

RICHARD BLUMENTHAL  
ATTORNEY GENERAL



55 Elm Street  
P.O. Box 120  
Hartford, CT 06141-0120

Office of The Attorney General  
**State of Connecticut**

*TESTIMONY OF  
ATTORNEY GENERAL RICHARD BLUMENTHAL  
BEFORE THE BANKS COMMITTEE  
FEBRUARY 24, 2009*

I appreciate the opportunity to comment on Senate Bill 953, An Act Concerning Hedge Funds, House Bill 6447, An Act Concerning the Licensing of Hedge Funds and Private Capital Funds and House Bill 6480, An Act Requiring the Disclosure of Financial Information to Prospective Investors in Hedge Funds and Private Capital Funds.

These legislative proposals seek to establish a regulatory framework and investor protections for hedge fund which currently operate without any meaningful legislation or oversight by federal or state governments. Hedge funds inhabit a regulatory black hole. I urge the committee to consider the attached legislative proposal as an alternative to Senate Bill 953 and House Bills 6447 and 6480.

Hedge fund integrity is critically important to our country's economy. Increasingly, retailization of hedge funds means that ordinary investors -- no longer only the wealthy, sophisticated ones -- have a material stake in them. So do charitable institutions, school endowments and pension funds. Hedge funds account for a huge proportion -- some statistics say about one half -- of all trading on major exchanges. And as we have learned to our sorrow, they use leveraging and debt devices that raise both their sway and susceptibility in market shifts. They are also activist shapers of corporate strategy and management.

The challenge is to achieve greater accountability and disclosure -- appropriate investor protections -- without stifling or impeding their contributions to market efficiency and capital accumulation.

Federal measures are preferable. National standards and rules are appropriate because federal agencies have the resources and expertise as well as the authority to make enforcement effective. But, in the current regulatory black hole, states must act.

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 as to how much risk, in what forms, an investor can anticipate and whether 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.

The legislative measure requires state registration by any hedge fund based in Connecticut or soliciting or providing services to investors here. The burdens of registration would be minimal, but the benefits in accountability and enforcement could be substantial. Registration would not be required if the hedge fund registers with the United States Securities and Exchange Commission pursuant to the Investment Advisors Act of 1940.

This proposed legislation requires hedge fund managers to disclose to each investor and prospective investor any financial or other interests that the manager has which may conflict with the interests of the hedge fund or its investors. The manager also must disclose to current investors on a quarterly basis the hedge fund investment strategy and philosophy.

Annually, the manager must provide a schedule of fees paid by the hedge fund, including management and brokerage fees, as well as the total amount of such fees and consultant contract fees paid during the previous year.

Hedge fund managers must disclose to prospective investors and to current investors within thirty days of entering into any side letters that provide preferential treatment to some of the fund's investors.

Finally, the legislation limits investors in hedge funds to those required by the Securities Exchange Commission which are currently \$2.5 million in investment assets for individual investors and \$5 million in assets for institutional investors.

This proposal guarantees hedge fund investors with important information concerning their investment. Potential conflicts of interest must be disclosed as well as any change in investment strategy. Investors may wish to withdraw funds exposed to new, potentially greater risks. As an example, Amaranth apparently shifted its investment strategy to concentrate funds in natural gas futures without alerting investors.

The legislative proposal also requires disclosure of any major litigation that may materially affect the hedge fund's performance within 7 days of management's knowledge of such litigation. This disclosure is similar to information that bondholders demand as part of any bond offering statement.

I urge the committee's favorable consideration of the proposed amendment.

OFFICE OF THE ATTORNEY GENERAL  
2009 GENERAL ASSEMBLY SESSION  
BANKS COMMITTEE

TITLE: An Act Concerning Investor Information Regarding Hedge Funds

SUMMARY: This proposal requires any hedge fund that has investors who reside in, or have their principal place of business in, the state of Connecticut or that solicits for investors in the state of Connecticut to:

- (1) comply with SEC requirements for minimum asset requirements for investors in such unregulated hedge funds;
- (2) disclose in the offering statement to prospective investors any conflicts of interest on the part of the fund manager, the fee schedule of management and broker fees and any side letter agreements regarding preferential treatment for certain investors;
- (3) disclose to current investors any conflicts of interest or new preferential treatment side letters within thirty days of the existence of such conflict or letter;
- (4) disclose to current investors on a quarterly basis, the current investments of such hedge fund and a general description of the fund's investment strategy;
- (5) disclose to current investors within 7 days of knowledge of the existence of major litigation against the fund, a governmental investigation or major change in investment strategy provided the hedge fund has not entered into a confidentiality agreement with the government investigation agency;
- (6) annually disclose to current investors, within 60 days of the end of the fiscal year, the fee schedule, the amount of fees, personnel expenses and consultant costs paid in the previous year and an independently audited financial statement;
- (7) register with the state of Connecticut unless such hedge fund registers with the United States Securities and Exchange Commission.

