02706					18 :01349			
47	OHN	2004R00843	U.S. v. Peter Wilson	Wilson, Peter		Closed	18 :01001	GT	PLED	No confinement or fine
	OHN	2004R00843					18 :01001	GT	PLED	
	OHN	2004R00843					18 :01348	GT	PLED	
48	OKW	2005R00034	US v. COOPER, ADRIAN	COOPER, ADRIAN	051117	Open	18 :01341			
	OKW	2005R00034					18 :01341			
	OKW	2005R00034					18 :01343			
	OKW	2005R00034					18 :01348			
	OKW	2005R00034					18 :01956			
	OKW	2005R00034					18 :01957			
	OKW	2005R00034					42 :00408			
49	PR	2004R00222	US v Soto, Carlos H.	Soto-Cruz, Carlos H.	040412	Closed	18 :01341	GT	PLED	Confinement
	PR	2004R00222					18 :01341	GT	PLED	
	PR	2004R00222					18 :01343	DM	GWOD	
	PR	2004R00222					18 :01348	GT	PLED	
50	SD	2004R00610	US v Diane Byrd	Byrd, Diane	041216	Closed	18 :01348	GT	PLED	Confinement
	SD	2004R00610					18 :01344	DM	GWOD	
	SD	2004R00610					18 :01348	GT	PLED	
51	TXN	2001R01393	Wannamaker, John	Wannamaker, John	050720	Open	18 :00371			
	TXN	2001R01393					18 :00371			
	TXN	2001R01393					18 :01343			
	TXN	2001R01393					18 :01348			
	TXN	2001R01393					18 :01956			
	TXN	2001R01393					18 :01957			
52	TXN	2001R01393	Wannamaker, John	Price, Patrick	050720	Open	18 :00371			
	TXN	2001R01393					18 :00371			
	TXN	2001R01393					18 :01343			
	TXN	2001R01393					18 :01348			
53	TXN	2001R01393	Wannamaker, John	Saporta, Nancy	050720	Open	18 :00371			
	TXN	2001R01393					18 :00371			
	TXN	2001R01393					18 :01343			

	TXN	2001R01393					18 :01348			
30**	UT	2005R00881	U.S. V. KENNETH L. WEEKS	WEEKS, KENNETH L.	050808	Open	18 :01348			
	UT	2005R00881					18 :01348			

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SAN FRANCISCO

July 27, 2006

BY OVERNIGHT MAIL & ELECTRONIC MAIL

Hon. Arlen Specter, Chairman
United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510
Attn: Barr Huefner

RE: Hearing of the Senate Judiciary Committee on "Hedge Funds and Independent Analysts: How Independent is Their Relationship?"

Dear Chairman Specter:

I am writing in response to your letter enclosing written questions from Judiciary Committee members arising out of the above-referenced hearing. My responses are below. I would also like to take this opportunity to thank the Committee again for its invitation to testify concerning these important issues, and to offer my continuing assistance in the Committee's efforts.

1. *Aside from the Overstock.com and Biovail cases, are you aware of other instances of hedge fund short selling involving the use of alleged phony research reports on publicly traded companies? How widespread are these activities in the capital markets?*

Yes. After our firm filed the civil action on behalf of Biovail, alleging collusion between certain powerful hedge funds and supposedly independent analysts, we were approached by a number of other companies who had similar experiences. In a number of instances, the companies were concerned about adverse publicity and, as a consequence, were unwilling to discuss their experiences publicly. In other instances, the companies asked us to undertake investigations of their situations, and a number of those investigations are ongoing.

In another egregious situation that has forced a public company to take action, our firm this week filed a lawsuit on behalf of Fairfax Financial Holdings Ltd. and an affiliated company (together "Fairfax"). Fairfax's lawsuit describes a shocking campaign of disinformation and harassment by a number of powerful hedge funds and their operatives, in collusion with securities analysts covering Fairfax, that was explicitly intended to destroy Fairfax and its business. For the Committee's information, I have enclosed a copy of the detailed complaint that was filed in New Jersey Superior Court.

Based on our investigations and information we have received from market participants, we believe that abusive and collusive use of securities analysis by hedge funds is a significant issue in the public markets. While we have no interest in painting with an overly broad brush, the evidence we have seen indicates that short-selling attacks on companies like Biovail and Fairfax are not isolated incidents and we believe that further investigation will disclose other instances of such wrongdoing.

2. *If it is so widespread, why then don't public companies file more suits? Are there impediments to public companies and investors defending themselves against these attacks?*

Based on our discussions with our clients and other market participants, we have learned that many public companies believe that they have been subject to attacks by short-selling hedge funds, but are unwilling to come forward publicly with that information. The reasons are several. First, companies know that coming forward publicly does not always serve to halt the attack. In many instances, public discussion of an attack by short-sellers subjects the target company to accusations that it is attempting to blame its troubles on others, and that such accusations are only made by "bad companies." Second, the hedge funds that engage in these attacks are extremely wealthy and powerful. Prosecuting an action against such formidable parties is very expensive, and fraught with risk. Many companies simply decide that the cost/benefit analysis suggests that they should not pursue such actions, and hope that they survive the attack and that it passes. In many instances, it is only when a company believes that its very existence is in jeopardy, that it is willing to take the risks associated with publicly discussing an attack on the company.

3. *How much weight do independent research analysts carry in the marketplace? How common do negative reports from independent analysts affect a company's stock price?*

"Independent" analysts can have great importance in the markets, particularly when they are writing on a company that is not heavily covered by Wall Street analysts. In many instances, however, the effect that an independent analyst has is different from that of a Wall Street analyst. While reports and ratings issued by prominent Wall Street analysts often have direct and immediate market-moving power, reports and ratings by independent analysts often have a more "viral" influence on the markets that can be gradual, but no less significant. Reports, ratings and commentary from independent analysts can take weeks, and even months, to infiltrate into the markets, being picked up and rebroadcast by journalists, market participants and other analysts. Therefore, in addition to a direct effect on a stock price, it is this viral effect of independent analysis that can, over time, have a serious effect -- positive or negative -- on a company's stock price and, ultimately, its business and future.

Respectfully,

Marc E. Kasowitz

Marc E. Kasowitz

Enclosure

Response to written questions from Senator Specter
Professor Owen Lamont
Professor of Finance
Yale School of Management
July 11, 2006

1) As a factual matter, I would guess that by far the majority of illegal manipulation is done on the long side, typically with the collusion of management (as in the case of Enron). While I don't have any statistics to prove this assertion, I think it is obviously true on a dollar-weighted basis, and almost certainly true in general. If you were to count SEC enforcement actions or investigations over the years, I am quite sure that the vast majority would not involve short selling. The classic Wall Street scam is "pump-and-dump".

As a conceptual matter, there are several reasons to believe that the long side is more likely involved in manipulation than the short side. First, short sellers face many regulations and technical hurdles that are not faced by other market participants. The law seems in some ways biased against short sellers. In my written testimony, I mentioned the case of Solv-Ex, where Solv-Ex orchestrated a public manipulation of the securities loan market. This type of manipulation appears to be legal. I do not understand why manipulation designed to drive the price up should be legal (as in the Solv-Ex case), but manipulation designed to drive down the price should be illegal.

Second, the long side typically controls the flow of information. For example, Enron had the ability to doctor accounting statements, issue false press releases, etc.

Third, in cases of manipulation by management, the long side is typically stealing from the shareholders, and thus has the ability to spend the shareholder's money on fraudulent schemes. For example, they can hire lawyers, private investigators, and so on, all using company funds. The short sellers don't have this ability.

2) I have no specific policy recommendation to make, and certainly no comment on any specific cases. What I am suggesting is that policy makers should consider steps to reduce suits aimed at stifling free speech. How to accomplish that goal, I don't know.

3) Yes, false information is one problem. However, even if no one anywhere ever lied, we still want to ensure the collection of true negative information. A world where only truthful optimists were allowed to speak, but truthful pessimists were not, is not ideal.

MANAGED FUNDS ASSOCIATION

July 27, 2006

The Honorable Arlen Specter
Chairman, Senate Judiciary Committee
c/o Mr. Barr Huefner
U.S. Senate
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Specter:

Pursuant to your letter dated July 7, 2006 to Managed Funds Association's (MFA) representative Joseph McLaughlin, MFA hereby provides the Senate Judiciary Committee with responses to the Committee's questions relating to the June 28th hearing concerning hedge funds and independent analysts.

Please find enclosed the following attachments:

> **Attachment A** – Responses to Senate Judiciary Committee Questions;
>
> **Attachment B** – MFA's letter responding to Committee question 7 and *MFA's 2005 Sound Practices for Hedge Fund Managers.*

Thank you for providing MFA the opportunity to participate in the Senate Judiciary Committee's June 28th hearing. If you have further questions about the enclosed materials, MFA or the industry we represent, please do not hesitate to contact me at (202) 367-1140.

Sincerely,

John G. Gaine

John G. Gaine

Enclosure

2025 M Street, N.W. Suite 800 Washington, DC 20036-3309 Tel: 202.367.1140 Fax: 202.367.2140

MANAGED FUNDS ASSOCIATION

ATTACHMENT A
MFA's Response to the Senate Judiciary Committee's Questions
Relating to the Committee's June 28th Hearing,
"Hedge Funds and Analysts: How Independent are Their Relationships?"

1. Do you agree that if a hedge fund colludes with a purportedly independent analyst to disseminate false and misleading analyst reports, that activity is barred by existing law?

   Intentionally publishing materially false and misleading statements about securities is a violation of existing law, and it is critical that the SEC pursue persons who do so.

2. Do you agree that if an analyst disseminates a report that does not contain independent analysis, but in fact contains the views of a hedge fund that has commissioned the report to support its trading strategy, the payment and the position of the hedge fund in the company's stock should be disclosed?

   A hedge fund should not attempt to manipulate the markets by paying an analyst, who claims to be independent, to publish research under the analyst's name but that is supplied by the hedge fund without disclosing that the hedge fund commissioned the research. It is entirely appropriate, however, for a hedge fund to pay an analyst to perform research and document the research performed in a report. It is also appropriate for an analyst to make a report prepared for one client available to other clients, or to incorporate in broadly disseminated research the views developed while performing research commissioned by a particular hedge fund. While there are extensive rules that govern the disclosure of potential conflicts of interest in research published by broker-dealers, these rules do not apply to, and may not be well-suited to, independent research firms.

3. Are you familiar with the federal criminal provision governing securities fraud, 18 U.S.C. § 1348? Hedge funds are subject to that provision as well, right?

   Yes, all market participants are subject to 18 U.S.C. § 1348. MFA firmly believes that those who commit securities fraud should be punished by the SEC, or in egregious cases, criminal authorities. Vigorous enforcement of the federal securities laws is an important pillar of our capital markets.

4. Do you believe that the regulators are doing enough to ensure that research that is paid for and sponsored by hedge funds, is not misrepresented as "independent," and that those in the marketplace who read that research, or read reports based upon that research, know the true source of the information and opinions?

   We respectfully refer the Committee to our response to Question #2 above. It is critical that any steps taken to address these issues not "chill" the free flow of ideas and information that is essential to our securities markets. It would not be easy to extend broker-dealer research requirements to non-regulated entities, and any attempt to do so could have unforeseen consequences. It is difficult in many cases, for example, to draw the line between "independent" research and the electronic and traditional financial press, journals, bloggers and the many other persons who express views on the securities markets or individual securities. As MFA suggested to the Committee on June 28, persons who

receive adverse information about a company have their own responsibility to treat it with a degree of healthy skepticism, and companies have their own responsibility to respond fully and frankly to criticisms of their business model or financial condition.

5. If a hedge fund is given advance notice that an analyst is about to give a company a particular rating and that hedge fund then trades on that information, does that activity violate existing securities or criminal law? If so, which provisions would arguably be violated?

   Research analysts should not give hedge funds or other market participants material advance information about ratings changes. Whether it would be a violation of law to do so, or for the recipient of such information to trade on the information, depends on all of the facts and circumstances.

6. In your testimony before the Senate Judiciary Committee you stated that "it is sometimes difficult to identify the source of negative information" but cautioned that "persons who receive adverse information have their own responsibility to treat it with a degree of healthy skepticism." (Tr. 55-56). Would the Managed Funds Association support legislation requiring independent analysts to disclose their sources and their sources' holdings or 'position' on a particular stock in the independent analyst reports?

   We respectfully refer the Committee to our response to Question #4 above.

7. Please provide the Managed Funds Association's "recently published . . . set of best practices" to prevent fraud and insider trading. Please indicate in a cover letter, if necessary, the date the best practices manual was published and its genesis.

   We respectfully refer the Committee to Attachment B, in which we furnish the requested information.

8. In response to a question from Senator Hatch concerning the influence hedge funds wield over broker-dealers because of the volume of trades they control and the resulting fees they pay, you testified that "[a]ny large customer or group of large customers tend to have some influence with the firms that execute their orders. *It would be suicide*, however, *for a broker-dealer firm*, because of the importance of the order flow from one or a group of hedge funds, *to jeopardize its standing with its customers, clients, and with the enforcement agencies* to step over the line and provide information, for example, where there was a duty of trust and confidence not to provide that information." (Tr. 106) (emphasis added). How do you reconcile your view that broker-dealers would not violate the law by 'tipping' large clients because of reputation-related concerns with Mr. Aguirre's written testimony (pgs. 5, 11) about late-trading? For ease of reference, Mr. Aguirre's written testimony summarizes the problem of late trading and its facilitation by broker-dealers as follows:

   > "Thirty percent of the brokerage firms the SEC surveyed helped clients mask market-timing trades, either by breaking up big orders or creating special accounts to hide identities." On top of that, "70 percent of the brokers said they were aware that some of their customers were timing the market." They just looked the other way. The SEC survey showed that twenty-five percent of brokerage companies allowed late trading. Late trading occurs where a hedge fund puts in a trade after the funds' 4 p.m. cutoff, but gets the pre-4 p.m. price. Some have likened it to betting on a horse race after it has been run. Some of those brokers who helped hedge funds pilfer mutual fund accounts were the brokerage arms of large investment banks like

Bear, Stearns, & Company, Merrill Lynch & Company, and CIBC. (Aguirre Written Testimony at 11).

"Tipping" large customers about other customers' specific orders or trading strategies is against the internal policies of every broker-dealer with which we are familiar, is contrary to the expectations of customers and the investing public and, as we said on June 28, a sure road to commercial suicide. MFA did not mean to suggest that such tipping could not also violate the law, e.g., where it operated as a fraud on customers or amounted to a conversion of customers' proprietary information. Whatever failures may have occurred that permitted the occurrence of "late trading," a practice that we have condemned for as long as it has been around, that practice did not involve the direct customer obligations that arise in connection with day-to-day trading activity.

MANAGED FUNDS ASSOCIATION

ATTACHMENT B

July 27, 2006

The Honorable Arlen Specter
Chairman, Senate Judiciary Committee
c/o Mr. Barr Huefner
U.S. Senate
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Specter:

This letter serves as a response to question 7 of your supplemental questions, dated July 7, 2006, to Managed Funds Association issued after the June 28th Judiciary Committee hearing. I am enclosing a copy of *MFA's 2005 Sound Practices for Hedge Fund Managers* published on August 2, 2005. This is MFA's latest iteration of hedge fund industry guidance for internal business practices in a number of areas including: internal trading controls, responsibilities to investors, valuation, risk controls, regulatory controls, transactional practices, and business continuity and disaster recovery. *MFA's 2005 Sound Practices* builds upon the "sound practices" that first was published for the hedge fund industry in February 2000 and subsequently revised by MFA in 2003. The original "sound practices" was produced in response to a 1999 recommendation by the President's Working Group on Financial Markets that hedge funds establish a set of sound practices for their risk management and internal controls (*see* Report of The President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (April 1999), page 37).

As our industry continues to grow and evolve, our members firmly believe that adherence to high business standards is a goal critically important to the long-term success and sustainability of our industry. *MFA's 2005 Sound Practices* lays the groundwork for achieving that goal by providing an aspirational standard of excellence for management and business practices for hedge fund industry participants. Our document was cited favorably and recommended for hedge fund managers in the Counterparty Risk Management Policy Group II Report, *Toward a Greater Financial Stability: A Private Sector Perspective,* issued on July 27, 2005.

I hope you find *MFA's 2005 Sound Practices* informative. Please feel free to contact me at (202) 367-1140, if you have any questions or comments about this document or anything else regarding the hedge fund industry.

Sincerely,

John G. Gaine

John G. Gaine

Enclosure

2025 M Street, N.W. Suite 800 Washington, DC 20036-3309 Tel: 202.367.1140 Fax: 202.367.2140

Senator Specter
Howard Schilit
Non-Executive Chairman and Founder
Center for Financial Research and Analysis
June 28, 2006

1. You testify that "pressure can be brought to bear on research firms by investment managers, such as hedge fund professionals, to write or not write on certain companies, and perhaps even to provide non-public information to a high paying client." Have you personally experienced these pressures from hedge fund professionals? If not, what is your basis for this statement?

RESPONSE: Fortunately, CFRA has been fortunate in client relations to avoid being placed in situations in which clients attempt to pressure us to engage in the unethical behavior you describe. I believe many reasons help explain this: (a) a very large and diverse client base that includes investment managers, insurance underwriters, auditors, regulators, attorneys, academic institutions: (b) no one client represents a material portion of our business; (c) clearly explaining to any new client what our ethical guidelines are and our strict adherence.

As I testified, I don't believe this pressure is pervasive, I recommended that all independent research firms should have written ethical guidelines that their guidelines should follow.

2. Has CFRA ever fired a hedge fund client who was unwilling to play by ethical rules governing the independence of your firm's research?

RESPONSE: In our first year (1994), we had a mutual parting with one client (Rocker Partners) when CFRA refused to publish a report on a company Rocker had expressed an interest in our examining.

3. Your testimony indicates that company-sponsored research creates special conflict-of-interest problems. Do conflict-of-interest problems equally arise if an independent analysts firm undertakes hedge-fund sponsored research about any particular company?

RESPONSE: No, in fact, most of the company-sponsored research is initiated by small public company who find small research boutiques or brokerage firms who agree to begin coverage (obviously with a glowing report) to help boost the share price. In such cases, hedge funds have no involvement at all.

SUBMISSIONS FOR THE RECORD

TESTIMONY OF

GARY J. AGUIRRE, ESQ.

BEFORE THE

UNITED STATES SENATE COMMITTEE ON THE JUDICIARY

June 28, 2006

United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510

Mr. Chairman, Senator Leahy, Committee Members:

The subject of your Committee's hearing today (Hedge Funds and Independent Analysts: How Independent Are Their Relationships?) is the most recent variant of a stubborn question that keeps popping at Senate committee hearings: is federal law enforcement adequately protecting the nation's capital markets and their participants from the risk of manipulation and fraud by the nation's 11,500 hedge funds? The answer is no.

And the answer is no whatever facts you consider. It is no when the Securities and Exchange Commission ("SEC") fails to recognize any hedge fund fraud or manipulation against other market participants for a quarter century: from 1979 until 2004. It is no when the SEC fails to protect mutual fund investors when billions of dollars are siphoned from their accounts by hedge funds. It is no when you compare what the SEC is doing and saying about hedge funds with what its counterparts in Europe are doing and saying. It is no when the Department of Justice ("DOJ") merely shadows the SEC's meager scrutiny of hedge funds. It is a deafening no when senior SEC officials throw a roadblock in the insider trading investigation of one of the nation's largest hedge funds because the suspected tipper has powerful political connections, *as they did with the investigation assigned to me.*

Overview

From September 2004 through September 2005, I had primary responsibility for conducting an investigation by the Securities and Exchange Commission ("SEC") of suspected insider trading and market manipulation by one of the nation's largest hedge funds, Pequot Capital Management ("PCM"). I worked long hours on the investigation with other equally committed staff. Among them was a thirty-year SEC veteran, then SEC's most experienced and respected investigator of insider trading. His duties included teaching incoming Enforcement attorneys and foreign regulators how to conduct an insider trading investigation. At his retirement party, he told Enforcement Director, Linda Thomsen, in my presence that the PCM investigation was the most important one he had worked on in his thirty-year career with the SEC. Another seventeen-year veteran, who worked side by side with me, told me the same. His expertise was market manipulation and insider trading.

I believe the nation's capital markets face a growing risk from unregulated pools of money--now called hedge funds--just as they did in the 1920s from unregulated pools of money--then called syndicates, trusts or pools. Those unregulated pools were instrumental in delivering the 1929 Crash.[1] They were, among other things, skilled at using various devices to manipulate stock prices to trick the public.[2] There is growing evidence that today's unregulated pools--hedge funds--have advanced and refined the practice of manipulating and cheating other market participants.

One final introductory point: you may be curious why someone comes to the SEC after twenty-eight years as a trial attorney in private practice. I left the full-time practice of law in 1995. I had achieved my professional and economic goals and had no intention of returning to the full-time practice. Five years later, I looked back on that career that had missing chapter. Very little of it had been devoted to public service. I decided it was not too late to write that chapter and returned to law school to retool for that purpose. While at Georgetown, I decided my skills might be useful at the SEC.

The "Good Old Times" Are Back Again

Fixing the SEC so it can protect investors and capital markets from hedge fund abuse will not be an easy task. Powerful interests want the SEC to stay just the way it is or, better yet, to become even weaker. Those interests are not just the hedge funds. They include the financial industries that are receiving tens of billions of dollars in revenues for helping hedge funds cheat other market participants or close their eyes to the carnage. At the top of that list are the big investment banks, e.g., Goldman Sachs, Morgan Stanley, Merrill Lynch and Bear Stearns. Those interests know how to reward friends and punish perceived enemies. Their tentacles reach far. They stopped the hedge fund investigation I was assigned to conduct. They cost me my job.

Wall Street's misuse of influence is nothing new. Ferdinand Pecora sensed this misuse of influence when he conducted the investigation in 1933 and 1934 on behalf of the Senate Banking Committee that led to the adoption of the securities acts and the creation of the SEC. His detailed cross-examination of powerful bankers, brokers, and industrialists revealed the ills the securities acts were designed to cure.

Five years later, he warned in *Wall Street under Oath*:

> Under the surface of the governmental regulation of the securities market, the same forces that produced the riotous speculative excesses of the "wild bull market" of 1929 *still give evidences of their existence and influence*. Though repressed for the present, it cannot be doubted that, given a suitable opportunity, they would spring back into pernicious activity (emphasis added).
>
> Frequently we are told that this regulation has been throttling the country's

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[1] JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929, 46 (1997); and FERDINAND PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS 3 (1939), *reprinted by* Augustus M. Kelly (1968), at 258.

[2] PECORA, *supra* note 1 at 264-265.

> prosperity. Bitterly hostile was Wall Street to the enactment of the regulatory legislation. It now looks forward to the day when it shall, as it hopes, reassume the reigns of its former power. . . .
>
> The public, however, is sometimes forgetful. As its memory of the unhappy market collapse of 1929 becomes blurred, it may lend at least one ear to the persuasive voices of The Street subtly pleading for a return to the "good old times."[3]

I suggest the "good old times" are now back again and the device Congress designed to protect the public investor--the SEC--needs fixing.

The first step in getting a handle on the risks posed by hedge funds is to separate and tag them. I believe there are three risks: (1) hedge fund conduct that cheats their own investors; (2) hedge fund conduct that randomly cheats everybody else, and (3) the systemic risks such as those that surfaced when Long Term Capital Management ("LTCM") collapsed. I will not address the LTCM class of risks because it is beyond my expertise and its solution appears to involve multiple federal agencies.

Hedge Fund Fraud Has Two Distinct Classes of Victims

There are two different species of hedge fund fraud. They are easily distinguished because each has a different victim. One species victimizes the hedge fund's own investors--wealthy individuals and institutions. The other species randomly victimizes everybody else.

Hedge Fund Fraud against Hedge Fund Investors

This species of fraud poses little risk of a *severe* crisis to the capital markets for multiple reasons. First, the incidence of fraud by hedge funds against their own investors is not disproportionately high.[4] Further, when hedge funds do cheat their own investors, the character of fraud is not unique. Put differently, a Ponzi scheme is a Ponzi scheme whether the investment vehicle is a corporation, an investment trust, or a hedge fund. That means the SEC has the experience to tackle this species of fraud. They have been doing it for decades. Indeed, through September 2003, all 38 enforcement actions the SEC brought against hedge funds over the prior four years were exclusively for this class of fraud--hedge funds victimizing their own investors.[5]

Further, hedge fund investors, as a class, are not the easiest targets. They are wealthy individuals and institutions.[6] They are more likely to become suspicious when the quarterly reports are a bit off. If they don't get the right answers, they are prone to call their attorneys, who file lawsuits and call the SEC. Once again, the SEC knows how to investigate this kind of fraud.

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[3] PECORA, *supra* note 1 at 3.

[4] Staff Report to the U.S. Securities and Exchange Commission, Implications of the Growth of Hedge Funds, at 73 (September 2003). Available at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

[5] *Id* at 90.

[6] However, certain investors in hedge funds may not meet the wealthy individual and institutional standard. For example, regulations may be needed to prevent the "reutilization" of hedge funds. Also, labor unions and universities may be taking on excessive risk through their hedge fund investments.

Of course, wealthy individuals and institutions have entrusted $1.2 trillion to hedge funds.[7] That is a big chunk of money, but it is only a tiny fraction of the total assets that individuals and institutions have invested in the capital markets. For example, mutual funds collectively manage $9.2 trillion.[8] The bond and equity markets are more than $40 trillion. Globally, $90 trillion of financial assets are under management.[9] Thus, by any measure, hedge funds have significant assets, but by no means dominate the capital markets. No amount of fraud by hedge funds against their own investors could cripple the capital markets. It is too little money.

From these facts, the hedge fund industry and others contend that hedge funds need no special attention. Why shackle an industry that does so much good for our capital markets, e.g., liquidity or risk transfer? Though the comments are valid when applied to the first species of hedge fund fraud, they are off the mark when applied to the second species discussed next.

Hedge Fund Fraud against Other Market Participants

This species of fraud has an easier target and a far greater potential to disrupt the capital markets. Its victims have no connection with the hedge fund. They are random victims. Much like the victims of a sniper, they never knew what hit them. For example, the millions of mutual fund investors had no clue that billions of dollars were being siphoned from their investment accounts each year by hundreds of hedge funds, as it happened in the recent mutual fund scandal. Likewise, the value investor has no clue that an attractively priced small cap is on its way to bankruptcy via the naked shorting of an $8 billion hedge fund. Similarly, the most sophisticated institutional investor will not second guess the expensive computer model when it begins blinking sell on XYZ stock because it has become overpriced. How could that investor know several hedge funds are buying up XYZ stock because they have been tipped by an investment bank executive that Google will make a tender offer for XYZ at a 50% premium to its current stock price?

The use of invisible fraud and manipulation is nothing new. It was just as invisible in the 1920s when banks and brokers employed the same devices to cheat the public. Pecora described why the public could not detect this type of fraud in the 1920s in words that ring true today:

> The Public was always in the dark. It could not tell whether sales were due merely to the "free play of supply and demand," or whether they were the product of manipulated activities…*It all looks alike on the ticker.* Nor did the public have access to the inside information on which the officers, the directors and the dominant shareholders act (emphasis added).[10]

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[7] The SEC Acting Director of the Division of Investment Management, Susan Wyderko, testified before the Securities and Finance Subcommittee the on May 16, 2006, that hedge funds currently manage $1.2 trillion dollars. However, SEC Chairman Christopher Cox testified before Committee on Banking, Housing and Urban Affairs on April 25, 2006, that the number was actually $2 trillion. Since the $2 trillion has never been repeated by the SEC, I am accepting the SEC's more recent figure in my testimony.

[8] *NASD's Glauber Says Worst Is over for Mutual Funds*, Reuters News, May 18, 2006.

[9] *FACTBOX-Reuters Summit-Five Facts about Hedge Funds*, Reuters News, June 22, 2005.

[10] PECORA, *supra* note 1, at 267.

