Hedge Funds[1]

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Hedge funds are targets of ethical criticism, and most criticism has focused on their opacity. Hedge funds are structured to block transparency for strategic reasons: that is, they systematically deny information to their own investors and to governments in order to protect their competitive advantage, typically a proprietary strategy, even though the information they hide holds tremendous significance for the interests of both groups. In this chapter I detail the major ethical allegations made against hedge funds, and explain why hedge fund opacity creates intractable conflicts, many of which cannot be resolved through government regulation. Sometimes opacity can be regulated away; but hedge funds are subject to what I call "regulatory recalcitrance." These considerations suggest strongly that, in the end, only tightly designed government measures to enforce limited transparency, combined with industry-wide voluntary moral coordination, can succeed. Moreover, any successful ethical and regulatory approach to hedge funds involves distinguishing among four key stakeholder groups of hedge funds: 1) direct investors; 2) indirect investors; 3) the global public; and 4) the national public.

While it may appear impossible for something that is known to be at the same time unknown, it is easy for one person to know something highly relevant for another person, even though that other person remains ignorant. Hedge funds are structured to block transparency for strategic reasons: that is, hedge funds systematically deny information to their own investors and to governments in order to protect the proprietary trading or investment strategies that constitute

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their competitive advantage. They resolutely hold their financial details and their strategies close, even though the information they hide holds tremendous significance for the interests of both groups. This particular form of asymmetry in information is not unique to hedge funds, but it is emblematic of them.

Background on Hedge Funds

Hedge funds are privately-owned financial firms that raise money from large investors, including individuals, pension funds, and charities, for the purpose of increasing the value of the investment. They grew dramatically from 1998 to 2008, and according to a report by the Zurich-based Financial Stability Forum commissioned by G8 governments, in 2008 they managed assets of $1.6 trillion (*New York Times,* 2007).

In contrast to traditional investment firms such as brokerage houses and banks, hedge funds successfully avoided traditional government regulation for years. At least until 2010, United States firms did not have to file quarterly reports with the Securities and Exchange Commission (SEC). It has, hence, been extraordinarily difficult over the years to get accurate information about either their strategies or earnings (Cassidy, 2007). This privileged position offered them almost unlimited freedom in designing investment strategies, and, indeed, the term, "hedge fund," is a loose–fitting blanket that covers a bewildering array of financial strategies. Hedge funds can invest in the distressed debt of a foreign country; can buy equities "long" (buy stocks or bonds hoping they will rise in value); can buy "short" (buy stocks or bonds expecting they will fall in value); can invest and trade using a complex computer-driven algorithm ("quant" strategies); can speculate in foreign currencies; can arbitrage commodity futures, and so on. In short, they can do anything sufficiently profitable to justify the fees they charge to investors.

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chapter.

The economic crisis and worldwide recession that began in 2008 promised to impose more regulations on this heretofore elusive industry. In 2009, SEC head, Mary Schapiro, argued that her agency needed the ability to inspect and examine the books and records of hedge funds as well as some rulemaking authority (Reuters, 2009). In addition, legislation seemed virtually certain requiring the registration of hedge funds with the SEC. Even more invasive regulatory measures, detailed later in this chapter, were proposed by the European Community in 2009.

The most salient feature of hedge funds is that they charge huge fees to their investors. The usual cost to an investor is "two-and-twenty," meaning that the fund receives annually 2 percent of the value of the invested money, i.e., two cents each year for every dollar it manages, plus 20 percent of any profit it happens to make for investors. Sometimes the formula is even "three-and-thirty." As has been noted, this can be a "heads-I-win; tails-you-lose" proposition. If the fund loses badly for investors, it still receives more than twice the normal fees charged large investors. But if the fund wins for investors, it receives not only twice the normal fee, but 20 percent of the profits. Fees are considered "carried interest" for tax purposes and taxed at the capital gains rate. Because most hedge fund managers pay only capital gains rates on their remuneration (15 percent), instead of income tax rates for top bracket earners (35 percent), it is little wonder that in 2006 three hedge fund managers, James Simons, of Renaissance Technologies; Kenneth Griffin, of Citadel Investment Group; and Edward Lampert, of ESL Investments, received more than a billion dollars in after-tax remuneration each (Cassidy, 2007).

