TRANSPARENCY, TRUST, AND A TALE OF HEDGE FUND ETHICS

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ABSTRACT OF THE THESIS

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“Hedge fund ethics” may seem counterintuitive. Many contend that hedge funds were a major contributor to the recent financial meltdown, and, moreover, that these funds are run by risk-loving, highly compensated managers who operate behind closed doors. While these points are true to some extent, it is equally important to remember that hedge funds possess a great deal of strategic freedom that enables them to earn above average returns for their investors. This freedom should be preserved in order to take advantage of hedge funds’ ability to provide management oversight, improve operational performance, and reduce investor fraud. However, the recent degradation of trust in our financial markets undoubtedly requires a response. Therefore, we will argue the need for a new, more transparent type of hedge fund, and suggest a voluntary, principle-based implementation method intended to ameliorate the recent trust issues exhibited in the hedge fund industry.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABSTRACT ................................................................. iv</td>
</tr>
<tr>
<td>LIST OF TABLES ........................................................... vii</td>
</tr>
<tr>
<td>INTRODUCTION .............................................................. 1</td>
</tr>
<tr>
<td>HEDGE FUND BACKGROUND .................................................. 4</td>
</tr>
<tr>
<td>Definition and Current Assessment ..................................... 4</td>
</tr>
<tr>
<td>Characteristics ............................................................. 4</td>
</tr>
<tr>
<td>Regulatory and Fiduciary Environment .................................. 6</td>
</tr>
<tr>
<td>TRANSPARENCY AND TRUST ................................................. 9</td>
</tr>
<tr>
<td>Transparency ............................................................... 9</td>
</tr>
<tr>
<td>Trust .............................................................. 14</td>
</tr>
<tr>
<td>Transparency and Trust Convergence within the Hedge Fund Industry .................................. 18</td>
</tr>
<tr>
<td>PROPOSAL FOR A MORE TRANSPARENT HEDGE FUND ..................... 19</td>
</tr>
<tr>
<td>Investment Objectives ..................................................... 20</td>
</tr>
<tr>
<td>Risk Evaluations ........................................................... 21</td>
</tr>
<tr>
<td>Accounting Information and Leverage/Illiquidity ...................... 22</td>
</tr>
<tr>
<td>Investment Adviser and Management Background ....................... 23</td>
</tr>
<tr>
<td>Third-Party Affiliations .................................................. 24</td>
</tr>
<tr>
<td>Fund Structure, Size, and Investor Base ................................ 24</td>
</tr>
<tr>
<td>Investor Terms and Obligations .......................................... 25</td>
</tr>
<tr>
<td>Performance Updates and Cooperation with Information Requests .......... 25</td>
</tr>
<tr>
<td>Preview to Implementation ............................................... 26</td>
</tr>
<tr>
<td>IMPLEMENTATION PROPOSAL FOR A TRANSPARENT HEDGE FUND .......... 27</td>
</tr>
<tr>
<td>The Regulation Argument ................................................. 27</td>
</tr>
<tr>
<td>Proposal for a Voluntary Approach ...................................... 29</td>
</tr>
<tr>
<td>Implementing a Voluntary Approach ...................................... 31</td>
</tr>
<tr>
<td>ARGUMENT FOR IMPLEMENTING A TRANSPARENT FUND ................... 33</td>
</tr>
<tr>
<td>Reduce Agency Costs, Risk of Moral Hazard, and Adverse Selection .......... 33</td>
</tr>
<tr>
<td>Increase Generalized Trust in the Industry ......................... 35</td>
</tr>
</tbody>
</table>
Attract Institutional and Individual Investors .................................................................36
COUNTERARGUMENTS TO A TRANSPARENT HEDGE FUND ........................39
  Transparency is Not Necessary Because Hedge Fund Investment is Increasing ...........39
  Transparent Funds Risk Losing a Competitive Advantage ........................................40
  Funds That Embrace Transparency Will Be Disadvantaged .................................41
  Increasing Transparency Increases Bonding Costs .................................................42
  Funds of Hedge Funds Already Provide Due Diligence ........................................42
  Funds May be Tempted to Hide Behind Transparency ........................................43
CONCLUSION ..................................................................................................................44
REFERENCES ................................................................................................................45
LIST OF TABLES

Table 1. Comparison of Investment Fund Transparency ................................................. 20
INTRODUCTION

In 2008, 300 San Diegans were told that they would earn a 2-4% monthly return if they invested in the Plus Money, Inc., hedge fund (San Diego News, 2008). The fund’s management also informed them that this fund specialized in “covered calls,” and that it was run by Matthew La Madrid. These investors, which included a housewife and two firefighters, were not privy to any information that explained the details of a “covered call” strategy, though. They did not know that Matthew La Madrid was only licensed as a real estate agent, and they were never given access to financial statements or performance reports. What was the result of their investments? Investors lost an average of $100,000, and some lost up to $1.6 million.

In another instance, 41 investors were led to believe that they would earn healthy returns by putting their investments under the management of Cantella Securities (Shell, 2004). This fund’s offering memoranda and prospectuses, however, did not inform investors that the fund specialized in risky technology stocks and employed day-trading strategies. It also did not elucidate that the fund managers had no technical training or experience managing money. These investors, too, experienced a large financial loss, and an estimated $3.5 million vanished.

Unfortunately, the media is flooded with similar anecdotes describing how hedge fund investors have suffered. Although the details of these stories vary, they all tend have one thing in common. Each is rooted in information asymmetry and a lack of transparency. Time after time, investors are not presented with adequate information, making it difficult for them to make wise investment decisions, and, at times, evade fraud.

The press has underscored these problems in reports of the role that hedge funds played in the 2008 recession. Influential investors, like George Soros, have claimed that hedge funds’ excessive use of leverage contributed to the recent financial meltdown (Soros, 2008). Some have also recounted that hedge funds are run by risk-loving, highly compensated managers who operate behind closed doors, and have contended that some action needs to be taken to monitor these funds.
Regardless of the extent to which hedge funds actually contributed to the recent economic downturn, the plethora of stories that cite a lack of transparency, combined with the public’s increasingly negative perception of the hedge fund industry, has resulted in a trust crisis. America’s confidence in the financial system continues to decline (Sapienza & Zingales, 2010), and this degradation of trust requires a response.

Regulating an industry is a popular approach to alleviating trust issues. Mutual funds, for instance, are highly regulated under the Securities Act of 1933, the Securities Act of 1934, and the Investment Acts of 1940 (Macey, 2008). These Acts all require mutual funds to register with the SEC and disclose information, such as investment objectives, risk evaluations, management backgrounds, and performance updates. Although this regulation limits the strategic leeway of these funds, it does increase transparency and ensure that investors have access to information that they need in order to make educated investment decisions.