In the Darwinian hedge fund world, cheating other market participants has its benefits. It increases the profits to the hedge fund's wealthy individual and institutional investors. Those happy folk tell their friends. New money increases assets under management. The hedge fund takes 2% of those new assets plus 20% of any profits those assets generate. If a manager can maintain that track record, he may join a very exclusive club. The top twenty-five hedge fund managers individually made between $130 million and $1.5 billion last year. The key to getting an investor to plunk down $500,000 to $50 million subject to the 2% and 20% hedge fund take: "As long as the performance is up there, in the end the investors do not care about the high fees."[11]

It also works the other way. A hedge fund manager may find his investors heading for the door. The profits at rival funds are a couple points higher. Rumors circulate that the competition found a way to siphon funds from mutual fund accounts. To survive, a hedge fund must learn to siphon. One after another, hedge funds learn the trick. *Fortune Magazine* offers this colorful and insightful account how market timing and late trading spread like a virus from one hedge fund to another until it infected more than 400:

> Eddie Stern's saga is the untold tale of the market-timing scandal: where the practices were conceived, how they took hold, and how they metastasized from a benign cat-and-mouse game to a sophisticated gambit in which hedge funds slung around billions, compromising an entire industry. "It was like a little brotherhood of people who embraced this niche in life," says Brown, "a whole grotesque industry growing up based on screwing small investors. It's about as bad as it gets."[12]

This species of fraud--victimizing other market participants--also operates under the SEC's radar. In fact, it went undetected by the SEC until September 2003, and, even then, it was not the SEC that discovered it. Rather, a state attorney general announced the first case and settlement involving a hedge fund that had used the market timing and later trading devices to siphon funds from the accounts of unsuspecting mutual fund investors. After two critical Government Accountability Office ("GAO") reports and an equally critical Congress, the SEC went after hedge funds and their helpers with a vengeance. Beyond this, as discussed below, the SEC--"the cop on the street"--does not spend much time walking this beat.

Hedge funds' Dominance of the Capital Markets Creates the Power to Abuse Them

The potential harm that hedge funds can inflict on other market participants has no real limits. Hedge fund trading now dominates the nation's capital markets. The $1.2 trillion under hedge fund management are on steroids.[13] They recycle at high velocity through the markets. With that $1.2 trillion, hedge funds execute up to fifty percent of the daily trading on the $21

[11] Jenny Anderson, *Atop Hedge Funds, Richest of the Rich Get Even More So,* N.Y. Times, May 26, 2006 at B1

[12] Peter Elkind, *The Secrets of Eddie Stern; If You Think You Know How Bad the Mutual Fund Scandal Is, You're Wrong. It's Worse,* Fortune April 19, 2004, at 106.

[13] A Review of Current Securities Issues: *Hearings Before the Sen. Comm. on US Senate Committee on Banking, Housing, and Urban Affairs,* 109th Cong., available at http://banking.senate.gov/index.cfm?Fuse action=Hearings.Detail&HearingID=206 (2006) (statement of the Hon. Christopher Cox, Chairman, Securities and Exchange Commission).

trillion New York Stock Exchange.[14] They also do seventy percent of the trading in the US distressed debt market, US exchange-traded fund market[15] and the convertible bond market.[16] The same picture is emerging in the derivative markets. Patrick Parkinson of the Federal Reserve recently testified at a Senate hearing: "The *active trading by hedge funds* has contributed significantly to the extraordinary growth in past years in the market for derivatives (emphasis added)." So far, hedge funds have dominated these markets with only $1.2 trillion under management. But that is changing too. The SEC projects the hedge fund asset base will increase from $1.2 trillion to $6 trillion by 2015.[17]

Hedge fund trading generates huge commissions and fees to investment banks and brokers. That revenue flow gives hedge funds influence with both brokers and investment banks. The Economist examined this growing influence in an article last year:

> At a time when mutual and pension funds have become ever more reluctant to pay the traditional five cents a share for trades, hedge funds pay up to four times that amount if in the process they can receive good ideas or particularly effective execution....
>
> And trading is just the beginning for banks. Hedge funds want hot issues, structured derivatives, margin, stock-lending for short sales and the equivalent for fixed-income, clearing and settlement, customer support and marketing. The money coming from all these transactions and fees is enormous....Although there is some overlap in the numbers, investment banks collected $15 billion either directly from hedge funds or because of them, producing $6 billion in profits. For individual firms, hedge funds were critical to last year's performance. They produced one-quarter of
>
> Goldman Sachs's profits, estimates Guy Moszkowski of Merrill Lynch, and only a slightly smaller slug of Morgan Stanley's returns.[18]

The revenue from hedge funds to investment banks was $25 billion for 2004.[19] Since hedge fund assets under management continue to grow exponentially, hedge fund revenue to investment banks will do the same. Consequently, hedge fund influence with those banks will continue to grow as well.

The United Kingdom's Financial Services Authority ("FSA") expressed concern in June 2005 that hedge funds were getting more from investment banks than their contracts specified.

[14] "Although, hedge-fund assets only amount to an estimated 5% of investment funds world-wide, they account for roughly half the trading on the London and New York stock exchanges." Edward Chancellor, *Hedge Funds Today: So Much Money So Little Talent*, The Wall St. J., August 24, 2005, at A10.

[15] *Hedge Funds' Hefty Contribution to Investment Banks,* Funds International, April 18, 2005, LEXIS.

[16] *UPDATE 1-Reuters Summit-Hedge funds see no big regulatory threat*, Reuters News, June 22, 2005.

[17] *Role of Hedge Funds in our Capital Markets: Hearings Before the Sen. Subcomm. on Securities and Investment,* 109th Cong., available at http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=208 (2006) (statement of Susan Wyderko, Director, Office of Investor Education and Assistance).

[18] *The New Money Men - Hedge Funds*, The Economist February 19, 2005 (U.S. Edition).

[19] *Morgan Stanley Top Hedge Fund Prime Broker-Survey*, Reuters News September 29, 2005.

According to the FSA, "insider trading is now institutionalized" because of the flow of tips from investment banks to hedge funds.[20] The FSA "had uncovered signs of insider dealing at almost a third of British M&A deals, with possible culprits including traders at hedge funds and investment banks."[21] That same month, the FSA also observed that hedge funds were "testing the boundaries of acceptable practice with respect to insider trading and market manipulation."[22]

The illegal flow of insider information from investment banks to hedge funds was the primary focus of the hedge fund investigation I headed. Senior SEC officials halted the investigation, as I was told, because the suspected tipper had powerful political connections. Indeed, he does at the highest level. When I raised the propriety of that decision with the most senior Enforcement officials, they fired me. When I apprised Chairman Cox of these events, he did not lift a finger.

How Influence Peddlers Stopped a Critical Hedge Fund Investigation in Its Tracks

The investigation was two-pronged. The insider trading prong involved the securities of twenty public companies. On eighteen occasions, a Self Regulated Organization ("SRO") had referred the suspected insider trading matter to the SEC after conducting its own investigation. In each case, the hedge fund traded shortly before a public announcement sharply increased the value of its new holding. In all but two cases, the hedge fund made at least $1 million. Some referrals involved much larger profits. In two cases, evidence suggested the tip may have come from court personnel. In five cases, the hedge fund made highly profitable trades shortly before public announcements of acquisitions. In two of these cases, evidence indicated the tip had come from an investment bank.

The second prong of the investigation--market manipulation--involved two classes of suspected violations: wash sales and naked shorts. Some of my colleagues believed this prong held a greater potential to severely injure the capital markets. Evidence indicated that hedge funds used wash sales to spike stock prices just as unregulated pools used wash sales to spike stock prices in the 1920s.[23] The investigation of both wash sales and naked shorts led to the hedge fund's prime broker, a large investment bank.

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[20] Richard Fletcher, Targeted: *The hedge fund insider dealers*, SUNDAY TIMES (London) June 19, 2005, at Business 11.

[21] Gerard Wynn, *UPDATE 1-Reuters Summit-UK to Probe for Hedge Fund Market Abuse*, Reuters News, April 4, 2006.

[22] James Drummond, *FSA Names Head of Hedge Funds Unit*, Fin. Times (London) September 20, 2005, at 6.

[23]

> Suppose, for example, you were a pool operator and the current quotation for the stock in which you were operating was $40, and you wished to raise the quoted price without running any risk. If you were allowed to use the "wash sale" technique, it would simply be necessary to offer to sell a quantity of the stock at say, $41, and at the same time arrange either through the same or a different broker to buy the identical stock you were offering to sell. There would, of course, be no real change of ownership; it would simply be selling to yourself.
>
> The public, however, would know nothing of this. All it would see would be a statement on the ticker: "100 shares blank stock sold at $41." There was nothing to apprise the observing public that the price had really not advanced $1 on the open market, but that the quotation of $41 was just so much camouflage."

By May 2005, one of the insider trading matters dwarfed all others: the hedge fund's trading in two companies just before the announcement of a cash tender offer by one for the other at a 50% premium over the last trading price. The hedge fund profited by $18 million in 30 days. The evidence suggested that the hedge fund's CEO acted on an unlawful tip in directing the hedge fund's trades. But the question remained: who tipped him? In May 2005, Branch Chief Robert Hanson, directed me to spend all my time on the one matter and focus on finding the tipper. Accordingly, beginning in May 2005, I searched through millions of emails and other records for clues indicating who tipped the hedge fund CEO and, in June 2005, questioned the hedge fund's CEO--the suspected tippee--on this issue.

By mid-June, growing evidence pointed to one person: the former CEO of a large investment bank. The suspected tipper likely knew about the tender offer, spoke with the hedge fund's CEO just before he began to trade, profited by the trades, and had other personal and financial motives for tipping the hedge fund's CEO. The two suspects trusted each other, did financial favors for each other, and exchanged stock tips. The evidence yielded no other viable candidates.

My supervisors enthusiastically endorsed this factual theory of the evidence. On June 14, I briefed Branch Chief Hanson and Assistant Director Kreitman for one hour on the insider trading investigation, including the evidence that pointed to the suspect as the likely tipper. After which, they authorized me to present this same factual theory and evidence to the FBI and the US Attorney's office in New York, as the first step toward a possible criminal proceeding against both suspects. Accordingly, at a meeting the next day, I presented the information to an Assistant US Attorney and two FBI agents.

A few days after the meeting, I informed Branch Chief Hanson that I intended to issue subpoenas for the suspected tipper's examination and key documents. He first reacted positively to the suggestion. But a few days later, to my surprise, Hanson abruptly reversed course. Hanson blocked the issuance of subpoenas for the suspected tipper's testimony and records, stating that it would be difficult to obtain the authority to issue the subpoenas because the suspected tipper had powerful political connections.

Immediately after Hanson's comment, external interference with the investigation became evident. A high-powered attorney, Mary Jo White, bypassed the normal protocol of discussing the investigation with the assigned staff attorney. Instead, she went directly to Enforcement Director Linda Thomsen, despite the fact Director Thomsen had no prior involvement in the case. For the first time, senior staff left me out of meetings when they discussed the case. Associate Director Paul Berger--who had very limited knowledge of the facts--emphatically stated in my presence that no case would be filed against the suspected tipper, but gave no reason or clue for his decision. Emails between the suspected tipper and tippee that I had subpoenaed from investment banks were delivered by Mary Jo White to Director Thomsen. That had never happened before in the other 100 subpoenas I had issued. My supervisors, who had strongly supported the case only two weeks before, became angry and defensive when I tried to discuss the issuance of the subpoenas.

PECORA, *supra* note 1 at 264-5.

Most confounding, I could not understand how senior SEC officials would authorize me to meet with the FBI and the US Attorney to initiate a *criminal* investigation and then, two weeks later, block the issuance of *civil* subpoenas for the suspected tipper's testimony and key documents. The only significant occurrence between those two events was the decision of the US Attorney and the FBI to begin looking into the matter.

From late June until September 2, 2005, I informed every link in the chain of command from my branch chief to the SEC Chairman in over thirty written communications of the special and favored treatment my supervisors were giving to the suspected tipper. By way of example, I enclose a redacted copy of the letter I faxed to Chairman Cox on September 2, 2005. It never got a response. Neither Chairman Cox, nor Director Thomsen, nor Associate Director Berger ever questioned why the investigation was stopped.

If you wish to know more details how the SEC stopped the investigations, including supporting evidence, the identity of the suspected tipper and tippee, and the tipper's political connections, you may find this information in the 42-page sworn statement and 46 supporting exhibits I provided Kathy Casey, Esq., Staff Director and Counsel for the Senate Banking Committee, in mid-March 2006.

My Termination

On August 4, 2005, I sent the following email to Director Thomsen:

> *Do you have an open door policy?*
>
> *If so, do you recall Hilton Foster's comment to you about the most important case he handled in his 30 years with the Commission?* [As discussed earlier, Mr. Foster routinely taught incoming enforcement staff and foreign regulators how to conduct an insider trading investigation. He worked with me on the investigation from October 2004 until he retired on June 30, 2005.] *He wanted me to talk to you about it. It was nearly killed 5 months ago and is now moving in circles.*
>
> *It could change the financial markets--make them a little more hospital [hospitable] for investors, small or big, who do their home work rather than buy information with favors*

The following day, my branch chief told me that senior staff would reconsider my recommendation to take the suspected tipper's testimony after he and I returned from vacation in September. I went on vacation two weeks later. On September 1, while on vacation, senior staff fired me.

My SEC performance evaluations

Until I questioned the suspected tipper's special treatment, my supervisors found my work met or exceeded all applicable SEC standards. They certified my performance met all applicable Enforcement standards for a staff attorney in June 2005. In mid-June 2005, Assistant Director Kreitman gave me his highest unofficial award for excellent work on the investigation. Later June, Branch Chief Hanson prepared his assessment of my 2004-2005 performance for a possible merit step increase. Just before the controversy over investigating the suspected tipper arose, Hanson praised my work on the hedge fund investigation, stating:

> Gary has an unmatched dedication to this case (often working well beyond normal work hours) and his efforts have uncovered evidence of potential insider trading and possible manipulative trading by the fund and its principals. He has been able to overcome a number of obstacles opposing counsel put in his path on the investigation. Gary worked closely with the Office pf Compliance Inspections and Examinations to develop the case and worked with several self-regulatory organizations to develop a number of potential leads. He has gone the extra mile, and then some.

Consequently, on August 21, 2005, the SEC approved my two-step merit increase based on my handling of the hedge fund investigation. The SEC terminated my employment eleven days later on one day's notice. According to the SEC union president, the SEC's decision in my case to award a merit pay increase and then terminate my employment is unprecedented.[24]

SEC's Dismal Record Protecting Market Participants from Hedge Fund Fraud

How the SEC Learned Hedge Funds Cheat Others; the Mutual Fund Scandal

For twenty-five years, from 1979 to 2004, hedge fund fraud and manipulation operated under the SEC's radar. The SEC brought no cases against hedge funds for manipulation, insider trading, or fraud directed against other market participants.[25] During this period, the SEC recognized only one species of hedge fund fraud: that committed by a hedge fund against its own investors.[26] The SEC first publicly recognized that there were two classes of hedge fund fraud in July 2004. Its proposed rule requiring hedge funds to register noted: "Since the staff report [of September 2003], *a new species of hedge fund fraud has been uncovered* (emphasis added)."[27]

So, how did senior SEC officials figure out after twenty-five years that hedge funds were also cheating other market participants? Well, as a matter of fact, they did not. A state attorney general announced the settlement of the first case involving a pattern of hedge fund fraud on other market participants. It was the first hedge fund caught for pilfering mutual fund accounts,

[24] Michael Clampitt is president of National Treasury Employees Union Chapter 293, the only SEC employees' union. You may reach him at 202-551-3434, his office at the SEC.

[25] As late as September 2003, the SEC staff report on hedge funds described its efforts to police hedge funds: it identified 38 enforcement actions brought by the SEC from 1999 to September 2003. (Implications, *supra* note 2 at 90.) All of those cases involved the same type of hedge fund fraud: fraud by hedge funds that victimized their own investors. But 1999 is an arbitrary cut off date. In searching through Lexis from the present to the past, the first case I could find where the SEC had filed an enforcement action against a hedge fund for causing injury to anyone other than hedge fund investor was SEC v. *Howard Associates et al.*, 1979 SEC LEXIS 2362.

[26] *Id.*

[27] Registration under the Advisers Act of Certain Hedge Fund Advisers 17 Fed. Reg. 45175 (July 28, 2004), available at http://www.sec.gov/rules/proposed/ia-2266.pdf.

the investment vehicle of choice for tens of millions--the classic small investor. As for the SEC--"the cop on the street"--it caught nothing.

The total cost to mutual fund investors was staggering. According to *Time Magazine*, "Academics estimate that late trading costs investors $400 million a year and market timing $4 billion to $5 billion."[28] According to *The Wall Street Journal*, "[H]edge funds ...reaped the lion's share of gains from the [unlawful] trading."[29] In March 2005, the SEC was investigating 400 hedge funds for their participation in the scam.

The SEC Also Failed to Catch the Helpers--Yet Another Industry it Regulated.

Hedge funds could not have skimmed mutual fund accounts without help. That is just what they got from the brokers the SEC also regulates. "Thirty percent of the brokerage firms the SEC surveyed helped clients mask market-timing trades, either by breaking up big orders or creating special accounts to hide identities." On top of that, "70 percent of the brokers said they were aware that some of their customers were timing the market."[30] They just looked the other way. The SEC survey showed that twenty-five percent of brokerage companies allowed late trading.[31] Late trading occurs where a hedge fund puts in a trade after the funds' 4 p.m. cutoff, but gets the pre-4 p.m. price. Some have likened it to betting on a horse race after it has been run. Some of those brokers who helped hedge funds pilfer mutual fund accounts were the brokerage arms of large investment banks like Bear, Stearns, & Company, Merrill Lynch & Company, and CIBC.

To sum up, the SEC was oblivious that hedge funds cheated other market participants for twenty-five years. The SEC somehow overlooked a hedge fund scam that cost mutual fund investors billions of dollars per year. The scam was executed for years with the participation of two industries the SEC also regulates: mutual funds and brokers. It would not listen to a whistleblower who was armed with the facts. Eventually, like the public, the SEC learned about the scandal when a state attorney general announced a $30 million settlement. How has the SEC done since then to detect hedge fund fraud that victimizes other market participants?

The PIPE Cases

Over the past year, the SEC has brought three cases for a new type of hedge fund fraud that victimizes other market participants.[32] All three involved a very specific form of insider trading. The facts follow the same pattern. A public company decides to raise money by making a private placement of its stock with the intent to register the stock a few months later. This is commonly

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[28] Jyoti Thottam, *Are They All Crooked? The Answer Is No, but the Mutual-Funds Scandal Is about to Get Worse. Here's How to Safeguard your Investments,* TIME MAGAZINE November 17, 2003, at 54.

[29] *Id.*

[30] Brooke A. Masters, *SEC Finds Illegal Fund Trading; Survey Discloses After-Hours Deals,* WASH. POST, November 3, 2003, at *A01.*

[31] Andrew Caffrey, *NASD Probing Fund Trading Dozens of Brokers, Securities Firms Facing Inquiries,* BOSTON GLOBE. November 12, 2003, at E1.

[32] *SEC v. Deephaven Capital Mgmt., LLC and Bruce Lieberman*, SEC Litigation Release No. 19683 2006 (May 2, 2006). *SEC v. Langley Partners, L.P., North Olmsted Partners, L.P., Quantico Partners, L.P., and Jeffrey Thorp,* SEC Litigation Release No. 19607, (March 14, 2006); and *SEC v. Hilary L. Shane,* SEC Litigation Release No. 19227 (May 18, 2005)

known as a private investment in public equity or PIPE. A hedge fund agrees to purchase stock through the placement. The hedge fund also knows that the public announcement of the PIPE will depress the market price of the stock. Knowing that, the hedge fund shorts the company's stock and covers it with the private placement for a quick and sure profit. In executing the short, the hedge fund acted on material nonpublic information and violated the securities laws.

Once again, the PIPE cases demonstrate the same old SEC enforcement patterns. The cop on the street--the SEC--did not detect this pattern of insider trading. Rather, it was detected by a $100 billion mutual fund and the evidence was then handed over to SEC officials.[33]

In handling the PIPE cases, the SEC again wore blinders. The SEC has twenty-seven PIPE cases; it has filed three; it is investigating twenty-four others.[34] Again, the PIPE cases demonstrate a pattern of insider trading by hedge funds. This pattern raises the obvious question: If hedge funds are willing to trade on nonpublic material information in one situation, might they not be doing the same in others? For example, are they getting tips from investment banks of pending acquisitions before they are publicly announced? Do hedge funds have techniques for obtaining tips, e.g., next quarter's earnings from public companies before they are publicly announced?

The SEC should be able to check for this. It receives a constant flow of suspected insider trading referrals from SROs. The NASD, NYSE, and AMEX all have market surveillance units that track the market daily for suspicious trades, including insider trading.[35] When their computers detect suspicious trading, the SRO's staff does its own review and, if the trading appears suspicious, refers the matter to the SEC.[36] Many of those referrals involve hedge funds suspected of insider trading.

But that system breaks down when it comes to referrals involving insider trading by hedge fund. Those referrals are rarely, if ever, investigated, unless they happen to meet the PIPEs cookie cutter mold. The investigation I conducted was an anomaly. The right person at intake found the right senior SEC official. That matter was assigned to me. I then found thirteen other insider trading referrals on the same hedge fund that had been gathering dust. None had been

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[33] "The focus on Pipes was prompted in part by complaints from a large mutual fund whose traders had noticed a pattern in which small-company stocks would decline in advance of a company's announcement of a Pipe deal, according to people familiar with the matter." Susan Pulliam, Stock-*Trading Cheats Are in the Cross Hairs,* WALL ST. J., July 8, 2004, at C1. "For Bradley, who gave the SEC a list about 18 months ago of companies whose stock might have traded irregularly after a PIPE deal, said there appeared to be a concerted effort to spread information in the market in an unaudited way." Herbert Lash, *Hedge Fund Instant Messaging Should Be Scrutinized*, Reuters News May 24, 2005.

[34] "The investigation is believed to involve more than two dozen investment funds and already has resulted in some scalps. Regulators are looking into allegations of stock manipulation by hedge funds, which are big investors in PIPEs." Neal St. Anthony, *Deep Haven among Funds in SEC Investigation*, Star Tribune (Minneapolis, MN), July 6, 2005, at 1D. "[T]he U.S. Securities and Exchange Commission is investigating 20 instances in which hedge funds may have used insider information to profit from upcoming stock offerings, according to people familiar with the matter." Susan Pulliam, *SEC pumps up hedge funds probe,* WALL ST. J., July 8, 2004, at B10.

[35] Paul B. Uhlenhop, *Managing Regulatory Investigations and Examinations for Cause* in S&P'S, THE REVIEW OF SECURITIES & COMMODITIES REGULATION (The McGraw-Hill Companies, Inc 2001).

[36] The scope of the review undertaken by an SRO varies widely among SRO's and from case to case.

investigated other than a cursory review. No one had looked at the referrals collectively for any patterns.

The institutionalized form of insider trading by hedge funds insidiously erodes the integrity of the stock markets. The concept is best illustrated with an analogy. Imagine a sports arena with thousand small boxes organized in rows on the arena floor. Each box contains an egg: some are Faberge, others gold, others silver and on and on gradually to the rotten eggs. Egg buyers--some sophisticated; some not--carefully inspect the *exterior* of the boxes for clues to their contents. None may peak inside. The inspection ends at 5 p.m. All egg buyers exit the arena, notes in hand, ready for tomorrow's auction. In the early hours, a security guard allows a team of egg buyers to enter the arena, open the boxes and survey their contents. The public auction of the boxes begins at 10 a.m. sharp. With their survey notes, the early morning team pays richly for the boxes containing the Faberge, gold and silver eggs and craftily avoids those with lesser value. The sophisticated egg buyers are puzzled why their boxes never contain the prized eggs.

My point is this: those that use insider trading cheat all investors--the most sophisticated institutional investor and the small investor alike. They cherry pick the market and, in so doing, undermine the integrity of the capital markets. They rig the game. One senior executive of a $97 billion mutual fund put it this way: "For the last five years, the hedge funds have gotten a free pass,...it's damn well time that they're held accountable to the capital market rules, which were created to protect companies and investors to know that the game isn't rigged."[37] For the sophisticated investor, there are two options: continue to be victimized or join the early morning team.[38]

The Most Recent Statement of the SEC on Policing Hedge Fund Abuse

The most recent testimony from the SEC on its efforts to police hedge fund abuse was given on May 16, 2006, before the Senate Subcommittee on Securities and Investment. Given the growing concern on this subject, this was a golden opportunity for a senior SEC official, perhaps from its Enforcement Division, to tell what new steps the SEC has implemented to protect market participants from hedge fund abuse. Instead, the SEC sent its Director of Investor Education, Susan Wyderko, as if to say that hedge fund abuse is merely a matter of educating investors. She was of course unable to give meaningful testimony or respond to the obvious questions.

Ms. Wyderko's written testimony offered a ray of hope. It cited three "recent significant cases" to demonstrate the SEC "has taken appropriate remedial legal action" against hedge funds

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[37] Lash *supra*, note 40.

[38] I also found one other case the SEC brought against a small hedge fund and its principals for insider trading, manipulation case *SEC v. Scott R. Sacane, et al.*, Litigation Release No. 19242 (October 12, 2005). and two others brought against individuals who had their own tiny hedge funds also for insider trading: *SEC v. Nelson J. Obus*, SEC Litigation Release No. 19667, (April 25, 2006); *In the Matter of Michael K.C. Tom*, SEC Administrative Proceeding File No. 3-12233 (March 8, 2006); and *SEC v. Gary M. Kornman*, SEC Litigation Release No. 18836 (August 18, 2004).

for "market abuse."[39] Unfortunately, those cases merely confirm the analysis above that the SEC has no new thought for dealing with hedge funds. The first cited case is a classic market timing-late trading case.[40] The second was a classic PIPE case.[41]

That leaves the SEC's handling of the third case, which would be funny, if the SEC were not offering it as an example how it is protecting market participants from hedge fund abuse. In that case, the media began detailing the transparent scheme of Scott Sacane and his hedge fund to manipulate two small biotech stocks in July 2003.[42] The media continued to do so for more than two years until the SEC finally filed its enforcement action in October 2005. The SEC complaint borrowed allegations made by *The Wall Street Journal* two years earlier, but left out the humor. On July 30, 2003, the Wall Street Journal published this account of Mr. Sacane's trading:

> Thursday, Mr. Sacane disclosed that his health-care fund... "inadvertently" had bought a majority stake in a small medical-products company called Aksys. Monday, Durus filed that it owned 77% of Aksys, whose stock has been plummeting for days on the news. Mr. Sacane insisted that the investment is passive.
>
> But Mr. Sacane, who declined to comment, didn't stop his "inadvertent" buying there. He also "inadvertently" bought a 33% stake of Esperion Therapeutics.[43]

So what exactly did the SEC uncover over the next two years? Its complaint alleges: "The statement [Sacane's purchase was inadvertent] was false because the Sacane Defendants knew about their Aksys stock purchases all along, and those purchases were not inadvertent."[44] How could it take the SEC two years to deduce the same point any reader of *The Wall Street Journal* article immediately understood? If this case were a movie, it would be titled *The Keystone Kops meet the Gang that Couldn't Shoot Straight.*[45]

Conclusion

No new legislation or regulation can protect market participants from hedge fund abuse unless the SEC does its job. By any measure, it has not. The SEC failed to detect that hundreds of hedge funds were siphoning billions of dollars from mutual fund investors. It also failed to

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[39] *Role of Hedge Funds in our Capital Markets: Hearings Before the Sen. Subcomm. on Securities and Investment,* 109th Cong., 7-8 available at http://banking.senate.gov/_files/wyderko.pdf (2006) (Written testimony of Susan Wyderko, Director, Office of Investor Education and Assistance, Securities and Exchange Commission).

[40] *In the Matter of Millennium Partners, L.P., Millennium Management, L.L.C., Millennium International Management, L.L.C., Israel Englander, Terence Feeney, Fred Stone, and Kovan Pillai.* Investment Advisers Act Release No. 2453 (dec. 1, 2005).

[41] *SEC v. Hilary Shane.* Litigation Release No. 19227 (May 18, 20005).

[42] Jesse Eisinger, *Ahead of the Tape,* WALL ST. J., July 30, 2003, at C1.

[43] *Id.*

[44] *SEC v. Scott R. Sacane, et al.,* Litigation Release No. 19242 (October 12, 2005).

[45] I also found one other case the SEC brought against a small hedge fund and its principals for insider trading, and two others brought against individuals who had their own tiny hedge funds also for insider trading: *SEC v. Nelson J. Obus,* SEC Litigation Release No. 19667, (April 25, 2006); *In the Matter of Michael K.C. Tom,* SEC Administrative Proceeding File No. 3-12233 (March 8, 2006); and *SEC v. Gary M. Kornman,* SEC Litigation Release No. 18836 (August 18, 2004).

detect a second pattern of hedge fund abuse--the PIPE insider trading. Its conduct and words give no reason to believe it will detect other hedge fund abuses of market participants.

And then there is the obvious. One SEC investigation picked up the trail of several patterns of hedge fund market abuse. One prong included suspected insider trading in twenty public companies. The other found evidence of numerous wash sales and naked shorts. Both prongs led to the hedge fund's connection with its prime broker. If the prime broker was involved in any of the violations, as appeared to be the case, the investigation would have had implications for the whole hedge fund industry. In sum, it was the only SEC investigation to put a high beam on the shadowy juncture where hedge funds and investment banks do their lucrative business.

