Testimony of

The Honorable Richard Blumenthal

Attorney General
State of Connecticut
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ATTORNEY GENERAL RICHARD BLUMENTHAL
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I appreciate the opportunity to speak in support of proposed legislation to toughen penalties and enforcement against securities fraud and require greater disclosure to investors by hedge funds.

The integrity of our securities and investment markets is critically important to the economic future of our country. Yet, almost daily, news about insider trading, questionable accounting practices and other indicia of possible wrongdoing demonstrate the need for investor protection
The trend toward increasing transparency is inevitable As hedge funds themselves raise capital in more conventional ways --going public, selling bonds and unsecured securities --they must play by rules requiring disclosure. Risk disclosure and risk control are two key elements. There must be adequate, accurate transparency of how much risk and in what forms an investor can anticipate and what controls exist to assure that risk strategies are followed and internally enforced. Investor due diligence may achieve such disclosure for many, but not all investors
Some hedge fund investors need help
New potential dangers are emerging and expanding --in the growing dimensions of leverage and debt, and increasing use of new financial instruments such as credit default swaps
Congress must act --or the states may fill the void --to provide stronger tools for the SEC to promote sound hedge fund management and disclosure of critical information Hedge funds remain a regulatory black hole.
My strong preference is for national standards and rules, federally enforced, since federal agencies have the resources and expertise as well as the authority to make enforcement effective. We should avoid a patchwork of differing state laws But federal inaction or inertia will invite -- and inspire --state action, sooner rather than later, as early as 2007.
The discussion draft's proposed provisions are a positive first step, a solid framework for further discussion and Congressional action. Many of the principles require greater detail for adequate assessment, let alone enforcement. I support this initiative and its concepts, and urge further consideration of specific provisions I will propose a set of reforms in the coming months.
My proposals will include strong new measures for protecting and supporting whistleblowers, including secure means of access and even specific incentives. Key to effective detection and investigation are the cooperation and insights of individuals willing to risk their livelihoods and reputations with leads, tips, guidance and documents. They must be protected against retaliation or revenge --direct or indirect --and rewarded and respected publicly for their courage and

conviction.
One critical proposal missing from the discussion draft is a set of higher threshold requirements in assets for accredited hedge fund investors. The Committee should consider increasing the minimum asset, income and investment levels for qualified persons to invest in hedge funds. A qualified investor might be required to have, for example, at least $2 million in assets and $1 million in income, to invest at least $500,000. These numbers are illustrative, not final. Such asset requirements would help ensure that hedge fund investors are capable of doing the due diligence and assessing the risks that informed hedge fund participation requires.
Even with these limits, the Committee should consider more demanding disclosure requirements as well as a tough code of ethics.
Equally important, the Committee should consider strict penalty proposals to enhance deterrence of wrongdoing. A broad spectrum of penalties would include both criminal and civil fines with concurrent federal and state enforcement authority
Reforms are driven by retailization of hedge funds --and by their increasing sway and impact on our entire economy
Connecticut values its role as home to many hedge funds --and investors in hedge funds I have personally met with numerous hedge fund managers, including some of the most prominent, as well as investors, academics, attorneys and advisors. While specific provisions may be debated, I am convinced that some degree of public oversight is necessary and inevitable.
Federal action such as the proposed legislation is preferable to state legislation because it is uniform and national in scope --providing protection for everyone, not just investors in particular states. It assures a level playing field, avoiding competitive disadvantages for hedge funds in one state versus others
When used appropriately, hedge funds serve very productive investment purposes --such as allocating risk, increasing market efficiencies, making available capital and motivating management They have clearly grown in investor reach and power

Today, hedge funds investors include pension funds, charities and university or educational endowments, and a broad cross-section of the investing public. Not all of them --big as some pension funds or endowments may be --have the resources or capacity to effectively elicit and analyze key information.

Hedge fund leveraging itself has profound financial and public policy implications, increasing their power and importance in the markets. Hedge fund clout has increased dramatically. Hedge funds can be highly leveraged, activist and interventionist, single or multi- strategy. Previously, hedge funds were private in both investors and impact. Today, hedge funds are public, with power to affect diverse public markets, as Amaranth showed.