Hedge funds, on the other hand, exist at the opposite end of the regulatory spectrum. These funds are exempt from the Securities and Investment Acts mentioned above, and they enjoy a great deal of strategic freedom that enables them to earn above-average returns for their investors (Brav, Jiang, Partnoy, & Randall, 2008). This freedom should be preserved in order to take advantage of hedge funds’ ability to provide management oversight, improve operational performance, and reduce investor fraud (Macey, 2008). However, it is also important to recognize that the liberty these funds have allows them to operate in an opaque investment environment where information is blocked from both investors and the public (Donaldson, 2008).

If we broaden our focus to the context of a trust crisis, the market appears to be characterized by two extremes. Regulated funds, such as mutual funds, are mandated to be transparent, and, therefore, do not require a great deal of trust from investors. Alternatively, unregulated hedge funds are opaque and rely on significant trust from investors. We suggest that a gap exists along this continuum, leaving room in the market for a transparent investment fund that provides information like a regulated mutual fund, yet retains the unregulated strategic freedom of a hedge fund. This transparent fund could potentially reduce the agency costs associated with information asymmetry, expand the market by
attracting institutional and individual investment, and, most importantly, increase trust in the hedge fund industry.

Greater trust in the hedge fund industry would yield several benefits. In particular, trust could be a source of competitive advantage (Barney & Hansen, 2006), and it also could reduce transaction costs associated with hedge fund investment (Dyer & Chu, 2003). Transaction costs can be described as all of the costs associated with conducting economic exchanges (Williamson, 1985). In high-trust situations, most of these costs are minimized, as each party involved in the exchange assumes that the other party is acting in good faith. Negotiations tend to be more flexible, and less time and resources are devoted to monitoring and enforcing agreements. Thus, hedge funds would potentially be able to compete more effectively and efficiently in an environment characterized by high trust.

As the hedge fund industry is still in the process of rebounding from the financial and ethical crises of 2008, the ability to compete successfully is critical. Before explaining how a transparent fund would lend to these competitive benefits and alleviate the current crisis of trust, though, the subsequent sections will review hedge funds, transparency, and trust.
HEDGE FUND BACKGROUND

In order to fully comprehend the need for transparency and trust in the hedge fund industry, it is important to first have a basic understanding of how hedge funds operate. Thus, this section will define hedge funds, illustrate their characteristics, and explain the regulatory and fiduciary environment that they face.

DEFINITION AND CURRENT ASSESSMENT

The Securities and Exchange Commission recently developed fourteen separate definitions to describe hedge funds (Vaughan, 2003). However, hedge funds can be generally be classified by four distinctive characteristics: “(1) they are pooled, privately organized investment vehicles; (2) they are administered by investment managers with performance-based compensation and significant investments in the fund; (3) they are not widely available to the public; (4) they operate outside of securities regulation and registration requirements” (Brav et al., 2008, p. 1735). Roughly 7,000 hedge funds exist today, and industry assets are estimated at $1.5 trillion globally (Credit Suisse Tremont Index LLC, 2010). This total is down from the industry’s peak in 2007; however, hedge fund formation is currently on the rise as these investment vehicles continue to outperform global equity markets.

Like other financial industries, hedge funds suffered during the infamous 2008 market crash. They lost roughly $582 billion in assets from November 2007 to February 2009, and the industry experienced significant withdrawal requests from investors (Credit Suisse Tremont Index LLC, 2010). While a number of funds were able to succeed in 2008, this asset class, overall, hit a historical low during the recession.

CHARACTERISTICS

Hedge funds’ characteristics make them distinct from other traditional investment vehicles. They are typically organized as limited partnerships in which the fund manager is considered the general partner and other investors play a passive role with little say concerning how the fund is managed (Brav et al., 2008). This structure, however, allows
passive investors to enjoy the benefits of limited liability, and it allows the fund itself to avoid taxation and significant regulation (Schneider & Ryan, 2009).

Hedge funds are also considered to be private equity or alternative investment funds (Schneider & Ryan, 2009). Private equity refers to pooled, privately owned investment funds that aim to generate high returns for their investors (Macey, 2008). Fund managers usually accomplish this task by generating capital and forming long-term partnerships with the management of private companies. Thus, while hedge funds invest in stocks, bonds, and other typical public market securities just as institutional investors do, they operate and are managed quite differently (Schneider & Ryan, 2009).

Although their name suggests that they are risk-averse, hedge funds typically engage in a wide array of investment strategies (Schneider & Ryan, 2009). For example, hedge funds may buy equities “long” with the hope that the security value will rise, or they may buy equities “short” with the expectation that the security value will fall. They may invest in the distressed debt of a foreign country, or they may use quantitative strategies with computer driven algorithms to determine if certain assets, such as real estate or oil, are overvalued or undervalued (Donaldson, 2008). Unlike traditional institutional investors, hedge funds are also allowed to trade on the margin, engage in derivatives trading, and maintain an undiversified portfolio (Brav et al., 2008). Therefore, hedge funds have a great deal of flexibility to pursue investment strategies that create value (Macey, 2008).

Regardless of the specific strategies that a hedge fund chooses to employ, the goal is the same across the industry: absolute returns with a positive alpha. Absolute, or market-neutral returns, are returns that are not correlated with financial market trends (Schneider & Ryan, 2009). A positive alpha, moreover, refers to abnormal or excess returns above what is expected by some market equilibrium model. In other words, if a hedge fund has earned absolute returns with a positive alpha, it means that it has outperformed its benchmark index.

Hedge fund managers have a large incentive to produce such generous returns. Investors usually pay fund managers a management fee of 2%, plus a 20% performance fee on annual investment gains (Donaldson, 2008). Essentially, this structure means that the fund managers receive “two cents for every dollar it manages, plus 20% of any profit it generates for its investors” (Donaldson, 2008, p. 407).
Hedge fund managers are not the only prosperous individuals involved with these funds. Investors must have a minimum net worth in order to invest in a hedge fund, and investment minimums can range anywhere from $1 million to $10 million (Macey, 2008). Therefore, hedge fund investor communities are typically made up of large institutions or wealthy, accredited individuals.

**REGULATORY AND FIDUCIARY ENVIRONMENT**

One of the most defining characteristics of hedge funds, however, is that they are much less regulated than traditional institutional investors. Specifically, they are not subject to the Securities Act of 1933, the Securities Act of 1934, the Investment Company Act of 1940, nor the Investment Advisers Act of 1940.

The Securities Act of 1933, often referred to as the “truth in securities law,” requires publicly offered securities to register and disclose material information (Federal Reserve System, 2007). The Securities Act of 1934, on the other hand, essentially created the Securities and Exchange Commission and empowered it to regulate those involved in selling securities in an effort to enhance governance for secondary market transactions. Due to the fact that hedge fund companies require their investors to have a minimum net worth and do not publicly solicit or trade shares, they are exempt from these Acts and, thus, not required to register or report information.