Just after the SEC authorized the investigation to be presented to federal prosecutors and the FBI for possible criminal prosecution, senior SEC Enforcement officials blocked the issuance of *civil* subpoenas for the suspected tipper's testimony and key documents. No insider trading case can be filed without proof of the source of the tip. Thus, stopping the investigation of the likely tipper stops the investigation. In so doing, the SEC has given hedge funds and investment banks notice that it will not police their joint activities. The SEC could do no greater disservice to other market participants and especially the small investor. This is not mere incompetence.

It is not surprising that the U.S. Office of Management and Budget (OMB) gave SEC Enforcement its lowest performance assessment: "Results Not Demonstrated."[46] According to the OMB, "that rating indicates that [Enforcement] has not been able to develop acceptable performance goals or collect data to determine whether it is performing."[47] In short, whether or not Enforcement performs is an unknown. And it is an unknown because it has no goals or data. That criticism is aimed at the top. No matter how committed and competent the SEC staff works the trenches, and that was my experience, they cannot achieve the SEC's mission without leadership equally committed to that mission.

Is there more hedge fund abuse on the horizon? Logic says yes. In the mutual fund scandal, hedge funds broke legal and moral boundaries to make billions in profits at the expense of small investors. In doing so, hedge funds compromised two financial industries--mutual funds and brokers. It seems implausible that hedge funds would suddenly recognize those boundaries if other opportunities arose to make a fast dollar without getting caught. The PIPE cases are just one more example that hedge funds break the law in packs.

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[46] http://www.whitehouse.gov/omb/expectmore/rnd.html; Thomas G. Donlan, Delusions *of Adequacy: How the Federal Government Reviews the Performance of its Programs*, Barron's March 6, 2006, at 50.

[47] http://www.whitehouse.gov/omb/expectmore/notperform.html.

TESTIMONY OF
Demetrios Anifantis
before the
SENATE JUDICIARY COMMITTEE
June 28, 2006

Chairman Specter, and members of the Committee, I am pleased to be called to testify before this Committee.

My name is Demetrios Anifantis. I have worked in the financial services industry for most of my professional career. In 1999, I received a Master's Degree in Economics from Fordham University. I then went to work for Thomson Financial around February 1999 as a Regional Manager for Thomson's Investment Management unit where I worked directly with large mutual fund and hedge fund analysts and Portfolio Managers.

I left Thomson in the summer of 2003 and in about November of that year, I began work for a company called Camelback Research Alliance, Inc. ("Camelback") now known as Gradient Analytics, Inc.

I worked for Camelback as a client relationship manager, performing services for Camelback's subscribers. I worked there for about a year until I was fired in November 2004. I'm now employed by J.P. Morgan Chase. During my tenure at Camelback, I became well acquainted with Camelback's business model, and its management team and staff. It was a relatively small operation.

Camelback touted itself as supplying "independent research" for a fee to subscribers. It was in the business of publishing reports on public companies, and it also sold some software to subscribers that would rank public companies according to their financial performance and prospects.

I worked most closely with Donn Vickrey ("Vickrey"), one of Camelback's two principals. Vickrey and the other principal, James Carr Bettis were the individuals who founded Camelback and had control of Camelback's operations.

Vickrey was in charge of the analyst group and also had close contact with the sales and client services group of which I was part. Vickrey's key function was to oversee the research and writing that went into the reports covering publicly traded companies. Bettis' primary responsibility was to manage the company.

Another manager, Jeff Mindlin had the primary responsibility of engineering as well as managing financial models which were used in Camelback's analytical functions.

There were approximately 18 to 20 analysts that worked for Camelback while I was there. These analysts had responsibility to research and write reports on publicly traded companies. The analysts were all recent graduates of universities with four-year degrees in business-related disciplines, yet management instructed employees to share with clients that the analyst team was comprised of "CFAs" and/or "CPAs" with advanced degrees, even though it appeared to me that none but Camelback's top management had such designations.

These analysts would conduct research on various public companies at the direction of Camelback's management, but few ever developed an expertise in the companies they were researching because it was the practice of management to rotate each analyst frequently so that no particular analyst would work on the same public company for any lengthy period of time.

Camelback advertised analytical reporting services on companies whose securities were publicly traded on various exchanges including the Over the Counter Bulletin Board ("OTCBB"), National Association of Securities Dealers Automated Quotation System ("NASDAQ"), New York Stock Exchange ("NYSE") and others.

At the time I worked for Camelback, Camelback's client base consisted almost exclusively of large hedge funds and mutual funds. My responsibilities included working with the clients to see that their requests were being met with a view towards keeping them satisfied so they would retain their subscription to Camelback's publications.

The price for Camelback's subscription varied, but commonly there was an annual base subscription fee of approximately $25,000 to $30,000 per year. For this fee, the client would receive access to all of Camelback's newly published reports and access to all historic reports on publicly traded companies.

Camelback published all of its reports on one or more websites Camelback owned and operated by Camelback including www.camelbackra.com, www.camelbackresearch.com, www.gradientanalytics.com. www.earingsquality.com, and others.

Camelback's clients could and did access published reports through the Camelbackra.com website. Camelback would also notify existing clients of its subscription service of new reports by dissemination through e-mail and faxes.

Camelback's promotional material and its actual sales practices included selling a yearly "Base Subscription" service to its research reports. Included in the "base" package, Camelback offered to provide subscribers with at least two "custom" reports that could be ordered by a client on a specific company at any time. In addition to the "base" subscription, subscribers could pay for additional custom reports.

Typically, Camelback's subscribers would call Camelback and request these custom reports either through myself, Vickrey, or other client service or sales representatives; however, all report requests would be drafted by an analyst and turned over to Vickrey who supervised the analyst's writing of the reports, and had final editorial oversight of the finished report.

These reports were represented to be "qualitative" analysis and were essentially more subjective in their coverage than "quantative," or technical analysis which involved almost no subjectivity. In Camelback's qualitative reports, the company covered would receive an alpha score from "A" to "F," "A" being the highest score, and "F" being the lowest.

Frequently, the subscribing client of Camelback requesting the custom report would actually supply Camelback with information on the companies that were the subject of the requested report, with instructions to consider and include such information in the report. Usually, the client would instruct Vickrey and other Camelback personnel involved in the intake of the request and the research and writing of the report to generate either a positive or negative report on the company that was the subject of the request.

I personally participated on many telephone conversations between clients requesting special reports and Vickrey. There were usually frequent calls on a single report, and during these, the client would often suggest that Camelback focus on the negative information the client supplied to Camelback for inclusion in the report. In such instances, there was no doubt that the client was asking Camelback to research and draft a negative report on the subject company, and Vickrey commonly altered the report to meet the client's request and expectations lobbied for in the calls.

In these advance publication calls, Vickrey and the client would discuss in detail the report contents. Many times the client would request, and the covered company would receive, an even lower grading than the grade received in the initial versions of the report. Clients rarely wanted a neutral or positive score and would feed Vickrey information, leading him towards a more negative score.

Though Vickrey retained final editing decisions over the reports Camelback published, based on my observations, there was no doubt that these reports were not the product of an independent, unbiased, objective view of the subject companies, but rather that the client was paying for a report that would heavily favor the requesting client's negative view of the company. And frequently segments of the final negative reports included; language, thoughts, ideas, directly shared by the requesting client. Also, frequently the same type of thing was accomplished in that clients often requested that positive aspects of the subject companies be downplayed to give the report an overall negative cast.

Camelback routinely published all custom reports to all clients without discriminating between those reports that might have been the product of independent research, and those that were ordered by a client. Likewise, when Camelback had given a subscriber an advance copy of the report prior to it becoming published or disseminated to the subscribing client base and/or when a subscriber had substantial influence over and input into the report's content, including over the negative assessment Camelback gave the company, there was no disclosure of these facts to either Camelback's subscriber base, or the media to whom reports were also disseminated.

Camelback's principals also made statements indicating that they understood Camelback's subscribers intended to republish the custom reports to third parties who had positions in the stock of the subject companies and to government regulatory agencies. It was also common knowledge, and I knew, that Vickrey would allow financial journalists to review these reports, all of whom Camelback principals anticipated would give wider public circulation to the content of these custom reports. That was part of the business model at Camelback.

Based upon numerous conversations in which I was personally involved, I can say that it was common knowledge at Camelback that those clients who wanted negative reports written on subject companies, and who supplied negative information or guidance to Camelback in connection with a custom report on the subject companies, either had short positions in the securities of these companies or intended to take short positions in advance of publication of the reports.

From all indications, the negative reports from Camelback on the subject companies were a key component in the clients' efforts to profit from the anticipated depression of the trading price of these companies' stocks In fact, clients sometimes would ask that Camelback not disseminate the report to the public for a specific period of time. This would be for the purpose of the client getting their own position in the stock before the public got the information.

In the writing of these negative research reports, it was the common business practice of Camelback to discuss in advance of publications, drafts of these custom reports with the requesting client. As part of my job, I personally was on many telephone calls listening while Vickrey gave clients advance copies of reports to be published. I was often instructed to email an advanced copy prior to the conference call with the client. Vickrey was a participant in nearly all such calls and there were also analysts who had research and report-writing responsibilities, supervised by Vickrey, who were frequent participants.

Some clients paid more fees for additional reports and several requested many reports on companies in a particular market segment. These clients requesting more reports were known to be large hedge funds with net short positions in the companies they were requesting reports on. Some of these were very aggressive and straightforward in their suggestion of what the negative content of the report should include. Occasionally, I would receive email indicating that Camelback's management was aware of whether a client was known to have a short strategy and therefore would profit from negative information on the companies in which they traded.

I heard representatives of client hedge funds request that Vickrey delay the public release of reports from 3 to 7 days to allow them to take or adjust a position in the stock of the company that was the subject of the report.

Also, while I was employed at Camelback, I was given the task to track the stock performance of the companies that were the subject of Camelback's reports. Camelback formulated a "Top Ten" list that consisted of those stocks that performed in terms of stock price according to the rankings given by Camelback in its reports.

Based upon what I was told by Camelback's management, the purpose of the Top Ten list was to provide to potential and existing clients the tracking results to demonstrate the ability of Camelback to not only predict, but affect, stock performance.

It was common knowledge at Camelback that the management of Camelback, and Vickrey in particular, wished to see the stock performance of the companies track the negative or positive rankings Camelback published in its reports. Vickrey emphasized this as a means of promoting the sales of the subscriber services of the company.

Camelback also tracked what it called "Blow ups by Grade." Camelback defined "Blow ups" as reported-on companies which suffered a one-day stock price decline of -20% or better, or, over the course of a week a price decline of better than -25%, within 12 months of the publication date of a Camelback report.

Camelback tracked blow-ups within the following intervals after report publication: 1 month, 3 months, 6 months, and 12 months. The "Blow up" report was a successful part of Camelback's promotional materials in selling its subscription services to short-selling hedge fund clients.

When Camelback published a negative report on a company, it afterwards published subsequent follow-up reports, by means of supplemental bulletins concerning recent news. In this way Camelback sought to continue to support its original negative ranking of the subject companies. These supplemental bulletins were particularly favored by short-selling, hedge fund clients, and I am aware of several of these published supplemental bulletins where Vickery discussed in advance, in phone conferences in which I participated, the content of these bulletins with a known principal in a short-selling hedge fund.

We were instructed at Camelback to make the subscriptions to these reports available to the media at no cost. I knew of prominent financial journalists who frequently accessed our website. In some instances it appeared to me that the journalists in question were acting in concert with Camelback's management and certain short-selling hedge funds to drive down the share price of companies Camelback covered negatively in its reports. It was commonplace that media reports by financial journalists that appeared to work with Camelback and the short-selling hedge funds would follow closely on the heels of the dissemination of Camelback reports to their client subscribers.

The public companies that were subject to the type of conduct I describe in my testimony today numbered somewhere between 20 and 40 companies while I worked at Camelback. Among these were some well-known companies like Swift Transportation, Krispy Cream Donuts, Taser International, Overstock.com, Net Flicks, and many more.

In the fall of 2004, while I worked at Camelback, it came to the attention of a fellow employee, and subsequently to my attention, that Bettis and Vickrey were portfolio managers for Pinnacle Investment Advisors, LLC, a hedge fund advisor, while at the same time they were principals at Camelback.

This management of a hedge fund by Bettis and Vickrey was directly contrary to my understanding and contrary to specific statements by Vickrey telling the staff, including myself, to be careful to always instruct clients that Camelback did not manage money.

I was present when Camelback management, including Vickrey, told its employees working with clients that if ever a client asked whether Camelback invested or managed money, we were to reply with a definitive, "No."

I initially received the information on Pinnacle from a website Camelback marketing employees used to obtain leads on new hedge fund clients called www.bigdough.com ("BigDough"). BigDough is a firm specializing in tracking hedge funds and hedge fund managers. Camelback sales personnel used information from BigDough's databases to obtain leads for potential clients. The Pinnacle information was contained in one of the BigDough databases. In fact, I personally heard Jeff Mindlin, an employee at Camelback answer one phone on his desk, "Camelback" and another phone on his desk, "Pinnacle Investments."

The BigDough information on Pinnacle specified that Pinnacle managed the Helios Equity Fund, the Pinnacle Insider Perspectives hedge funds and the Hallmark Informed Investors Grown mutual fund.

I became aware that there was a link on Camelback's website that provided access to a website with information on Pinnacle.

I showed the link and subsequent pages, including the Helios portfolio information to Mindlin, and Mindlin seemed very concerned. Within 24/48 hours later the Pinnacle link disappeared.

I was fired in November 2004 along with Robert Ballash. Immediately prior to my firing, both Mr. Ballash and I began to ask questions of Camelback's management regarding Pinnacle, as well as Camelback's practices respecting its clients and some of the material I have discussed here today. I strongly believe that Mr. Ballash and I were fired for asking these questions.

Mr. Chairman, looking back on my year at Camelback, I realize I should have questioned earlier and more sharply the practices there. It took some time for me to understand what was taking place, and the Pinnacle revelation was a turning point.

Also, looking back, and drawing on my experience in the financial markets, it is my opinion, that a few years ago, when large brokerage firms were being fined millions of dollars for creating incentives for their in-house analysts to speak favorably regarding their firm's investment banking clients, and when the SEC responded by enacting regulations concerning the certification of these brokerage firm analysts, that action ignored a large market for similar practices: the so-called "independent analysts" trade. In fact, I believe that much of the in-house business moved out-house, both to escape the regulatory scrutiny of the new regulations, and the scrutiny of the oversight of the self-regulated broker-dealers.

I believe that this type of thing I saw at Camelback is more common in the industry than regulators believe. The independent analyst field is virtually unregulated, and lacks meaningful disclosure. I hope my testimony hear today results in change in this area, both in enforcement and regulation, that will benefit America's public companies and their shareholders.

Thank you, Mr. Chairman.

GRADIENT

June 26, 2006

SPECIAL DELIVERY

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
United States Senate
224 Dirksen Senate Office Building
Washington, D.C. 20510-6275

Dear Chairman Specter:

Thank you for the invitation to participate in the Senate Committee on the Judiciary hearing entitled "Hedge Funds and Analysts: How Independent is their Relationship" on Wednesday, June 28, 2006.

Independent analysis and opinion serves as an important risk assessment tool for both mutual funds (in particular) and hedge funds that provide for the financial underpinnings of our national pension assets. As recently indicated by the Chairman of the SEC, independent analysis is a key element in assuring market integrity and the identification of subjects of regulatory interest. Indeed, the analytic services provided by Gradient Analytics, and other independent analysts, contribute to the free flow of information and opinion that is essential to the maintenance of fluid and functional financial markets.

Gradient Analytics is a Scottsdale Arizona based company providing independent analysis about publicly traded companies. This analysis is seeded in academic evidence that shows an imperfect (but shareholder value-relevant) relationship between accounting choices, executive behavior, and corporate governance on one hand, and future earnings and share price performance on the other. Gradient's clients are mutual funds and hedge funds that gain access to our complete library of work and on-going publications via an annual subscription agreement. Those who subscribe do so with full knowledge of Gradient Analytics' subscription terms and service offerings. Further, Gradient Analytics is not paid (directly or indirectly) by the companies that they write about, unlike other stock research firms and financial newsletters.

Since 2002 Gradient Analytics has published over fifteen hundred reports expressing opinions about the accounting practices and choices at firms, their corporate governance, executive behavior anomalies and compensation practices. Attendant risks identified in many of the reports have subsequently been

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evidenced by regulatory actions, gradual or delayed declines in stock value and even bankruptcy. Gradient Analytics has also reported on companies where its analysis demonstrates that accounting practices and other corporate behaviors have positive implications for shareholder value.

Recently there have been allegations made by a few troubled companies that hedge funds and analysts have colluded to publish false information about those companies. Gradient Analytics is itself involved in lawsuits by Overstock.com and Biovail, in which allegations of conspiracy and biased research have been made. These actions against Gradient Analytics are based on fanciful stories fabricated from a few isolated facts and many falsehoods, combined in a thinly veiled effort to chill free speech. Gradient Analytics' response to the allegations of participation in a fantastic and implausible market conspiracy is plainly stated in the court record. We wish to direct the Judiciary Committee's attention to the manor of these cases, particularly as they attempt to shift the blame for poor management execution to those who have the integrity and independence to report on companies that have failed to live up to the expectations they have painted for shareholders.

Because of the pending lawsuits, counsel has suggested that Gradient Analytics decline the invitation to testify before this Committee. We are sure that the Committee appreciates the sensitivity of discourse pertaining to matters that are central to on-going litigation.

Respectfully,

Gradient Analytics, Inc.

Carr Bettis, Ph.D.
Founder, President and CEO

Donn Vickrey, Ph.D.
Founder and Editor-in-Chief

CB,DV:sw

cc: Members of the United States Senate Committee on the Judiciary

Kim Blickenstaff Testimony to Senate Judiciary Committee Hearing: "Hedge Funds and Analysts: How Independent is their Relationship?"
June 28, 2006

Chairman Specter and distinguished members of the Committee, thank you for inviting me to testify today. My name is Kim Blickenstaff and I am a founder, Chairman and CEO of Biosite Incorporated. Briefly, Biosite is a San Diego-based medical diagnostics company focused on improving diagnosis of critical diseases. The Company completed its initial public offering in 1997.

My testimony today relates to a period in 2002 during which Biosite experienced a rise in its stock price accompanied by highly negative research coverage that contained inaccuracies and speculation. During this same period the Company's short position increased six-fold. In many cases the distribution of reports seemed timed to off-set positive business developments. Due in large part to our experience during this period, we believe that the unregulated activities of independent research firms and their possible links to hedge funds merits further investigation.

To provide context I will share specific situations that have influenced my perspective. In the Spring of 2002, Biosite's business had upward momentum following reports of several positive financial and scientific developments. The stock had increased from $13 per share in January to approximately $19 in early February to $36 in May of that same year. Much of the enthusiasm was fueled by investor belief that the market for our Triage® BNP Test, a new test to detect heart failure, could be substantial. I believe the rapid rise of our share price and the opportunity for negative speculation about the entry of competition into this rapidly growing market set the stage for what we experienced next.

In the ten months from February to December 2002, the number of shares controlled by short sellers increased from 690,000 to 7.1 million shares, which represented nearly 50% of our outstanding stock.

During this same period, Sterling Financial Investment Group, a Florida-based research firm, issued at least seven negative research reports on Biosite, each carrying a SELL/SELL SHORT recommendation, and an $11 target price. Contrary to standard industry practices, no author was listed on these reports. We believe that these reports contained numerous inaccurate or false and misleading statements, which ultimately lent volatility to the stock's performance, thereby harming many of our long-term, fundamentally-based investors.

- In a number of reports issued in the Summer and Fall of 2002 Sterling predicted the failure of our BNP Test due to the expected entry of a competitive test. In several of these reports, Sterling included outright inaccuracies regarding competitive advantages that supposedly favored the competitive test. The reports also included inaccuracies and misstatements regarding Biosite's test performance, which also were construed to present an advantage for our competitor.

- On September 11, 2002, the same day Biosite issued positive news, a column written by Sally Yanchus appeared on the web site RealMoneyPro.com. The column, which was critical of Biosite, was posted to Yahoo's Biosite message board.

  Ms. Yanchus previously participated on Biosite quarterly conference calls under the affiliation Nightingale and Farber. We were subsequently able to link Ms. Yanchus to Sterling Research through a NASD Disciplinary Panel Decision, dated April 15, 2005, which refers to her admission of knowingly including inaccuracies in reports on another healthcare company while working on behalf of Sterling Financial.

- On November 18, 2002, members of our management team, including myself, met with an analyst from Sterling at an American Heart Association meeting. During our discussion the Sterling analyst told us her research at the conference had elicited positive feedback on our BNP Test. She also acknowledged that certain reports did contain inaccuracies, but indicated that what her Research Director wanted written was not necessarily in line with her views. She further maintained that the Company would continue to do well and expressed her own surprise as to why her managers felt the stock was a good short target. When asked why she was writing negative material about the Company she said that her role was research and that the reports were in fact written by someone else, who was at liberty to revise her research. She also said she was considering leaving Sterling because of the way they were operating.

During this entire period our BNP Test was in fact gaining market momentum, with sales growing from $3.4 million in 2001 to $38 million in 2002. Despite the progress being made by Biosite, our investors continued to see their investments compromised by volatility in the stock, fueled by the dissemination of these reports.

In the Fall of 2002, we attempted to investigate the activities of short sellers and their links to Sterling. Unfortunately, the lack of visibility into these trades made it impossible for our investigators to definitively produce a link between Sterling's activities and the resulting increase in our short position. Nevertheless, we believe the parallels between the magnitude of Sterling's research activity and Biosite's short position are more than mere coincidence.

Thank you very much Mr. Chairman, for the opportunity to give this testimony, and I am open to any questions.

RICHARD BLUMENTHAL
ATTORNEY GENERAL

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Office of The Attorney General
State of Connecticut

TESTIMONY OF
ATTORNEY GENERAL RICHARD BLUMENTHAL
BEFORE THE SENATE COMMITTEE ON THE JUDICIARY
JUNE 28, 2006

I appreciate the opportunity to speak on the subject of short selling activities by hedge funds and the independence of stock analysts.

After the court of appeals decision in *Goldstein v. SEC,* USDC (DC Cir. 6/23/06) last week, hedge funds are a regulatory black hole -- lacking even minimal disclosure and accountability required of mutual funds and other similar institutions. The number and financial power of hedge funds -- now reportedly more than 13,000 with assets exceeding $2.4 trillion -- provide fertile opportunity for potential fraud based on false or deliberately misleading stock analyst reports.

Either Congress or the SEC must act quickly to fill the void and assure confidence in the integrity of the markets and the hedge fund industry. Federal action is profoundly preferable -- maximizing uniformity, expertise and resources -- but the states must fill the void if Congress fails to act.

States must consider their own regulatory standards -- perhaps modeled on the SEC rules -- achieving the same goals of disclosure and accountability. Federal resources and authority are clearly important to effective scrutiny. Federal inaction or inertia are a powerful impetus -- indeed an open invitation -- to state intervention. States must be proactive to require greater disclosure and accountability. If federal agencies abandon the field, we will join forces, as we have done before in joint legal action, or act separately to proactively protect our citizens.

No one seeks regulation for its own sake, but if some measure of regulation or scrutiny is appropriate, it need not be the exclusive province or purview of the federal government. Disclosure and accountability, not interference or intrusion, should be guiding principles.

Hedge funds and short selling play important, legitimate roles in the financial markets but these financial tools may also be susceptible to investor fraud and abuse -- preventable harms which may be forestalled through specific measures.

First, Congress should even -- if not level -- the regulatory playing field between mutual funds and hedge funds by extending appropriate applicable rules to hedge funds. Congressional action is particularly critical after the ruling in *Goldstein v. SEC*, invalidating the minimal hedge fund SEC measures. Congress must now impose standards of disclosure and accountability on the hedge fund industry enabling some regulatory scrutiny. Responsible hedge fund managers should welcome increased regulation. Greater transparency will help enhance investor confidence in this increasingly important and influential part of the market.

Congress should also extend the 2003 Securities Exchange Commission (SEC), National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE) rules to so-called "independent research companies" whose independence and objectivity may be compromised by clients that provide a significant amount of business.

Further, Congress should toughen federal criminal, civil and administrative penalties to deter and punish fraudulent hedge fund and short selling practices. Such penalties should include treble damages and forfeiture of all profits by all parties who participate in the issuance of a false stock analysis.

Finally, Congress should provide incentives to encourage the Securities Exchange Commission and state banking regulatory agencies to intensify and enhance enforcement actions. Lack of aggressive enforcement can make any law meaningless, leaving investors and markets unprotected.

Several years ago, Wall Street was rocked by revelations involving mutual funds and investment bankers who were pressuring their in-house stock researchers to issue positive stock outlooks that facilitated their investments or pleased their clients.

Firms engaged in a pattern or practice of influencing their research reports on corporations that were clients of their own investment bankers. With huge revenues from their investment banking divisions at stake, some firms sought to cater to their clients by issuing positive stock analyses. The stock analysts publicly issuing positive reports were at the same time privately expressing their concerns about negative developments.

Joint SEC and state actions produced hundreds of millions of dollars in fines and consumer restitution. In response, Congress required the SEC, the NYSE and NASD to develop new regulations to protect the integrity and independence of in-house stock analysts. These rules prohibit (1) investment banking supervision over their firm's stock analysts, (2) investment banking department review or comment on a stock analysis; and (3) stock analysts attending investment banking solicitations of new clients. In addition, the rules require stock researchers to disclose any direct or indirect compensation they receive for issuing stock analyses.

As welcome as these regulations are, they do not apply effectively to situations -- common with hedge funds -- where the stock analyst is separate from an investment banking firm but is compensated by clients for supposedly independent stock analysis. In this situation, if the paying client represents a significant amount of the stock analyst's business -- commissioning frequent, repeated research reports -- the analysis may be compromised by the client's preferences or positions. Independence may be a mirage -- reports "independent" in name only -- and the analysis shaped to suit the client hedge fund's interests.

Such problems may be the aberrant exception, a small proportion, not the rule. But this committee's interest is well-founded. The Committee is justifiably concerned about hedge funds that "short and distort", or take a short position on a stock and then use supposedly independent investment analysts to purposefully and misleadingly malign the company. Analysts dependent on the hedge fund's business may skew their stock analysis to enable the hedge fund to successfully short the stock, and profit at the expense of unsuspecting investors.

The concern about deceptive claims of independence and conflicts of interest, and possible collusion between financial institutions and supposedly objective analysts, really extends beyond hedge funds to other financial entities -- and not just to short selling but long positions as well. Undisclosed relationships or financial dependence involving research analysts -- touted as independent -- may not only distort the results and sabotage objectivity, but also mislead the public and enable the investment entity to manipulate the market. Whether the client is a hedge fund or another entity, supposedly independent research may be skewed to benefit the client's short or long position in the stock.

The danger is perhaps heightened with hedge funds because they have amassed so much financial power -- in the markets and elsewhere -- with so little transparency or accountability. Indeed, after the court of appeals ruling, they will be subject to virtually no required disclosure or other regulatory regimen. Shielded from many reporting mandates, and empowered by flexible missions and charters, they can be nimble, powerful and secret in investment strategy and tactics.

My concern about hedge funds also relates to their phenomenal growth -- expanding beyond sophisticated wealthy individual investors to include pension funds, charitable organizations and middle income individuals. Hedge funds have been exempt from regulation since the 1930's because they have been viewed as solely private investment vehicles for individuals with significant financial resources and presumed knowledge. The conventional wisdom was that these individuals, by virtue of their financial means, were so sophisticated and knowledgeable that they did not need federal regulations to protect them from fraud or abuse.

The growth of hedge funds and their broader reach compel a new approach. What is different now is the realization that hedge funds are more and more the same as many other financial investments -- in the type and number of their investors, their strategy, and their problems.

Connecticut is home to many of the largest hedge funds. I have consulted directly with managers, investors and others in the hedge fund industry to determine how best to protect investors while preserving and respecting the important contribution that hedge funds make. I am not yet prepared to make a final or definitive or comprehensive recommendation.

One consistently expressed view is that independent stock analysis has a key role in protecting investors from stock price manipulation by hedge funds or anyone else.

In various instances, companies have alleged illegal collusion between hedge funds and stock analysts. Overstock.com has claimed that a hedge fund paid an investment advisor to issue false, negative reports on the company, thereby enabling successful hedge fund short-selling.

Biovail Corporation has sued some of the same analysts alleging that they aided hedge fund short selling. These allegations are only claims in court, unproved and unsubstantiated by public evidence. They are a long way from trial, let alone verdicts.

