

September 26, 2004

Honorable Richard Pombo

Dear Mr. Pombo

I have previously written to you regarding this matter. You replied, requesting that I write to you if I had additional information. What follows is all of the information that I have gathered. Also, please realize that I am suggesting that the SEC may be knowingly or unknowingly assisting criminal activities of the hedge fund mentioned herein.

I believe that NovaStar Financial (NFI - NYSE), is being manipulated by a hedge fund – Rocker Partners controlled by David Rocker. In his latest SEC filings Mr. Rocker has disclosed significant put positions in NFI, and a recent NY Times article exposed the fact that Rocker is short NFI, drawing from his Q2, 2004 letter to his investors as proof, wherein David Rocker states that Rocker Partners is actively shorting NFI shares.

This situation began more than two years ago, in July, 2002, when David Rocker, through his Hedge Funds (Rocker Partners, Compass Holdings and Helmsman Holdings – the latter two BVI based funds) apparently made a very poor bet against the company. Now they are so far underwater they have seemingly taken to actively manipulating the share price through activities that I believe are illegal. There is ample evidence that NovaStar has been the victim of an organized campaign to negatively impact their share price, involving both captive and sympathetic media outlets, class action attorneys who systematically file frivolous lawsuits on behalf of questionable plaintiffs, sympathetic or complicit members of the SEC who launch investigations, timed particularly advantageously for the shorts, as well as related party trading between accounts on specific days to create dramatic declines in the company's price per share.

I believe that with the information I provide in this letter, it will be possible for an investigator to definitively prove that this is in fact occurring.

Some History

In July, 2002, a massive short attack began against NFI. Prior to this attack daily trading volume was roughly 75K/day, a very thinly traded stock. Since then, as many as 11 million shares have traded in a single day with average volume presently over 500K/day.

Mr. Rocker first appeared on the Q3, 2002 (October) NFI conference call asking off-base and innuendo-laden questions about the company's strategy and business plan. Mr. Rocker was also on the Q1 2003 NFI conference call and raised a number of easily rebutted "concerns." Representatives from both Helmsman and Compass were also on the Q2 2003 conference call asking questions deliberately framed in a pejorative manner.

NFI is presently among the top ten most shorted companies on the NYSE, with a September Short Interest of 9.4 million shares. This level of short interest represents an incredible 38% of the 25 million issued shares.

NFI doubled its earnings and business in 2002, and tripled earnings in 2003. This year, NFI is on track to double their earnings again!

The Media

David Rocker is the single largest shareholder of TheStreet.com (TSCM.) Jim Cramer holds 3.495 million shares of TSCM as of 4/3/03 when he filed pursuant to SEC regulations that he had sold 81,666 shares. That gave him a 14.64% stake. Other owners include David A Rocker, with a stake of 2.224 million shares, or 9.32% (held personally), and an additional 1.284 million shares (6.87%), held in Compass Holdings. This combines to a total of 16.19%, making David Rocker the sole controller of the largest block of shares in TSCM. Thestreet.com (TSCM) began a negative media campaign against NFI in late 2002. A large number of articles appeared from that point forward, questioning everything from the company's honesty to its accounting to its business plan to its staffing decisions. Jim Cramer was involved personally - among other claims, Mr. Cramer repeatedly made the provably false statement on his radio program that NFI doesn't have the money to pay their dividend, ignoring the fact that they clearly do, quarter after quarter after quarter.

Several of Mr. Rocker's already-rebutted "concerns" were echoed in Liz McDonald's articles of May 8 and May 15, 2003 in Forbes online, and repeated in Forbes print edition at the same time. She advised readers to short the stock (low \$40's at the time) and cover at \$20. Liz McDonald also hyped Martha Stewart Omnimedia as her best single long stock idea on Forbes on Fox. MSO was a \$13.5 million (1.438 mm share) holding by Rocker Partners in the June 30, 2003 SEC filing. It was \$10.6 MM (1.291 MM shares) in the Mar 30 SEC filing. The low \$40's share price was pre-split pricing, equivalent to \$20 now.