The Investment Company Act of 1940 focuses on regular disclosure to the investing public of information about a fund, such as its investment objectives and policies, its company structure and operations, and its financial condition (Macey, 2008). Again, because hedge fund companies do not solicit publicly, they are not regulated by this Act. Finally, the Investment Adviser Act of 1940 historically required that advisers who manage at least $25 million of assets register with the SEC. Fund managers with a small, sophisticated clientele (Schneider & Ryan, 2009), and fewer than 15 funds in their portfolios were exempt (Macey, 2008). However, this Act was recently amended with the Dodd-Frank Bill described below.

Overall, hedge fund companies and their investment advisers were not subject to the 1933, 1934, or 1940 Acts for decades. Recently, though, regulators have been pushing a variety of Bills that would drastically change the regulatory landscape of hedge funds.
The government’s first attempt to increase the scope of hedge-fund regulation occurred in 2004 when “The Hedge Fund Rule” was promulgated (Goldstein v. Securities and Exchange Commission, 2006). This rule would have required investment advisers to redefine their investors as “clients,” and, as a result, would have forced a majority of funds to register with the SEC. In 2006, though, the U.S. Court of Appeals for the District of Columbia Circuit struck this proposition down in the Goldstein v. Securities and Exchange Commission case. The court found that it was arbitrary to equate the term “client” with “investor,” and, moreover, could not rationalize why the term “client” would define “to whom fiduciary duties were owed, and whether an investment adviser had to register” (2006, p. 1). Thus, The Hedge Fund Rule was reversed.

Since the ruling on that case, Congress has made several additional attempts to pass legislation that would encroach upon the current freedom that hedge funds enjoy. The first, and most prominent, piece of legislation is the Hedge Fund Transparency Act of 2009. This bill would amend the Securities Acts of 1933 and 1934. It would require hedge funds with assets of at least $50 million to register with the SEC, file an annual report, maintain certain books and records, and cooperate with any request for information or examination (Library of Congress, 2010). It would also require hedge funds to establish an anti-money laundering program, report suspicious transactions to the government, and implement a variety of due diligence policies and procedures. This bill is still in the first stages of the legislative process, and is currently under review by the Committee on Banking, Housing, and Urban Affairs.

Additionally, the Hedge Fund Adviser Registration Act of 2009 would amend the Investment Advisers Act of 1940. The 1940 Act allowed hedge funds that had fewer than 15 clients and did not solicit publicly to be exempt from registration with the SEC. The 2009 amendment, however, would require investment advisers to register (Library of Congress, 2010). This bill is also in the early stages of the legislative process, and is currently under review by the Committee on Financial Services. The proposed Private Fund Transparency Act of 2009 goes a step further to amend the 1940 Act. It would not only require advisers to register, but also to maintain and submit records to the SEC so that federal authorities can monitor systemic risk. It also broadens the meaning of the term “client,” and requires advisers to disclose the identity and investment affairs of its investors to the SEC. Like the
previous bills, The Private Fund Transparency Act is in the initial stages of the legislative process, and is currently being reviewed by the Committee on Banking, Housing, and Urban Affairs.

While the three Acts described above have not progressed far past the introductory stages of the bill creation process, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed by President Barack Obama on July 21, 2010, just eight months after its introduction (Library of Congress, 2010). Title IV of this bill requires investment advisers whose assets are greater than $150 million to register and submit information to the SEC. Thus, the overarching objectives of the Hedge Fund Adviser Registration Act of 2009 and The Private Fund Transparency Act of 2009 were addressed through this bill.

It is important to recognize, though, that the Dodd-Frank Act applies to the investment advisers of hedge funds, not to hedge fund companies themselves. If the Hedge Fund Transparency Act of 2009 (or similar legislation) is enacted, hedge funds would also be subject to SEC supervision.

Although hedge fund companies are not subject to the early Acts, they are still bound by a variety of antifraud provisions. They do not, however, face heightened fiduciary standards, such as the “prudent man” investing standards embodied in the Employee Retirement Income Security Act (ERISA) of 1974 (Brav et al., 2008). This act made the security of retirement-plan promises a substantial objective of federal policy, and imposed a range of fiduciary responsibilities on those who offer retirement plans (Wooten, 2003).

On the whole, the loose regulatory and fiduciary standards that the industry faced in the past lent to an opaque investment environment where fund information was not easily accessible. This opacity has been the root of a variety of ethical issues, and even scandals, over the years. Despite the fact that investment advisers now face more stringent regulation, hedge funds still have a high degree of regulatory freedom. While we will argue that this freedom should be preserved, a need exists for increased transparency, as ethical transgressions have degraded trust in this industry. Therefore, we will take our analysis of hedge funds to the next level, after exploring the concepts of transparency and trust.
TRANSPARENCY AND TRUST

In the absence of transparency, trust diminishes. So, in order to restore the trust that was recently lost in the financial world, we need to increase transparency. We will begin by defining transparency and discussing the literature on voluntary information disclosure. We will then shift our focus to notions of trust and discuss this topic in the context of business relationships. Finally, we will explain how transparency and trust are interrelated and, more specifically, how these concepts apply to hedge fund ethics.

TRANSPARENCY

Transparency can be defined as “the degree to which information flows freely within an organization, and outward to those with vested interests” (Bennis, Goleman, & O'Toole, 2008). In a transparent setting, nothing is hidden and material information is easily accessible, seen through, and understood. Investors’ questions are freely answered, and requests for position disclosures and return estimates are regularly granted (Black, 2007). Furthermore, some consider transparency to be critical for a free market in securities where strategies and other factual information should be available (Overdahl, 2007).

The two main categories in which a business entity can be transparent are financial transparency and social transparency (Van Buren, 2007). Financial transparency essentially refers to making accounting information known in a complete and fair manner. Social transparency, on the other hand, includes information about the treatment of employees and environmental performance. While social transparency is important, investors and the public tend to have a greater expectation for financial transparency.

Business entities can also be transparent in two ways. First, active transparency occurs when entities consciously choose to reveal material information (Tapscott & Ticoll, 2003). Issuing reports, submitting press releases, and engaging in dialogue with constituencies are all examples of active transparency. Alternatively, forced transparency occurs when constituencies or the media reveal information about an organization without its consent. One of the most famous examples of this type of transparency is when Sharon Watkins “blew the whistle” on Enron and revealed the company’s fraudulent activity.
Regardless of how transparency is achieved, operating in a transparent environment offers a variety of noteworthy benefits. First, business entities that provide more information can help current investors make sound investment decisions, monitor fund performance, and personally assess risk exposure (Hedges, 2005). They can also attract prospective investors, increase trust, and meet the rising expectations of the public, whom, now more than ever, demand information. Information disclosure is also a useful means to educate and maintain dialogue with investors. It can result in fostering positive, long-term relationships, and even decrease instances of fraud, deceit, and misrepresentation. Decreasing deception is a critical advantage, as opacity has been the root cause of a variety of financial crises. For instance, during the Asian financial crisis in the late 1990s, millions of jobs were lost, interest rates exploded, share prices collapsed, and foreign business investment plummeted (Tapscott & Ticoll, 2003). During the Enron era in the early 2000s, investors’ withdrawal from capital markets caused a 28% decline in the S&P 500 index, market capitalization was destroyed, billions of dollars in bad debt were uncovered, thousands of jobs were lost, and hundreds of corporate crime and fraud investigations took place. Today, in the wake of the sub-prime mortgage crisis, the same vicious cycle has repeated itself, where a lack of information has led to self-dealing, corruption, and increased transaction costs. While transparency has clear benefits, the costs of not being transparent are epic.

