Testimony of

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June 28, 2006

UNITED STATES SENATE
COMMITTEE ON THE JUDICIARY
Hedge Funds and Independent Analysts:
How Independent are Their Relationships?-
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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, oil 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 shortselling 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 shortselling 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 2000fs, 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-ofinterest, 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 firmsf 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,' 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."