Herb Greenberg, a notorious TheStreet.com columnist, was the leader of the attacks against NovaStar while employed by that publication. Greenberg has continued his onslaught now that he has moved to CBS Marketwatch, sometimes publishing a negative piece about NFI three and four times PER WEEK!!! That's a lot of attention for a small mortgage lender from the Midwest to receive out of the constellation of companies traded on the public markets.

On April 12, 2004, Wall Street Journal writer, Jonathan Weil, published a calamitous negative article blasting NovaStar. Weil criticized NFI for everything from its branch strategy to its accounting. During the days following the release of that dubious article, all of Weil's outrageous statements were proven incorrect. It is noteworthy that Weil never published a follow-up article correcting his blatant errors nor did ANY other journalists embellish upon his scandalous claims. Journalists who have taken the time to

understand REIT stocks know full well that Weil's accusations are untrue, all lies. The damning article was obviously written for "other purposes".

The day after its release, NFI's share price plummeted from \$54 to \$37. Herb Greenberg had his first of over five articles that week released 45 minutes after the WSJ article hit the wire. Twenty-four hours after the newswire published the article, Milberg Weiss in San Diego filed the first class action suit. MW has also sued numerous other Rocker shorts, including ACAS, ALD, and KKD. It is unknown when MW was retained to file this suit, but it is suspected that it was before the article was ever released, which would be a clear indication of complicity. The SEC was quick to add to the downward pressure, and within 48 hours of MW's filing they had initiated an inquiry into the company – this is the same agency that couldn't figure out or investigate the mutual fund scandal for years. The same day that the SEC inquiry was announced, Herb Greenberg "mistakenly" issued an article claiming that one of NFI's vendors was suing it. That was untrue, and was forcibly retracted by NFI's attorneys. But by then the damage was done, and the stock had hit a low of \$28.80, after having hit \$70+ just a few short weeks earlier.

David Rocker apparently had a multi-million dollar put position that serendipitously was taken out just a few weeks before the onslaught was initiated. That position which would have expired worthless within a few more weeks turned into over \$10 million of profit, if simple calculations are even close to accurate.

Manipulation

Thinly traded stocks, such as NFI, are relatively easy to manipulate if one has a large amount of money, a large number of shares in a number of long accounts, has control over multiple investing entities in multiple jurisdictions, and doesn't mind bending a few federal securities laws.

Several companies "targeted" by Rocker and Thestreet.com have had frivolous class-action lawsuits brought against them, similar to NovaStar. These class-action lawsuits temporarily depress the share price. Anyone "short" these companies prior to the lawsuits would be able to "cover" and reap tremendous profits in the aftermath of the price declines (due to investor panic) that the lawsuits caused.

I believe that there is no legal exit strategy for Rocker's short position of NFI that would not bankrupt his hedge fund. Through all of their suspicious short-selling activities, NFI continues to thrive, increasing their loan portfolio size, earnings and dividends. Alarming, however, the short interest has been steadily increasing since May at an incredible rate of 1 million shares per month!!! Rocker Partners is destined to lose everything and force bankrupt unless they successfully contrive some event in the near future, hence the widespread belief that there will soon be another Media/SEC/legal onslaught to terrorize the company's mostly retired shareholder base.

Here are some additional reasons I feel there is illegal market manipulation occurring with this company:

Elliot Spitzer (NY DA) was an investor in Jim Cramer's hedge fund. Mr. Spitzer went to school with Mr. Cramer. Mr. Spitzer's office has been apprised of the situation and has responded that it's not their job (paraphrasing); in spite of the fact that they felt it clearly was their job with Canary Capital hedge fund.

A recent article written by Michael Flaherty from Reuters called "RPT-Investor Profile: Bearish fund comes out of hibernation" identifies David A. Rocker as having a short position in NFI, removing suspicion and now confirming in the press that Mr. Rocker is indeed short this company. Here is a link that can be accessed to view the article:

<http://www.ecmreport.com/index.php/articles/news/765>

In the following article, David A. Rocker is identified as being short NFI. Rocker also purchased a very large PUT position (controlling 277,000 shares) right before the April onslaught against NovaStar. Looking at the March/April takedown of the share value of NFI from \$70.00 per share to \$28.00 this looks like an incredibly serendipitous and well-timed trade. Here is the filing:

<http://www.sec.gov/Archives/edgar/data/898373/000089837304000004/z13f1q2004.txt>

So, there is clearly a profit motive. Mr. Rocker also controls two offshore hedge funds - Compass Holdings and Helmsman Holdings. See page 40 of the following document:

<http://www.sec.gov/spotlight/hedgefunds/hedge-mccarty.pdf>

It is believed by many that these two funds might frequently trade shares of NFI back and forth using the Pacific Exchange for no other reason than to drop the share price. It appears to be an attempt to lose money on a long position in order to make money on a much larger short position as well as to strike fear into the hearts of investors, and encourage them to sell. This is speculation that could easily be verified or put to rest as incorrect. Here is some trading data from March 24, 2004. This off NYSE trading occurred in an up market, on no news, when the company had released positive earnings the week before. The only event that was noteworthy was that NFI hit \$70 that day for the first and last time:

<http://www.nfi-info.net/3-24trade.htm>

In addition to highly suspect trading practices, Rocker Partners appears to use a most willing media to spread disinformation about NFI.

Marc Cohodes is a business partner of David Rocker's. Cohodes appears to be a long time source of information for the aforementioned financial writer Herb Greenberg, now with CBS MarketWatch, formerly with TheStreet.com.

Herb Greenberg's Yahoo! Chat Transcript (September 15, 1998) features a "Chat with Herb Greenberg and Marc Cohodes of Rocker Partners!" In Herb's opening comments he states "Marc Cohodes has been a quoted shortseller in my column for years."

On December 5, 2000 in an article for The Motley Fool "Addressing Cree Concerns" by Rex Moore the relationship between Mr. Greenberg and Mr. Cohodes is again discussed. "Herb Greenberg of TheStreet.com, who often cites the work of Cree short Marc Cohodes of Rocker Partners,"

In an article for TheStreet.com on February 13, 2001, "Is Black Box Really That Much Different?" by Herb Greenberg the relationship is again shared with the reader. "It's time to check back with longtime source Marc Cohodes of Rocker Partners."

Clearly, there is a longstanding relationship between Marc Cohodes of Rocker Partners and Mr. Greenberg. Herb Greenberg appears ready and willing to print inaccurate or incomplete information about NovaStar Financial, and his articles often seem to be timed to go along with an attack on the share value of this company.

On December 20, 2002, after the Q3 conference call and the resultant unexpected and unprecedented dividend increases, Herb Greenberg began a series of inflammatory and bashing pieces about NFI. Jim Cramer had also started issuing "sell" recommendations on his radio show, the latest (that I am aware of) occurring on August 5, 2003, wherein he echoed the language and innuendo used on the July 31, 2003 NFI conference call by the Compass Holdings representative J.C. Kittinger and Helmsman Holdings representative Russell Lynn, and additionally made the provably false statement that NFI, "couldn't afford to pay its dividend". The broadcast is available in the archives at TSCM. In addition, two articles were published in May 2003 in Forbes by Elizabeth MacDonald, a Senior Editor, using many of Rocker's phrases, and advising readers to short the company and cover at \$20.00. On May 1, 2003 the share price opened at \$43.00. Not a very good call.

Here is a short list of early articles Mr. Greenberg has written referencing NovaStar Financial since David Rocker has been involved with shorting NFI.

Herb on TheStreet

1. NovaStar Owes Investors a Better Explanation
<http://www.thestreet.com/p/rmoney/herbonthestreet-rm/10059767.html>
12/20/02 02:01 PM ET

Herb on TheStreet

2. NovaStar Sellers and the REIT Stuff
<http://www.thestreet.com/p/rmoney/herbonthestreet-rm/10060032.html>
12/24/02 09:44 AM ET

Herb on TheStreet

3. American Capital Cashes In on Dividend Drama

<http://www.thestreet.com/p/rmoney/herbonthestreet-rm/10061750.html>

01/08/03 02:29 PM ET

Herb on TheStreet

4. Gazing at NovaStar's Insurance Setup

<http://www.thestreet.com/p/rmoney/herbonthestreet-rm/10062202.html>

01/10/03 02:11 PM ET

Herb on TheStreet

5. Down Is the Trend at Columbia Sportswear

<http://www.thestreet.com/p/rmoney/herbonthestreet-rm/10065914.html>

01/31/03 03:05 PM ET

Herb on TheStreet

6. Nothing Behind the Shine at NovaStar

<http://www.thestreet.com/p/rmoney/herbonthestreet-rm/10067685.html>

02/07/03 04:37 PM ET

These articles have continued throughout the summer of 2004, sometimes with 3 and 4 time a week frequency!