Despite the severe costs of being opaque, transparency has some drawbacks worth considering. First, being open requires tracking, reporting, gathering, and disseminating information, all activities that require significant time and money (Tapscott & Ticoll, 2003). Knowledge also has inherent limitations as sometimes information gets so complex that it is difficult to report. Organizations with little transparency experience could reveal information poorly or give up too much strategic information. This balance of information disclosure is critical, as significant value can be derived from concealing competitive or confidential facts. In accord with this idea, America’s litigious society goes so far as to dissuade companies from being fully transparent. In the seminal case Nike vs. Kasky, commercial speech was expanded to include most of what a company reports, thus limiting businesses’ legal protection under the First Amendment (Nike v. Kasky, 2003). Therefore, attorneys tend to intentionally block transparency. Finally, it has been argued that transparency may actually result in investors receiving less information (Van Buren, 2007). This argument is rooted in...
the idea that, as more information about securities becomes apparent, individuals have less incentive to discover new information. With less incremental return, investors have little incentive to gather additional material information to incorporate into market prices. As a result, security prices could ultimately be less informative in a transparent world.

Overall, transparency can lead to a variety of positive and negative outcomes for society. As the public begins to demand more transparency in the financial world, revealing the optimal amount of information is clearly a balancing act. Beyond the main benefits and drawbacks, though, other elements of transparency are worth mentioning, such as what drives transparency, who it is owed to, and how it should be communicated.

Tapscott and Ticoll (2003) present five different transparency drivers. The first is rooted in the idea that, as business becomes more globalized, the competitive success of firms and nations depends on reporting genuine performance information. Second, the rise of knowledge-based work encourages transparency because knowledge-worker productivity depends on trusting, open relationships. Third, the spread of communication technology and the pervasiveness of the internet have greatly amplified the amount of available information. This idea leads to the fourth driver of transparency, which is the rise of the Net Generation, where the plethora of information online is a part of their everyday lives. Finally, the “rising global civil foundation” drives openness, as the world’s increasingly educated generations raise the standards for the quality of human interaction. Thus, transparency has become expected in our modern world, and these drivers will likely persist for decades to come.

It is also vital to address to whom transparency is owed. The wide variety of perspectives on this topic can be boiled down to either the traditional or the stakeholder viewpoints (Van Buren, 2007). The traditional view states that “a firm should be governed for the benefit of equity holders and primarily aim to increase their wealth” (Schrenk, 2006, p. 82). Therefore, those with ownership interests in the firm deserve financial transparency so that they can decide whether or not to remain invested in an organization, and if changes in an organization’s practices should be pursued. The stakeholder view, on the other hand, suggests that “managers have the moral obligation to consider and balance the concerns of all groups with an interest in the organization” (Schrenk, 2006, p. 83). Thus, stakeholder theorists suggest that businesses owe transparency not only to shareholders, but also to employees, suppliers, customers, and communities. Regardless of one’s beliefs, it is worth
mentioning that shareholders are owed fiduciary responsibilities whereas other stakeholders are not.

Finally, information can be communicated in a variety of ways. Methods of financial reporting, in particular, have received significant attention in recent years with the Sarbanes-Oxley Act of 2002 (Dodwell, 2008). This legislation was a response to the scandals of the Enron era, and it raised the expectations of firms to improve the accuracy, timeliness, and scope of financial disclosures. While an analogous regulation to promote social transparency does not exist, a number of standardized reporting regimes address what and how often corporations should report publicly. For instance, the Global Reporting Initiative has developed a leading sustainability template for businesses, and it encourages voluntary disclosure on environmental, economic, and social performance (Brown, de Jong, & Lessidrenska, 2009). Regardless of the type of transparency in question, business institutions cannot avoid the fact that people desire and expect more information. Therefore, the real debate is not centered on the need for transparency, but, rather, on the level of information disclosure that is truly necessary (Hedges, 2005).

Wheeler, Colbert, and Freeman (2003) present a popular model that describes three different levels of information disclosure that a firm can practice. Level 1 represents those business and financial entities that follow disclosure laws and norms, and simply preserve organizational value by providing a minimal amount of information. Level 2 refers to organizations that instrumentally offer information to investors in order to create value. Finally, businesses at Level 3 disclose facts about a broad scope of activities in hopes of maximizing the creation of value for the firm. It is important to note that no entity or institution should operate exclusively at only one of these levels (Tapscott & Ticoll, 2003). Rather, it should choose the level of transparency that works in its favor by attracting investors without entirely revealing its strategies.

Furthermore, full transparency may not always be completely necessary or valuable in the investment world (Hedges, 2005). Investors would have little use for real-time, daily snapshots of a portfolio’s earnings, and they may be confused and overwhelmed by mass amounts of data. Partial transparency, on the other hand, would be an optimal compromise between investors and managers with conflicting transparency interests (Black, 2007). Financial entities can successfully be partially transparent by disseminating performance
summaries to investors, presenting data in aggregate form, and providing third-party valuations from outside auditors with financial expertise.

Whether or not a system of full or partial transparency is practiced, it is important to recognize that voluntary information disclosure is a form of active transparency. In the wake of so many financial meltdowns, though, the need for mandated transparency has become heavily debated.

Today, little empirical evidence on transparency exists, so regulators must decide in a vacuum whether the government or the free market is in a better position to judge the appropriate level of transparency (Van Buren, 2007). Those in favor of mandated regulation believe that the government must step in because opacity has resulted in market failures and anticompetitive conduct. Alternatively, free-market advocates believe that opacity occurs when entities act to protect their private property, and, thus, market forces can be relied on to determine the appropriate balance of transparency.

Regardless of one’s perspective, concepts of market efficiency shed some light on the appropriate level of transparency. Market efficiency refers to a situation in which “prices always fully reflect available information” (Fama, 1970, p. 383). This hypothesis can be broken down into three categories of efficiency: weak, semi-strong, and strong. The weak form of efficiency suggests that prices reflect historical data. Semi-strong efficiency states that prices naturally adjust for all information that is made publicly available, such as earnings announcements. Finally, strong-form efficiency claims that prices include unpublished or “insider” information. Although this hypothesis is highly debated, most agree that the market exhibits semi-strong efficiency (Malkiel, 2003). Therefore, the level of transparency that yields the greatest value tends to be the one in which private information is made available to investors.