Even if these lawsuits lack any shred of truth, as may be shown, there remains the specter of fraudulent stock analysis used to artificially deflate a stock price in order to benefit hedge fund officials.

I urge the committee to extend the SEC, NYSE, and NASD stock analyst rules to independent research firms and their clients. For example, current rules prohibit investment banking divisions from directing or reviewing stock analyses by in-house analysts. These rules should similarly prohibit clients from directing or reviewing stock analyses of an independent research firm.

Also, by act of Congress, the committee should toughen existing penalties for fraudulent stock analysis.

Federal law prohibits any person "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." Section 17(b) of the Securities Act. Second, regulations have been adopted to address "conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information. . ." Section 15D of the Exchange Act. Third, stock brokers are prohibited from inducing "the purchase or sale of, any security . . . by means of any manipulative, deceptive, or other fraudulent device or contrivance". Section 15 of the Exchange Act.

There are significant civil penalties for any violation of these provisions. For any violation of the securities law, the maximum fine is $5,000 for an individual or $50,000 for a company per violation. For any fraud or manipulation, the maximum fine is $50,000 for an individual and $250,000 for a company per violation. If the fraud or manipulation poses a significant risk of substantial losses to other persons, the maximum fine is $100,000 for an individual and $500,000 for a company per violation.

I urge the committee to consider adding a civil fine of treble damages. Treble damages are a significant deterrent in antitrust law. Similar to antitrust cases, a staggering amount of complex evidence is necessary to prove violations of federal laws prohibiting stock manipulation. Significant civil penalties would help to ensure substantial deterrence.

In addition, the law should prohibit stock analysts from hiding assets behind the cloak of limited liability companies. Fraudulent analysts and others who engage in such schemes often take profits from one scheme and hide or launder them through other corporations. Those illegal profits, like racketeering profits, should be disgorged wherever they are concealed.

Finally, SEC and state enforcement agencies should be given the tools and resources to ensure aggressive investigation and enforcement One possible measure is allowing agencies to retain some civil fines for their enforcement divisions. Fraud and stock manipulation cases require significant resources. Most cases lack a single star witness or document, e-mail or memo. Rather, most fraud and manipulation must be proven by developing a complex set of facts and evidence Complexity and cost are significant obstacles to enforcement actions

Enhanced civil penalties, combined with a federal-state partnership in enforcing the securities laws, will help deter fraudulent stock analysis I look forward to working with the committee in this effort.

STATEMENT OF JONATHAN A. BOERSMA, CFA
DIRECTOR, STANDARDS OF PRACTICE
CFA CENTRE FOR FINANCIAL MARKET INTEGRITY
CFA INSTITUTE

UNITED STATES SENATE
COMMITTEE ON THE JUDICIARY

Hedge Funds and Analysts: How Independent is their Relationship?

Wednesday, June 28, 2006

Good morning. My name is Jonathan Boersma, and I am the Director of Standards of Practice at CFA Institute. I would like to thank Senator Specter, Senator Leahy, and the other members of this committee for the opportunity to speak to you today.

CFA Institute is widely recognized as the organization that, for more than 40 years, administers the Chartered Financial Analyst (CFA®) examination and awards the CFA designation -- a designation I share with nearly 70,000 investment professionals worldwide. While the term "analyst" is part of the name of the designation, our members work on behalf of their clients — investors — in virtually every aspect of the financial services industry. Hence, I am here today to speak on behalf of investors' interests. We take this role seriously. In December 2004, we created the CFA Centre for Financial Market Integrity, which promotes high standards of ethics, integrity, and professional excellence.

The hallmark of membership in CFA Institute is adherence to our Code of Ethics and Standards of Professional Conduct. Each of our members, as well as the more that

100,000 candidates in the CFA program, must abide by, and annually attest to their adherence to, our Code and Standards. Among other things, our Code and Standards:

- require our members to maintain their independence and objectivity,
- prohibit them from engaging in market manipulation,
- require that they perform their research with diligence and rigor; and,
- require that they disclose any conflicts of interest.

CFA Institute maintains a dedicated staff to deal with enforcement, which includes stripping the CFA designation from any member we have found to have violated these rules.

The term "independent research" can have different meanings. It is not simply the product of a firm that lacks an investment banking department. Research can be influenced by any number of sources: internally, through investment banking, or externally, by the company the analyst is covering or by an investor. Client-sponsored or even issuer-paid research (whereby a company with little or no research coverage hires a firm to write a report on their company) is certainly not independent.

The key question is whether such research is "objective?" Research that is by its very nature *dependent* can still be objective. Our Code and Standards mandate that all research must be conducted with integrity, thorough analysis, and care. There must be a reasonable and adequate basis to support and substantiate recommendations. This applies to positive and negative ratings. Analysts must not rely on hearsay or rumors, but must conduct careful investigations and rigorously test their hypotheses.

Conflicts of interest are often present and must be managed appropriately – all with the mandate that investors' interests come first and foremost. In order to maintain trust and confidence in our capital markets, it is critical that such conflicts are minimized to ensure that investors' interests are protected. Thorough disclosure is key here. This means, for example, letting investors know whether the research report has been funded by a third party.

Another conflict that has been raised is whether analysts should be allowed to own — or short — shares in the companies they cover. While some argue that analysts should be prohibited from such ownership, others maintain that analysts should be *required* to own shares because it aligns their interests with those of their clients. Our view is that this is indeed a conflict of interest and, like any other conflict, it needs to be managed carefully —-- through black-out periods, pre-approval of trades, or other means. And this conflict must be disclosed in order to help investors fully evaluate analysts' recommendations. As U.S. Supreme Court Justice Louis Brandeis stated, "sunlight is the best disinfectant."

Last year the CFA Center issued the Asset Manager Code of Professional Conduct. This voluntary code is to be used by asset managers, and hedge fund managers in particular, as a template for developing procedures that protect investors and promote ethical behavior. We believe that asset managers have a responsibility to act with integrity and, relevant to the discussion here today, refrain from market manipulation. Under our code, asset managers must not knowingly spread false rumors, or attempt to influence analysts to rate or recommend a security in a way that benefits the asset manager or their clients.

Asset managers are not prohibited from hiring outside research firms to supplement or validate their own research. Such research may be positive or negative, and asset managers should be free to take investment actions as a result of their own negative views or as otherwise confirmed by an outside research provider. Short-selling plays an important role in our capital markets by providing information, enhancing liquidity, and bringing prices to equilibrium. It is worth noting that if a short seller were to drive down the price of a stock, at some point long buyers would likely start to buy shares and bring the price back to a fair level.

Finally, let me say a word about corporate issuers, because they also have a critical role to play here. In December 2004, CFA Institute and the National Investor Relations Institute issued joint best practice guidelines dealing with the relationship between analysts and corporate issuers. These guidelines, which have been endorsed by the New York Stock Exchange and the Nasdaq, outline the duties and responsibilities of analysts and corporate issuers with the goal of reducing retaliation and improving the integrity of research.

As I stated at the beginning, all analysts have a responsibility to act with integrity and to publish only honest, thorough research. Market manipulation of any kind must be dealt with appropriately – and the Securities and Exchange Commission and self-regulatory organizations are empowered to do so. Yet, analysts must be free to state their opinions and be protected from pressure or threats from the companies when they do so. Not every stock is a "buy", and analysts must have the freedom to say so. Corporate issuers must refrain from trying to influence analysts, because that is market manipulation as well.

There is a deeper problem, though, than what the title of today's hearing suggests – the degree to which short-term investment decisions dominate capital market activity.

If companies focus on long-term performance (and that is reflected in their compensation structure), then they should not care what an analyst says in the short-term. Over the long-term, the analyst will be proved right or wrong, which I believe is ultimately a good way to evaluate these cases. This problem of "short-termism" is not confined to corporate issuers – it affects virtually every participant in the capital markets. CFA Institute and the Business Round Table's Institute for Corporate Ethics will be issuing a white paper on this topic next month. We would be glad to share our recommendations with you when we publish our white paper.

In closing, I would like to thank Senators Specter and Leahy, and the committee for the opportunity to speak with you today. CFA Institute and its Centre are committed to providing any assistance we can offer as you examine these issues.

TESTIMONY OF

Matthew Friedrich, Principal Deputy Assistant Attorney General

and Chief of Staff of the Criminal Division

UNITED STATES DEPARTMENT OF JUSTICE

Before the

Committee on the Judiciary

United States Senate

"Hedge Funds and Independent Analysts:

How Independent are Their Relationships?"

June 28, 2006

I.

INTRODUCTION

Good afternoon Chairman Specter, and members of the Committee. Thank you for the opportunity to appear before you today, and for inviting the Department of Justice to testify about recent developments in corporate fraud prosecutions and the Department's overall efforts to combat white collar crime.

We appreciate the Committee's concern about the relationship between hedge funds and industry analysts. We share your concern that we need to ensure the integrity of the financial markets. The additional tools that Congress provided in the landmark Sarbanes-Oxley legislation have been beneficial in this regard. We work closely with our partners at the SEC who oversee the regulation of the financial markets. While it is the SEC who identifies regulatory violations, they refer to the Department at the earliest opportunity matters with potential for criminal investigation. While I cannot discuss any pending matters in the area that is the subject of this hearing – that is analysts and hedge funds – and there are not any currently closed cases in this area, I would like to assure you that the Department shares your concerns regarding integrity in the marketplace. We are dedicated to utilizing our law enforcement tools to ensure the integrity of the markets and protection of investors and the public from fraud.

Toward that end, I would like to take this opportunity to update you on the progress of the Department's Corporate Fraud Task Force. This update comes just short of four years after the passage of the Sarbanes-Oxley legislation. That far-reaching legislation has been of significant benefit to the efforts of the Department of Justice, and we appreciate the substantial work of the members of this Committee, and the Congress as a whole, in securing its passage. It was a significant achievement that sent a powerful message that the Federal government and the American people would not tolerate corporate malfeasance in the wake of the unprecedented corporate scandals of late 2001 and early 2002 that involved the spectacular collapse of such corporate giants as Enron and WorldCom. The sweeping provisions of Sarbanes-Oxley have helped prosecutors, investigators and regulators combat corporate and white collar fraud through a variety of new statutes including expanded securities fraud provisions, requiring Chief Executive Officers and Chief Financial Officers to certify the accuracy of periodic reports under section 1350 of Title 18, enhanced attempt and conspiracy provisions aimed at fraudulent activity, and expanded criminal provisions to address document destruction and obstruction of justice in the corporate and accounting arena. We are also seeing increased success under these new criminal provisions, including the new general securities fraud statute, section 1348 of Title 18.

II.

White Collar Crime Remains A Priority For The Department Of Justice.

While Sarbanes-Oxley has clearly been a well-heralded success, the problem of corporate and white collar crime nevertheless remains a priority for the Department of Justice. The Attorney General reiterated that message earlier this year when he told all Department of Justice employees that "At every level – federal, state and local – we're enforcing the laws that protect the integrity of our government and corporate institutions. I've told prosecutors to operate with one principle in mind: No one is above the law." The Attorney General made it clear that this principle includes Chief Executive Officers, and he added that, "We will hold corporate executives accountable for the duties that they owe to shareholders." As the Attorney General noted, the Department's emphasis on the accountability of corporate officials remains a top priority because, "Integrity in government and business is essential for a strong America."

III.

The President's Corporate Fraud Task Force.

A hallmark of the Department's commitment to prosecuting corporate and white collar crime is the President's Corporate Fraud Task Force, established three and a half years ago. The Task Force's mandate is to clean up corruption in the boardroom; restore investor confidence in our markets; and send a strong message that corporate wrongdoing will not be tolerated. Since its formation, the Department has worked hard, together with its partners, to move aggressively against corporate fraud and other white collar criminal activity.

That partnership is expansive. The Task Force, chaired by the Deputy Attorney General, includes members from the U.S. Attorney community, the heads of the Department's Criminal and Tax Divisions and a broad range of law enforcement and regulatory agencies, including the Federal Bureau of Investigation ("FBI"), the Postal Inspection Service, the Securities and Exchange Commission ("SEC"), the Commodity Futures Trading Commission ("CFTC"), and the Internal Revenue Service ("IRS"). The Task Force meets periodically in Washington, D.C., to map out strategy and identify best practices. At the working level, the agencies interact daily on individual matters. The Task Force has been a resounding success and remains an essential part of the Department's priority in fulfilling its ongoing mission.

From its inception in 2002 through this past December, the Task Force has obtained over 1,000 corporate fraud convictions, and has convicted 92 corporate presidents, 82 Chief Executive Officers, 40 Chief Financial Officers, 14 Chief Operating Officers, 98 Vice Presidents, and 17 corporate counsel or attorneys. The Enron Task Force alone has charged 34 individuals and obtained 25 convictions to date, which include the convictions last month of former Enron CEO Jeffrey K. Skilling and former Enron Chairman and CEO Kenneth L. Lay. Moreover, in addition to bringing corporate and securities fraud prosecutions, the Task Force has also brought a number of tax prosecutions through the Tax Division, although the details of those cases are beyond the scope of my testimony today.

The Department's enforcement efforts have also sought to prevent the recurrence of criminal activity by requiring significant reforms from corporations under investigation. The Department has applied this approach in resolving investigations involving, among others, PNC Corporation and Computer Associates. Those reforms have included requirements that the companies establish a restitution fund, agree to new policies in connection with financial reporting, perform additional internal audits, and, where appropriate, consent to the monitoring of these procedures by independent auditors.

IV.

Recent Success Prosecuting Securities Fraud under Section 1348, Title 18

Section 1348 of Title 18, enacted by Sarbanes-Oxley is proving to be a potent tool in the fight against securities fraud. Just this month, the United States Court of Appeals for the First Circuit affirmed the sentence of 144 months against Carlos Soto-Cruz who pled guilty to violations of Sections 1348 and 1341 of Title 18 in connection with a 12-year scheme to defraud investors by channeling their investments through fictitious corporate accounts into high risk investments, rather than the promised low risk portfolio. Actual losses to his clients, including two banks, exceeded $10 million dollars.

On February 17, 2006, Timothy C. Moses, former President and CEO of International BioChemical Industries, Inc. ("IBCL"), was sentenced in Atlanta on charges of securities fraud in violation of Section 1348 of Title 18, and perjury. Moses was sentenced to 6 years, 6 months in federal prison to be followed by 5 years of supervised release, and ordered to pay $1.65 million in restitution to IBCL shareholders. Moses was convicted on October 27, 2005 following a two-week jury trial. In all, since its enactment, more than 53 defendants have been charged under Section 1348.

V.

Working With Our Law Enforcement and Regulatory Partners

In pursuing these important white collar and corporate fraud prosecutions, the Department of Justice works closely with a variety of law enforcement entities to bring the investigations, both civil and criminal, to a successful conclusion. The most important law enforcement entity in this arena is the FBI. In large part because of the FBI's unique array of resources, which includes talented and experienced agents and supervisors, many of whom have backgrounds as attorneys or accountants, the Department has been able to efficiently investigate and prosecute a broad range of corporate and white collar crimes. The FBI's expertise and resources are a cornerstone of our white collar crime enforcement efforts.

Another of the Department's partners is the Securities and Exchange Commission. The two agencies have historically maintained separate areas of responsibility, with the Department taking the lead in criminal prosecutions while the SEC addresses civil enforcement actions and regulatory oversight. But that subject-matter separation has not stood in the way of the Department's commitment to work cooperatively with the Commission in attacking corporate fraud and white collar crime.

This cooperative effort has garnered several notable successes, including:

- In 2005, the SEC and the Department of Justice announced an agreement to settle a civil enforcement action and resolve criminal charges against Adelphia Communications Corporation for its part in one of the most extensive financial frauds ever committed within a public corporation. The Government was able to recover more than $1.5 billion in forfeited assets from which Adelphia paid $715 million in restitution, secure permanent injunctions barring founder John J. Rigas and his sons from further violations of the federal securities laws, and obtain an order barring them from acting as officers or directors of any public company. In a related settlement, Deloitte & Touche LLP agreed to pay $50 million to settle charges arising from its 2000 audit of Adelphia and consented to a substantial overhaul of its procedures for audits of high risk clients. In conjunction with this investigation, the Department of Justice also convicted Rigas and his sons for crimes stemming from the fraudulent scheme. The Rigases have since been sentenced, with founder John Rigas receiving a sentence of 15 years of imprisonment.

- The Department of Justice successfully prosecuted WorldCom CEO Bernie Ebbers, who was sentenced to 25 years of imprisonment and ordered to pay up to $45 million in restitution. The SEC obtained court approval of a plan to distribute more than $500 million and 10 million shares of MCI stock valued at $250 million, that it obtained from WorldCom, to a fund to compensate the victims of the company's widespread accounting fraud.

- In February 2006, the Department of Justice and the SEC each reached an agreement with AIG Insurance in which AIG accepted responsibility for its involvement in two fraudulent transactions and agreed, among other things, to pay $25 million in penalties to the United States, to cooperate in the government's ongoing criminal investigation, and to simultaneously pay the SEC a fine of $100 million and disgorge $700 million.

These successes, and others, are directly attributable to effective interagency coordination, which ensures focus and maximizes the combined efforts of the Department, including the United States Attorneys, the Criminal Division, the FBI, other key law enforcement agencies such as the Postal Inspection Service, the IRS, CFTC, and the Commission.

VI.

Voluntary Disclosures

In addition, corporations have increased the effectiveness of their compliance programs in the wake of the Sarbanes-Oxley and the stepped up enforcement efforts of the Department and its partners. General Electric Corporation voluntarily disclosed to the Department and the SEC in 2004 that employees of InVision Technologies, a maker of airport security screening devices that GE was considering acquiring, had paid or offered to pay bribes to foreign officials in Thailand, China and the Philippines. GE detected these violations while it was performing due diligence on InVision and voluntarily reported them. In December 2004, the Department entered into nonprosecution agreements with General Electric and InVision Technologies. InVision disgorged almost $600,000 in profits and paid a criminal penalty of $800,000, and GE agreed to integrate InVision into its own Foreign Corrupt Practices Act compliance program.

It is also important to note that our corporate fraud enforcement efforts encompass health care fraud prosecutions. The Corporate Fraud Task Force has encouraged an alternative approach to addressing the unique challenges in health care fraud cases related to publicly-traded health care companies. The Task Force has been largely successful in prosecuting these health care companies and the responsible officers by focusing on public misrepresentations of their financial condition and operations. For example, 17 defendants were convicted in the HealthSouth case, a case that focused on fraudulent accounting practices. At the same time, we have achieved success in addressing the problem of an underlying corrupt corporate culture in cases like HealthSouth, where the company agreed to pay the Government $325 million plus interest and entered into a company-wide 5-year corporate integrity agreement with the Office of Inspector General of the Department of Health and Human Services. This settlement agreement resolved allegations of Medicare Part A cost report fraud uncovered during the Government's investigation of the company's financial statements. The settlement also resolved allegations that the company submitted false claims to Medicare Part B for certain outpatient physical therapy services

In addition to bringing various corporate fraud and white collar prosecutions, the Department has also placed a premium on training prosecutors and investigators on investigating and charging corporate and white collar cases. Immediately after the passage of Sarbanes-Oxley, the Department undertook an effort to train prosecutors across the country on its landmark provisions. The Department also regularly conducts detailed training programs, incorporating its most experienced personnel in the Criminal Division and United States Attorney's Offices, on securities fraud and white collar crime for prosecutors and investigators. We also use our Securities and Commodities Fraud Working Group to keep prosecutors updated on the latest developments in the field.

VII.

Conclusion.

The story of the Department of Justice's efforts to prosecute corporate corruption is ongoing. Much of that effort has built upon the impressive arsenal of new laws that are contained in the landmark Sarbanes-Oxley legislation and in the Department's commitment to follow through on the clear and unmistakable mandate laid down by the Congress. In partnership with our civil and law enforcement colleagues at the local, state, federal and international levels, we now have the attention of the corporate community, and our corporate citizens are stepping up to the plate to meet these new requirements. These efforts are a cornerstone to the Department's efforts to strengthen the integrity of the market place, protect the public, and restore confidence in our corporate institutions.

Thank you again for the opportunity to testify. I look forward to your questions.

STATEMENT OF SENATOR CHUCK GRASSLEY, SENATE JUDICIARY COMMITTEE HEARING "HEDGE FUNDS AND INDEPENDENT ANALYSTS: HOW INDEPENDENT ARE THEIR RELATIONSHIPS?"

Chairman Specter, I'm pleased that you are holding this oversight hearing on hedge funds and independent analysts. I share the Chairman's concerns regarding corporate fraud and integrity in the marketplace. The allegations we're hearing today remind me of the Enron debacle, where positive accounting information was fabricated and disseminated about that company to increase the value of its stock. This Committee held hearings on Enron's fraudulent partnerships and accounting practices, and we passed legislation included in the Sarbanes-Oxley law that strengthened the criminal prosecution of persons who defraud investors of publicly traded securities. The Sarbanes-Oxley law also included a provision that I authored with Senator Leahy providing whistleblower protections to individuals who raise concerns about fraudulent activity. All in all, I thought that the Sarbanes-Oxley law had done much to assist federal regulators prosecute illegal activity and keep our financial markets on the up and up.

But maybe we didn't do enough. The wholesale fabrication of information in collaboration with market players to pull down the price of a stock sounds suspect to me. In my mind, this kind of market manipulation seriously distorts the integrity of the financial marketplace, and everyone – that is, everyone except the bad actors - loses. So, I'm glad that we are looking into these practices, what is legitimate and what is not. What is "independent" analysis? Is research ever "independent"? Is there enough scrutiny of this kind of activity, or do we need more disclosures and safeguards in the trade?

I want to make sure that the Department of Justice and the Securities and Exchange Commission are being aggressive in their investigations of alleged wrongdoing. I want to make sure they are doing everything in their power to protect investors and the public from fraudulent activity and manipulation of the marketplace. Moreover, I want to find out whether the Department of Justice has a need for more tools and/or resources to get the job done. The stakes are high, because so many are impacted by fraudulent market information – pension plans, small investors, seniors, ordinary workers and their families. So we need to support our enforcement agencies in their efforts to clean up the market, and make sure that we have tough laws in place to not just punish, but deter, these bad actors.

STATEMENT OF STANTON GREEN,

CHAIRMAN OF INVESTORSIDE RESEARCH ASSOCIATION

BEFORE THE SENATE COMMITTEE ON THE JUDICIARY

U.S. SENATE

JUNE 20, 2006

"Hedge Funds and Independent Analysts: How Independent are their Relationships?"

My name is Stanton Green. I am Chairman of the Investorside Research Association ("Investorside"). I appreciate the opportunity to provide this statement for the record on behalf of Investorside regarding the role it plays in promoting independent research.

Investorside is an independent trade organization formed in 2002 by a group of independent research firms. We are a non-profit trade association that includes 73 leading investment research firms who provide individual and institutional investors with investment ideas, recommendations, and research services. To become a member of Investorside, a research firm must not engage in investment banking or company consulting; in addition, firms must be primarily paid by clients and not companies who are the subjects of the applicant's research coverage. Our members cover the entire spectrum of research methodologies, markets, and instruments.

Our mission is to increase investor and pensioner confidence in the U.S. capital markets system through the promotion and use of independent investment research; research that is both free from conflicts and financially aligned with investor interests. We try to accomplish these goals by:

- Certifying that our members are free of investment banking, consulting, and research-for-hire conflicts and providing certified member firms with the trademarked Investorside seal;
- Promoting the growth of independent research by exposing member firms to individual and institutional investors through Investorside annual conferences and regular media communication;

- Promoting government policies that encourage the use of independent research by representing our members' interests before regulators, lawmakers and industry groups; and
- Promoting the use of investment research that is aligned with investor interests.

History:

At the time of Investorside's inception, the SEC, the New York Attorney General's office and Congress were focused on examining potential conflicts within research departments at the large investment banks. As you are aware, systemic conflicts were found and determined to be caused by ties between the research and investment banking departments at several firms.

We knew that regulators, lawmakers and investors needed a better understanding of what truly independent research really is. In fact, the use of the term "independent research" was being used by firms with investment banking conflicts and with no effective firewalls or policies in place to prevent potential bias. Investorside developed because of the need to better define "independent research" and to illustrate that true "independent research" is not associated with such conflicts.

Our membership criterion allows investors to distinguish between our members, who provide independent research free of investment banking conflicts, and research firms with investment banking conflicts. The main purpose of this distinction is to align ourselves with the interests of investors, both institutional and retail. Prior to accepting a firm for membership, our Membership Committee reviews the applicant's research, marketing materials, and Web site for conflicts, paying particular attention to the applicant's research disclaimer. Members must be re-certified every three years.

Once firms become certified providers of Investorside research, they must abide by the Investorside's Code of Ethics. This code requires firms to maintain the highest standards of integrity and professionalism, promote truth and fair representation in investment research, and serve investors forthrightly. Investorside has tasked itself with increasing the awareness of the financial interests behind investment research and educating investors as to how they can promote better research that is better aligned with their interests.

We continuously work to reduce regulatory and industry barriers to competition. We do this by continually striving to gain regulatory parity between independent research and research produced by firms with investment banking conflicts. We also advocate transparency in the use of commissions to pay for research. In this respect, we have worked with the Educational component of the 2003 Global Research Analyst Statement (the "Global Settlement") to promote the values of transparency.

These initiatives have increased investor confidence in the market. In February 2003, the Gallup Index of Investor Optimism dropped to 9 from 115 in January 2002 as a result of the New York Attorney General's investigation and corporate/accounting scandals. That was the lowest level the index had reached since it's inception in 1996. Investors surveyed cited corporate and accounting scandals more than terrorism or war as a reason for their lack of confidence. Optimism has rebounded since that time with both independent research and Investorside playing vital roles.

Recent Events:

Investorside is a body comprised of individuals and institutions with high integrity and a true desire to aid the financial markets. Our very existence, goals and certification process is proof that we take conflicts within our industry very seriously and have a desire to eliminate them altogether. We believe that free markets are built on the trust of investors and that this trust must be earned every day.

One of the primary purposes of the Global Settlement was to encourage the expansion of independent research so that retail investors would have a chance to see unbiased reporting before making important investment decisions. Thirty-five percent of the firms chosen to provide independent research as a part of the Global Settlement are members of Investorside.

As you are aware, many research firms provide "buy", "hold" and "sell" recommendations. Prior to the Global Settlement, studies showed that there were a disproportionate number of "buy" recommendations to "sell" recommendations. Many believe that the heavy weighting toward "buy" recommendations existed due to the conflicts between the research departments and the investment banking departments within the large investment banks. Positive recommendations helped investment bankers secure capital market transactional business from their clients. In fact, according to Buys, Holds, and Sells: The Distribution of Investment Banks' Stock Ratings and the Implications for the Profitability of Analysts' Recommendations[1], in 2000, 2% of all recommendations were "sell" recommendations, as opposed to 74% "buy" recommendations. In 2003, "sell" recommendations constituted 17% of all recommendations versus 42% "buy" recommendations. In 2005 "buy" recommendations fell to 28.2% of all recommendations. This dramatic shift is extremely positive for the market. Setting aside market dynamics that might dictate more "sell" recommendations, the drastic increase in the percentage of "sell" recommendations shows that the conflicts and pressures associated with investment research have been reduced. It also exemplifies the positive impact that independent research and Investorside have had on creating a more level playing field which, in turn, promotes confidence in our markets.

While Investorside does not promote or encourage "buy," "hold," and "sell" recommendations, we do believe in a conflict free environment where full disclosure is available to allow investors to make better decisions. Accordingly, we would recommend that the Committee keep the following important points in mind as it digests the current events:

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[1] Barber, Brad M., Reuben Lehavy, Maureen McNichols, and Brett Trueman. Buys, Holds, and Sells: the Distribution of Investment Banks' Stock Ratings and the Implications for the Profitability of Analysts' Recommendations. 16 June 2006.

First, as the number of "sell" recommendations increases there will be continued assault on those analysts and firms that are providing true and accurate, but negative information regarding an issuer. If, for example, a company has partaken in accounting fraud, they, of course, will not be pleased with a research firm that begins to uncover such issues. Rather, such companies will likely take measures to dissuade research firms from writing and exposing the truth. Regulators, research firms and lawmakers must act together to ensure that independent voices are not silenced.

Second, Investorside believes that ethical, transparent behavior is the hallmark of independent research. If a firm engages in unethical behavior or violates securities laws, the firms, or its employees should be prosecuted to the fullest extent of the law. We therefore do not recommend further regulation but encourage prosecution of illegal activity.

In conclusion, we at Investorside believe we are succeeding in our goals. Independent research is viewed favorably within the industry by investors who rely on this research to make sound business decisions. Additionally, the market has shown that independent research continues to provide value to investors.