Jonathon Weil's April 12, 2004 Wall Street Journal article did nothing more than parrot Rocker's "concerns" and cite a 2 month old Las Vegas paper's flawed reporting about a regulatory proceeding. The Wall Street Journal piece was full of errors and even the most cursory due diligence by any journalist would have squashed the piece – it would simply have never made it to print. The day of this article in the most respected publication in the country, NFI's price plunged 30%.

This specious article was followed within 24 hours by a series of class action law suits, led by Milberg Weiss, who is a popular Rocker Partners foil (they also sued RP shorts ACAS, ALD, and now Krispy Kreme). It would not seem suspect except that the same pattern of activity has occurred in the past with the same suspicious patterns and the same individuals.

The CEO of NFI recently wrote a rebuttal to the claims being made by Mr. Greenberg.

<http://www.marketwatch.com/news/yhoo/story.asp?source=blq/yhoo&siteid=yhoo&dist=yhoo&guid=%7B393D79C9%2D5DE5%2D47B1%2D98B0%2DC01C2D8014CB%7D>

Even with this corrected information, Mr. Greenberg was unwilling to correct his misstatements. Why would any financial journalist become so obsessed with a very small, obscure mortgage company? Indeed, there are several years of documented communications with Greenberg that demonstrates his “vendetta” against NFI. He refuses to accept the facts. He refuses to cease his bashing articles – all designed to dissuade investors from buying NFI shares.

The short position continues to grow (9.4 million shares) as of September 15, 2004.

From March 23, 2004 to April 29, 2004 the company share price declined from around \$70.00 a share to \$28.00. It is currently trading at about \$46.00. This might be considered “normal” but the company is having a year of robust growth. “Fair Market Value” is estimated to be \$70-\$80. Growth in Taxable Earnings (where the dividend is paid from) indicates that the 2005 quarterly dividend will be increased from the current \$1.35 to approximately \$2.00/quarter. This strong earnings and dividend growth is what makes Rocker Partners’ situation so urgent – they pay the dividend for every share that they have shorted. And, most devastating of all, the act of “covering” their shorted shares will only result in much HIGHER prices for NFI shares. Therefore, David Rocker has the MOTIVE (his short position in NFI) the MEANS (offshore funds where he can trade between related accounts with the assistance of market makers) and the CONNECTIONS to the financial media who are willing to spew inaccurate and false information about a fine company in an effort to get people to sell so he can cover his poor bets.

Anatomy of a Manipulation

So how does the trading manipulation work? Here are a few days where trading action and volume was particularly interesting and worth a look.

March 23, 2004

Volume increases from 1,265,600 on March 22 to 2,788,500 on March 23.

There was massive selling from the Pacific and Midwest exchanges. The low of the day was made right at the close. The price was brought down from an open of \$69.75 to a close of \$62.06. Trading data at <http://www.nfi-info.net/3-23trade.htm>

There was no news released related to NFI and the MREIT sector rose. NFI seemed to move in an unrelated fashion to the rest of the market. The only significant event to take place is that for the first time in history, NFI traded over \$70 per share.

March 24, 2004

Volume increases from 2,788,500 on March 23 to 3,210,200.

There was additional massive selling from the Pacific and Midwest exchanges. The price was brought down from an open of \$62.06 to a close of \$58.90. Trading data at <http://www.nfi-info.net/3-24trade.htm>

Still there was no news released that should have impacted the share value of NFI. The MREIT Sector rose during that period, as did all of NFI's peers. NFI seemed to move in an unrelated fashion to the rest of the market.

March 30, 2004 Herb Greenberg decided to continue his ongoing assault against NFI. Nothing was addressed that affects the real business, just another attempt to make NFI look as though it is some sort of a scam company.

April 12, 2004

March loan origination data released. NFI recorded its highest volume ever with a 116% increase over March 2003.