Despite these various discussions of transparency and market efficiency, it is important to bring our focus back to hedge funds and remember that hedge fund companies currently operate in a very opaque and lightly regulated environment. Investors, however, are beginning to urge greater transparency in this industry. In a 2009 Datamonitor survey among investment managers and institutional investors, 62% of respondents claimed that investment managers should give investors more transparency on investment risk and 60% agreed that more information on investment strategy should be revealed (Lindsay, 2009).
Furthermore, many noted that risk management and corporate governance have stagnated in this industry. Investors desire more communication, greater transparency, and a client relationship approach where “clients are at the heart of everything they do” in order to rebuild trust. The next section will explore trust and will touch upon how it applies to the hedge fund industry today.

**Trust**

In Aristotle’s examination of *ethos* in his seminal work, *Rhetoric*, he stated that trust was “the expectation that others will be honest, accountable, considerate, and open,” and that it “depended on another’s perception of one’s correctness of opinions, character and goodwill” (Tapscott & Ticoll, 2003, p. 78). While this conception of trust is still widely referred to today in a variety of disciplines, scholars continue to define trust in new and different ways. For instance, trust has been described as a leap of faith that one takes in the face of incomplete information (Kath, 2007). It can also be viewed as a process and an outcome at the most basic level of social contact that determines long-term success (Golin, 2004). Most simply, trust is hard to pinpoint, but people can usually tell when it is warranted. For the purposes of this paper, though, we will follow Ryan and Buchholtz (1998, p. 3), and define trust as “the extent to which individuals see people and institutions as moral, honest, and reliable.” Furthermore, trusting behavior is “one’s willingness to increase one’s vulnerability to another whose behavior is not under one’s control” (Ryan & Buchholz, 1998, p. 3).

Trust can generally be broken down into two categories: organizational trust and personal trust. Organizational trust refers to the trust placed in a system or institution (Lorenz, 1996). Personal trust, on the other hand, has to do with trust in a particular individual’s or group of individuals’ intentions and competence. These types of trust can further be broken down into relational and rational components (Kath, 2007). The former stems from social identity theory, and it emphasizes that a trusting relationship is a reflection of shared values. The latter is based on expectancy theory, and it suggests that individuals weigh risks and outcomes to determine the level of trust deserved in a relationship or situation.
From a psychological standpoint, interpersonal trust dominates the empirical literature. Interpersonal trust has two commonly cited factors worth exploring. First, specific trust is rooted in facts about individuals and relationships (Bulter, 1991; Driscoll, 1978). This type of trust, like relational trust, is influenced by situations, and it refers to the trust people have in an individual about whom they have specific knowledge. Alternatively, generalized trust is based on a trustor’s disposition. It is similar to rational trust in that it is related to game theory’s “unfamiliar actors.” Thus, generalized trust has to do with the trust people have in someone that they have no specific knowledge about. Aside from the fact that some sophisticated investors will be familiar with select fund managers, hedge fund investor relationships typically deal with “unfamiliar actors.” Therefore, our argument, and the remainder of this paper, will be based on generalized trust. Within this category, institutional trust and dispositional trust are the main focuses.

The first category of generalized trust “relates to individuals’ confidence in social institutions, or the organizational and institutional arrangements that produce trust among strangers” (Bigley & Pearce, 1998). Institutional trust can further be defined as “a social relationship in which principals invest resources, authority, or responsibility in another to act on their behalf for some uncertain future return” (Shapiro, 1987, p. 626). Interestingly, the U.S. market has been structured to encourage institutional trust. Two schools of thought dictate the level of trust that individuals have in institutions within the market (McKnight, Cummings, & Chervany, 1998). Those with situation-normality views believe that the market is reinforced when it acts as it is expected, and trust varies only when unexpected market events occur. On the other hand, those with structural assurance beliefs have faith that the government will impose legal and regulatory restraints in order to safeguard the market. Regardless of the specific viewpoint, those who have great institutional trust have confidence in the business and financial transactions they engage in with unfamiliar actors. Furthermore, they develop this level of trust due to dispositional characteristics.

Dispositional trust is the second type of generalized trust, and it refers to “individuals’ trust in human nature or predisposition to trust strangers” (Ryan & Buchholtz, 1998, p. 4). This type of trust deals with comfort levels in human interactions, and it can have a significant influence on future relationships. Dispositional trust is also developed over a long period of time, and is built from personal experiences and knowledge about individuals. In
the context of hedge funds, dispositional trust would refer to trust in an individual fund manager, whereas institutional trust would refer to trust in a particular fund or the industry as a whole.

Given this understanding of the different types of trust that play into our market economy, it is important to explore how trust is initially established and how it affects long-term relationships. The initial formation of trust tends to depend on the individual and the situation, where a favorable intersection of the two serves to deepen trust (Kath, 2007). Tapscott and Ticoll (2003) add that parties must have shared norms and values for trust to exist. Reciprocity also plays an important role, as trusting relationships provoke reciprocal obligations.

More specifically, two prominent views explain sources of trust. The norm-based view suggests that “norms are thought to produce trustworthiness understood as certain types of behavior” (Lorenz, 1996, p. 6585). Thus, trust is dependent on what a person knows about another’s values and norms. The calculative view claims that people develop trust in others based on evidence that a person has behaved in a trustworthy way.

Zand (1972) developed a behavioral study of trusting behavior that demonstrated trust levels in a variety of situations. He discovered that, when both parties entered into a relationship with good intentions and expectations, fulfillment of those expectations tended to lead to a greater level of transparency and trust. In contrast, if either party failed to fulfill his or her commitments, then both parties became defensive and tried to minimize risk exposure while simultaneously maximizing personal control, and a point of low trust was ultimately reached. Therefore, entering into relationships with a high level of trust and following through with commitments is critical to establishing and maintaining open, honest interactions.

Finally, Kreps (1990) argued that reputation effects also play a large role in establishing trustworthy behavior. In other words, people will be trustworthy if it will promote or maintain a favorable image. Later, however, Williamson argued that trust added little value to the traditional analysis of decision making under risk, and that the topic had little economic importance (Williamson, 1993). The classic rebuttal to this argument is that, when one considers bounded rationality where individuals have limited time and information to make decisions, trust can usefully contribute to economic analysis (Lorenz, 1996).
Trusting relationships can also have many advantages for an organization or financial entity. For instance, trust can help increase commitment among employees, improve performance, and, also, facilitate existing relationships with investors and partners (Kath, 2007). Trust has also been shown to lower transaction costs, and, as a result, promote risky investments (Lorenz, 1996). Distrust, on the other hand, is generally characterized by fear, opacity, and controlling behaviors. So, while no obvious disadvantages from engaging in trusting relationships exist, the consequences of not having trust are great.