Thank you again for the opportunity to provide this testimony

UNITED STATES SENATE

COMMITTEE ON THE JUDICIARY

Hedge Funds and Independent Analysts:
How Independent are Their Relationships?

JUNE 28, 2006

TESTIMONY OF MARC E. KASOWITZ

My name is Marc Kasowitz. I would like to thank the Committee for inviting me to testify this morning concerning the relationship between certain hedge funds and supposedly independent securities analysts.

I am the senior partner of Kasowitz, Benson, Torres & Friedman LLP, a 180-lawyer firm based in New York City with offices around the country.

Our firm has developed considerable expertise and experience in the subject this Committee is considering today. We represent a number of clients who have been severely harmed by the market manipulation activities of, and collusion among, certain extremely powerful hedge funds and supposedly independent securities analysts and research firms.

We already have filed a lawsuit, on behalf of one of our clients, against some of those hedge funds and analysts. We are currently investigating and analyzing claims on behalf of other clients. While the lawsuit we filed and the other investigations are addressing the illegal activities of certain hedge funds, I want to make clear that this is in no way a vendetta against hedge funds generally. In fact, our firm represents many hedge funds in a variety of matters. The concerns raised by our investigations have nothing to do with those and many other hedge funds, which engage in perfectly legal and legitimate investment and market activities, and have nothing to do with truly independent securities analysts.

However, what a number of our clients and other companies have experienced is truly shocking. Those companies have been targets of a pattern of egregious collusion between certain influential hedge funds and supposedly independent analysts -- whose research, in effect, was bought and paid for by the hedge funds -- in order to further illegal market manipulation schemes, typically involving short-selling.

Short-sellers are investors who take positions in stocks on the expectation that the stock price will decline. Here we are not talking about short-sellers who trade legally based on honestly-held and reasonably-based opinions derived from the public record. Instead, we are talking about short-sellers who engage in schemes to manipulate the market and drive the price of those stocks down through, among other things, the dissemination of unfounded or grossly exaggerated negative research reports and other disinformation.

One particularly effective illegal strategy involves the following scenario: the short-selling hedge fund selects a target company; the hedge fund then colludes with a so-called independent stock analyst firm to prepare a false and negative "research report" on the target; the analyst firm agrees not to release the report to the public until the hedge fund accumulates a significant short position in the target's stock; once the hedge fund has accumulated that large short position, the report is disseminated widely, causing the intended decline in the price of the target company's stock. The report that is disseminated contains no disclosure that the analyst was paid to prepare the report, or that the hedge fund dictated its contents, or that the hedge fund had a substantial short position in the target's stock. Once the false and negative research report -- misrepresented as "independent" -- has had its intended effect, the hedge fund then closes its position and makes an enormous profit, at the expense of the proper functioning of the markets, harming innocent investors who were unaware that the game was rigged, and damaging the target company itself and its employees.

There are a number of other ways that certain short-sellers and their analyst co-conspirators proactively manipulate the market to bring about the very stock price declines from which they reap huge, illegal profits. We have seen, in increasing frequency, orchestrated efforts by short-selling hedge funds to drive down stock prices through surreptitious campaigns aimed at disseminating unfounded or grossly exaggerated disinformation. Such disinformation is spread in the financial press or internet chat boards, in investor conference calls, at analyst presentations, and at industry conferences. There are organized campaigns to communicate egregiously false information to a target company's key board members, largest shareholders, principal banks and outside auditors. We are aware of instances in which the perpetrators of such campaigns have sought to instigate regulatory investigations based on disinformation, in order to cause more adverse publicity about the targeted companies.

The effects of these orchestrated campaigns can be devastating. They severely erode investor confidence in the target companies. That erosion in turn artificially depresses stock prices, exaggerates market reactions to bad company news, and suppresses market reactions to positive company news. Moreover, even the mere existence of such disinformation in the marketplace invariably leads the media and regulators to investigate the rumors, and the resulting publicity and investigations exponentially aggravate the severity and duration of the negative effect. What results is a self-sustaining downward pressure on a stock that is extremely difficult -- if not impossible -- to reverse. And although this pressure is artificial, the devastating impact on the company and its shareholders can be and often is enormous.

These attacks consume massive amounts of corporate time, attention, and resources that would otherwise be devoted to running the business. The cloud under which companies targeted by these attacks must operate frequently impairs or destroys critical business relationships, including relationships with major customers and other companies, lenders, banks and the capital markets. The damage to the targeted companies as a result of these attacks provides huge profits to the short-selling perpetrators of the disinformation campaigns, to the great detriment of honest investors.

Those who would prefer to avoid scrutiny of these aggressive and illegal short-selling market manipulation practices -- including the role of analysts in these practices

-- seek to obscure the real issue. The real issue is not whether a robust exchange of investment ideas or legal short-selling should be permitted or enhances market efficiency, and it is not whether truly independent capital market research is desirable. There is no question that a robust exchange of information is critical to the capital markets. There is no question that unbiased and uncorrupted market research is desirable. There is no question that legal short-selling is an appropriate and even desirable market activity.

Nor am I suggesting that there is anything wrong with someone sharing their opinions -- whether positive or critical concerning a company or investment -- on the internet, at investor conferences, with journalists, or otherwise.

That is not our position at all. Our position simply is that all such activities must be done within the law. Just as a public company or its investors are not permitted to make material misstatements and omissions for the purpose of increasing the price of the stock, likewise short-sellers and their analyst co-conspirators may not spread false, misleading, unfounded, or exaggerated information for the purpose of creating or accelerating a decline in stock price.

The problem of corrupted and co-opted securities research is not a new one, and it has, in recent years, been a major focus of regulatory attention to the securities markets. In the late 1990's and early 2000's, for example, analysts employed by major investment banks were found to have adjusted their purportedly "independent" securities research in order to accommodate companies with which their associated investment banking operations did -- or sought to do -- business. As a result of the scandals arising out of these conflicts-of-interest, Congress, as part of the Sarbanes-Oxley legislation, mandated that the Securities and Exchange Commission address such conflicts.

The rules promulgated under Sarbanes-Oxley thus sought to insulate analysts from the influence of their firms' investment banking business. However, an unintended consequence of those rules was a large increase in the number of purportedly independent research firms, certain ones of which tout their purportedly conflict-free "unbiased" analysis, but which provide anything but. Instead, certain of these firms provide supposedly independent analyses, which are bought and paid for -- and even ghost-written -- by the short-selling hedge funds. If anything, this has made the problem worse. Whereas, formerly, investors at least knew (or were on notice) that stock analysts had potential conflicts because of their disclosed employment by investment banking firms, now these analysts claim

-- falsely -- that their disengagement from those firms has rendered them "independent." Nothing could be further from the truth. Instead, these analysts provide custom-made research designed to further the goals of the short-selling market manipulators who pay them.

Prior legislation also failed to anticipate the development of a potentially even more serious conflict arising from the exploding growth in the hedge fund industry and in the amount of commission revenues that industry generates for Wall Street firms providing brokerage services. Hedge funds now control well over a trillion dollars in capital, and their highly active trading strategies generate huge trading commissions for Wall Street's largest firms. As Wall Street's largest customers, hedge funds exercise enormous power on Wall Street, which certain hedge funds use to influence in-house analyst recommendations and to secure privileged access to non-public information, for the purpose of trading on that information before it becomes available to the market.

* * *

The conduct of certain hedge funds, in collusion with various analysts, has developed into a pervasive pattern of market manipulation that is insidious, egregious and widespread. While civil remedies exist to address the damage caused by such misconduct on an individual basis, and there is a statutory basis for prosecuting criminal collusion between hedge funds and analysts,[1] this Committee should consider whether further steps are necessary and appropriate to address and remedy this serious and growing problem.

[1] Sarbanes-Oxley included a broad and clear new securities fraud provision, 18 U.S.C. § 1348, introduced by this Committee, which provides the Department of Justice with the authority to prosecute securities fraud involving corrupt analysts and those, including hedge funds, that work with them. Under that provision, for example, the United States Attorney in Missouri recently prosecuted a securities analyst who was attempting to extort money from a company he covered in exchange for his agreement to stop issuing negative research reports on the company. The U.S. Attorney in that case correctly observed that "[a] corrupt financial analyst can affect millions of dollars worth of investments and individuals' life savings and retirement plans" and is "intolerable." (See http://stlouis.fbi.gov/dojpressrel/pressrel04/stlouis101804.htm)

June 28, 2006

Testimony by Owen A. Lamont
Yale School of Management

I am honored to have this opportunity to testify about hedge funds and analysts.

As an economist, I am concerned with prices. It is important that we get the prices right. When security prices are wrong, resources are wasted and investors are hurt. In order to get prices right, we need to allow all information, both positive and negative, to get into the market. In the world of financial markets, just like the worlds of politics or science, free speech and open discussion of ideas is essential.

Unfortunately, US financial markets and institutions have a substantial bias against discovery and dissemination of negative information. Bad news is suppressed while good news is accepted. This bias comes in many ways. One is the difficulty of short selling. Short selling, which today is done primarily by hedge funds, is an important channel for negative information to get into the market. A second and related element is retaliation against any public criticism of a company from anyone, including journalists, short sellers, or analysts.

What happens when negative information is suppressed? Stocks can become overpriced because only optimistic opinions are reflected in the stock price. An example is Enron, which became massively overpriced before market participants realized it was a fraud. To prevent future Enrons from occurring, we need to make sure pessimistic voices are allowed to be heard.

Short selling

Our current financial system is not set up to encourage short selling. We have well-developed institutions, such as mutual funds, to encourage individuals to buy stocks, but few institutions to encourage them to short. As events of 1999-2000 made clear, the infrastructure of our system, such as analysts, underwriters, and some elements of the media, have an overly optimistic bias. In addition to this optimistic bias, there are technical issues with short selling related to our system of lending equities. Simply put, our system is not designed to facilitate short selling of equities, and it can be difficult or impossible to short some stocks.

Constraints include various costs and risks, such as the expense and difficulty of shorting, legal and institutional restrictions, and the risk that the short position will have to be involuntarily closed due to recall of the stock loan. If these impediments prevent investors from shorting certain stocks, these stocks can be overpriced and thus have low future returns until the overpricing is corrected. In addition to the problems in the stock lending market, there are a variety of other short sale constraints. Regulations and procedures administered by the SEC, the Federal Reserve, the various stock exchanges, underwriters, and individual brokerage firms can mechanically impede short selling. Legal and institutional constraints inhibit or prevent investors from selling short.

Analysts

Part of the optimistic bias in our system comes from analysts from investment banks. These analysts have an incentive to curry favor with issuing firms in hopes of gaining future underwriting business from the issuers. There is substantial evidence that these analysts are corrupt and intentionally issue overly rosy forecasts. This evidence comes in two forms. First, there is direct evidence gathered by the SEC and other authorities, resulting in 2003 in the $1.4B settlement between regulators and securities firms. This evidence left little doubt that the obvious conflict of interest for sell-side research analysts resulted in dishonest forecasts.

Second, academics have gathered a great deal of indirect evidence indicating corrupt and over-optimistic behavior by analysts employed by investment banks (see Bradshaw et al, 2003). Despite the 2003 settlement and other regulatory changes, it appears that most investment banks continue to be overly optimistic in their forecasts.

The antidote to this problem is independent research analysts, unaffiliated with any investment bank (as mandated by the 2003 settlement). In the case of Enron, for example, Healy and Palepu (2003) showed that independent analysts were less over-optimistic about Enron's prospects. Unfortunately, independent analysts also have reasons to be optimistic. First, if they are critical of the company they cover, they may be denied access to information by the company. This problem has been reduced, but not wholly eliminated, by Regulation FD (which the SEC instituted in 2000). Second, independent analysts who issue negative reports may be sued or otherwise harassed by the companies they cover. Lawsuits are a particular threat to independent analysts who typically lack the resources to withstand legal costs.

Evidence for overpricing

A variety of evidence suggests that when stocks are difficult to short, they get overpriced. One example I have studied is battles between short sellers and firms (Lamont, 2003). Firms don't like it when someone shorts their stock, and some firms try to impede short selling using legal threats, investigations, lawsuits, and various technical actions. Consistent with the hypothesis that short sale constraints allow stocks to be overpriced, firms taking these anti-shorting actions have in the subsequent year very low abnormal returns of about -24 percent per year. The negative returns continue for up to three years. What appears to be happening is that these companies are overpriced, either because of excessively optimistic investor expectations, faulty products or business plans, or just plain fraud on the part of management.

Firms can take a variety of actions to impede short selling of their stock. Firms take legal and regulatory actions to hurt short sellers, such as accusing them of illegal activities, suing them, hiring private investigators to probe them, and requesting that the authorities investigate their activities. Targets of legal harassment also include journalists and analysts. Firms take technical actions to make shorting the stock difficult, such as splits or distributions specifically designed to disrupt short selling. Management can coordinate with shareholders to withdraw shares from the stock lending market, thus preventing short selling by causing loan recall. These battles between short sellers and firms can be extraordinarily acrimonious. The following statement from the sample I used gives a flavor of attitudes toward short sellers: "Your activities are mean, shameful and loathsome. They are motivated by appalling avarice and greed, and they will not be permitted to go unanswered."

An example of the various anti-shorting strategies used by firms is provided by Solv-Ex, a firm that claimed to have technology for economically extracting crude oil from tar-laden sand. Short sellers claimed that Solv-Ex was a fraud. On 2/5/96, the management of Solv-Ex faxed a letter to brokers and shareholders: "To help you control the value of your investment…we suggest that you request delivery of the Solv-Ex certificates from your broker as soon as possible." This suggestion, entirely legal on the part of Solv-Ex, was essentially an attempt at market manipulation. The letter was an attempt to orchestrate a short squeeze using the stock lending system.

Any shareholder heeding Solv-Ex's suggestion would have withdrawn his shares from the stock lending market, potentially forcing short sellers to cover their positions. On 2/2/96, before the letter, Solv-Ex's price was at $24.875. By 2/21/96, the price had risen to $35.375, perhaps due to Solv-Ex's attempted squeeze. Solv-Ex took other action against short sellers as well. Later in 1996, Solv-Ex said that it had hired private investigators to find out who was spreading misinformation about the firm, and subsequently it filed suit against a well-known short seller, claiming he had spread false information. However, in this case it was Solv-Ex which was engaged in illegal activities, not the short sellers. Solv-Ex delisted at 7/1/97 at $4.25, amid an SEC investigation of whether Solv-Ex had defrauded investors. It entered Chapter 11 bankruptcy in 1997, and in 2000 the court ruled that the firm had indeed defrauded investors.

In this case, the evidence is consistent with the idea that Solv-Ex was overpriced in February 1996, since it subsequently fell sharply. My study, Lamont (2003), looks at long-term returns for a large sample of 270 similar firms who threaten, take action against, or accuse short sellers of illegal activity or false statements. It turns out that (as in the Solv-Ex case) sample firms have very low returns in the year subsequent to taking anti-shorting action. Returns relative to the overall stock market are approximately -24 percent per year. The evidence is strongly consistent with the idea that short sale constraints allow very substantial overpricing, and that this overpricing gets corrected only slowly over many months.

While the underperformance of -24% per year is very large, it is similar in magnitude to the range found in other studies of stocks with very high short sale constraints, such as Jones and Lamont (2002), Lamont and Thaler (2003), and Ofek, Richardson, and Whitelaw (2003). Jones and Lamont (2002) find data for six years (1926-1933) while Lamont and Thaler (2003), and Ofek, Richardson, and Whitelaw (2002) studied data for a few years around the year 2000. Each one of these four data sets has unique characteristics, and it is conceivable that any one result reflects chance or an unusual sample period. But taken together, the evidence shows that in extreme cases where short sellers want to short a stock but find it difficult to do so, overpricing can be very large.

Fraud

A notable feature of the data is that many of the firms fighting with short sellers and analysts are subsequently revealed to be fraudulent. A variety of other evidence suggests that short sellers are good at detecting and publicizing fraud on the part of firms (Dechow, Sloan, and Sweeney 1996, Griffin 2003). An SEC official testified that "many of the complaints we receive about alleged illegal short selling come from companies and corporate officers who are themselves under investigation by the Commission or others for possible violations of the securities or other laws." (U.S. House of Representatives, 1991, Pages 434-435). The SEC and other regulators cannot be our only line of defense against corporate fraud. To protect investors, we need a vibrant short selling community.

The case of Enron illustrates many of the benefits of short sellers. It was short sellers who first raised red flags about Enron's accounting. These short sellers were able to communicate to the media, which helped publicize the problems. Short sellers helped detect and stop the fraud at Enron before it got any worse. Indeed, the problem with Enron was that there were too few short sellers and they arrived too late. Had short sellers been more numerous and aggressive, perhaps they could have detected the fraud earlier and prevented much of the damage done by Enron. Executives from Enron, in their recent trial in Houston, claimed short sellers had caused the demise of the company. This is nonsense; the jury didn't buy this story, and neither should you.

Tech stock mania

Even absent corporate fraud, though, short sellers play an important role in protecting individual investors from overpriced stocks. When informed traders are not able to go short, it will be small investors who unwittingly buy the overpriced stock, while the smart money stays away. For example, during the tech stock mania in 2000 there were some stocks that though clearly overpriced were not shortable for technical reasons. The victims were the individual investors who bought these stocks and suffered substantial losses. An example, documented in Lamont and Thaler (2003), is Palm, Inc. Palm was irrefutably overpriced in March 2000, but was difficult or impossible to borrow in the stock lending market, and thus could not generally by sold short. Institutions avoided owning Palm, and individual investors who blindly bought Palm suffered as it subsequently declined.

More generally, suppose we consider the possibility that Internet stocks were priced much too high around 1998-2000. Perhaps many investors thought that Internet stocks were overpriced during the mania, but only a small minority was willing to take a short position, and these short sellers were not enough to drive prices down to rational valuations. As a result, billions of dollars was wasted on uneconomic enterprises, millions of investors suffered losses, and hundreds of thousands of workers switched jobs only to see their new companies fail. It seems to me that the problem was not enough short selling in 1998 to prevent stock prices from reaching untenable levels.

Historical pattern

There is a natural tendency to feel that short selling is somehow inherently malevolent or un-American. To the contrary, it is quite positive for our economy to correct overpricing and detect fraud. And nothing could be more American than free speech, free markets, and a healthy competition among ideas and firms. If we are to have liquid markets that properly reflect available information, investors must be able to buy sell stocks as well as buy stocks.

Governments often restrict short selling in an attempt to maintain high security prices. Meeker (1932) reviews the attempts by a colorful cast of characters (from Napoleon to the New York state legislature) to ban short selling. Unfortunately, short sellers face periodic waves of harassment from governments and society, usually in times of crisis or following major price declines as short sellers are blamed. Short sellers are often thought to be in league with America's enemies. The general idea is that short selling is bad, and when bad things happen (such as war) it probably involves short sellers in some way. For example, the New York Stock Exchange imposed special short selling regulations during World War I (in November 1917), in response to both a substantial market decline and a fear that the Kaiser would send enemy agents to drive down stock prices. Jones and Lamont (2002) discuss another historical episode following the crash of 1929. The anti-shorting climate was severe in October 1930. President Herbert Hoover met with the president of the NYSE to discuss the situation and to curtail possible bear raids implemented via short-selling. The FBI's J. Edgar Hoover was quoted as saying he would investigate the conspiracy to keep stock prices low. Numerous anti-shorting regulations stem from this period, such as the uptick rule and the Investment Company Act of 1940 which placed severe restrictions on the ability of mutual funds to short.

This historical pattern has continued in recent years, as press reports indicate that authorities in Japan have sought to discourage shorting. Thankfully, in the past few years, Congress and the SEC have shown admirable restraint in not succumbing to the temptation to blame short sellers for the market decline following 2000.

Manipulation

It is of course appropriate for the SEC and other authorities to investigate possible manipulation involving short sales. But in general, there is no reason to believe that short selling is more likely, compared with other trading activity, to be used to manipulate stock prices. In fact, there are reasons to believe that short selling is less likely to be involved in illegal manipulations. There are even certain types of manipulation (such as "cornering" the stock) in which short sellers are the desired victims of manipulation.

Certainly, the big story from the past few years has been questionable behavior on the part of issuing firms, analysts, accounting firms, and underwriters. The short sellers have been the heroes of the past few years, alerting the public and the authorities to corporate fraud. And it has been the hedge funds which have simultaneously preserved investor capital and corrected mispricing.

Recommendations

My opinion, therefore, is that we need to change the current lopsided system that discourages short selling. First, in the narrow technical arena, we should consider ways to make the equity lending system work better. It seems particularly unhelpful that (sometimes fraudulent) firms are able to abuse various aspects of the system in order to prevent short selling. Second, in the broader arena, we should continue to encourage the development of institutions that channel capital into short selling. Happily, there are signs of progress on both fronts, and as more capital is devoted towards short selling it is likely that market forces will help improve the efficiency of the equities lending system. Third, it would be useful to consider ways of protecting independent analysts from lawsuits. It is important that analysts not be reduced to cheerleaders, but rather be allowed to express honest opinions.

Congress and the SEC will continue to hear complaints from companies about short sellers. As I mentioned earlier, the evidence shows that when companies and short sellers fight, it is the short sellers who are usually vindicated by subsequent events. For example, in 1989, the House Committee on Government Operations (Commerce, Consumer and Monetary Affairs subcommittee) held hearings about the alleged evils of short selling, featuring testimony from supposedly victimized firms. Officials from three firms testified. Subsequent to this testimony, the presidents of two of these three firms were charged with fraud by the SEC.* Thus when you hear companies complain, keep in mind that short sellers are often the good guys.

Thank you for this opportunity to testify, and I would be happy to answer any questions.

* The three firms were American City Business Journals (Wall Street Journal, 1991), Carrington Laboratories (U.S. House of Representatives, 1991, p. 513), and IGI, Inc. (Wall Street Journal, 2002)

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The Subversion of Our Stock Markets Through the Illegal Shorting of Shares is Destroying Hundreds of Companies and Erasing Untold Billions in Shareholder Equity

Written only as the opinion of Greg Manning; not to be relied upon by anyone except the Senate Judiciary Committee[1]

I am writing this overview of what, in my opinion, is a well-orchestrated manipulation of share prices solely in my role as a shareholder of Escala Group, Inc. (ESCL), which was formerly known as Greg Manning Auctions, Inc. (GMAI) until September 28, 2005. Greg Manning Auctions (now an Escala Group company) is a collectibles-related company that conducts philatelic auctions in the United States, Europe and Hong Kong. Through other divisions of the company, Escala Group also sells coins via live auctions, Internet auctions and wholesale sales; as well as historic arms & armor through live auction sales. The company's majority shareholder (67%) is Afinsa Bienes Tangibles, SA (Afinsa) of Madrid, Spain. Since August 2003, GMAI has also been, by contract, the exclusive supplier of philatelic collectibles to Afinsa. I served as CEO of GMAI until September 28, 2005.

To avoid confusion, I will refer to the company by its former name, Greg Manning Auctions, Inc. (GMAI), which was in place during most of the events outlined in this piece. Consequences of these events included a $700 million loss of market value in GMAI share price, approximately 3,500 jobs lost in Europe and the United States, as well as other losses that have yet to be defined. On a personal level, I currently still own all of the GMAI shares that I have acquired since GMAI's initial public offering on May 20, 1993. As a result of what I believe was a coordinated effort to harm GMAI, the bulk of my personal worth has been decimated by well over a $60 million loss in share value.

I write this piece today and offer my opinions in the hope that legislation can be drafted and approved that will stop this type of activity from harming other companies and possibly, in the

[1] "Escala Group, Inc. has not authorized or approved the attached report and, accordingly, the report should not be construed as representing the views of Escala Group, Inc."

process, destroying tens of thousands of jobs and tens of billions of dollars in shareholder equity. I believe that what happened to GMAI is not at all unique. It is my opinion that similar well-planned and coordinated attacks have greatly negatively impacted hundreds of companies.
It is my belief that with the major proliferation of hedge funds, a certain "make money at any cost, no matter who is hurt" attitude has taken hold of a segment of that largely unregulated community. I am certainly not suggesting, of course, that all hedge funds are bad, or that all short selling is bad. I am sure that the vast majority of hedge funds are managed in an ethical manner, and that the legal shorting of shares in companies that are perceived to be overvalued is certainly a legitimate investment tool.

I am not normally a conspiracy theorist. I have been active in the philatelic business world since the age of 12, and today, having recently turned 60, I have experienced 48 years of continuous activity in various business ventures, including commercial banking, real estate, restaurants, and my main interest, GMAI. What I am outlining in this piece is disturbing for many reasons. The premise of ethical, unbiased research analysis; the premise that news should be independently reported; and that our financial institutions should also be run ethically, has been shattered for me personally. The modùs operandi outlined in this report has become all too common. A perceived weakness, or even a real one, in any company is hammered on by the research firms, the media, and, I believe, financed by the hedge funds involved, until they bring the company, or in our case its major shareholder, to its knees.

I have had limited time to prepare this document and, through additional research, much could be added to it, including further statements from individuals and companies approached by the hedge fund through Louis Corrigan, and Neil Martin, the *Barron's* reporter. In addition, I have only critiqued one CFRA report, their February 3, 2005 Update.

<u>Research Firm Coverage of GMAI</u>

The Center for Financial Research and Analysis (CFRA) grades companies on a scale of 1 to 5, with 5 being the highest level of concern. Based on their grading scale, which I believe would cater well to the short selling hedge fund community, a '5' rating such as GMAI received could possibly trigger significant short selling by their client base. I have only viewed two of the

CFRA reports on GMAI, a June 15, 2004 report and the February 3, 2005 report, both of which rated GMAI a '5'.

This February 3, 2005 report is a classic. At the time I first read it, I recall being amazed that any research firm could issue such a report without comment or sanctions from a government body. Today's playing field is not level, since public companies are held to extremely high and expensive standards under Sarbanes-Oxley, while other firms and the media, who can positively or negatively impact a company's shareholder value greatly with one report or article, have virtually no governmental oversight whatsoever.

Herewith (see below, pages 3-7) is my review of the February 3, 2005 report, which was written contemporaneously with its issuance (see Appendix A for the original CFRA Report).

GREG MANNING CRITIQUE OF CFRA REPORT

(written February 10, 2005)

Page 1 – CFRA Report:

Financial Summary: Ignores 1/21/05 guidance relating to aggregate sales, revenue, profits, cash on hand and cash flow.

Second quarter guidance is mentioned on page 3, so CFRA had in hand the January 21, 2005 guidance, which highlights a turnaround in cash flow and cash on hand. CFRA summary is therefore "stale" financial information meant, in my opinion, to malign GMAI to their clients, by using financials that are known not to reflect the current status of the company. In addition, what responsible analyst uses September information with guidance out and second quarter results less than one week away?

Page 2 – Headline:

"Update – Operating Cash Flow Falls to Negative $9.5 Million and Growth in Existing Operations Remains Stagnant"

How can an update ignore the 1/21/05 guidance of 2nd Quarter expected cash flow of \$22-24 Million that CFRA mentions on page 3? Any responsible analyst would use current information to ascertain the most current anticipated results, not use completely misleading information as an "update", with a hysterical headline. Had they waited one week for the full 2nd Quarter results, they would have had fresh up-to-date information to include in their analysis.

Page 2 – Summary:

- CFRA is concerned about revenue growth and cash flows without waiting less than one week for 2nd Quarter figures. Also denigrates the exclusive supplier agreements with our "largest shareholder".
- Again mentions stale cash flow September quarter figures
- States Company has \$6.6 million cash on hand (as a current figure, in spite of 1/21/05 guidance of \$28-30 million cash on hand). More importantly, CFRA implies potential bankruptcy by stating, "\$6.6 million cash on hand, however during the next twelve months approximately \$12.8 in demand notes and leases are due for payment." Again, another instance where CFRA ignored recent guidance on cash balances and cash flow and, of course, expected positive continuing operating cash flow. This type of statement is obviously intended to question GMAI as a going concern, which is patently absurd based on our equity, assets, and ongoing profitability, which metrics are all ignored by CFRA.
- "GMAI's growth continues to be fueled primarily by sales to its majority shareholder." What CFRA has not done is wait for current 2nd Quarter numbers to review this statement. Why should GMAI be criticized for building a new business to supply Afinsa, which generates over \$100 million per year? Most companies and knowledgeable analysts are extremely pleased to see a new growth engine contributing sales and profits of \$100 million! Again, our 13 acquisitions are not mentioned as a revenue driver.
- "GMAI's earnings benefited by \$0.01 due to the absence of bad debt expense in the September 2004 quarter." This is a true reach; in essence the CFRA analyst claims to be more knowledgeable about GMAI's accounts receivable than GMAI, its outside auditors, and its internal auditors. This is not worth further comment due to its brazen nature.

