Testimony of

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State of Connecticut
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Office of The Attorney General
State of Connecticut
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ATTORNEY GENERAL RICHARD BL.UMENTHAL
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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 hnds 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 $24 trillion --provide fertile opportunity fbr 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 h din dusby 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 fbr 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 hnds and short selling play important, legitimate roles in the financial markets but these financial tools may also be susceptible to invest01 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 Goldstern 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 socalled "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 fiom 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 he a mirage -- reports "independent" in name only -- and the analysis shaped to suit the client hedge fund's interests.

Such problems may he 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 fIom 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 fimds, charitable organizations and middle income individuals Hedge funds have been exempt fiom 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 fiom 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 repoxts 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 fiom directing or reviewing stock analyses by in-house analysts These rules should similarly prohibit clients fiom 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 fbr 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 fiom 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 etai in 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