Before delving into how distrust issues have specifically affected the hedge fund industry, it is worth recognizing that distrust in this industry is not an isolated problem. It is widespread throughout business, and it has only been exacerbated by poor relationships and short-term, results-driven business strategies (Golin, 2004).

Demographic findings have given further details about the trust crisis in the American business world. Studies have shown that women do not lend their trust as easily as men do (Golin, 2004). Additionally, young Americans are much more trusting than older Americans, and those with college educations hold businesses to a higher trust standard. Moreover, the greater individuals’ income, the more value they place on trust in financial relationships.

A study by Golin-Harris International also found that 69% of those surveyed no longer knew whom they could trust after the Enron transparency crisis in 2002 (Golin, 2004). Respondents claimed that they were going to be more careful and cynical about what to believe in the future, and, furthermore, that they were going to hold businesses to a higher standard of trust. Eighty-three percent also stated that they would give a company that they trusted the benefit of the doubt if performance were poor or behaviors were questioned.

With regard to hedge funds, a study of the public’s opinions of investment managers found that a breakdown in trust of financial intermediaries was particularly evident (Lindsay, 2009). Seventy-seven percent believed that financial intermediaries lacked knowledge and were less trustworthy than politicians. Additionally, 57% claimed that financial intermediaries need better training in order to regain trust with their investors. Research also showed that investment managers do not have faith in top-level management, and current risk management and corporate governance procedures have little direction.

The future of trust research, however, may take a new direction given recent developments in the world of neuroeconomics. Zak (2008) has recently discovered that
humans’ levels of the “moral molecule” Oxytocin play a large role in trusting behaviors. “When people are in settings that promote feelings of trust and safety, they release Oxytocin and their behavior becomes more trusting and generous in return” (Haederle, 2010). Zak demonstrated this concept with two separate game-theory experiments, which showed that administrations of Oxytocin made people, on average, 80% more generous in investment situations. These results are noteworthy and will surely impact future literature on trust.

TRANSPARENCY AND TRUST CONVERGENCE WITHIN THE HEDGE FUND INDUSTRY

Now, given basic information concerning hedge funds, transparency, and trust, it is important to remember how these three topics converge. As mentioned above, the 2008 market crash took a toll on the hedge fund industry. Billions of dollars in assets were lost, gated investors desperately tried to withdraw their capital, and ethical scandals dominated the media. For example, separate funds run by Stanford and the infamous Bernie Madoff were all involved in Ponzi schemes that cost the industry billions of dollars (Bandler, 2009; Chew, 2009). Rajaratnam, from the Galleon Group Fund, was arrested for insider trading, and other insurance companies and banks were all culpable of unethical practices (Merced, 2009). As was also true during the Enron era, the recent transgressions of these investment managers, coupled with an economic downturn, has led to a serious trust crisis in our market.

Given that trust and transparency are highly correlated (Van Buren, 2007), it is worth referring to research that considers both elements simultaneously within the context of the investment industry. A study conducted in 2008 accomplished this objective, concluding that “transparency, or complete information, significantly increased trust in both one-shot and repeated investment game settings” (Kanagaretan, Mestelman, Nainar, & Shehata, 2010). Furthermore, the researchers suggested that transparency was a critical element in building trust in business environments.

The following section will, therefore, build upon this argument by proposing a new, transparent type of hedge fund in order to alleviate trust issues and encourage investment freedom within this private investment industry.
PROPOSAL FOR A MORE TRANSPARENT HEDGE FUND

Hedge funds, as previously mentioned, are dynamic, lightly regulated investment vehicles with a great deal of strategic freedom. While this freedom has allowed funds to outperform the market and generate large returns, it has also largely contributed to a crisis of trust. Therefore, this section will propose a new, transparent hedge fund intended to address the gap that we suggest exists along the transparency spectrum. This new investment fund would provide information like a regulated mutual fund, yet retain the unregulated strategic freedom of a hedge fund. Furthermore, it would disclose information beyond the scope of due diligence without subjecting investors to the additional fees that funds of hedge funds charge.

Table 1 outlines the various categories of information that can be disclosed, comparing funds along a continuum from highly transparent mutual funds through opaque hedge funds and funds of hedge funds. Transparent hedge funds would fill a niche between the two extremes, embracing the informative benefits of regulated funds and the strategic advantages of unregulated funds. As mentioned earlier, regulated mutual funds are mandated to provide investors with a breadth of information in a standardized format (Macey, 2008). Unregulated hedge funds, however, provide very minimal information to investors. While funds of hedge funds, or investment vehicles that invest in multiple hedge funds (Jonna, 2008), tend to provide greater transparency than traditional hedge funds, they charge investors additional due diligence fees.

The following paragraphs will expand on how this transparent investment fund should be structured and areas where transparency would be most beneficial. For instance, a transparent fund should reveal more information about investment objectives, risk, leverage and illiquidity, advisers and management, third-party affiliations, fund structures, investor obligations, and fund performance. Furthermore, the implementation of this new fund should be voluntary and principle-based. Under this approach, current, opaque funds would have to option to persist, and hedge fund companies that chose to embrace transparency would be
Table 1. Comparison of Investment Fund Transparency

<table>
<thead>
<tr>
<th></th>
<th>Mutual Funds</th>
<th>Transparent Hedge Funds</th>
<th>Hedge Funds</th>
<th>Funds of Hedge Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Objectives</td>
<td>Yes</td>
<td>Yes</td>
<td>Minimal</td>
<td>- Minimal - Due Diligence</td>
</tr>
<tr>
<td>Risk Evaluations</td>
<td>Yes</td>
<td>Yes</td>
<td>Minimal</td>
<td>- Minimal - Due Diligence</td>
</tr>
<tr>
<td>Asset Valuation</td>
<td>Yes</td>
<td>Yes</td>
<td>Minimal</td>
<td>- Minimal - Due Diligence</td>
</tr>
<tr>
<td>Leverage and Illiquidity</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Adviser and Management</td>
<td>Yes</td>
<td>Yes</td>
<td>Minimal</td>
<td>- Minimal - Due Diligence</td>
</tr>
<tr>
<td>Background</td>
<td>Third-Party Affiliations</td>
<td>Yes</td>
<td>Yes</td>
<td>Minimal</td>
</tr>
<tr>
<td>Fund Structure, Size, and</td>
<td>Yes</td>
<td>Yes</td>
<td>Minimal</td>
<td>- Minimal - Due Diligence</td>
</tr>
<tr>
<td>Investor Base</td>
<td>Investor Terms, Obligations, and Costs</td>
<td>Yes</td>
<td>Yes</td>
<td>Minimal</td>
</tr>
<tr>
<td>Performance Updates</td>
<td>Yes</td>
<td>Yes</td>
<td>- Minimal - Bias Tendencies</td>
<td>- Minimal - Bias Tendencies</td>
</tr>
<tr>
<td>Presented in Plain English and</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>a Standardized Format</td>
<td>Subject to Additional Fees</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Subject to SEC Oversight</td>
<td>Yes</td>
<td>No</td>
<td>No, unless registered voluntarily</td>
<td>No, unless registered voluntarily</td>
</tr>
</tbody>
</table>

eligible for a third-party transparency endorsement, as well as a variety of benefits associated with decreased information asymmetry. Before discussing the implementation of this fund, however, we will suggest areas for disclosure that hedge fund companies, third parties, and market participants should focus on in order to improve transparency.