But there is no reason to condemn prosperity *per se*. Making large sums of money is not itself morally objectionable. One must ask, then, whether there are genuine moral issues raised by hedge funds. At least three moral allegations are often made: that they 1) receive unfair tax

benefits, 2) dupe investors, and 3) cause social harm. Let us examine these moral allegations in turn, in order to see the extent to which, if at all, each involves the problem of transparency.

Alleged Unfair Tax Benefits

Critics point out that hedge fund managers and also private equity fund managers pay only 15 percent capital gains tax on their remuneration in contrast to the normal 35 percent top income tax rate that others in the highest tax bracket pay. Even the salaries of executives in investment banks and brokerage firms are taxed as income, not as capital gains. What is more, taxes are even lower for the many firms legally based in tax havens. About 75 percent of the world's hedge funds are said to be based in the Cayman Islands.

As a *Wall Street Journal* article noted, Stephen Schwarzman in 2006 earned almost double the combined pay of the bosses of Wall Street's five largest investment banks (Schuman, 2007). This appears to violate a basic principle of tax fairness: namely, like should be taxed alike. The secretaries of hedge fund managers, indeed, usually pay a higher tax rate than their bosses, who are earning hundreds of millions of dollars. In the United States in 2007, legislation was introduced that would have removed this tax perk. It was supported by prominent senators including the chairman of the Senate Finance Committee, Max Baucus, Democrat from Montana, and Charles Grassley of Iowa, who is the ranking Republican on the committee. (Anderson and Sorkin, 2007) The legislation was fought vigorously by the industry and as of 2008, the congressional effort had failed.

Fund managers argue that the lower rate is appropriate because of the risky nature of hedge fund investments. This is, in effect, the same argument often been used to justify lower tax

rates on investments generally. The critics, however, note that most fund managers have very little of their own money at risk. They raise and manage the money of other investors and in this sense function as investment managers and advisors—just as managers of investor stock portfolios do. If it walks like a duck and quacks like a duck, critics allege, then it is a duck and should be taxed accordingly.

Alleged Investor Duping

Hedge funds are said to dupe investors with false or misleading claims. The data are hazy, but there is no solid evidence to support the claim that the average hedge fund performs any better than a traditional investment in the stock market. Since 2000, the average hedge fund does not appear to have done any better, after fees, than the market as a whole. Interestingly, very large funds, many of which are not open to new investments, appear to outperform the market after fees, while smaller ones underperform (Leonhardt, 2007).

Given the fact that many hedge funds at the time of this writing (2009) have some exposure to subprime investments, the slow unwinding of leverage over the next few years may be painful for hedge fund investors and depress profits even further. Warren Buffet, in a 2008 letter to Berkshire Hathaway shareowners, called the fee arrangements of hedge fund managers "grotesque" and warned shareholders not to expect high returns. Moreover, it is not only the rich who invest in hedge funds anymore: pension funds are now invested heavily, and many middle-income Americans are indirectly exposed to hedge fund risk through their pension funds.

A physicist is said once to have quipped that "the most powerful force in the universe is compound interest" (Kay, 2008). The 2 percent annual fee charged by hedge funds seems

modest, but compounded over years its effect is staggering on a given investment. In an intriguing set of calculations set out in the *Financial Times* by John Kay, one can see how much an investor stands to lose when investing money with a hedge fund, in contrast, say, to investing it with an investment manager who charges little or no fees—as the renowned investment manager, Warren Buffet, does. Kay calculates how much less Buffet investors would have today if, instead of investing in the actual Berkshire Hathaway (a collection of investments), they had invested it in a hypothetical Berkshire Hathaway managed by hedge funds with a "2 and 20" annual fee structure. The results are staggering. Instead of creating 62 billion dollars of wealth, those investments would have only created approximately 5.6 billion. In other words, the effect of sacrificing compound interest and lowering the annual profits of the investments by "2 and 20" is to reduce the accumulation by more than 90 percent (Kay, 2008). It is not clear the average hedge fund investor is fully aware of these implications.