Page Two – Continued:

"Operating cash flow turns sharply negative absent inflows from majority shareholder." More repetition of stale information. This statement is also riddled with inaccurate assumptions and guesses, many of which have no basis in fact. GMAI's non-Afinsa business in 2004 totaled 60% of aggregate sales and obviously has an impact on cash flows. Afinsa alone cannot, as stated by CFRA, be the only factor in cash flow. In the first quarter, Afinsa sales represented 33% of GMAI's aggregate sales.

Page 3:

Finally, acknowledgement by CFRA of the 1/21/05 2nd quarter guidance and specifically the expected cash flow of $22-24 million. Of course, the CFRA caveat is that "we again raise the concern that the improvement in cash flow appears to be driven by an influx of cash from GMAI's majority shareholder…". Another CFRA statement not based on any published financials. However, if the improvement were in part driven by improved procedures, why would this be a negative, since all future quarters will be positively impacted?

Table 1: "Cash from Operations, Quarterly Trend". Certainly with the A/R cash flow improvements being permanently impacted in Q2 and beyond, this table may represent prior quarters before Q1, but is completely meant to mislead investors regarding future results based on Q2 and beyond.

Growth from Existing Operations

CFRA cautions on slow growth, again without factoring in sales in our new auction companies, without waiting for information from our 2nd quarter report.

Page 4:

"Increase in Gross Margins Appears Driven by Increases in Percent of Sales to Afinsa." CFRA states estimates of cost of goods as facts, and makes their Table 3 appear to be factual when it is not based on facts but in my opinion, only the analyst's suppositions and estimates. "Earnings Boost No Bad Debt Expense Despite Significant Increase in Accounts Receivable". This is another hysterical warning about reducing our EPS by $0.01 to allow more bad debt expense. Reserves for doubtful accounts are reviewed, and appropriate reserves made as required.

<u>Page 5 -</u> "Accounts Receivable Skyrocket to 83 Days"

The September quarter accounts receivable were negatively impacted by the normal European summer holiday (typically the month of August). In addition, non-Afinsa A/R's are also affected by the summer season. As CFRA knows, GMAI has improved collection procedures in place with our major customers, as evidenced by the cash guidance for the 2nd Quarter ending December 31, 2004, which CFRA ignores in their February report (update). Highlighting known stale information and knowing that GMAI's management has improved procedures in place is misleading.

"Growth in Inventory Sparks Concern Regarding Possible Write-Down"

GMAI management was, of course, never questioned by CFRA about the content of our inventory and a need for further reserves, nor anything else in our public filings or the business outlook for the company. The stamp and coin inventory is extremely liquid, with a significant portion pre-sold to clients against known monthly purchase orders. The coin inventory turns approximately 6-7 times per year based on sales. Obviously this occurs as more than 1 complete turn per quarter in coins. Stamps are procured for Afinsa, in advance of purchase orders, which are in-house through June 30, 2005. Opportunistic purchases and sale completion in stamps for the auction companies follow a longer sales cycle, as multiple auctions are used. Typically a strong inventory foreshadows greater sales and profits in subsequent quarters, due to the liquid nature and wholesale purchasing of stamps and coins. Market conditions have been strong and steady for five years (minimum) and the company does not purchase any speculative coins or stamps that might need additional reserves.

Finally, as expected, in an effort to spark further alarm about GMAI's inventory, CFRA has added into the inventory totals used in their analysis long-term collectibles inventory held for sale over a three to four year period, to maximize the realized gross profit. They note this addition with a small asterisk, if one happens to notice it. A full description of GMAI's inventory and reserves is available in the company's public filings.

GMAI – Summary of the 2/3/05 CFRA Report (Update):

In my opinion, this report is an overt attempt to distort, mischaracterize and fabricate numbers in an unprofessional attempt to discredit the growth and profitability that GMAI has achieved over the past three years. There is no excuse for the constant repetition of stale September figures in this report when 2Q guidance was issued on 1/21/05, and our full 2nd quarter was released within days. This report appears timed to do the most possible damage prior to our 2Q release. I believe that CFRA caters to the short selling community of hedge funds, and the huge short position in GMAI has, I believe, been augmented by CFRA reports.

The constant demeaning of our relationship with Afinsa is calculated to sow concerns. Sales of stamps and coins to Afinsa average over $8 million per month against purchase orders, and are a new regular monthly revenue source for GMAI. These sales add stability to GMAI, and have helped grow the company. CFRA also fails to note 13 successful acquisitions that have also added sales and profits to GMAI. CFRA had our 1/21/05 guidance, and yet built this complete report around a Q1 filing. I believe that this was truly an attempt to unprofessionally smear GMAI prior to our 2nd Quarter earnings release.

Any fair-minded analyst would, I believe, have waited a week and filed a report that included full Q2 numbers, or at least fully acknowledged the guidance that was given on 1/21/05 and proven by CFRA's statements on 2/3/05 to be known to them. To use headlines and statements targeting GMAI's September cash flow and cash on hand is completely unprofessional when such figures are known not to be representative of the current metrics.

This report apparently had a sharp impact on GMAI's share price of 2/4/05, causing a $22 million drop in market cap. This report also completely ignores the overall quarter-to-quarter and year-to-year financial progress made by GMAI.

(The above comments are the opinion of Greg Manning as a GMAI shareholder, relating to the CFRA report of February 3, 2005.)

The polar opposite view of GMAI was held by Oppenheimer Research reports (see Appendix B), written by Barry Sine, as well as a profile by Institutional Equities (see Appendix C), as reported by Ivan Sacks and Chad McCurdy. The Oppenheimer research speaks for itself, in that field research was done by attending auctions, visiting both the U.S. and Madrid offices of GMAI and its majority shareholder Afinsa, interviewing employees, and verifying financial results with management; none of which, to the best of my knowledge, was done in any way by CFRA with the exception of several brief telephone calls to our then CFO, Larry Crawford, regarding one report. I have also attached the January 21, 2005 guidance release (see Appendix D), as well as the earnings release for GMAI's fiscal Second Quarter (see Appendix E), which came out on February 9, 2005, only days after the so-called "update" by CFRA.

Barry Sine of Oppenheimer comments in his June 24, 2005 report, in which he initiates coverage of GMAI with a "Buy" recommendation, "Short Interest Could Equal as Much as Half Of Float". He also notes "the company's shares have been listed in Germany on the Berlin-Bremen stock exchange without the company's consent. In February the company filed a complaint with the NASD, and sought to have its shares delisted in Germany."

On November 29, 2005, Barry Sine published a company update on GMAI, noting that "On Wednesday, November 23… two publications simultaneously published stories regarding Escala Group (GMAI), rehashing arguments that have been previously published in articles dating back 15 months. We believe that the timing of the articles is highly suspicious, and would note that one of the news organizations has made note of the fact that its previous articles on Escala (GMAI) were researched by fund managers with a short position in Escala (GMAI) shares. As we note in this report, the articles uncovered no new facts and while implying wrongdoing, never cited any improper actions. With short sellers having lost an estimated $40 million in Escala (GMAI) shares, they presumably have conducted extensive research. As a result, if these two articles were all they could come up with, we are even more bullish on the stock."

Also in the November 29 update, Mr. Sine states, "Last Wednesday, *Barron's* sister publication, the *Wall Street Journal*, published a story (written by Karen Richardson) which implied that

Escala is the subject of a criminal investigation. The article starts by saying, "Escala Group, Inc.'s (GMAI) regulatory concerns don't appear to be small change," but then goes on to note that the entity being investigated is a money manager known as Capital Coin." The double-barreled November news included a *Motley Fool* story of which Mr. Sine states, "At the end of the article the author notes that he personally purchased the stock in March, but is only now discovering the GMAI/Afinsa relationship. This relationship is extensively documented in the company's 10-K filings, and has been the subject of two articles in Dow Jones' *Barron's* publication. The author does not cite the source of his sudden edification, citing only critics of the company. We suspect that these critics are fund managers with short positions in the stock." What Barry Sine most likely did not know at the time was that Louis Corrigan, a fund manager at Kingsford Capital and acknowledged by witnesses to be closely working with *Barron's* reporter Neil Martin, had been a writer for *Motley Fool* until September 23, 1999. I believe the two stories had their desired effect, as GMAI (then known as Escala) shares dropped $5.25 in one day in November 2005 (see Appendix F), eviscerating almost $150 million in shareholder equity.

<u>The Role of the Media</u>

On September 27, 2004, *Barron's* published an article entitled "Return to Sender", featuring Greg Manning Auctions, Inc. (see Appendix G). The article was so riddled with misinformation and mistruths that GMAI and its then CEO, Greg Manning, published a full page ad in *Barron's* (see Appendix H) in an attempt to correct the blatant errors of fact contained in the article.

In order to create a negative story and, in my opinion, bias against GMAI, the *Barron's* writer, Neil Martin, utilize misleading research from CFRA's Jill Lehman that contained numerous analysis errors, as well as the following:

- Characterized Robert Campbell Rowe, a retired publisher of magazines related to collector's edition dolls and teddy bears, as a stamp and coin expert.
- Mr. Rowe's statement that "collecting has been turned on its head by the Internet," and that collectors are "coming out of the woodwork with stamps and coins thought to be rare or non-existent," is a fabrication without any basis in fact. The Internet, especially eBay,

has greatly augmented the sale of less expensive stamps and coins, and added liquidity to the marketplace. Rare stamps and coins are still rare, and no landslide of undiscovered rarities has ever come forth into the on-line marketplace.

- "Virtually all publicly owned companies with the bulk of their business based on collecting ultimately fail," is another Rowe statement ignoring Sotheby's 200 total years in business, Stanley Gibbons' 150 year history, as well as other collectibles-related companies that are public.
- This *Barron's* article mentions three institutions or funds that sold GMAI shares and characterized as "dumped by a number of…". What the writer ignored was that the percentage of institutional ownership increased from 1.65% (6/30/03) to 6.05% (12/31/03) to 10.85% (6/30/04), representing an increased participation from 8 to 45 funds in a one-year period.

After the September 2004 article, Neil Martin continued, in my opinion, to "create" negative news about GMAI and Afinsa. Together with a hedge fund employee, Louis Corrigan of Kingsford Capital, a division of West Highland Funds, Martin and Corrigan made contact with, I have reason to believe, dozens of stamp dealers and other professionals, a number of who contacted me directly, in an effort to spread malicious accusations and create negative news about GMAI and Afinsa.

One Corrigan/Martin contact, David Kols (see Appendix I) was called by Corrigan who, at first, claimed to be a research analyst looking at GMAI. When Corrigan asked if this philatelic auctioneer was aware that Afinsa was laundering drug money through offices in Cartagena, Colombia, Mr. Kols realized that this was an unusual statement for an analyst to make. After making other negative comments, Corrigan stated that a *Barron's* reporter would contact Mr. Kols. Neil Martin of *Barron's* later called him and also made derogatory statements regarding GMAI. Martin also told the auctioneer that he had called the SEC to find out about our record with them, and was told by the SEC there had been no complaints made against GMAI. Martin then proceeded to "suggest" hypothetical illegal situations to the SEC that he stated GMAI "may be guilty of". It is certainly my opinion that he was trying to make his own "news" by fomenting an SEC inquiry, which he very well may have done successfully. Other Martin-initiated calls included one to the broker who had placed our insurance with Lloyds of London. Our insurance account executive called me immediately after his conversation with Neil Martin, stating that at first Martin asked him questions about GMAI that he declined to answer. Martin then launched into a diatribe about illegal over-insuring of shipments, inventory and other hypothetical actions possibly taken by GMAI, and also Afinsa. Our agent stated to me that since he had known our firm and myself for many years, he did not take Martin seriously at all, but wanted to warn me about this malicious and slanderous attack. Later I spoke with our agent again, who stated that Martin had tried to reach his superior, the agency founder and managing director, through numerous channels. He also told us that Martin had contacted many other Lloyd's agents in the United States, England and Spain. It appeared that Martin did find one agent who took his diatribe against Afinsa seriously, and then Martin used this agent's quote in numerous negative pieces as the "insurance" angle to his self-created story.

In the May 23, 2005 issue of *Barron's* (see Appendix J), Neil Martin wrote a negative article about Afinsa which contained the following statement, "The two sets of stamps that *Barron's* brought to Pena ... had been purchased by two representatives of an American hedge fund; one an American living in Spain, the other a Spanish national... The hedge fund, it should be noted, has been short-selling shares of Greg Manning since last summer, betting they will decline. But *Barron's* verified the transactions, examined the contracts and visited the two locations where the stamps were purchased." Prior to publication of the May 23, 2005 article, *Barron's* editors had received a letter from our attorneys indicating that we had information that Neil Martin was working with Louis Corrigan of Kingsford Capital. At that time we did not know of the two additional hedge fund employees Martin was working with in Spain, nor did we have the incontrovertible proof that *Barron's* revealed in print – that the article was, in fact, financed at the very least in part through the portfolio purchases by a hedge fund. It is my opinion that *Barron's* would never have disclosed the true facts absent our legal letter.

Unusual and suspicious circumstances abound with regard to the media treatment of GMAI over the past 21 months. For example, it was reported that Neil Martin spent considerable time in Madrid last year. By coincidence Leslie Crawford, a reporter for the *London Financial Times* (based in Madrid), spoke with a stamp dealer in Madrid and exhibited the same overt negative bias noted by interviewees of Neil Martin and his hedge fund partner, Louis Corrigan. In fact, the dealer interviewed in Madrid stated to me that he believed, based on the questions posed, that Leslie Crawford was working with Neil Martin. Also noted was the same "insurance" issue raised by Crawford and Martin, as well as the same source being quoted.

The *Wall Street Journal* published an article by Karen Richardson on November 23, 2005, clearly designed, in my opinion, to make it appear that GMAI (Escala) was embroiled in and possibly the target of investigations by State and Federal authorities in Ohio. Statements such as "GMAI (Escala) is being pursued for funds by a court-appointed official in charge of liquidating Capitol Coin... 'I would view this as an immense and gathering storm for Greg Manning,' says William Brandt, the liquidator of Capitol Coins." In fact GMAI had, months before, paid any and all obligations to Capitol Coins. Through its coin division, GMAI was the successful bidder in a Brandt-run auction for a $7.5 million portfolio of Capitol Coin inventory. Certainly Mr. Brandt had a unique method of creating bidding interest. However, Richardson wasn't finished with GMAI yet. A gratuitous mention of Afinsa and GMAI's relationship ends the article, with the completely unsourced comment, "Stamp appraisers and other critics have raised concerns about Afinsa's financial ability to buy back or resell those stamps." Certainly an interesting unattributed quote with which to close an article about an Ohio coin fund. I wonder whether one of the unnamed critics could have been Neil Martin?

The *Toledo Blade* articles mentioned in Richardson's piece also contained extensive quotes from Brandt, as well as a stamp collector, Ken Lawrence, who has also, coincidentally, been quoted by Neil Martin. In my 48 years in the stamp business I have had only one public disagreement, which was with Ken Lawrence, making him a perfect, and of course unbiased, source for Mr. Martin.

Recently the media campaign against GMAI (Escala) reached a new low point. After the events of May 9, 2006 (profiled in the Conclusion section), the media pressure appeared to be designed to turn up the heat to maximum or beyond on the company. This included a FOX reporter coming to our New Jersey office with a television crew to witness the serving of a class action lawsuit by an attorney to me personally. When I did not personally walk out, they then filmed my home and the office, and put a file photo of me on the news, suggesting that I was missing. This was the first time I have ever heard of a story being put on national television regarding the service of a lawsuit.

But FOX wasn't finished yet. On April 26, 2006, George Russell and Claudia Rosett wrote an article regarding the sale of the United Nations Philatelic Archive. The archive was sold at a well-publicized public auction in Switzerland, conducted by David Feldman. The article states that "the auction was carried out in an entirely legal fashion," and that the auction catalogue even contained a letter from a U.N. senior executive, Andrew Toh, who acknowledged that the offering constituted "all known items to exist of this kind." Certainly for the auction house and any potential buyer, this was a forthright statement regarding the legitimacy of an official sale by the United Nations. The archive sold for $3,068,000 to Champion Stamp Company of New York City, from whom we subsequently purchased it.

Apparently the correct United Nations officers and officials may not have been notified of the auction vetted by Mr. Toh, Anthony Fouracre, the U.N. philatelic chief from 1992 through 2002, and another executive, Toshiyuki Niwa, as noted in the FOX article. An internal issue at the United Nations arose, as outlined in the article. GMAI's November 2003 auction catalogue containing 2,500 lots of U.N. Archive material is reviewed favorably in the original FOX article, and no negative aspersions were cast on GMAI whatsoever.

However, another FOX News article appears on June 8, 2006, written by Richard Behar. In this article, Behar states, "Escala (GMAI) is already embroiled in another scandal involving the mysterious 2003 sale of the United Nations unique postal archive." Interesting, in that this piece was written weeks after the previous FOX U.N. piece, which actually reported the story correctly. Also in the Behar piece, we find another quote from Ken Lawrence. Although the piece went to press well after the Washington [DC] 2006 International Philatelic Exhibition had closed, at which venue Behar had gathered information, he failed to mention that out of the four auction houses who had conducted major auction sales at the 8-day international show, our auctions grossed over $3.6 million and were clearly the highest in aggregate sales of any of the four. In order to achieve this result, hundreds of bidders and buyers participated. But instead, Behar characterized me as "looking harassed and lonely," and quoted another stamp dealer remarking, "Everyone is afraid to deal with them right now." Behar also stated, ***"Manning is correct to note that major short sellers have been playing his stock for a long time, and have been assertively communicating with reporters, including those from FOX News."*** The question is, how does a story regarding the public and legal acquisition of the United Nations archive morph into a "scandal" in a matter of weeks? The answer to that question is all-important, as is Behar's truthful admission of the pressure from the hedge funds placed on the media.

Hedge Fund Involvement

On a number of occasions, Louis Corrigan has publicly identified himself as being associated with Kingsford Capital Partners, which is apparently a division of West Highland Capital of Greenbrae, California. As stated in *Barron's*, we know that at least two other Kingsford employees are working with the media, besides Corrigan. Neil Martin is tied directly to Corrigan by David Kols' statement, as well as others I've spoken with. It was also reported to me that the West Highland fund had a major problem with their short position due to the rise of GMAI stock in 2005 and through April of 2006; I have not independently verified that report. From the June 2006 article written by Richard Behar for FOX News, we also have a direct statement of hedge funds being actively involved in his article, as quoted above.

Conclusion

On May 9, 2006, the hedge funds won the battle over the GMAI (Escala) share price. They couldn't seem to bring down GMAI, as the share price continued to rise steadily in spite of the well orchestrated and incessant negatively biased media onslaught. Oppenheimer's well-researched analyst reports citing the actual numbers and positive performance of the company, I believe, offset much of the "hedge fund-controlled" media attack articles. In addition, a significant amount of institutional and fund buying came in over the past year. At the same time, I have reason to believe that millions of counterfeit shares were "created" by the hedge funds and purchased by the new buyers.

In my opinion, the hedge funds were set to lose many tens of millions of dollars unless they could engineer something dramatic to turn the upward bias of our share price into a downward freefall. On May 9, 2006, the perfect storm did occur and the hedge funds profited tremendously, as thousands lost their jobs and many hundreds of millions of shareholder equity was wiped out in only a few short days when the GMAI (Escala) share price plummeted from $32 on May 8 to a low of $3.85 post that date.

How and why did this occur? I am of the opinion that Louis Corrigan of Kingsford and Neil Martin of *Barron's*, plus their other confederates, were successful with the reported complaints they filed with the government agencies in Madrid. In the statement taken from David Kols on June 7, 2005, he stated that Martin told him he "had talked to Spanish regulators about Afinsa." A knowledgeable source from Madrid informed me that complaints had, in fact, been filed.

Once in an e-mail, Neil Martin commented that it didn't make any difference if Afinsa used buttons instead of stamps. The reasoning was that Afinsa had, for over 26 years, honored every commitment to its 142,000 clients in full. It is interesting to note that one of the reasons Martin claims that he was after Afinsa was because the stamps were not worth full catalogue value. Of course if Afinsa honors all agreements, whether the stamps are sold at 75% of catalogue or 100% doesn't seem quite as important. Martin's implication has been that the stamps Afinsa sold should immediately be worth the prices paid, to anyone. In the real world, we know this is not true with anything we buy, since there is a mark-up on any tangible asset, including paintings, gold and all collectibles. Also it appears that Corrigan and Martin alleged in their complaints that Afinsa was insolvent by €1.1 billion with regard to its total assets and the value of its clients' stamp portfolios. What Corrigan and Martin probably did not discuss was the fact that Afinsa's investment in GMAI (Escala) had a value in excess of $600 million, and that Afinsa held the shares. In a recent statement, Juan Antonio Cano, an Afinsa 50% partner, stated that the company had €182 million or $230 million in cash on deposit with multiple banks in Madrid, including UBS. Of course the fabricated story put out after May 9 was that Afinsa had $250 million in numbered "Swiss" accounts. In addition, Afinsa owns substantial real estate in Madrid, a palace converted into a conference and training center, other businesses, and a substantial modern art collection on display in their headquarters building in downtown Madrid.

I certainly don't claim to know their total assets, but they appear to have been far from insolvent, especially since I believe that whatever obligations exist under their stamp portfolio agreements are spread out over a number of years. Like any well-run business, Afinsa would know the average redemption rate of stamp portfolios and prepare for this in an annual budget. Rather than being "insolvent", I believe that until May 9, Afinsa was most likely well prepared to handle their normal business as well as most other circumstances. No one could envision that the Spanish government would act so precipitously, thereby devaluing one of Afinsa's largest assets by $500 million for no logical reason, when sensible negotiations could have prevented this and protected the 142,000 customers, 2,500 Afinsa sales staff, 600 corporate staff, and additional hundreds of employees of firms doing business with Afinsa, from all being at risk.

Afinsa is not the only stamp company to sell stamps at full catalogue value. Stanley Gibbons (SG) of London, England has been in the business for over 150 years, and offers stamp investment portfolios almost mirroring Afinsa's terms at full catalogue value, using the venerable Stanley Gibbons catalogue as a basis. SG is also a public company in England. It's surprising that Corrigan and Martin didn't file a complaint in London regarding SG, since I doubt you'd receive full catalogue offers for their stamp portfolios immediately after purchase. Other major stamp companies sell at full catalogue pricing since the higher the overhead level, the greater the need for a reasonable margin to cover expenses plus make a profit. Capitalism is behind the margins, not Ponzi.

Afinsa has been in business for 26 years, and during that time period has been awarded numerous honors, including Company of the Year 1989, For Performance Excellence 1997, Gold Master of Executive Management 1998 and 2000, Dirigentes 200 Quality Award, and others. The company is also involved in philanthropic activities including Patron of the Guggenheim Museum in Bilbao, Spain, Friends of the Prado Museum Foundation, the Reina Sofia Foundation and the Segovia Mint Foundation, as well as sponsorships including "The Greeks in Spain" exhibit at the National Archaeology Museum in Athens, plus many others. In the philatelic world, Afinsa has sponsored the Albertino de Figueiredo Foundation with the mandate of promoting the postage stamp as one of the world's most comprehensive expressions of art and culture. This foundation also works closely with the Universal Postal Union (UPU) in an effort to eradicate fraudulent stamp emissions from non-UPU recognized entities. I mention the above as these facts have not been brought forth in any piece written by Neil Martin or his cohorts.

Afinsa is a market maker in the stamps they sell, and have continued to do so for 26 years, thus insuring their clients that they can sell on the open market, or to Afinsa. Until now, that system has worked flawlessly. Certainly in extraordinary times the soundest company can be brought down, as happened in the Depression with our banks, and during the real estate downturn of the early 1990's, to the savings & loan industry. What happened to Afinsa, however, was calculated to cause the maximum damage without any regard for the human and financial consequences. The truth about Afinsa, good or bad, will come out eventually, but based on their long history and public image alone, they certainly should have been given an opportunity to fully answer these charges in a reasonable forum prior to their building being circled by 300 policemen, and hauling the top executives away to jail (all of whom were later released without bail). This tactic, of course, played into the Perfect Storm scenario – can this only be a coincidence?

It is my opinion that the tremendous surge in the short position of GMAI (Escala) shares since January 1, 2006 was attributable to the knowledge having been disseminated regarding the impending Afinsa incident. At the time I remarked to a colleague, "I have no idea why the short position is escalating when our business is doing so very well. The shorts must know something that we don't know," and they apparently did have inside information about what was going to happen in Madrid. Experts can, hopefully, some day examine our stock's trading patterns to ascertain the true short position that has been grandfathered. In my non-scientific estimate, it would not surprise me to discover that seven or eight million shares have been shorted illegally, in addition to the legal shorting. Over the past 21 months, it has been incredible how many times the company has surpassed analysts' estimates on earnings and other key metrics, only to have the share price driven down on good news. This behavior has caused concern among many smaller shareholders. Other shareholders thought that continued solid performance would drive the hedge funds out. Few recognized exactly how organized and determined to prevail the hedge funds were.

Looking back, it's easy to see the "coincidences" piling up: both Neil Martin and *Wall Street Journal* writer Karen Richardson writing "puff" pieces on CFRA; the same "experts" quoted in diverse newspapers; the same exact background material in story after story; the same story being repeated over and over; the absolutely perfect wordsmithing to create the ultimate negatively-biased stories, such as Behar's, Martin's, Richardson's, Crawford's and other pieces. The June 2005 research reports from CFRA and Oppenheimer, if read without our company name attached, would undoubtedly seem to have been written about two different companies.

The news that I believe was apparently created by Martin regarding insurance, stamp values, Afinsa and much more is truly amazing. It's obvious that, since Martin mentioned several times in print that GMAI (Escala) might be facing regulatory concerns, he appeared at that time to be very disappointed that we hadn't yet announced any SEC inquiry. Could this have been because his continuing efforts to "create" another storm had not borne fruit?

Our system of justice and our security laws take insider trading very seriously, with harsh punishment meted out when the offense may net only a small amount of money for the perpetrators. The abusive practice of what I would call "outsider trading" has, in my opinion, caused far more damage that anyone in the SEC or our government may be aware of. The complicity of important financial publications such as *Barron's* as noted by Neil Martin, when he openly admits that a hedge fund short GMAI shares played a significant role in the financing of research materials for his article, is astounding to me. It is astounding not because of the admission in *Barron's,* since I knew before the article that Martin was working with the hedge fund and Louis Corrigan as a co-writer, based on David Kols' and other individuals' statements. What surprised me the most was the lack of interest from the regulatory bodies that this practice is now out in the open. Richard Behar further acknowledged this in his FOX article, with another printed statement regarding the media assertiveness of hedge funds short our stock.

Outsider trading is even more insidious than insider trading, often using planned and created news timed for maximum advantage and designed to leave a long-lasting negative bias, which can then be built upon in future articles. Negative press is often timed to come out after positive earnings releases to ensure that the unleashing of a flood of short selling, along with the media onslaught, has the desired effect on the share price, which is, of course, to drive it down. Outsider trading is the worst and most destructive form of journalism because, instead of reporting the news in an unbiased manner as any ethical reporter would do, these writers attempt to create news as Martin did, or report, as Behar did, in a totally biased manner.

The free press is an awesome force, molding and shaping public opinion about our politicians, Iraq, global warming, and any and every subject imaginable. When the press has the power to be subverted and influenced by those wishing to bring down our companies and institutions, it is time for he leaders of our country to investigate exactly what is happening. I certainly do not advocate any rush to judgment, but I do believe that the truth will and must come out; to prevent other premeditated campaigns against companies belonging to your friends and neighbors. It will take political courage, since we all know how sensitive this issue is. However it must be undertaken or it will only broaden, as more and more hedge funds need to find a way to make ever increasing profits from a smaller pool of investment ideas.

When Neil Martin contacted my CFO, Larry Crawford and myself for background on his first article about GMAI in *Barron's* in August 2004, he initially stated that this was going to be a straightforward article regarding the company. As he called us on numerous occasions over a ten-day period, his questions went from normal inquiries to extremely negative assertions and questions. Larry and I asked him what had changed the tenor of his article, and he stated pressure from his editors to write a negative piece. He even stated to us that he "was considering pulling his by-line" from the article. Well, Mr. Martin did not pull his by-line, and that was only the beginning of his collaboration with the hedge fund.

I am personally not an advocate of great oversight on our freedom of speech, unless it is criminally abusive or may cause irreparable harm. We are at that stage right now. When writers or hedge fund partners are calling the SEC and others to do anything possible to hurt companies, then something needs to be done. When a public company faces an SEC inquiry, it can cost the company up to several million dollars in accounting and legal fees. When a planned negative article comes out, it can cost shareholders of any company tens of millions of dollars in one trading day. Without checks and balances, the abuses by our free press will only become far worse than today.