Jonathon Weil's suspicious Wall Street Journal article:

Most of Weil's slanted article addressed numbers of branch offices and claimed that NFI had licensing issues in several states (which turned out to be a gross misstatement of two regulatory proceedings, one of which was directed against misconduct by an unauthorized branch.) They did shut down in Nevada for a few weeks as they addressed a disagreement with the state.

(A news column today in The Wall Street Journal draws attention to a licensing issue in Nevada involving several branches operated by NovaStar. NovaStar opened the branches under its interpretation of a statutory lending exemption. After Nevada regulatory authorities advised that they did not accept the company's interpretation, the branches voluntarily ceased originating loans in January 2004 until licensing issues could be satisfactorily resolved. The company paid a fine of \$80,000 and was cleared to resume lending in February.) - NovaStar Press Release

Other spurious accusations in Weil's article:

Weil claims NovaStar to be a Ponzi scheme: "NovaStar pays a whopping \$5.00 annual dividend to common shareholders, slightly higher than its 2003 earnings of \$4.91 a share. NFI has been funding its dividend payments, in part, with money raised from public stock offerings."

The fact of the matter is, NovaStar paid out \$4.88 in dividends in 2003. Also, dividends are not paid from GAAP earnings but from Taxable Earnings. NFI had, at the time of the article, over \$200 million cash in the bank and had \$1.00 in retained earnings that must be paid to shareholders between now and September 15, 2004. This is irresponsible reporting of facts that the simplest of accounting diligence could have corrected. As usual, "un-named short sellers" were referenced.

The stock closed on April 8, 2004 at \$54.18, and as a result of this deliberately damaging article rife with erroneous information plunged to the \$30's, closing at \$37.50.

Volume was particularly interesting this day as well. The company has a total outstanding issuance of about 25 million shares. According to Yahoo, 33.58% of the shares are held by insiders (8,395,000 shares) and 31.94% of shares are held by institutions (7,985,000 shares). If one assumed that these shares were not traded on April 12th, trading volume of 11,556,000 means that every available share was traded and 2,936,000 additional shares were traded more than once. Does my suggestion that shares were trading between related accounts sound like paranoia? I think that it is a reasonable probability.

April 13, 2004

After the bell and the recovery to \$40, the first of the class action lawsuits were filed by Milberg Weiss, who apparently had it ready to go upon release of the WSJ article. This fact begs the question as to WHEN the firm was retained, and by WHOM. NFI price per share dropped the next day by over 10%.

April 15, 2004

[Moody's affirms NovaStar servicing quality at its second highest ranking](#) with a score of SQ2, the second highest rating available.

April 20, 2004

Company announces that the SEC has initiated an informal inquiry of NFI. The decline continues to the \$30 range. Who requested the SEC to initiate this staffer driven inquiry is unknown.

Through all of this, short interest has increased about 5 million shares. The latest reported short interest in 9.4 million shares of a company with a float of about 25 million shares. It was also recently discovered that the company had been listed on the Berlin and Frankfurt exchanges, without their knowledge or permission – venues notorious for their involvement in “naked shorting” schemes.

Among other noteworthy information released during this period, on April 28, 2004 the earnings were announced (\$1.72) and the dividend was raised from \$1.25 to \$1.35. Another .37 cents has been pushed forward to be paid in future quarters. The business and performance of NovaStar Financial certainly cannot explain the brutal drop in the value of NovaStar's share value. With all the good news being reported by the company, it seems extraordinary efforts were needed to bring this share price down from \$70.00 to the low \$30's (briefly reaching \$28.750 a share on April 29, 2004.)

Interestingly enough, this whole scenario seems to have been repeated with other stocks. The large short position by Rucker Partners, negative articles from The Street.Com and

Herb Greenberg, articles placed in the Wall Street Journal, even a class action lawsuit filed by Milberg Weiss.