TEXT: Sec. 1. (NEW) (Effective October 1, 2009): (a) As used in this section:

(1) "hedge fund" means any investment company, as defined in section 3(a)(1) of the Investment Company Act of 1940, that (A) claims an exemption under section 3(c)(1) or section 3(c)(7) of the Investment Company Act of 1940; (B) whose offering of securities is exempt under the private offering safe harbor criteria in Rule 506 of Regulation D of the Securities Act; (C) offers or solicits in this state for investors in such hedge fund or has an investor whose residence or principal place of business is in this state; and (D) meets any other criteria established by the Banking Commissioner in regulations adopted pursuant to chapter 54;

(2) "investments" shall include any security, commodity, real estate held for investment purposes, bank deposits, cash and cash equivalents, commodity futures or option contract traded on or subject to any contract market designated for trading such transactions under the Commodity Exchange Act, and such other forms of investments established by the Banking Commissioner in regulations adopted pursuant to chapter 54;

(3) "investor" means any person who purchases and holds securities in a hedge fund; and

(4) "manager" shall mean the person who has direct and personal control over the investments of a hedge fund.

(b) Each hedge fund shall register with the Department of Banking. Such registration shall be accompanied by a fee of five hundred dollars. The Banking Commissioner shall develop a registration form that shall contain such information as the commissioner deemed appropriate. The provisions of this subsection shall not apply to any hedge fund that has registered with the United States Securities Exchange Commission pursuant to the Investment Advisors Act of 1940.

(c) On or after January 1, 2010, a hedge fund shall only have investors who comply with the asset requirements for such investors in such hedge fund established by the Securities and Exchange Commission, as amended from time to time.

(d) A manager of a hedge fund shall disclose in the offering statement issued to each prospective investor in such hedge fund: (1) any financial or other interests the manager may have that conflict with or are likely to impair, the manager's duties and responsibilities to the fund or its investors; (2) the fee schedule paid by the hedge fund, including but limited to management fees, brokerage fees and

trading fees; and (3) any side letter or other agreement between the hedge fund and an investor that provides such investor with a financial benefit that is more preferential than the majority of the investors in such hedge fund. In addition to any disclosure in such offering statement, if such conflict or preferential agreement occurs after a person has invested in such hedge fund, the manager such disclose such conflict or preferential agreement to current investors in such hedge fund in writing within thirty days of the occurrence of the conflict or of the entering into such agreement.

(e) On or after January 1, 2010, within thirty days of the close of a quarter of the fiscal year, a manager of a hedge fund shall disclose in writing to each investor in such hedge fund the current investments by such hedge fund, including the number and dollar value of long and short holdings and the market sector of such holdings and a general description of the strategy and philosophy of the fund for the succeeding quarter. In addition to such disclosure, a manager of a hedge fund shall, within seven business days of obtaining knowledge of such information, disclose to investors the existence of a major litigation filed against such manager or hedge fund, the existence of any governmental civil or criminal investigation into such manager or hedge fund and any major change in investment strategy or personnel that may have a material effect on the operations of such hedge fund, provided such requirement is waived if the governmental agency conducting a civil or criminal investigation enters into a confidentiality agreement with such manager for the purposes of advancing such investigation.

(f) On January 1, 2010 and annually thereafter, a manager of a hedge fund shall, within sixty days of the close of the fiscal year of such hedge fund, disclose in writing to each investor in such hedge fund: (1) the fee schedule paid by the hedge fund, including but limited to management fees, brokerage fees and trading fees; (2) the amount of the fees described in subdivision (1) of this subsection paid by the hedge fund in the preceding year; (3) the amount of personnel expenses and consultant fees paid by the hedge fund in the preceding year; and (4) the hedge fund's income and loss statement and statement of changes in financial condition that have been audited by an independent auditing firm.

(g) The Banking Commissioner may adopt regulations in accordance with chapter 54 of the general statutes to implement the provisions of this section.