**INVESTMENT OBJECTIVES**

To begin, many will argue that a hedge fund’s ability to conceal its strategy lends to its competitive advantage. However, potential investors should be aware of the overall investment objectives for the fund. For instance, does the fund engage in short selling, arbitrage, derivatives trading, or quantitative strategies? What types of investment
instruments are used, and does the fund trade internationally? Transparent funds would explain such overarching concepts in order to give potential investors a picture of the fund’s investment style.

The President’s Working Group on Financial Markets also mentions the importance of “style integrity” (Investors' Committee, 2008). Style integrity refers to a hedge fund’s ability to maintain the original investment style the investor evaluated and selected. Investors should be informed of a fund manager’s style integrity upon entering a fund, and be provided with operational details if a significant shift in strategy occurs.

**Risk Evaluations**

Along with strategic information, investors should be provided with information pertaining to the costs and the risks associated with a fund’s strategies. Risk is commonly defined as “an element of randomness in situations where the ultimate outcome is unknown, yet the range of potential outcomes are quantifiable” (Investors’ Committee, 2008). It differs from uncertainty because uncertainty is not quantifiable, is rooted in incomplete knowledge, and refers to situations where potential outcomes are unknown.

Two broad types of investment risk exist: systematic risk and idiosyncratic risk (Malkiel & Xu, 1997). Systematic risks are related to volatility that results from general movements in the market, such as stock price fluctuations. Alternatively, idiosyncratic risk concerns volatility that results from specific events. Correlation risks, counterparty risks, and basis risks are all common examples of idiosyncratic risk, and each can be reduced through portfolio diversification. Regardless of the type of risk a fund is exposed to, increased risk exposure can generally lead to larger return fluctuations. Therefore, investors should be aware of the risk factors that can influence their fund.

A transparent hedge fund should also provide investors with evidence that investment risks have been analyzed and considered. For example, results of stress tests, scenario analyses, and other measurement metrics and models can all improve risk management efforts (Investors' Committee, 2008). Furthermore, describing management’s risk philosophy and tolerance levels for specific funds, as well as any contingency plans that would be employed in an adverse event, can be helpful. Validation should also be provided that the fund manager performed some type of due diligence before engaging with third
parties. Finally, transparent hedge funds should consider organizing an independent risk committee that oversees risk management. This committee would be responsible for identifying, analyzing, and monitoring risk factors, conducting tests that evaluate and quantify risk, exploring risk exposure from third-parties, and developing policies and models that help manage risk prudently. This committee should have a close working relationship with the fund manager and be involved with significant investment decision-making processes.

**ACCOUNTING INFORMATION AND LEVERAGE/ILLIQUIDITY**

Revealing accounting information, especially current asset value, to investors is critical, as well. Transparent hedge funds should present financial statements that are in accordance with U.S. GAAP or IFRS standards. Furthermore, they should offer proof that such statements have been audited. This accounting information will not only give investors a current snapshot of the financial health of the fund, but will also allow both managers and limited partners to judge the fund’s performance over time.

Information on leverage and illiquidity should also be provided. Leverage is an indicator of economic risk, and it represents the amount of investment that is financed with borrowed money (Doyran, 2009). Hedge funds, in particular, tend to be highly leveraged, and it has been argued that fund managers with $1 billion in equity may borrow as much as $10 billion in bank credit to support their strategies and enhance earnings (Eichengreen & Mathieson, 1998). Although having high debt-to-equity ratios can greatly increase potential returns, they also embody the inherent risks associated with borrowing investment capital. Existing liquidity issues may be aggravated, and fund portfolio structures tend to get complicated with external obligations (Investors' Committee, 2008). Thus, investors should be aware of how leverage plays into the fund’s investment strategies.

Liquidity, on the other hand, refers to asset value that is “more certainly realizable at short notice without loss” (Keynes, 1930). In other words, a liquid asset is an asset that can be converted to cash easily without loss of principal. Illiquidity, therefore, refers to assets whose value cannot be realized immediately. Investors should be informed about how much of the fund’s assets are illiquid, and, furthermore, how this liquidity level could affect investors. For instance, gating provisions, or withdrawal limits imposed on investors in order
to prevent a run on the fund during a redemption period (Ozik & Sadka, 2010), are usually enacted to combat liquidity events and prevent a mass exit from the fund (Investors' Committee, 2008). Investors should be aware of what kind of circumstances would cause such provisions to arise.

Finally, a transparent fund should consider forming a valuation committee. The President’s Working Group on Financial Markets recommends that a valuation committee be composed of senior management and be responsible for approving, reviewing, and valuing the assets of the fund (Investors' Committee, 2008). Additionally, the Group suggests that conflicts of interest may arise with valuation committee members and traders or portfolio managers. Therefore, committee positions should be appointed in a manner that would minimize potential conflict.

**INVESTMENT ADVISER AND MANAGEMENT BACKGROUND**

It is also important to recognize that investors do not simply invest in a hedge fund. They invest in the people that manage and operate that hedge fund on a daily basis. Therefore, providing managerial background information is a crucial factor to increasing transparency.

Fortunately, funds have historically been rather open about describing their personnel. According to a recent survey by Deutsche Bank (2010), however, investors are still rather cautious when selecting hedge fund managers. This survey found that the most prevalent manager-selection criteria among investors include a fund manager’s historical investment performance, risk management practices, investment philosophy, and transparency tendencies. Investors want to know how the management team works as a whole, the competence, expertise, and trustworthiness of the team, and the educational and professional background of key players.

Therefore, we recommend that a transparent hedge fund provide investors with the following four categories of information. First, the names of the primary fund managers that manage the fund on a daily basis, the managers’ educational and professional backgrounds (including specialized expertise), the managers’ chosen risk tolerance for a particular fund, and any ownership interest that managers have in the fund should be revealed. Second, a transparent fund should include a brief description of the primary relationships that fund
managers have. For instance, relationships with advisers that will be involved in making investment decisions for the fund and their backgrounds and expertise are important to illuminate. Third, persons or organizations responsible for back-office functions should be identified. Fourth, any additional personnel information deemed relevant should be presented, such as long-standing relationships or noteworthy experience.

Overall, fund managers are going draw investors in and set the tone for the organizational culture, so managerial transparency is key, and also offers an opportunity to market superior fund managers who have exemplary reputations and a competitive edge in the market.