The games do not seem to be stopping. On July 26, 2004 (in conjunction with another attack on the share value of NFI, 1,505,100 shares were traded that day) Herb Greenberg wrote "Has earnings quality really improved? Commentary: One accounting pro doesn't think so"

The article is about what Donn Vickrey, co-founder of Camelback Research thinks about the current state of earnings reporting. The article discusses how companies try to make themselves look better than they are and how Camelback research identifies "problems". Examples of companies where Camelback identified problems early are provided. This little nugget is slipped in at the end of the Greenberg article:

More recently, in the first of a two-part series, Camelback explained why it gave an "F" to the earnings quality of NovaStar: "I really like it when you have a number of indicators pointing in the same direction -- where you have a situation where the cash flow and earnings pattern is diverging," he says, "and where there's something funny about receivables and inventories and where all of the explanations don't add up."

Strangely, no link to the article is provided. He just points out that NovaStar gets an "F" – no supporting evidence what-so-ever. Where is NovaStar making earnings look better than they are? Where is business slowing? Where are revenues declining?

Could these articles be designed to make investors feel uncertain about the future of a good company? Could the purpose be to frighten investors into selling so the short position can be covered at a profit? Could Herb Greenberg be trying to help his friends at Rocker Partners out of an extremely poor trade?

How many Federal Securities Laws does it appear are being violated here? Naked Shorting? Trading between related accounts for the purpose of manipulating the share price? Spreading lies and innuendo in the media to scare investors? Painting the tape? Frivolous lawsuits brought forth at the request of a hedge fund manager prompting the SEC to start an informal investigation of NFI?

The Securities Act of 1934: Prohibits trading where there is no change in the beneficial owner (such as trading between mutual funds all run by the same person);
Inducing customers to buy and sell, (such as creating a stream of negative press about a company designed to shake shares out of the hands of nervous investors);
Making false and misleading statements about a company.

Common Threads and Summary

I am of the opinion that we are witnessing a systematic and deliberate program, a conspiracy designed to destroy the market cap of relatively small companies in order to create financial gain for those perpetrating the destruction. Here are the common threads

in the attack on NFI, which is shared by ALD, ACAS and a host of other companies that have been targeted by the same affiliation of short sellers.

- 1.) Young upstart companies or rapidly growing companies that are a threat to established industry competitors
- 2.) Large Short Interest relative to float, and/or the short sellers are deep in the red before triggering SEC action. SI too large to cover by normal means.
- 3.) Repeated negative articles in TheStreet.com, CBS Marketwatch (Herb Greenberg) continually updated as to be one of the current headlines for the stock
- 4.) Repeatedly slandered on Yahoo message board by organized (paid) basher teams
- 5.) Misleading/inaccurate articles in Wall Street Journal or Barron's (sister publications)
- 6.) Listed on Berlin stock exchange without company's knowledge
- 7.) SEC investigation brought swiftly in response to SHORT SELLERS complaints, not investors
- 8.) Short sellers raise regulatory issues - In NFI's case, questions about licenses of some branches in some states, in ALD's accounting, ditto for ACAS
- 9.) Milberg Weiss class action suits, and M-W possibly retained by the short sellers

I sincerely hope someone from your office will look into this situation. The public at large needs to have confidence in the financial markets of this country. It should not be a playground for the rich and powerful. You would do the country a great service by investigating this situation and putting a stop to those who continue to prey on the innocent for personal gain.

To date, David Rucker operates with impunity and seeming immunity from securities laws. In my opinion, he sees himself as influential and so well-connected that he would not be investigated and/or stopped. I sincerely hope this is not the case. I believe that the information I have provided is enough to allow an investigator to determine if this matter requires further investigation. Trading between Rucker's related accounts should be easy to document. Looking into Rucker's holdings should be possible. I believe that you will discover that Rucker made a terrible mistake by shorting NFI, incurred great losses, and is presently acting illegally to prevent further catastrophic losses to his hedge funds.

I know I don't have to tell you how to do your job. I just sincerely hope someone looks into this matter. I TRULY BELIEVE criminal activity is occurring here and innocent people are being hurt. Many people who own REIT stocks, such as NovaStar, are retired and use the dividends for living expenses. NovaStar is an outstanding company that is

being ruthlessly being attacked by Rocker's hedge fund. Innocent peoples' life savings are at risk of being stolen.

I'm sure you will agree Rocker's activities are illegal and should not be happening. I hope someone in your office will take steps to put a stop to this.

Sincerely yours,
Robert W. Hallam
Investor