Clearly, however, it is the hope of above-average financial returns that lures investors to deviate from traditional investments that possess more transparency and regulatory safeguards. Does this not imply that hedge funds are duping their investors?

Hedge funds have vigorously opposed legislation that would require them to provide data to the government about their various investments and credit exposure. They protect their secrecy with vigor. Most even hide critical information from their investors. The rationale is strategic: in effect "If we expose our positions, we expose our strategy. Doing so would sacrifice our competitive advantage." But this strategic absence of transparency, even to their own investors, can create a perverse incentive that separates the interests of fund operators and investors. If a fund is doing poorly, might not it disguise its loss to investors, hoping that things improve later?

The valuation of assets at hedge funds is another important concern in the investor-duping question. It is difficult to value the increasingly complex assets owned by hedge funds, and this has implications for investors. Incorrect valuations can mean that investors pay too much, lose out when they sell or overpay for performance fees. A key issue is the valuation of derivatives that do not trade on exchanges, such as the collateralized debt obligations (CDOs) that helped spawn the 2008 subprime crisis in the United States. It is easy to imagine a situation where a valuation problem remains undiscovered for years, substantially affecting net asset value. The United Kingdom's Financial Services Authority (FSA) flagged this issue in 2006 when it reprimanded a small U.K. hedge fund, Regents Park Capital Management, for a discrepancy between the valuations offered to investors and the actual market value of the fund's assets (Kelly, 2007). Valuation, Robert Kelly notes, is not an exact science even in the best of circumstances. How much less precise valuation will be, then, in a context where managers may have conflicting interests with investors and in which non-transparency is the norm? Even relatively sophisticated pension fund directors can become prey to such imprecise hedge fund valuation since whatever their financial expertise, they may have little knowledge of the instruments being traded by hedge funds.

Finance professors Dean Foster and Peyton Young recently analyzed hedge fund statistics and concluded that "it is quite easy for a hedge fund manager to 'fake' high performance over an extended period of time without getting caught." Hedge fund managers can undertake calculated gambles by investing money in deals that return substantially above-average returns in contexts where the higher returns derive entirely from a small but extant risk that the entire investment will explode (Foster and Young, 2008). This phenomenon has a formal name: it is a called a "Taleb distribution," i.e., a distribution with a high probability of a modest

gain and a low probability of huge losses in any period (Wolf, 2008). Even if the risk of the rare event is only 10 percent, it can be enough for the manger to collect high returns, to earn his "2 and 20," and to make his investors happy in the process. Of course, if the one-in-ten risk occurs, he will be out of business. But he may well be willing to take that risk since it is not his money, and since it is likely that he will profit handsomely for many years. The manager appears to his clients to be enormously talented. The catch is that his investors don't have any way of knowing that he is gambling with their money, and in turn, no way of knowing that their "talented" manager has no talent at all (Foster and Young 2008).

Alleged Social Harm

Finally, hedge funds are alleged to aggravate financial crises and create significant social harm. Bank lending in recent years to hedge funds has been huge. Hedge funds, meanwhile, have been loading up on high-risk debt. With hedge funds, then, we must ask what happens when the good times become bad times, as now appears to be the case. In response to the problems of the Long Term Capital Management hedge fund in 1999, the U.S. Federal Reserve was forced to cobble together a multi-billion dollar bailout because it worried that the hedge fund's meltdown would spark a tsunami in the financial system.