I could go on, but to what end? In a recent interview with Jim Lehrer on PBS, Ben Bradlee, Vice President at Large of *The Washington Post*, stated, "There should always be a firewall between news and business." Until something serious is done by our government to prevent what happened to GMAI (Escala) and Afinsa, I firmly believe that business will take full advantage of a morally and ethically corrupt segment of our media, which will result in the destruction of many more companies, individuals, and many an entrepreneurial dream.

MANAGED FUNDS ASSOCIATION

TESTIMONY BEFORE THE

SENATE COMMITTEE ON THE JUDICIARY

"HEDGE FUNDS AND INDEPENDENT ANALYSTS: HOW INDEPENDENT ARE THEIR RELATIONSHIPS?"

JUNE 28, 2006

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TESTIMONY OF MANAGED FUNDS ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON THE JUDICIARY

June 28, 2006

I. INTRODUCTION

As the largest and most diverse U.S.-based association representing the hedge fund industry, Managed Funds Association ("MFA") is pleased to provide this testimony to the Senate Committee on the Judiciary for the hearing "Hedge Funds and Independent Analysts: How Independent Are Their Relationships"?

The hedge fund industry has experienced significant growth in recent years, with assets under management estimated at $1.5 trillion.[1] MFA believes this is a direct result of the demand, largely from institutional investors, for investment vehicles that offer a diversity of investment styles and help them meet their future funding obligations and other investment objectives. As former Federal Reserve Chairman Alan Greenspan has noted, hedge funds have "become increasingly valuable in our financial markets."[2] Hedge funds enhance market liquidity and contribute to pricing efficiency and market stability. Hedge funds also foster financial innovation and risk sophistication among the market participants with which they deal. As discussed later in this testimony, hedge funds' ability to deliver these benefits to the financial marketplace depends in large measure on their ability to engage in short sales and related activities.

MFA recognizes that with the growth and evolution of the hedge fund industry have come new responsibilities and challenges. The hedge fund industry and policy makers currently face an important challenge, namely to preserve the benefits offered by hedge funds while addressing legitimate investor protection and market integrity issues presented by the growth in hedge fund investments. MFA is committed to meeting these industry challenges.

Background on MFA. Founded in 1991, MFA is the U.S.-based global membership organization dedicated to serving the needs of the professionals who specialize in the alternative investment industry. MFA's over 1,000 members include professionals in hedge funds, funds of hedge funds and managed futures funds. MFA

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1 Based on reported estimates by Hedge Fund Intelligence (London).

2 Remarks by Chairman Alan Greenspan, "Risk Transfer and Financial Stability," to the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure, Chicago, Illinois, May 5, 2005.

members manage a substantial portion of the estimated $1.5 trillion invested in these investment vehicles. Members include representatives of a majority of the 50 largest hedge funds groups in the world. The larger hedge fund managers represented within MFA collectively manage in excess of $500 billion in assets and pursue a wide range of investment strategies.

As further explained below, MFA's activities include educational outreach to and representation before the U.S. Congress, the Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC"), Federal Reserve Board, U.S. Department of the Treasury, state legislatures, and international regulatory agencies. MFA also participates in a number of private sector initiatives, including development of industry sound practices, participation in Treasury-sponsored advisory committees, and work with the major dealers in improving credit derivative market practices.

II. OVERVIEW OF HEDGE FUNDS AND THEIR STRATEGIES

Definition of hedge fund. The term "hedge fund" is not a defined term under the federal securities laws, but it is used generally to connote a private investment fund that is not required to register as an investment company under the Investment Company Act of 1940 (the "Investment Company Act").[3] It is thus a term that is susceptible of meaning different things to different people. In general, and for purposes of this testimony, MFA considers a "hedge fund" to be a privately offered investment company that is administered by a professional investment manager that seeks attractive absolute return, typically through investments and trading in publicly traded securities and other interests.[4] In this regard, hedge funds are similar to venture capital, private equity, leveraged buyout, oil and gas, and real estate funds, although MFA does not intend to capture them within its definition of "hedge fund."

Size. Because of the non-public nature of hedge funds, there is no universally accepted estimate on the size of the hedge fund universe. MFA believes it consists of 5,000 to 7,000 funds with total assets of approximately $1.5 trillion. A small number of these hedge funds are part of large organizations with aggregate invested assets of over $1 billion and performance records extending 10 years or more. At the other end of the

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3 More technically, a "hedge fund" is an investment company that is not required to register with the SEC by virtue of Section 3(c)(1) or 3(c)(7) of the Investment Company Act and that conducts only private offerings under the SEC's Regulation D or another exemption under the Securities Act of 1933.

4 This is in keeping with the definition used by the President's Working Group on Financial Markets, of "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." President's Working Group on Financial Markets Report, "Hedge Funds, Leverage and the Lessons of Long-Term Capital Management," April 1999, at 1.

marketplace, there are thousands of small firms managing hedge fund assets under $50 million each, many of them relative newcomers to the industry.[5]

Investment profiles. As noted above, hedge funds are more easily defined in relation to what they are not. They are investment companies that are not publicly offered. The hedge fund universe is characterized by a wide variety of strategies, with different risk characteristics and different return expectations. Many hedge funds managers engage in "absolute return" strategies, meaning that their returns do not depend on, nor are they benchmarked against, the long-term return of the markets or the assets in which they invest. In other words, hedge funds seek to achieve positive returns based on the skill or strategy of the manager rather than to meet or exceed the performance of the underlying market or asset class. Many hedge fund strategies employ "enhanced active management," in which managers combine traditional active management with techniques such as short selling and leverage. Some hedge fund strategies may not be based on traditional techniques at all, such as risk arbitrage, convertible hedging, and distressed debt.

Major hedge fund investment strategy classifications include the following:

- Long/short strategies for trading in equities.
- Dedicated short sale equity strategies focusing on selling short securities that are deemed to be overvalued.
- "Macro" or global directional investment strategies, which take positions in domestic and international currency, interest rate and equity markets based on global economic conditions and opportunities perceived to be presented by them.
- "Market-neutral," "relative value," or arbitrage strategies, which take offsetting long and short positions or otherwise hedged positions to reduce market risk and utilize leverage to achieve desired returns.
- Event-driven strategies, which seek to profit from anticipated events or special situations, such as mergers, restructurings, distressed securities.
- Regional strategies, which concentrate on a particular geographic region (such as emerging markets).
- Sectoral strategies, which focus on a particular industry.
- Long only, or "buy and hold", equity strategies, similar to traditional equity mutual fund strategies, but which may also include active efforts to become involved in the management of holdings.

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5 See Robert Jaeger, *All About Hedge Funds*, McGraw-Hill (2003), at 57.

- Specific asset class strategies (such as currencies, commodities, interest rates).

The significance of this broad array of strategies should not be underestimated, as it reflects the increasing segmentation of the hedge fund industry, and with that the growing segmentation of risk. Today's hedge fund industry is thus actually comprised of many sub-industries, with separate and distinct pockets of risk. Each strategy can prudently withstand different levels of leverage, and each strategy has a different time horizon for investment and varying levels of volatility. The diversity of strategies employed by hedge funds also presents important considerations for policymakers seeking to accurately understand the scope of potential challenges as well as the efficacy of potential remedies.

III. BENEFICIAL ROLE OF HEDGE FUNDS IN CAPITAL MARKETS

Diversification for institutional investor. Much of the growth in hedge funds since the 1980's can be attributed to the increasing recognition by sophisticated investors that hedge funds can help diversify returns and thereby reduce the overall risk of an investment portfolio. The majority of direct investment in hedge funds by institutional investors has come from endowments and foundations. From 2004 to 2005, endowments increased their hedge fund allocations from 7.3% to 8.7% on average.[6]

According to a study by the Bank of New York, "the hedge fund industry is midway through an important transition in its source of capital."

> Five years ago, hedge funds derived virtually all of their assets from wealthy individuals. Institutional interest was limited to a small number of endowments and foundations. Over the next five years, institutions (including pension funds) are likely to provide an additional $250 billion of hedge fund capital, accounting for 35 percent of net new flows in this period.[7]

Corporation and public pension plan investments in hedge funds continue to grow, both through direct investments and through fund-of-hedge-funds vehicles.[8] Former Federal Reserve Chairman Alan Greenspan has noted that these inflows may be

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6 2005 NACUBO Endowment Study.

7 Bank of New York and Casey, Quick & Acito, "Institutional Demand for Hedge Funds: New Opportunities and New Standards" (September 2004).

8 A Morgan Stanley Prime Brokerage report suggests that corporate pension plans prefer direct allocations to hedge funds while public pension plans prefer indirect allocations.

attributed to institutional investors seeking alternatives to long-only investment strategies in the wake of the bursting of the equity bubble in 2001.[9]

These institutional investors understand that hedge funds provide attractive mechanisms for portfolio diversification because hedge funds' absolute returns tend to have little or no correlation to those of more traditional stock and bond investments. Many hedge fund categories may therefore outperform stock and bond investments when the latter perform poorly. Investment in hedge funds can thus help diversify risk in many institutional investment portfolios. Drawdowns in individual hedge funds — largest drop from peak value to trough value — are often less than in publicly traded indices. Academic research recognizes that hedge fund investments can reduce overall risk of investment portfolios for investors such as endowments and public and private pension plans.[10]

Source of liquidity. As active trading participants in international capital markets, hedge funds add depth and liquidity to markets. This characteristic of hedge funds has been recognized by commentators including former Federal Reserve Chairman Alan Greenspan. He testified before the Senate Banking Committee in 2004, "it's so important that [hedge funds] are left free to supply the extent of liquidity that they are supplying to our financial markets. ... [T]he degree of flexibility in our economy has been instrumental in enabling us to absorb the shocks which have been so extraordinary in recent years. One of the most successful parts of our system is our ability to absorb financial shocks."[11]

Increase in efficiency. By trading on the basis of sophisticated and extensive market research, hedge funds provide markets with price information that translates into pricing efficiency. In targeting temporary price inefficiencies and market dislocations, hedge funds effectively help to minimize market distortions and eliminate these dislocations. The President's Working Group described this function as follows:

> Hedge funds and other investors with high tolerance for risk play an important supporting role in the financial system in which various risks have been distributed across a broad spectrum of tradable financial instruments. With financial intermediation increasingly taking place in the capital markets

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9 Remarks by Chairman Alan Greenspan, "Risk Transfer and Financial Stability," to the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure (May 5, 2005), at 6.

10 See Written Statement of Managed Funds Association before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, U.S. House of Representatives, May 22, 2003, at Annex A.

11 "Renomination of Alan Greenspan as Chairman of the Federal Reserve Board of Governors: Hearing before the Senate Banking, Housing and Urban Affairs Committee" (testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve) (June 15, 2004).

> instead of banking markets, prices play a larger role in the allocation of capital and risk. In this world, investors such as hedge funds that undertake a combination of long and short positions across markets help maintain the relative prices of related financial instruments.[12]

Decrease in volatility. The increase in hedge fund growth has coincided with a decrease in overall market volatility. This may be due to the added liquidity that hedge funds provide to the market. This may also result from the fact that hedge funds generally eschew the "momentum trading" that many individual investors engage in. Because hedge fund investors generally have accepted longer redemption horizons, hedge funds have fewer incentives to engage in momentum trading. By contrast, more traditional investors, such as mutual funds, are more likely to buy into rising markets and sell into falling markets as a result of purchases and redemptions by individual retail investors, accentuating market volatility.[13]

IV. BENEFICIAL ROLE OF SHORT SELLING IN CAPITAL MARKETS

In periods of bear markets, as has been true from time to time recently, the topic of short selling becomes controversial, particularly among those who have an interest in seeing market prices rise. Critics of short selling practices often claim that short-sellers unfairly collude to drive down stock prices, but academic research has not linked market declines to any single trading strategy or concluded that short selling drives prices to levels they would not otherwise reach on the basis of issuer fundamentals or other, exogenous factors.

The fact is that short sellers, by expressing negative views on particular stocks, tend to dampen what may be irrationally positive market perceptions. They contribute to liquidity and to price formation, which are fundamental to market efficiency and to free-market pricing of assets. Those whose investments lose value when prices decline are counterbalanced by those who can buy at the reduced prices and whose buying pressure tends to restore market equilibrium. By targeting companies whose financial positions — or whose accounting — is shaky, short sellers identify and stigmatize the bad actors, many of whom, like the former Chairman of Enron Corporation, complain about the "shorts" as the engine of their downfall, a myth his criminal trial exploded:

> The trial underscores that neither defendant fully accepted what happened at the company. Mr. Lay testified that the collapse was largely caused by short sellers, critical articles in The Wall Street Journal, and a resulting panic in the marketplace.

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12 President's Working Group Report at 2-3.

13 "Hedge Funds and Financial Market Dynamics," Occasional paper 166, International Monetary Fund (May 1998), at 29.

But short selling, negative press and market concerns are issues that scores of companies deal with every year, without collapsing. Indeed, to some degree, Mr. Lay's argument was a bit like blaming a match for igniting a basement filled with gasoline. In this case, the accelerant was the poor condition of Enron's financial structure.[14]

As Edward Chancellor wrote in 2001, "we need more, not less, shorting activity if, in the future, we are to avoid wasteful bubbles, such as the recent technology, media and telecoms boom."[15]

MFA believes that there is no demonstrated need to further restrict short-selling or to tilt the playing field further toward the long side by implementing additional restrictions on short-sellers. Many hedge funds engage in investment strategies that involve short-selling, such as long/short strategies — buying some securities "long" and selling other securities "short", but these strategies are by no means confined to hedge funds. Many other market participants engage in them as well. Consequently, if a re-examination of short-selling were to be undertaken, MFA believes that it should be undertaken by the Division of Market Regulation of the SEC, the Federal Reserve, the Commodity Futures Trading Commission and the Treasury, in consultation with representatives of the industries that would be impacted by increased regulation.

MFA believes that short selling is not only a legitimate investment activity, but one that plays an important role in improving market efficiency and price discovery. By allowing market participants to place short positions on particular securities that they believe to be over-valued, the existing regulatory scheme allows investors not only to protect their own investment portfolios, but also to reduce market volatility and help bring asset valuations back into line. As noted above, short-selling serves as an important counter balance to "bubble" markets and the long biases of other market participants. In several recent cases, hedge funds have acted indirectly as "whistle-blowers" by engaging in short-selling, the validity of which was later borne out by discoveries of fraud or other misconduct by the issuers concerned.

The research done by academic economists tends to confirm that short selling is contributes to the health of the markets and that the companies that complain most bitterly about short selling are often the companies most in need of governmental investigation and possibly prosecution:

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14 Kurt Eichenwald, "In Enron Case, a Verdict on an Era," N.Y. Times, May 26, 2006, available at: http://www.nytimes.com/2006/05/26/business/businessspecial3/26verdict.html?ei=5088&en=a9fee664060b30ea&ex=1306296000&partner=rssnyt&emc=rss&pagewanted=all.

15 Edward Chancellor, "A Short History of the Bear," Guest Analysis, http://www.prudentbear.com/press_room_short_selling_history.html (October 29, 2001).

> The evidence on subsequent stock returns suggests that in public battles between short sellers and firms, short sellers usually are vindicated by subsequent events. The evidence suggests that short sellers play an important role in detecting not just overpricing, but also fraud. Policy makers might want to consider making the institutional and legal environment less hostile to short sellers.[16]

The prospect of additional regulation of short selling raises fundamental market issues that go far beyond those related to the trading activities of hedge funds. It potentially affects the efficiency and volatility of U.S. equity markets and the position of U.S. market participants in the world financial system. The adoption of additional short selling rules could constitute a rash and harmful overreaction to isolated incidents of alleged impropriety that would be better addressed under the existing anti-fraud provisions of the U.S. securities laws.

V. RECENT ALLEGATIONS OF ABUSES INVOLVING SHORT SALES AND THIRD-PARTY INFORMATION

Whether investment managers are investing on the long or short side, they have a fiduciary duty to their investors to consider all reasonably available information that might bear on the advisability of their decisions. Fortunately, we live in a time that a recent SEC chairman referred to as the "age of information," and information relevant to investment decisions is in fact available to investors from many sources, including sell-side and independent research, the financial press, "bloggers" and reports filed by public companies with the SEC. Another SEC commissioner many years ago compared the information available at any given time to pieces of a "mosaic" that would support an investment point of view if the individual pieces could be correctly assembled. For this effort to succeed, there must obviously be a robust supply of information from many sources, including those that express views that are at odds with prevailing sentiment.

Where available information leads some investors to take significant short positions in a public company's common stock, it sometimes occurs that the public company – particularly in the last few years – will allege that the short seller has been assisted by third parties in seeking to profit from the short position. For example, companies frequently allege that an investor has established a short position in a company's stock while feeding reports to the financial press that criticize the company's accounting or financial conduct. The allegations often extend to the feeding of such reports to bloggers and analysts, the posting of such reports on Internet message boards and to the investor's making direct contact with the SEC asking that it initiate an

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16 Owen A. Lamont, Associate Professor of Finance at the Graduate School of Business, University of Chicago, commenting on the data in his study of battles between short sellers and firms entitled, "Go down fighting: Short sellers vs. firms."

investigation (or direct contact with law enforcement authorities or even congressional committees).

Allegations of this kind are, of course, not new. A columnist in a well-known financial newspaper was sued with his publisher in the late 1970s for allegedly writing negative articles about a stock in order to enhance the value of certain investors' short positions in that stock. As so often happens, the plaintiffs' case fell apart for lack of evidence, leading the court a few years later to assess a total of $76,000 in attorneys' fees against the plaintiffs for continuing the litigation in bad faith.[17]

As discussed above, short sellers often turn out to be right in their allegations about public companies. MFA believes it would be a serious policy mistake to inhibit short sellers from continuing to perform the essential contrarian function described above and that it would raise serious constitutional issues to attempt to restrict short sellers' communications with third parties, including those referred above.

On the other hand, if an investor knows its allegations about a company are untrue, existing law and the SEC's rules provide a means for dealing with this conduct. As we have seen from the reverse situation of the "pump and dump" schemes — which involve the dissemination of untrue or misleading *favorable* information about a company — the SEC has ample authority under Exchange Act Rule 10b-5 and Securities Act Section 17(a) to take action against those responsible. Of course, unlike the "pump and dump" schemes, it is usually difficult to identify the source of negative information except by requiring the recipient of the information to reveal his or her sources – a step that often threatens to undermine constitutional and other important societal values.

If the investor's negative allegations turn out to be true (or if it develops at least that investor did not know the allegations to be false), the existence of a remedy is less clear. On the other hand, it is obvious that there may be little need for a remedy in such cases — indeed, the short seller may deserve the market's thanks.

At the same time, persons who receive adverse information have their own responsibility to treat it with a degree of healthy skepticism. We assume that the SEC staff routinely asks "tippers" whether they have a short position or other source of bias, and we believe that responsible members of the press and securities analysts should do no less. In fact, we believe the financial press has been increasingly diligent over the past few years in identifying possible sources of bias of persons whom they quote as having positive or negative views on a stock.

In this connection, sell-side analysts, i.e., research analysts employed by member firms of the New York Stock Exchange or the NASD, are subject to those organizations' rules aimed at revealing conflicts of interest and otherwise enhancing the integrity of

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17 *Nemeroff v. Abelson*, 704 F.2d 652 (2d Cir. 1983).

analyst research. Independent analysts are not subject to the same rules. The views expressed or reported by independent analysts are nonetheless part of the relevant mosaic, and users of independent research must make allowances for the fact that independent research is not subject to the same internal and external scrutiny and standards as research produced by securities firms.

It has been alleged, for example, that some independent analysts have delayed the release of a negative report to permit an investor to complete the accumulation of its short position. Depending on the nature of that analyst's relationship with his clients, such a delay may well raise questions such as whether the analyst has violated its duty to its clients in violation of the federal securities laws. If the analyst were employed by a member firm of the NYSE or NASD, of course, he or she would likely also face criticism by those organizations based at least on a departure from "just and equitable principles of trade."

We should not overlook allegations that plaintiffs who are about to bring a securities fraud class action against a public company sometimes "tip" an investor about the imminent filing of the action, giving the investors an opportunity to short the stock. In these situations, there may be no violation of Rule 10b-5 because the plaintiff and the short seller have violated no previously-recognized duties in making the "tip" and in shorting the stock. It has been suggested that state law remedies may apply, but this is not at all clear. It may be more productive to focus on whether these situations raise questions about plaintiff's counsel's ethical violations, whether such conduct should be taken into consideration for purposes of a later motion for sanctions against plaintiff's counsel and whether such conduct should disqualify a plaintiff as "typical" for purposes of representing a class.

These allegations all raise serious ethical and legal questions. MFA unequivocally condemns the intentional spreading of false or misleading information. At the same time, there will be many cases where the facts and the law are not clear, and MFA believes — as have so many during the preceding two centuries and more — that the remedy in such cases should be "more speech." We urge that the Congress and the regulators follow this principle in dealing with those isolated situations where the applicability of current law and regulation may not be clear.

VI. SEC REGULATION OF SHORT SELLING

The SEC has observed on many occasions that short selling can contribute to market liquidity and pricing efficiency:

> Short selling provides the market with two important benefits: market liquidity and pricing efficiency. Substantial market liquidity is provided through short selling by market professionals, such as market makers, block positioners, and specialists, who facilitate the operation of the markets by offsetting temporary imbalances in the supply and demand for securities. To the extent that short sales are effected in the market by securities

> professionals, such short sale activities, in effect, add to the trading supply of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of supply.
>
> Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise. Both the purchaser and the short seller hope to profit by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.[18]

To be sure, the Commission also has recognized that short selling can cause market operational problems and can be used as a tool for manipulation. The market operational problems can result from failures to deliver securities in settlement of trades (short sales or long sales). Manipulation can occur when short sales are made with the purpose of driving down the market price of a security, rather than for the purpose of profiting by covering their shorts when the market at large recognizes what the short sellers believed they were first to see, that the security is mispriced and should be trading at lower levels.

In recognition of the need to guard against improper uses of short selling, the SEC has comprehensive rules addressing short selling. The SEC adopted Regulation SHO in 2004 to limit failures to deliver on short sale trades. Before a broker-dealer executes a short sale for a customer or for its own account, Regulation SHO requires a broker-dealer to locate a source of securities that can be borrowed to deliver to the purchaser at the time of settlement. In recognition that not all trades will settle in a timely manner, however, Regulation SHO also requires broker-dealers to go into the market and buy sufficient securities to close out a persistent fail to deliver position in so-called "threshold securities."

Manipulation of security prices is illegal, and is one of the primary concerns of the SEC and the self-regulatory organizations ("SRO") because of its pernicious effect on market integrity and the investing public. Accordingly, the SEC and the SROs have a

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18 *SEC Concept Release: Short Sales*, Securities Exchange Act Release No. 42037 (October 20, 1999), in text accompanying n. 4, available at: http://www.sec.gov/rules/concept/34-42037.htm

wide array of laws and rules to deter and detect manipulation. Market manipulation can also be prosecuted criminally.

One kind of short selling, namely, so-called "naked short selling," is the focus a much issuer and media attention. As the SEC staff has noted, this term can have many meanings, and it is important to know which activity is the focus of discussion. The term typically is used to have any of the following meanings:

(1) selling stock short without having located stock for delivery at settlement. This activity would generally violate Regulation SHO, which places the "locate" obligation on broker-dealers.

(2) selling stock short and failing to deliver shares at the time of settlement. This activity doesn't necessarily violate any rules, because there are legitimate reasons why a seller may not have the stock available on settlement day.

(3) selling stock short and failing to deliver at settlement with the purpose of driving down the security's price. This manipulative activity is not addressed by Regulation SHO, but generally would violate various securities laws, including the general antifraud and anti-manipulation provisions.

The SEC and the self-regulatory organizations ("SROs") are actively examining broker-dealers and others for compliance with Regulation SHO. In addition, they have said that they are continually on the alert for instances where the third type of naked short selling, namely, manipulation, is occurring. Hedge funds, like all short sellers, and the broker-dealers that execute their trades are fully subject to this panoply of regulation, and can be prosecuted if they engage in violations.

As briefly outlined above, short selling is subject to a comprehensive regulatory scheme, and compliance with those regulations is very much in the forefront of the regulators' agenda. One of the main purposes of the SEC's adoption of Regulation SHO was to create a uniform set of requirements for short sales. As part of that process, the SROs were required to rescind their overlapping (and occasionally disparate) rules. MFA believes it would be a mistake to reintroduce differences and disparities in short sale regulation, either on the federal or the state level.

VII. CONCLUSION

The hedge fund industry has experienced significant growth in recent years. Much of this growth can be attributed to institutional investors seeking to diversify their returns and thereby reduce the overall risk of their investment portfolios. This growth has enabled hedge funds to serve as source of liquidity in global capital markets, increasing efficiency and decreasing risks.

Short selling is not un-American, particularly when it is on the basis of information obtained from a variety of sources and some of which contradicts the conventional wisdom. Information released by public companies does not reflect all that is known — or should be known — about such companies. Short selling helps to correct mispricing of stocks and in that way it contributes importantly to the honesty and fairness of our markets. It does so in particular by:

- Identifying overvalued securities and causing their prices to return to more appropriate levels.
- Identifying companies whose public disclosures and accounting are false or misleading.
- Providing liquidity to the markets and assists in price formation and price discovery.
- Providing handsome returns to the investors — often pension funds and other aggregators of wealth who represent the savings of many thousands of U.S. individuals.
- Offering a means by which those who have formed negative views on the competence or integrity of incumbent management can act on those views, often to the displeasure of companies like Enron Corporation and some of the other companies complaining the most vociferously about short sellers.

* * *

We thank the Committee for the opportunity to allow MFA to share its views with you on this important topic.

Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Committee on the Judiciary

United States Senate

June 20, 2006

Hearing on Examining Short Selling Activities of Hedge Funds

Insuring Disclosure to Control Manipulative Short Selling

Mr. Chairman, Ranking Member Leahy, and members of the Committee, thank you for the opportunity to testify today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. I am also a director of several organizations, including Allied Capital Corporation, which as an investment analyst wrote this month, "has successfully worked through a blistering short attack."

Manipulative short selling has a long, colorful and disreputable history, going back at least to the seventeenth century, and has been a perennial problem in publicly traded financial markets. Manipulation on the London Stock Exchange caused the British Parliament to go to the extreme of outlawing short selling from 1734 to 1860. "Bear pools" were a notorious feature of the New York Stock Exchange in the 1920s.

Fifteen years ago, in 1991, the House Committee on Government Operations submitted a report which stated that its Subcommittee on Commerce, Consumer and Monetary Affairs had inquired of the SEC in an "attempt to verify company complaints that the SEC often assisted short sellers by investigating companies that the short sellers had identified as targets." The report notes further: "The SEC responded that they did not have the necessary information in their possession to respond to this inquiry."

The disclosures I recommend would give the SEC the necessary information to address this question.

As everyone who is involved in this discussion is quick to say, there is no objection to (and much to be said for) legitimate short selling based on an investment view of asset prices, including, of course, the securities of a specific company. The issue is manipulative short selling. This reflects the unfortunate fact that some market actors succumb to the temptation to make profits on short positions come true, by themselves causing a drop in specific stock prices.

Spreading negative rumors is a centuries-old element of such efforts. The patterns are alleged to include coordinating short sales with lawsuits against the target companies. They certainly do include, as inquired about in the 1991 House report, trying to induce the SEC to initiate investigations, a sure fire way to knock down the price of a stock. It is remarkable that the financial interests involved in such activities currently do not need to be disclosed.

Financial markets with today's technology reflect an intense network of virtually instantaneous communication. In the midst of this network, the SEC cannot regulate capital markets from an Olympian height. It is itself immersed in the markets as a very powerful source of market-moving events. This effect has been magnified by the post-Enron or Sarbanes-Oxley era. Unavoidably, some market actors draw this conclusion: If I can move the SEC, I can move the market to my personal profit.

In other words, these market actors have unfortunately observed the force of the following logic:

1. Disclosure of an SEC investigation of a company can reliably be expected to depress the price of the company's stock.

2. If I am short the stock, this is a very profitable event for me.

3. Therefore, if I can induce the SEC to begin an investigation, I will almost certainly make a lot of money.

How should the SEC deal with the fact that other people wish to use it to change the price of certain stocks? And with the fact that since these people have very large financial interests at stake and rightly appreciate the market-moving power of SEC investigations, they will work tirelessly to achieve this?

A Manipulative Short Selling Scenario

With these questions in mind, consider the following scenario.

