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Office of The Attorney General
State of Connecticut

July 26, 2006

The Honorable Arlen Specter, Chair
Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Specter:

Thank you for inviting me to speak on the critical issue of hedge funds and their relationship with stock analysts on June 28, 2006. The hearing provided important information about this relationship and emphasized the need for Congressional action further regulating this relationship specifically and hedge funds generally

Attached are my answers to the four follow-up questions contained in your July 7, 2006 letter. If you need further information or articulation, please don't hesitate to contact me or Special Counsel Rich Kehoe at 860-808-5322.

Very truly yours,

Richard Blumenthal

RB/RFK/sk

ANSWERS OF
CONNECTICUT ATTORNEY GENERAL RICHARD BLUMENTHAL
TO QUESTIONS POSED BY
THE SENATE COMMITTEE ON THE JUDICIARY
JULY 27, 2006

1 Elaborate on ways to enhance federal criminal penalties for potential fraudulent short selling practices by hedge funds.

There are significant criminal penalties for a stock analyst who issues a fraudulent stock analysis when such fraudulent analysis poses a significant risk of substantial losses to other persons. These penalties are a maximum fine of $100,000 per individual and $500,000 for a company violation. I urge the committee to consider supplementing these criminal penalties with additional civil penalties, including treble damages.

Effective deterrence should include state civil action as well as criminal prosecution and private civil lawsuits. It is very difficult for victims of stock fraud to bring civil actions against those individuals who perpetuated the fraud. Enormous resources are required to successfully investigate and prosecute such private citizen actions. This financial burden -- on those who have already lost significant sums of money -- often prevents victims of fraud from bringing a civil action. As one person testifying before the committee indicated, he spent hundreds of thousands of dollars trying -- and failing -- to bring a civil action against a hedge fund whose illegal activities cost investors millions of dollars

Giving federal regulators the authority to bring civil actions when criminal prosecutions cannot be brought will greatly enhance the deterrent affect of these federal laws. Federal antitrust law has long included criminal fines and imprisonment as well as the option for civil penalties and treble damages which can be used when the fraudulent company has financial resources sufficient to compensate those victims harmed by the fraudulent scheme.

2 Is Sarbanes-Oxley an effective enforcement tool?

I agree with the Department of Justice that Sarbanes-Oxley has been a very useful enforcement tool for the federal government. I commend the federal DOJ for their efforts However, as the DOJ representative acknowledged, the DOJ is working with civil law enforcement and other state and local agencies on white collar crime cases, tacitly noting the value of civil enforcement as a supplement to criminal prosecutions. Congress should consider providing law enforcement with a broad range of penalties and enforcement actions to further bolster law enforcement response to investor fraud.

3. What is the Connecticut Attorney General's office doing to combat hedge fund fraud and abuse?

As I indicated to the committee, many state attorneys general lack resources and strong civil and criminal sanctions to bring actions against hedge fund fraud. A federal statute containing strong criminal and civil penalties would increase the likelihood of a joint federal-state task force to effectively root out the causes of hedge fund fraud and abuse. I am also informally conferring with many individuals involved in the hedge fund industry, from managers to consumers, to discuss formulating recommendations for effectively regulating hedge funds while protecting their unique role as an investment alternative.

4 Does the 'retailization' of hedge funds require greater attention to conflicts of interest and improved disclosure? How so?

Seventy years ago, hedge funds were excluded from general securities regulation because they were limited in scope and investors The hands off approach was justified because of the perceived sophistication of those who invested in hedge funds In the past ten years, there has been an explosion in the number of hedge funds and amount of funds in such investment vehicles -- estimated at more than $2 trillion. Smaller investors and even pension funds are at risk of losing substantial dollars in hedge fund scams

The original rationale for exempting hedge funds from regulation has been obliterated by the rapid growth and expansion of this investment option.

The committee should consider requiring disclosure of certain financial information to investors as part of any solicitation to invest; defining conflicts of interests between the fund manager and investments of the fund's assets; ensuring proper independent auditing of the hedge fund; and encouraging greater federal/state/local enforcement partnerships.