Again, the absence of transparency underlies the purported problem. The economist Paul Krugman observed that when two hedge funds run by Ralph Cioffi of Bear Stearns imploded in the summer of 2006, it shocked investors and helped trigger a financial panic. But subsequent investigation showed that the funds were a "disaster waiting to happen." "The funds borrowed huge amounts, and invested the proceeds in questionable mortgage-backed securities. . . and more than 60 percent of their net worth was tied up in exotic securities whose reported value was

estimated by Cioffi's own team" (Krugman, 2007). Later, in April of 2007, the U.S. government spent billions of dollars in a bailout of the Bear Stearns firm. Only a few days earlier, Bear Stearns's CEO spoke confidently about the financial health of his firm.

Before rushing to judgment and condemning hedge funds for the subprime credit crisis of 2008, it is worth remembering that banks, not hedge funds, held the largest share of subprime CDOs in 2008. Moreover, hedge funds were not involved, as the banks were, in creating them and collecting fees for their "slicing and dicing." Indeed, the overall situation is so complex that hedge funds often can be credited with playing a role in limiting investors' risks for subprime mortgages. Hedge funds often hold derivatives contracts that pay money to investors when bonds backed by subprime mortgage loans—loans made to less creditworthy borrowers—run into trouble (Scholtes 2007). In this way and in others, hedge funds often serve the vital role of expanding liquidity in the market, and of spreading risk more broadly.

Governments are worried about hedge funds, but how much they worry varies. German Chancellor, Angela Merkel, attempted in the summer of 2007 to have a strongly-worded statement announced at the G8 Summit Meeting demanding greater hedge fund transparency But her attempt failed, likely because of resistance from the United States and the U.K.

While less concerned than their European counterparts, American regulators have expressed worry for years about the systemic risks inherent in hedge funds. In the spring of 2006, and long before the advent of the recession of 2008, Federal Reserve chairman Ben Bernanke granted that market forces offered strong corrective powers for dealing with hedge fund excesses, but added a series of personal concerns about hedge fund risks. He identified the risk that, because hedge funds are now among the most important customers of American banks, and because they have a huge appetite for credit, banks and dealers may be tempted to reduce their

margin levels, i.e., the level of their holdings that provides a safety net in the event of default. He also worried about whether in the face of increasingly complex transactions between banks and hedge funds, it is even possible for one side to measure accurately the amount of risk exposure on the other (Bernanke, 2006). His concern speaks directly to the issue of transparency. Bernanke cautioned that good management demands that when banks and investors lend to hedge funds, hedge funds must provide transparency appropriate to the lender's determination of risk. Creditors may not "fully internalize the costs of systemic financial problems" and "time and competition may dull memory and undermine risk-management discipline" (Bernanke, 2006).

These three allegations, namely tax unfairness, duping, and societal risk, then, are the most salient of the ethical charges made against hedge funds. Of these, it should be noted that only the second and third entail significant problems of transparency and information asymmetry. Issue number one, the allegation that the current tax structure unfairly favors hedge fund operators, is significant but not unique to hedge funds. Indeed, it is an historical but arbitrary fact that hedge funds are treated for tax purposes as they are, not unlike the arbitrary tax treatment of thoroughbred horse owners or peanut growers. There may be good public policy reasons for hedge funds' privileged tax status (although I doubt it), but the issue is unconnected to the underlying nature of the hedge fund entity.

Hedge Fund Transparency and Regulation

Focusing on the transparency issues in numbers twp and three, let us now assess the most popular suggestion for dealing it, namely, government regulation. Why cannot the transparency problems endemic to the hedge fund structure be transferred into the "known-known" category though disclosure laws? Data on hedge fund positions could be collected by government authorities and, if necessary, aggregated for public policy purposes. Even more precise data

could be disclosed to hedge fund investors. Of course, even without attacking the opacity problem directly, the government can and does establish sanctions for hedge fund conduct through laws that prohibit insider-dealing and fraud (Mallaby, 2007). But the option to sue for fraud, many argue, cannot substitute for real information that is vital in protecting the public interest.