While establishing a large short position in the stock of a target company, a manipulative group or its representative urges claims of accounting or financial deficiencies as "tips" to the SEC. Let us stipulate that these claims are spurious. Whether or not the claims are spurious, however, the fact that the group is pushing them on the SEC and knowledge of how the SEC staff is reacting constitutes key non-public information, highly relevant to the price of the stock in question.

In our scenario the claims are spurious, so when the SEC staff asks the company about the question, it receives a reasonable explanation. That should close the matter, since there is no real problem. But the group tirelessly continues to press its claims with strident rhetoric and urge an SEC investigation.

Now consider the position of the SEC staff in the post-Enron era. They are well aware that such claims often reflect the financial self-interest of those making them and their intense desire to cause adverse movement in market prices. This is the so-called "short and distort" strategy. But in the post-Enron era, the political and public relations penalty for the SEC staff of missing any problem is great, however low they may view its probability. <u>However, there is no political or public relations penalty on the SEC for imposing great costs and market losses on the shareholders of the target company</u>. None. In this environment, the SEC staff cannot afford to take the personal and bureaucratic risk of not commencing an investigation.

An SEC investigation is therefore begun, and in compliance with the SEC's own disclosure requirements, is publicly announced by the company. As the manipulative group planned all along, the price of the company's stock drops. This means that the group has itself caused the realization of handsome profits on its short position by using the SEC's regulatory structure to manipulate the stock market. The strategy has successfully developed from "short and distort" to "short, distort, and get the SEC to support" the attack.

The public rationale leading to this scenario is the watchword of the Sarbanes-Oxley requirements: disclosure. <u>But the most essential elements underlying this situation--the financial interest of the investor group and its activity with the SEC--are not required to be disclosed at all</u>! Even though the group benefits by causing fear of an SEC investigation among stockholders of the target company, and thereby transfers wealth from them to itself, that critical fact never has to be revealed so the market can weigh its claims accordingly.

A scenario like this is certainly not what the authors of the Sarbanes-Oxley Act had in mind and obviously should not be permitted in well-designed capital markets. Everyone should be able to agree on this point.

However, situations like this are in fact one source of the informal investigations the SEC has in process, at great cost to everyone concerned. Especially great administrative and market costs are imposed on the shareholders of the target companies who are supposedly being "protected," while profits are created for the group with the undisclosed short interests.

A related scenario has become well-publicized through the allegations in the lawsuits brought by Biovail Corp. and Overstock.com Inc. These suits assert that short-selling hedge funds, having conspired with an investment research firm to produce misleading negative research reports, had non-public information of the content and timing of their release. They could then time their market moves to benefit from the market price reaction.

It is well known that short sellers routinely and aggressively push views favorable to their investment positions on journalists, analysts and regulators. "We have had hedge funds twist our arms to write reports in a certain way," said one analyst. But if this morphs into the use of privileged, non-disclosed, market price-moving information, it is a different matter.

As another related example, consider using private knowledge that there will be a lawsuit filed, as discussed in papers published by the Washington Legal Foundation. Use of the non-public information that there is an imminent lawsuit, especially when the short-selling group is itself initiating or arranging the suit to cause the resulting price movement from which it will profit, is self-evidently manipulation. "The failure of the short-seller to disclose the impending suit," Professor Moin Yahya writes, "...is arguably a material omission and constitutes fraud.... No rational investor would ever consent to purchasing stock from someone who was about to sue the company."

Let us return to the scenario of the group selling you stock while doing its utmost in private to cause the SEC to commence an investigation of the company. No rational investor would ever consent to purchase stock from a seller working hard to use the SEC to knock down the price of the stock.

The Answer: Disclosure

The principle of disclosure provides a straightforward way to help address this problem: Require that any party bringing claims of accounting or financial irregularities to the SEC publicly disclose all the short or long financial interests it has or represents in the company involved, and whether it is acting as part of a group. A simple SEC questionnaire could provide this disclosure. Appropriate penalties for failure to disclose would automatically be covered by existing sanctions for making false statements.

Disclosure should be a continuing requirement for all interests acquired or disposed of while any contacts between the group and the SEC continue and/or during the life of the SEC's inquiry or investigation of the issues raised. This is because ongoing communication with the SEC can allow the group to have trading advantages based on its private knowledge of how the SEC staff is responding and what they are likely to do.

Such a disclosure requirement would reveal how much profit the group has realized while involving the SEC to move market prices. The SEC could then measure this effect.

Any profits derived by effective insider information of coming SEC investigations or actions, should be treated exactly as other profits from trading on insider information.

The good news is that this problem can be addressed with a simple and obviously appropriate requirement. This could be enacted as legislation, adopted as policy by the SEC, or implemented as a required procedure by the SEC staff. I believe that at least one of the three needs to be energetically put in place, as promptly as possible.

Parallel Disclosures of Large Short and Long Positions

While we are about improving disclosures for the benefit of the entire market, the disclosure of large, concentrated short positions should be required in exactly parallel fashion to the existing required disclosures of long positions. The importance, simplicity and fairness of this idea seems obvious to me.

To be specific, Sections 13 (f) and 13 (d) of the Securities Exchange Act of 1934 should be amended to require publicly filed reports of any short positions equivalent in value to the long positions already covered by these statutory provisions, including their coverage of group actions. Disclosure of such short positions will be at least as useful to investors and market participants generally as are the existing disclosures of long positions.

I believe this is a straightforward and essential reform to improve the fairness and transparency of our capital markets.

Mr. Chairman, I very much appreciate the Committee's interest in these very important issues. Thank you again for the opportunity to be here today.

The Relationship between the Independent Investment Research Profession and Investment Managers

Testimony before the United States Senate Committee on the Judiciary

Dr. Howard M. Schilit, CPA

Founder and former president of the Center for Financial Research & Analysis

June 28, 2006

Senator Specter and other esteemed members of this committee, I am grateful for the opportunity to participate in this important hearing entitled, "Hedge Funds and Analysts: How Independent is their Relationship?"

My name is Howard Schilit. I am author of the book *FINANCIAL SHENANIGANS: How to Detect Accounting Gimmicks & Fraud in Financial Reports*, and founder and former president of one of the largest independent investment research firms, the Center for Financial Research & Analysis (widely known as CFRA). Since our founding in 1994, our research center has helped thousands of investors, lenders, insurance underwriters, and others analyze and interpret complex accounting issues and make better economic decisions.

Prior to founding CFRA, I spent 17 years as an accounting professor at American University in Washington, researching ethical (and sometimes unethical) behavior of auditors and publicly-traded companies and their executives. My research first led to the publication of my book *FINANCIAL SHENANIGANS*, and later to the founding of my research boutique.

As an author and one of the pioneers in the independent investment research profession, I have learned much about the behavior of investment managers (including long-only and hedge fund professionals) and independent research firms. I would like to share my observations about both the investment managers and the research providers, focusing on the current state and some recommendations to eliminate (or at least lessen) conflicts of interest that ultimately hurt smaller investors.

Investment Managers:

Investment managers can be segmented into two groups: those that can only own stocks (long-only managers), or those that can both own stocks and short stocks (typically, but not necessarily in a hedge fund structure). In recent years, both the long-only and hedge fund manager have searched for and found independent research, no longer relying exclusively on either their own in-house analysts or on sell-side (brokerage-company) research. The rise of high quality independent research boutiques has been a real benefit, not only for investment managers, but investors, in general.

Please note that investment managers (both long-only and hedge funds) are grouped together and should be evaluated as such. Aberrant behavior can occur just as easily in either group.

Independent Research Organizations:

Perhaps as many as five hundred investment research organizations are now selling a wide variety of products and services to investment managers. While most are still one or two person "mom-and-pop" operations, some have grown to generate tens of millions of dollars in revenue.

Some research firms have well thought out conflict of interest policies, while others may demonstrate little or no scruples.

I believe the most important result of this committee's work would be to move the investment research profession to establish policies and procedures to eliminate both real and perceived conflicts of interest.

Recommendations

Please allow me to offer a number of recommendations that will likely make it much more difficult for research organizations to be labeled as *Independent*:

1. For firms selling a subscription product, all subscribers should receive the product at the same time and in the same form. No subscribers should be given advance copies, nor should they ever be tipped-off of an upcoming report.
2. Research firms should refrain from using non-public information to trade in their own accounts, particularly, in advance of disseminating a report to clients.
3. Moreover, research firms that make recommendations for stock purchase or sale should not be permitted to also manage an investment fund. While this may sound self evident, today some research firms are also investment firms (either long-only or hedge funds).
4. Fees received from investment management clients should never contain a "percentage of profits earned from a research idea." Becoming a "partner" with a client would immediately strain the objectivity and independence of the research analyst.
5. Research firms that also provide investment banking services should be prohibited from using the "Independent" label.
6. Company-sponsored research creates special conflict-of-interest problems and should generally render the research firm as "not independent."
7. Just as an oversight board exists for auditors (the PCAOB) and many other professionals, such a board is needed to review polices, procedures and practices of investment research firms.

While this list is far from complete, I believe it provides a good starting point.

Relationship between Investment Manager and Research Firm

I would now like to talk briefly about the relationship between the investment manager and the research firm. Today, pressure can be brought to bear on research firms by investment managers, such as hedge fund professionals, to write or not write on certain companies, and perhaps even to provide non-public information to a high-paying client. My experience in running a large research center for over a decade is that by establishing transparent and verifiable rules for both clients and employees, rarely will clients push the research firm to act unethically. It is critical that at the beginning of a relationship with a client, he or she knows the rules of the game and also knows that they will always be enforced. That means occasionally firing a client who is unwilling to play by the ethical rules established by the research firm.

Concluding Thoughts

While there may be only isolated cases of bad behavior by investment managers or research providers, the need exists for a careful review of the practices of each group and how they interact. For sure, from time to time, investment managers will act badly and try to pressure the research providers to act unethically, to the detriment of other clients, or investors, in general. This problem is not too different than the one we all face as parents, as our *usually wonderful* children sometimes act badly and try to pressure us to do things we later regret doing. The absence of rules or failure to enforce them not only emboldens children to misbehave, but also some investment managers.

In conclusion, while I do not believe widespread unethical practices by independent investment research firms exist today, I think it is imperative for each firm to show transparent polices and procedures to lessen concerns about real or potential conflicts-of-interest.

I hope that these thoughts and recommendations help this committee and would be happy to answer any questions. Thank you.

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June 25, 2006

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
224 Senate Dirksen
Washington, DC 20510

Dear Mr. Chairman:

I am writing to express concern about the integrity of our financial markets and the protection of individual investors and stockholders who have come to rely more and more upon their personal investment holdings to secure their futures. Today, there exists a largely unregulated group of sophisticated professional investors who engage in abusive, fraudulent practices and profit through the destruction of the wealth of others. Their tool is abusive short-selling.

Let me note that I am a firm believer in efficient capital markets. Liquid, efficient capital markets require the ability to hedge investment positions through instruments such as derivative securities or short selling. Passive, legal short-selling investors may legitimately profit by predicting market shifts or by spotting overvalued companies to provide market corrections. Short selling itself is not an inherently "bad thing."

However, we need to recognize that when a person or institution engages in short selling, their goal is to profit through a drop in shareholder wealth. Therefore, it is only reasonable that we have in place controls to monitor and ensure that short-sellers do not illegally engineer or cause the destruction of shareholder value for their personal gain.

By analogy, if my neighbors take out a home owner's insurance policy that pays them if my house burns down I need to make sure they aren't teaching my kids to play with matches.

Yet, while our current regulatory environment places significant control, oversight, and transparency requirements on the stewards of shareholder value, there are almost no controls or oversight, and zero transparency required of those who stand to profit through the destruction of shareholder value – abusive short sellers.

Our experience at TASER International, Incorporated is a case in point.

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In 1993, I started TASER International with my brother Tom in a garage in Tucson. Two of our friends had recently been shot and killed by an irate motorist on a Friday night in Scottsdale, Arizona. We had come to the conclusion that our world could be a much safer place if people had more effective non-lethal options. For the first 8 years, we struggled to survive, losing money each year (as is common for many entrepreneurs). By 1999, our parents were teetering on the edge of financial ruin – they had invested everything they had into TASER. Fortunately, in 1999 we were able to introduce a revolutionary new product, the ADVANCED TASER M26. This was the most effective non-lethal weapon ever developed – and it was a tremendous success with law enforcement agencies around the world.

Sales began to take off in early 2000. We successfully completed an IPO in 2001. In 2003 we introduced a new product, the TASER X26. This new product was much smaller, lighter, and even more effective than the M26. Sales more than doubled each year from 2002 to 2004. Our revenues and profits soared – and so did our stock price. From a low of around $3 per share, our stock price hit a peak of about $400 at the end of 2004 (we had split the stock 12 for 1 since 2002, so the post-split price of about $33 corresponds to a pre-split of right around $400).

We were living the American dream. We built a great company, creating jobs for hundreds of fantastic employees and contractors. Over 7,000 police agencies were using our products to save lives everyday. Our relationships with our customers were great. Tom and I were named the Ernst & Young Entrepreneurs of the Year for the state of Arizona in 2002. And in 2004, we were the Wall Street Journal's #1 performing stock based on both 1 and 3 year returns.

As our stock price took off, I remember my personal stock broker, Michael Dwyer at RW Baird, called me to his office one day. He warned me, "As your stock price increases, short sellers will get into your stock. Be very, very careful. These people are ruthless. They will hire private investigators to go through your trash. They will plant negative stories in the media about the company, and about its management. They take large positions worth hundreds of millions of dollars to see a company's stock price drop, and they don't sit idly by and wait for it to happen."

At the time, I told him I wasn't concerned. We ran a clean shop at TASER. His warning sounded rather conspiratorial to me. Besides, TASER's financial performance, growth, and technology leadership were all too strong for this to be a real concern.

But then, in early 2004, strange things started to happen. Starting with our first quarter, we were hit with a vehemently negative news story just about every quarter – on the weekend before we announced earnings. One of our board members, Dr. Mark Kroll (who holds more patents on cardiac devices than anyone else in the world), ran some quick statistics and showed me the probability of these highly negative stories randomly occurring before our earnings calls was infinitesimally small.

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The most damaging of these negative stories was a front page article in the New York Times on July 18, 2004.

We received a report from one of our active shareholders which claimed that the short interest in TASER stock jumped 50%, from 9 million to 14 million shares in the two days before the New York Times story. We have tried to validate this information, but have not been able to do so – due to the complete lack of transparency on short sales. Following the article, the stock price dropped 30%, erasing $300 million of shareholder value.

Most of the controversy focused on the safety of TASER devices and management's contentions regarding their safety. (It should be noted that every senior manager at TASER has been hit with the device – I've done it seven times.)

We believed the controversy was settled when the Department of Defense released the results of it's study into the safety of TASER devices. On October 18, 2004, the Department of Defense released the executive summary of the Human Effects Center of Excellence (HECOE) report on TASER type devices. The same day, TASER International issued a press release, which was approved by the Department of Defense, describing the study which had concluded the TASER was generally safe and effective. The executive summary of the report was concurrently posted on our website.

Believing that the controversy was behind us, we lifted a voluntary restriction on stock sales by executive management. During the course of the year, we as a group decided not to sell any shares until we felt the controversy was behind us – as we did not want any negative interpretations of insider sales to compound the safety controversy. Despite the negativity in the public media, our revenues had continued to explode, and the stock price was up dramatically from the beginning of the year. Accordingly, many of the insiders did sell shares and diversify their holdings in late October and early November. The stock continued its rise over the next 60 days, ending the year at an all time high.

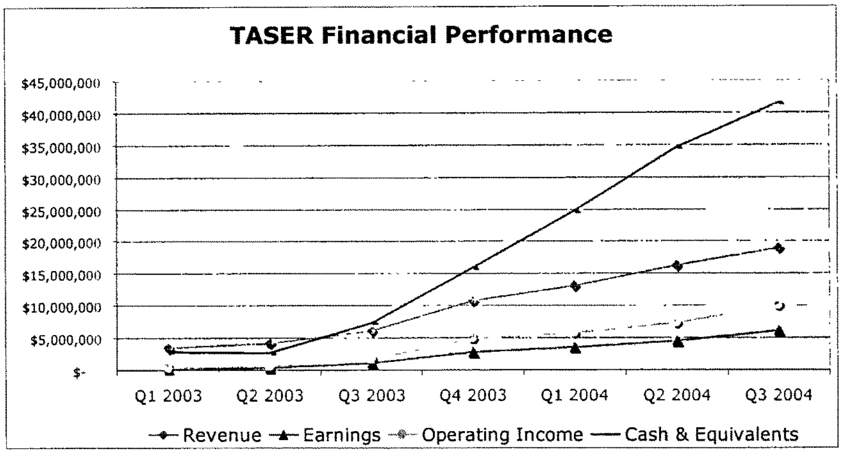
Unfortunately, the controversy was not behind us. On November 26, 2004 the New York Times was back. In its article, "Claims Over TASER's Safety Are Challenged," the Times implied that TASER International had misrepresented the results of the Department of Defense HECOE study on TASER safety. Prior to writing his story, the reporter had talked with Captain Dan McSweeney, a press officer at the DoD who had informed him that the DoD had, indeed, approved our press release on the issue. The Times spun the headline of our press release "... Report Concludes TASER Technology is Generally Safe and Effective" against some of the qualifying language in the release and concurrently released executive summary.

The article implied that TASER executives had misrepresented the study (again, knowing our press release had been through the approval process and approved by the DoD), pumped the stock, and sold shares profiting from the misstatements.

Needless to say, we were infuriated. To add insult to injury, the story's author had attended a conference less than two weeks earlier where he had voluntarily taken a hit from a TASER device. Nowhere in any of his articles alleging the gross danger of these devices did he disclose he felt confident enough in its safety to personally expose himself to a hit.

One of our directors conducted a brief background search on the reporter to understand his motivation for going so far as to manufacture the November 26 story. We found a telling story in PR Week from June 2004. PR Week reported the New York Times author has close relationships and joins in a regular card game with prominent short sellers. Given the potential impropriety (and the fact this would be a violation of the New York Times ethics handbook), we wrote a letter to the New York Times requesting an investigation into the matter (See Appendix). We received a letter from the Times dated December 22, 2004 disclaiming any inappropriate links between their reporter and short-sellers.

Shortly after the New York Times' November 2004 article, a research firm called Gradient Analytics released a report giving TASER a "C" grade on financial performance. Gradient subsequently dropped TASER's rating to an "F" within a very brief period. During this same time frame, TASER International's financial performance was nothing less than extraordinary. Revenues exploded from $3.4 million in the first quarter of 2003 to $19 million in the third quarter of 2004. Earnings had grown from $400,000 to $10 million per quarter. And even with this incredible growth, operating income had surged from 12% of revenue to 53% of revenue while cash reserves grew from $2.8 to $41.5 million.



No reasonable and objective analyst could have given TASER an "F" on a financial scorecard during 2004. Even more troubling, Gradient Analytics was headquartered less than a mile from TASER International. Yet, the analyst never visited the facility, nor did he ever call to "get to know the business." The only calls were very brief, and very hostile.

In late December 2004, Gradient wrote another negative report – this one focused on a mid-December sale to one of our largest distributors, Davidsons, Inc. The report alleged "channel stuffing" – because part of the order was for inventory for the launch of a new product. In the Gradient report, they described several potential outcomes of the order – all of which were highly negative. The report failed to even acknowledge the potential outcome that the customer would sell the product and reorder (which is what actually happened). It was highly suspicious that an analyst would write a report with several hypothetical negative outcomes and not even acknowledge the possibility that the order would sell-through.

Even more suspiciously, this Gradient report was picked up and featured prominently in the USA Today. Like any public company, we have hired public relations firms (several over the course of our history). We understand how exceedingly difficult it is to get a story placed in the USA Today. It was highly unlikely that USA Today randomly picked up a report from Gradient on a relatively small order (we had had several larger orders in that timeframe, such as a $3.7 million order from the Houston police earlier in the quarter). It is my belief that the only way the Gradient report could have been published in the USA Today is through an aggressive, well-funded PR campaign.

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Since that time, a number of former employees of Gradient Analytics have signed affidavits that the company was selling "hit-piece" reports on other companies – i.e. reports engineered (and even written and edited) by short-sellers to drive stock prices lower.

Gradient would return for an encore report on TASER in January 2005 – an entire report dedicated to attacking the reputation of our medical director, a highly respected electro physiologist and coronary care specialist. None of us have ever seen a report billed as a "financial analyst report" that is entirely dedicated to attacking the reputation of a single individual. It is hard for me to imagine the report on Dr. Stratbucker could be anything other than part of a coordinated campaign to assail the safety of our products and the company behind them.

On December 31, 2004, we received a letter from the SEC advising us that TASER International was the subject of an "informal inquiry" into two subjects: the company's statements related to the safety of our products and the Davidson's order.

By now, it was becoming clear to everyone, even me (I had been skeptical), that these events were not random nor unrelated. In fact, looking back, we realized we had received a series of questions from a Wall Street Journal reporter in early December inquiring as to whether we had received any letters from the SEC. This inquiry was made weeks before we had received any inquiry letter from the SEC, and was the first question of its kind. It is possible the reporter was tipped off by someone who had sent a report to the SEC trying to prompt an investigation.

In mid-December we received a call through our auditors advising us that the SEC letter was coming. Because we had been advised by the SEC that the inquiry was confidential, and because we knew how disruptive such news would be to our business, we set up careful security to handle the letter when it arrived to preserve confidentiality. The hard copy of the letter arrived in early January.

On January 6, 2005 we received a call from a reporter at the Arizona Republic asking us whether we had received an inquiry letter from the SEC. Based on the specificity of her questions, we ascertained that she had obtained a copy of the letter.

Preserving confidentiality was no longer a possibility. We released a public statement on the SEC inquiry and on January 7, 2005 our stock dropped 18%. When the New York Times released its story on the TASER SEC inquiry, they added another piece of information:

> *An internal company document suggests, meanwhile, that TASER was struggling to meet its sales goals at the end of 2004. The document shows that in another sale, a distributor bought $700,000 in TASERS and accessories on December 30,*

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the last business day of the fourth quarter, about 3 percent of the sales that TASER expected for the quarter.

"Hope this will help out!!!!!" the distributor noted in the purchase order, which was provided by a person who will profit if TASER's shares fall.

Shell shocked best described our reaction. Here was the New York Times, which had just weeks before disclaimed its reporter's relations with short-sellers – announcing that they had received copies of material, non-public information in the form of confidential company records delivered by an individual who was trafficking in material, non-public records of our company. Surely, this was evidence of a significant and intentional securities law violation by someone attempting to manipulate our stock price.

As if that realization were not enough, it got worse. The New York Times story was slated to run on the 8th. Knowing that the story was coming out (the reporter had called us on the 7th), my brother, Tom Smith, logged on-line to read the story at midnight. When he saw the specific notation with the five exclamation points "Hope this will help out!!!!!" – he logged into our computer network to download all faxes from December 30. Sure enough, when he downloaded the fax, the notation was right there. (FYI – we see nothing wrong with the notation. It simply reflects that the distributor has a good relationship with his salesperson and wished her well that the order would help meet her sales goals).

The next morning, Tom went into the office to meet with our CFO, Dan Behrendt, to discuss the situation. As they discussed the article, Dan noticed something strange. The notation "hope this will help out!!!" was missing from the hard copy of the facsimile in his file. Trying to understand what was happening, Tom and Dan tracked down every copy of the order in our building (one copy stays in sales, one goes to accounting, etc). On every hard copy of the order, the statement was missing.

We determined what happened: someone on our staff had taken the original copy of the purchase order and sent it to "a person who will profit if the stock drops." She then used white-out to erase the comment, made a photocopy, and replaced the original with the doctored document. All subsequent copies were made from the doctored original.

Brainstorming to understand the situation, we realized the only plausible explanation was that someone was setting a trap for management. TASER's leadership has built a reputation as straightforward, head-on crisis managers. Our style is to confront misinformation straight away. We had been on CNBC several times in 2004 addressing bad information. We believe someone was setting us up to go on CNBC with the doctored document and claim that there was no such notation. When the media then obtained the original purchase order document from our customer's files it would have looked like TASER management had doctored the purchase order. We would have lost all credibility.

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We all realized we weren't in Kansas anymore.

I'm always one to believe people are good. When the story first hit that the NY Times had copies of confidential documents, my explanation was that likely someone had gotten it out of our trash. Or perhaps someone had bribed one of the cleaning people from a contractor who maintains our building. The realization the original had been intercepted and doctored however could only mean we had someone inside the company illegally sharing confidential information with short sellers.

We responded by hiring a local investigative firm and providing them carte-blanche to investigate everyone inside the company from the CEO on down. In very short order, they identified the person responsible for the leak as my secretary.

The secretary originally claimed she had never seen the SEC letter. Yet, when we located the original letter, evidence showed she had opened it. The woman subsequently admitted to lying about the letter.

Worse, it appeared that this individual had lied about having ovarian cancer earlier in the year. Claiming that she was undergoing radiation therapy, she had asked to borrow $2,500 to help meet financial strain. At my direction, we bonused her the money. Later, when we suspected that the cancer claim might be part of a ruse and confronted her, the woman admitted she had never submitted any claims for reimbursement for her supposed medical costs. She claimed she had paid over $90,000 in cash for medical treatments because she was concerned that her medical records were in her married name and her insurance was in her maiden name (or vice versa) – and didn't think the insurance could deal with the dilemma.

The investigation yielded other concerning information such as purchases well outside the means of a person earning a salary of $42,000 per year. Based on this information, interview tapes, and my personal interactions with her – I have come to the conclusion the individual pursued employment with our company (just 9 months earlier in early '04) specifically for the purpose trafficking information to some outside, unknown client.

I cannot prove this contention. Our investigators did not have subpoena power or access to the financial records necessary to solve the question. But, as someone who was originally skeptical that things like this could happen, I can tell you today that these events were not mere coincidences.

From January 8th onward, a campaign of well coordinated negative messages barraged the company throughout 2005. In fact, when it was released to the public that we were being investigated by the SEC, our revenues were cut in half. After eight consecutive quarters of consistent revenue growth of about 20%, we saw a 50% decline. As you can imagine, our law enforcement customers were loathe to buy from a company that was

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under a federal investigation. Larger police agencies in particular pulled their orders and took a "wait and see" attitude. Our stock dropped by more than 80%. The SEC investigation had become a self-fulfilling prophecy. The mere announcement of the investigation caused our business great damage. Our retail shareholders lost over one billion dollars.

I cannot prove who or what was behind this series of events. Perhaps they were all independent and purely unrelated, but commonsense says they were not.

In December 2005, after reviewing over 100,000 pages of documents provided by the company over an 11 month period, the SEC concluded its investigation into TASER's public statements related to product safety as well as the Davidson's order with a recommendation of "No enforcement action." -- That's as good as it gets with the SEC.

Following the resolution of the investigation, it appears our business is getting back on track. The first quarter of 2006 had record revenues for a Q1 – even eclipsing Q1 of 2004.

The fact we are now recovering doesn't help the farmer who called me in January 2005 to tell me he had mortgaged his farm to buy TASER stock and been wiped out. It doesn't help many of the individual investors who owned part of the TASER dream and sold their position or got wiped out with margin calls when the stock cratered. TASER was the stock that Wall Street missed. We didn't fit any of the typical financial specialties. We're not biotech or internet, or health care. The investors who bought our stock were individuals who understood that a world with better non-lethal weapons is a safer place where fewer lethal weapons need to be used. Fortunes were made by many of these people as we built a great company. But many lives were crushed when it tumbled in 2005.

These shareholders deserve answers. And they certainly deserve to be protected in the future.

We carefully monitor those who create wealth to ensure they don't fool investors into seeing wealth where it does not exist. We should monitor even more closely those who can profit by destroying wealth, and the jobs, technology, and dreams that go with it.

The answer is not to outlaw short-selling. The answer is control, oversight, transparency and enforcement. Today short-sellers are without oversight and enforcement is meager. There is little or no transparency. Those who profit from dark deeds can operate in near total darkness.

Regulation SHO was a good first step in shining the light onto companies that could be subject to abusive naked short-selling. TASER has been continuously atop the SHO list since its inception. We have had and continue to have today over 20 million phantom,

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non-existent shares held on the market as a result of naked short selling of our stock. Honest investors are being bilked and steps need to be taken to monitor and control potential abusers.

A system where the powerful can destroy the property of the weak, demolishing jobs as well as wealth, and profiting from the result is distinctly un-American. I cannot tell you with certainty how or what is happening. But the fact we cannot say with certainty that it is not occurring, should scare us all.

There is much more to our story, and I would be glad to share it with you in person and answer any questions you may have.

I appreciate your inquiry and hope it helps you shed the necessary light and promote the enforcement needed protect our markets' integrity and investors' future. Thank you.

Sincerely,

Rick Smith
Chief Executive Officer
TASER International