



Raising the Bar for Hedge Funds

Stanley Goldstein and Frank Plantan

Even the best economists have trouble explaining the recent unravelling of global financial markets. Headlines suggest a lack of focus in Washington and on Wall Street. This has contributed to a crisis of confidence not only in our policy makers but also the system itself.

Rationality among professional traders has given way to fear verging on panic. The spill-over effects are impacting even firms whose balance sheets were considered sound. Because hedge funds operate for the most part outside the regulatory environment overseen by the Securities and Exchange Commission (SEC), the Department of the Treasury, and the Federal Reserve, many construe hedge funds to be above the law, serving the sole interests of fund managers and their wealthy clients.

Until the past year, enviable returns reinforced the logic of the industry's freedom of operation. It was this freedom combined with the belief that unfettered market forces would play the role of ultimate regulator that shaped changes in behaviour. Industry advocates claimed that this operating environment proved the worth of self-regulation, noting that managers who committed fraud were prosecuted, that transparency in fund transactions was advanced as a result, and that funds engaged in illegal practices were disciplined by the marketplace itself through losses and exits.

But this paints too rosy a picture. Withdrawals and liquidation of investments now test the resilience of the industry, challenging its working assumptions. Some investors, unconvinced that losses have been due to fallout from larger market forces, have turned litigious in their search for evidence and explanations of investment losses. They have faulted fund managers and charged them with unsuitable investment decisions, insufficient or improper disclosure, misrepresentation, negligence, misconduct and other behaviours relating to omission of information.

Hedge funds, though not among the worst culprits in the financial crisis, have drawn disproportionate attention because of their size, fees and secrecy. There is much discussion today about taking a fresh look at the regulatory environment in which hedge funds operate – with five of the more prominent fund managers recently testifying before Congress¹.

Nor has it helped the industry that a number of high-profile fraud cases cast a spotlight on the industry. The two leading financial market regulators, the SEC in the US and the UK's Financial Services Authority, face increasing pressure from the public and have begun to contemplate new regulations.

What changes can restore public confidence in the industry while enhancing market forces, even if there is not a return to historic performance levels?

Elevating the role of ethics, making it a fundamental corollary to the normal functioning of the market and the basis of transparency and accountability will produce these results. An accepted code of conduct and best practices – hallmarks of all professions – will shape the hiring and training of personnel, define management responsibilities, enhance investor relations and help moderate government regulation.

Moreover, the institutionalisation of ethical practices by hedge fund managers in their organisations will lead to higher profitability. Surveys of CEOs in other business sectors and growing empirical evidence indicate that ethical behaviour leads to higher profit levels. The same should hold for hedge funds. This is not simply a matter of weeding out the bad apples in the industry, but of establishing standards and norms that will socialise new professionals to expectations concerning ethical standards.

Behaviour modification is difficult but possible. Systemic changes in society usually occur incrementally. Think of walking into a business meeting in 1962 and finding 12 smokers among the (mostly) men in the room. It is unlikely one could imagine such a meeting today. Changes in smoking behaviour and the role of women in business came first from the public, particularly civil society groups that lobbied for changes in laws and also changed public perception about the acceptability of certain behaviours. Changes in perceptions and preferences eventually impacted corporate culture.

¹ <http://dealbook.blogs.nytimes.com/2008/11/13/hedge-fund-managers-set-to-testify-before-congress/?ref=business>.



What do smoking habits have to do with hedge funds? Peer pressure and standard business usage can nudge the managers of hedge funds to set standards of conduct and ethical behaviour out of enlightened self-interest.

Many charities today are adopting whistleblower policies and creating audit committees within their boards of directors. There was no mandate behind this promulgation. Rather it was the questions that grantors had begun to ask that led to their creation. After repeated queries regarding whistleblower and corporate governance policies, charities caught on to the fact that it is better to attend to these issues as a means to attract funding.

The ultimate goal of such behaviour is to reap the value of a good reputation. The voluntary adoption of these policies has a direct impact on a charity's ability to instil confidence in funders. Most charities would prefer to avoid such expenditure of time and resources, but consumer and client demands make it a necessity.

One of the best examples of the power of ethics to guide behaviour comes from the New York State Society of CPAs. Serving on one of the Society's committees is a highly desirable privilege for an accountant. The accounting firms that make up its leadership know which firms behave ethically and which ones cut corners or cross the line either legally or ethically. Such individuals are effectively excluded from committee membership, which consequently limits both their professional and their revenue growth. Within the accounting community and individual firms, this paradigm produces a profound amount of peer pressure to dissuade and ostracise miscreants. This implicit code of conduct emerged in the industry without legislative action.

The Army has an old saying: "Anyone can fool the company commander but no one can fool the guys in the platoon." Soldiers know in a matter of weeks who they would be willing to share a foxhole with and who to avoid. Likewise, self-regulation with high standards will lead to an elevated set of expectations on the part of investors. If some hedge funds do not meet these standards, they will find investors taking their money to funds where they implicitly have more confidence. In this way, industry usage will push the management of these financial organisations to do what the buyer expects and demands.

Investor expectations can elevate ethical behaviour. Hedge funds have the opportunity to push for higher standards out of enlightened self-interest. By being proactive they can help set the framework for the debates to come regarding new regulations. This approach also complements the President's Working Group on Financial Markets² for establishing a best practices standard for the hedge fund industry.

Hedge fund managers already share characteristics with professionals in medicine, law, accounting and higher education. Each has a highly specialised knowledge base; there are certain barriers to entry into the profession; they represent a societal elite. What is missing is an associational body that oversees the conduct of its members and insists on conformity to professional norms. University faculty, lawyers and doctors all risk sanction, censure and even expulsion from the profession when they violate these norms. Self-policing has been shown to be effective, especially as a complement to regulatory agencies involved in external monitoring.

The way forward is difficult. Unlike public corporations, non-governmental organisations, international organisations and universities, hedge funds are not structured in a way that facilitates addressing ethical issues. Most hedge funds are small, closely held organisations with a small staff. The presence of an ombudsman reporting on malfeasance would be at best awkward and likely difficult. Escalating regulatory risk and the new demands for reporting and transparency compel the hedge fund industry to take the lead in order to maintain the independence and freedom of movement it values.

Doing so will create powerful bonds with stakeholders through an investment in corporate citizenship. A growing base of empirical evidence reports that good corporate citizenship also inspires people to disseminate good opinions about a company. Such word of mouth can be especially powerful in the relatively small world of the hedge fund industry and can be far more powerful than advertising in developing and maintaining loyalty and investments in a world where reputation and confidence means more than superficial branding.

² <http://www.treas.gov/press/releases/hp1177.htm>



For hedge funds to move in the direction we propose is a challenge but it is not impossible. There is a clear value proposition to putting ethics at the core of the industry and its transactions. Doing so can reduce costs of compliance, improve human resources, stabilise the market, enhance the confidence of investors and reduce industry volatility related to scandal and fraud.

Government regulation would not signal the death knell of the hedge fund industry, yet it would dampen the flow of capital if it becomes too intrusive. Self-regulation would relieve the pressure on governments to take drastic action. Adam Smith, in his *Wealth of Nations*, explained how man engages in actions for his own self-interest but in the process enriches the community around him. Hedge funds deserve the opportunity to grow into that self-governance mode.

Goldstein is president, [New York Hedge Fund Roundtable](#), and Plantan is co-director of the International Relations Program at the University of Pennsylvania.

This article first appeared in Policy Innovations on 15 December 2008 at <http://www.policyinnovations.org/ideas/commentary/data/000098>. It is licensed under a [Creative Commons License](#). Please read its [usage policy](#).