To be sure, forced-transparency remedies have a successful track record, not only for the financial service industry in particular but for business in general. When information asymmetry in the past meant that pharmaceutical customers were ignorant of the side effects of drugs, governments instituted drug labeling laws. When asymmetry meant that borrowers were ignorant of the true costs of their home and car loans, governments instituted credit disclosure laws. And when asymmetry meant that investors were ignorant of the financial status of the companies whose stock they purchased, governments instituted financial disclosure requirements. Why should not governments require hedge funds to disclose their precise financial positions both to their investors and to the government? This is currently true for registered dealers and brokers under Financial Industry Regulatory Association (FINRA) rules in the United States, and for broker-dealers in other developed economies.

Such forced disclosure, however, raises special issues of what I call "regulatory recalcitrance." As is well known, some social problems are more recalcitrant to regulation than others. Two types of recalcitrance are pertinent to the moral problem of transparency, namely:

Type 1. The regulatory process that gathers information and forces disclosure may not only bend entrepreneurial aspirations (as any regulation does) but destroy them. In other words, monitoring and disclosure requirements may constitute a market force of their own, and end up destroying the value of the original aspirations of market participants.

Type 2. The regulatory process that requires monitoring or data collection is either impossible

to effect or impossibly costly.

Examples of Type 1 recalcitrance are rare but include the self-destructive process of government attempts to regulate the arts. Regulating literature, drama, and cinema has the pernicious effect of destroying the creative process of art. Most modern societies have abandoned attempts to regulate the arts, but Soviet-era governments who attempted to do so paid a high price in the deterioration of artistic quality. In Type 1 cases, the regulation that forces disclosure is not exogenous to the creative process; rather, it is internal to the it and pernicious. In other words, the regulation directly dampens or eliminates the incentive of hedge fund managers to develop innovative strategies.

Examples of Type 2 recalcitrance are more common, and arise often both in private and economic life. The notorious failures of government attempts to regulate private sexual mores show that what government cannot see, it cannot regulate. Some societies manage to regulate private sexual behavior with moderate effectiveness, but not from the strength of the regulatory apparatus, but on the basis of the culture's shared religious belief (for example, strict Islamic cultures).

Type 2 regulatory recalcitrance is common in economic life. One of the most obvious instances is bribery. All countries in the world have laws that forbid bribery, yet bribery's prevalence varies widely from country to country. Nor are the differences among countries driven solely by levels of regulatory enforcement. Some differences may be enforcement-related, but even much higher expenditures on enforcement would leave bribery difficult to regulate, especially in countries where gift-giving practices are historic and endemic. Bribery with checks or wire transfers is easily monitored. But people can also be bribed with cash payments, physical goods, jobs to family members, free services or payments to a third party that are channeled into

a bribe. In the end, the array of bribing possibilities is almost endless and impossible to monitor and regulate fully. The dramatic differences among nations in levels of bribery owe more to cultural norms than to levels of enforcement.

Other examples of Type 2 regulatory recalcitrance include government attempts to prevent employees who move from one firm to another firm from passing trade secrets to their new firm (called "post-employment restraint agreements" or "non-competes"), and government attempts to prevent digital reproduction (e.g., attempts to forbid software piracy and music downloading).

Important is the fact that bribery, software piracy, and trade secret transfers are inefficient for the market as a whole. They are classic examples of market imperfections. Bribery distorts the market's natural allocation mechanism and promotes economic waste. Software piracy and trade secret transfers corrode the economic incentives that spur creativity and advance social welfare. These points are well established. Hence, to the extent that regulatory control is difficult or impossible, we are brought to consider the cultural and moral attitudes that help explain national differences in behavior.

It is not surprising that market efficiency requires more than market freedom and government regulation. Governments enforce business contracts but would be powerless to enforce them were it not for shared norms of promise-keeping and honor. Such moral norms are crucial for facilitating efficient economic activity.

