Testimony of

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Hedge Funds and Analysts: How Independent is their Relationship?

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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.