This discussion draft properly looks to existing anti-fraud laws and current investor disclosure rules as guidance for any regulation of hedge funds

The proposed legislation requires hedge funds to disclose the following critical information to their investors: (A) investment objectives and strategies; (B) risks of making an investment; (C) baseline performance; (D) side agreements between the hedge fund and preferred investors that varies the material terms of general investor agreements; (E) the extent to which a qualified external audit is conducted on the hedge fund financial statements.

One key question is whether such information is already available to hedge fund investors --and in what form, to whom, and when or how often

Another issue is whether to require disclosure of the hedge fund's use of debt to leverage returns --a key risk factor --and its contracts with brokers and stock analysts Certainly this concept merits strong Committee consideration

In addition, the Committee should seriously consider requiring that any hedge fund with assets exceeding a specified amount engage an independent external auditor --tasked not only to review the accuracy of the hnd's financial statements but, perhaps most important, to verify the true value of the hedge fund's investments Often, hedge fund investments may be difficult to value because they are not publicly traded In some instances, hedge funds have inappropriately valued certain investments to enhance their stated rate of return to investors

I support further consideration of two other provisions of the discussion draft first, requiring hedge funds to register under the Securities Act if more than 5% of its capital is from investors who are pension funds or non-qualified persons (Pension funds may expose individuals to the risks of hedge funds) Second, requiring hedge funds to adopt a code of ethics and a compliance progam to prevent wrongful release of non-public material information Protecting such information from misuse and investor fiaud is particulaly important to the integrity of financial markets

My discussions with a very extensive variety of hedge fund investment firms and analysts --promising only that I would name none of them directly or indirectly --indicate that many see some reform as necessary and timely The concept of a code of ethics would have broad potential acceptance Indeed, some groups such as the Managed Funds Association and Centre for Financial Market Integrity already have codes of ethics applicable to the hedge fund industry The Committee should consider requesting the Securities Exchange Commission (SEC) study the existing codes, take input from investors, analysts, fund managers and advisors in determining the most effective code of ethics

The proposal also adopts in statute the SEC rule regarding registration of hedge fund advisors under the Individual Advisors Act of 1940. The SEC rule was struck down by the federal court of appeals as beyond the statutory authority of the SEC This provision would specifically authorize the SEC to register these advisors.

I strongly endorse one critical concept based on the federal qui tam law --authorizing the US Attorney General to provide an incentive to individuals who supply critical information about insider trading or other investor fraud of up to 30% of the fine or penalty Whistleblower protection and incentives are critical because they produce vital tips, leads and sometimes road maps for investigation Laws are effective only if they are diligently enforced with visible results Such incentives have proven effective in encouraging individuals to act against companies that defraud the U S Government procurement

I support protecting whistleblowers from retaliation by allowing the victim to bring a civil action for damages. Protection from retaliation is a central aspect of any whistleblower law. In Connecticut, my office investigates whistleblower complaints about fraud and waste in government. Our retaliation protection law seeks to support and encourage whistleblowers who risk their livelihoods and careers by coming forward with evidence of wrongdoing The Committee should consider enhancing this protection by allowing the victim to recover treble damages Treble damages would be an even greater deterrent against retaliation. If no other proposal is adopted, this one for enhanced whistleblower protection and incentives should be, Either in the SEC or elsewhere, confidential access --a channel for volunteering information --

should be established,

As the Committee moves forward with this discussion, it should consider providing additional civil remedies and state attorney general enforcement authority. Often, civil action may be more efficacious since it requires no evidence of criminal intent Concurrent enforcement authority among the federal government and the states has proven very effective in the consumer protection area The Federal Trade Commission has worked with state attorneys general in many areas of consumer fraud, including telemarketing, odometer tampering and dangerous toys,

I commend the Senate Committee on the Judiciary's initiative in this area of significant concern I look forward to continuing to work with the Committee