I have argued elsewhere (Donaldson and Dunfee, 1999) that rational participants in a market economy will endorse a "hypernorm" or basic moral principle that imposes civic duties on market participants to avoid systematic abuse or sabotage of the overall market system. Such duties of avoidance are important in achieving market participants' shared goal of overall

economic welfare. Thomas Dunfee and I have referred to this principle as the "efficiency hypernorm" and linked it to the overall need for moral coordination in a market economy (Gauthier, 1986). Such economic duties stemming from the need for coordination are especially relevant to the present problem of transparency, for they include duties on the part of market participants to limit the distortion of information available to market participants, i.e., information upon which market efficiency depends. We remember that in a perfectly efficient, ideal, market, information is perfect.

We all want our society to have a higher level of economic welfare, what Amartya Sen has called the level of "aggregative resources." By this expression Sen means the sum total of what is available for society (Sen, 1992). More bread, more wealth, more health care resources, more educational resources--all of these we presume to be good even prior to considering how the "more" is to be distributed. All other things being equal, more efficiency means greater aggregative resources, and because regulatory regimes are unable to enforce all of the norms necessary for efficiency, market participants possess at least some civic responsibilities to support cooperative practices that enhance efficiency. These include:

1. Respecting intellectual property
2. Engaging in fair competition and avoiding monopolies
3. Avoiding nepotism and "crony capitalism"
4. Not abusing government relationships
5. Providing non-deceptive information to the market (including transparency of relevant information)
6. Avoiding bribery
7. Respecting environmental integrity
8. Honoring contracts, promises, and other commitments

We are now in a position to return to the issue of the possible regulation of hedge funds and determine whether the regulation of hedge funds will encounter either Type 1 or Type 2 regulatory recalcitrance. The answer is that regulation would encounter both forms of

recalcitrance. Type 1 recalcitrance occurs when the regulatory process destroys entrepreneurial aspirations. If we grant the possibility that hedge fund operators may at least sometimes discover novel and creative investment strategies (this appears to be the presumption of investors prepared to pay “2 and 20” to fund operators), then fund operators may be seen as involved in the creation of a form of intellectual property. But unlike other forms of intellectual property such as literature, music, drugs, and novel product design, investment strategies, just as business strategies, are notoriously difficult to protect through patents, copyrights, and trade secret law.

They are also highly perishable: this week’s strategy may fail next week and need to be replaced by a new one. The relatively slow reaction of legal regimes to infringements upon intellectual property seems wholly inadequate to protect the creative investment designs of hedge funds. Requiring hedge funds to disclose their positions in detail could well disclose their underlying strategies to competitors. How, then, would proprietary information be protected? “Protection of proprietary information,” Ben Bernanke writes, “would require so much aggregation that the value of the information . . . would be substantially reduced” (Bernanke, 2006). Regulation that demands disclosure, thus, would inevitably either stifle the incentive of fund executives or violate their right to intellectual property.

Type 2 regulatory recalcitrance also poses problems for the regulation of hedge funds. Collecting sufficiently precise data to avoid social harm seems impossible on a practical level. Ben Bernanke asks:

> [Should the government create a] data base on hedge fund positions? To measure liquidity risks accurately, the authorities would need data from all major financial market participants, not just hedge funds. As a practical matter, could the authorities collect such an enormous quantity of highly sensitive information in sufficient detail and with sufficient frequency (daily, at least) to be effectively informed about

> liquidity risk in particular market segments? How would the authorities use the information? Would they have the authority to direct hedge funds or other large financial institutions to reduce positions? If several funds had similar positions, how would authorities avoid giving a competitive advantage to one fund over another in using the information from the database? (Bernanke, 2006)

Because hedge funds are capable of pursuing any strategy that an individual might pursue, such as long positions, short positions, arbitraged currency, mathematical investment models, hedged currency, and so on, it follows that monitoring the economic activity of the existing 9,000 hedge funds in real time, on an ongoing basis, would be as formidable a task as monitoring the real-time economic actions of every single individual in an entire city. This may be bad news for those who have already made up their mind that hedge funds should be regulated regardless. Yet, while frustration with hedge funds is understandable, frustration does not justify concocting irrational regulation as punishment.

Our reasoning here is no different from that used to analyze other difficult contexts where regulatory recalcitrance prevails and where market freedom and law do not by themselves ensure acceptable market outcomes. Again, analogous contexts of regulatory recalcitrance include bribery, corporate/host-country relationships, software piracy, and cronyism. As with other such examples, the implication for hedge funds is not "anything goes." Rather the implication is that hedge funds must be pushed to pursue the development ethical norms and codes that instantiate cooperative action, i.e., industry standards that help resolve the cooperative action dilemma that lies at the bottom of the hedge fund problem. Elsewhere I have called these standards "microsocial norms" (Donaldson and Dunfee, 1999).

There is little doubt that microsocial norms work. Stark differences in levels of bribery, nepotism, cronyism, and software piracy must be explained against the backdrop of different

cultural, industry, and national norms. During the 1990s and 2000s, substantial progress was made by corporations on issues such as bribery and global supply chain labor standards. For the most part regulation was not involved. Their progress often involved coordination with other key organizations, e.g., industry associations, NGOs, and host country governments. Nike and other members of the Global apparel industry coordinated with NGOs on the design and implementation of industry codes of conduct, codes that had measurable impact on labor standards for first-tier suppliers in China and elsewhere. The regulatory apparatus that now constitutes FINRA, and which grew from the NASD (National Association of Securities Dealers), not only began as a securities industry exercise, but even today is governed, especially through its National Adjudicatory Council (NAC), by an elected industry participants and appointed independent, but non government, representatives.

Recall that regulation always lags behind novel events, so that sometimes it is only our ethics—or ethics instantiated broadly through industry standards--that can save us from future disasters. The law regulating asbestos in the mid-twentieth century lagged behind the knowledge held by scientists in the industry about the cancerous product's danger, just as laws regulating banking lagged behind bankers' knowledge of the dangers of the leverage they employed in the economic crisis of 2008.

This is not the place or time to speculate about the precise form of industry codes, "best practices," and other standards appropriate to hedge funds. But there is little doubt that such norms can reach beyond regulation's grasp. For example, a hedge fund industry standard for desirable transparency between a hedge fund manager and his client would be a standard known to both client and manager and thus available to guide and even arbitrate conflicts between the two. Industry standards, whether formal or informal, in other words, provide an agreed-upon

benchmark that can guide discussion and arbitrate disputes. A challenge, thus, is for the hedge fund industry is to discover, design, and agree upon norms for industry behavior and to contribute to the specifications of "best practices" in client relations, especially practices affecting transparency.

It does not follow that every single hedge fund activity should escape government regulation. Predatory short selling is a case in point. If hedge funds gang together and intentionally circulate false information in order to "short" the shares of a company stock, then their fraudulent activity can be exposed in court. U.S. legislation currently even limits the percentage of stock and the size of the company whose shares may be susceptible to so-called "naked-short" strategies, i.e., strategies that promise to deliver shares at a later date without the firm even owning shares.

Nor does our analysis condemn any regulations that might manage to avoid the problems of "recalcitrance" identified earlier. In April of 2009, the European Community (EC) proposed new rules to regulate hedge funds. The new rules exempted managers of funds under €100 million who use leverage—or borrowings. For ones who do not use leverage and have a five year lock-in period for their investors, a much higher threshold of €500 million applies.[2] Because of the dominance of large firms, the new rules were expected to take in only 30 per cent of hedge fund managers but 90 per cent of European hedge fund assets (Tait and Masters, 2009). Fund managers would have to meet certain reporting, governance and risk management standards, including some minimum capital requirements (Tait and Masters, 2009). The new rules aroused controversy immediately and the obvious ire of a European hedge fund trade association, namely, the European Private Equity and Venture Capital Association. Because of

such resistance, the implementation of the proposed EC standards remains uncertain at the time of this writing (eventual implementation requires agreement from both the European Parliament and member EU states.)

The shape of such regulations avoids many of the regulatory recalcitrance problems identified earlier. By not demanding real-time collection of data for all funds, it limits the impact of Type 1 recalcitrance problems in which the regulatory process bends and destroys entrepreneurial aspirations by requiring disclosure of competitively sensitive information. For the same reason, it limits Type 2 recalcitrance problems by limiting the kind of data collected and, in turn, the costs of collection. Of course, any collection of data will carry some recalcitrance "friction"; but some collecting is better than others, and the cost of data collection may be weighed against the benefit of lower systemic risk in the economy.

By limiting more stringent regulatory requirements to large, leveraged firms, regulations like those proposed by the EC target better the problems of systemic risk that lay behind the recession of 2008-09. With the issue of systemic risk in mind, it is helpful to classify the key stakeholders of hedge fund activity for ethical purposes. These are: 1) direct hedge fund investors; 2) indirect hedge fund investors (through, e.g., hedge funds); 3) national public (citizens of the nation state); and 4) global public (citizens of all nations). Figure 1 below maps these stakeholders, depicting how as one moves from 1 to 4, the degree that the respective stakeholder's involvement is voluntary decreases. The so-called "harm principle" in moral philosophy implies that informed market transactions among adults deserve prima facie protection unless third parties are exposed to significant harm. As Robert Nozick famously quipped, we ought not "prevent capitalistic acts among consenting adults" (Nozick, 1975). This

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[2] Notably, regarding issue one identified earlier, the proposed EU standards included "tax matters" that may exclude

implies that as one moves from the bottom to the top of the diagram, the prima facie justification for regulation to gather information increases. To put the matter another way, the trade-offs between the problems of regulatory recalcitrance on the one hand and limiting risk on the other vary depending on the level to which the stakeholder's involvement is *voluntary*. Demands for enhanced provision of sensitive information to regulators to protect a poor farmer in Bangladesh have higher moral priority than demands for enhanced provision of sensitive information to protect a wealthy Wall Street speculator making a calculated gamble on a particular hedge fund.

[Figure 1 about here]

It is difficult to estimate the level of risk to, say, a Bangladeshi farmer from the activities of hedge funds, and such a task lies beyond the scope or competency of this chapter. Yet, it is worth noting that hedge funds, including leveraged ones, were not key culprits in the global recession of 2008. Banks and insurance companies with average leverage estimated to be five times that of hedge funds were seen as far more culpable. Nonetheless, as the comment from Bernanke above makes clear, leveraged hedge funds often gain leverage through borrowing money from banks. Hence, either closer bank regulation or the collection of selected data from hedge funds relevant to the generation of systemic risk offers the possibility of lessening systemic risk.

These considerations show that certain well-tailored regulations designed to make appropriate trade-offs between the downside of regulatory recalcitrance and the upside of

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firms based in tax havens.

protecting third parties are neither unreasonable nor immoral. Yet, as we have also seen, even such limited regulation will not be fully effective in the absence of the industry-level cooperation, i.e., the instantiation of microsocial norms designed to include the inevitably clearer, inside-the-industry perspectives on certain risks.

To conclude, hedge funds raise important ethical issues, including those of taxation and transparency. I have focused primarily on the latter in order to see whether and what kind of government regulation might aid investors and the general public. We have seen that these conflicts cannot be resolved easily through government regulation because hedge fund activity is subject to two forms of regulatory recalcitrance. In turn, the only practicable resolution lies in the development of sharply tailored regulations designed with an eye to the avoidance of regulatory recalcitrance and the voluntary/involuntary status of key hedge fund stakeholders, along with the development of microsocial norms in the form of industry level codes and the articulation of best practices. Moral coordination, instituted as an industry standard, is essential to help circumvent the inherent limits of regulation. The solution to ethical conflicts in hedge fund opacity, then, is itself partly ethical and not regulatory.

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Figure 1

Hedge Funds: Key stakeholder constituencies