**THIRD-PARTY AFFILIATIONS**

Investors not only place a great deal of trust in fund managers, but they also indirectly trust third-party institutions affiliated with the fund. Third-party service providers typically include entities such as auditors, legal counsel, prime brokers, banks, and trading counterparties (Investors' Committee, 2008). Transparent funds should inform investors about which third parties they engage with, the sophistication and financial stability of those parties, their service capabilities, the regulatory environment in which they operate, and their credit risks.

**FUND STRUCTURE, SIZE, AND INVESTOR BASE**

Investors should also be presented with information on fund structure, size, and investor base. With regard to structure, transparent hedge funds should identify the legal structure of the fund. Most funds are organized as limited partnerships where the fund manager is the general partner, and the investors are limited partners with limited liability (Brav et al., 2008). Clarifying this organization and stating where the fund is domiciled (onshore or offshore) is recommended, as both will influence investor confidence and determine regulatory and tax environments.

Next, the size of the hedge fund, in terms of number of investors and their contributions, should be made clear. Small, newly formed hedge funds tend to be very agile and adaptable; however, they also tend to be riskier than large, established funds (Investors' Committee, 2008). Transparent hedge funds should provide information that would allow the investor to compare the relative size of the fund to other funds in the market.
Other investors can also affect stability of a fund. For example, if a significant investor withdraws his or her fund, the fund may have to liquidate assets, it may suffer a loss, or overall performance may be affected. Thus, we recommend that a transparent hedge fund provide an anonymous description of the limited partners and their capital contributions. This approach maintains the confidentiality and privacy of investors, while simultaneously allowing potential investors to determine what percentage of their capital contributions compose the fund.

**INVESTOR TERMS AND OBLIGATIONS**

Although investor terms and obligations are typically drawn out in contracts, further clarification will aid in increasing fund transparency. Typically, hedge fund contracts are drawn up by individual law firms, and therefore vary from fund to fund. In general, though, they include a summary of the fund’s general partners and managers, the fund’s regulatory status, the fees that it charges, investor rights and limitations, and other standard legal provisions commonly found in Limited Liability Company (LLC) contracts. While some contracts also provide a brief summary of investment strategies, overall, hedge fund contracts tend to be vague (in terms of strategic information) and written in favor of the general partners. A transparent fund would address this issue by providing investors with critical information beyond the scope of the contract. Investors would have access to information on strategies, risk, leverage, illiquidity, management experience, third-party affiliations, fund structures, and fund performance. The availability of this information is crucial because, as in other investment communities, hedge fund investors are responsible for the risk that they voluntarily take on, and for the contracts that they sign. Therefore, explicitly providing transparent information will assist investors in fulfilling their obligations to remain informed and make calculated, educated risks.

**PERFORMANCE UPDATES AND COOPERATION WITH INFORMATION REQUESTS**

Finally, investors should also be given access to historical performance records. For example, highlights of particularly strong periods should be provided, as well as weak periods and how fund managers responded. While the industry is pushing for real-time
updates, this information should also be updated on at least an annual basis in order to reveal trends and give investors a cohesive picture of the fund’s status.

Investors, as limited partners, should also be provided with investment information upon their request, and have the freedom to examine the hedge funds that they invest in. This will benefit investors by presenting them with the information that they need to make educated decisions and allow them to monitor the operations of a fund.

**PREVIEW TO IMPLEMENTATION**

On a concluding note, it is important to remember that hedge fund companies are lightly regulated compared to traditional investment vehicles, primarily because their investor base is considered “sophisticated.” Hedge fund investors tend to be very wealthy, accredited individuals who invest millions in funds and, therefore, in the eyes of regulators, do not need much legislative protection. By adhering to the transparency guidelines above, however, funds could potentially provide enough information to further enhance the sophistication level and financial literacy of investors who typically invest in hedge funds, or of those potential investors who are interested in a slightly lower returning fund with slightly less risk. This idea will be explored in later sections of this paper. For now, though, consideration of this dual audience contributes to how the above information should be presented.

Transparent fund information should be available to potential and, especially, current investors in the form of a guide that is audited by a third party. Organizational sustainability and corporate social responsibility guides are good examples of how a transparency guide could be developed. Moreover, information should be outlined in clear, concise, and simple terms that both sophisticated and less financially sophisticated individuals could understand. The general presentation of transparency information is a minor consideration, however, compared to the implementation of the fund. Therefore, we will shift our focus toward putting this new, transparent hedge fund into practice.
IMPLEMENTATION PROPOSAL FOR A TRANSPARENT HEDGE FUND

This new type of transparent hedge fund could be implemented through either regulatory or voluntary means. While imposing legislation is currently a popular approach to increasing investor trust, legally forcing transparency would, ultimately, not be the best method to increase transparency. Regulation would not lead to legitimate trust, but instead may result in regulatory recalcitrance, or reduced entrepreneurial activity and impossible data collection and monitoring processes (Donaldson, 2008). Legislation would also only apply to onshore funds. Therefore, we propose a voluntary, principle-based approach rooted in fiduciary duty as a means to increase hedge fund transparency.

THE REGULATION ARGUMENT

The underlying goal of mandated transparency would be to improve ethics in the industry and increase trust. However, it is important to recognize that laws intended to force trust rarely materialize into legitimate trust. In fact, a 1958 study revealed that regulation actually prevented people from developing trust in one another (Strickland, 1958). In this study, trust became unimportant in the presence of regulation, and favorable actions were attributed to laws over individual character. Kollock’s study in 1994 validated this finding, and showed that because a lack of regulation led to more social uncertainty, people were given the opportunity to make attributions of trust based on another’s behavior (Kollock, 1994). This argument can further be supported by research on intrinsic and extrinsic sources of motivation. Studies have shown that depending on extrinsic factors to control behavior negates any intrinsic motivations to engage in the same behavior (Enzle & Anderson, 1993). Therefore, if we legally mandate hedge fund transparency, fund managers will be less likely to share information voluntarily or in areas where legislation does not directly apply. Thus, implementing a transparent hedge fund through voluntary measures would lend to an environment capable of breeding trust, whereas a regulated approach would not.

Additionally, mandating transparency may result in “regulatory recalcitrance” (Donaldson, 2008). Two types of regulatory recalcitrance exist. Type 1 recalcitrance occurs
when mandated disclosure discourages entrepreneurs from entering the market. Accordingly, fund managers would have no incentive to develop investment strategies because mandated disclosure would hinder their ability to conceal them or protect them under the narrow scope of intellectual property law. Type 2 recalcitrance, on the other hand, entails an impossible and costly process of data collection and monitoring that could lead to bribery. In fact, in order to truly measure market risk, authorities would need to frequently collect a vast amount of sensitive, highly detailed information from all market participants, not just hedge funds (Bernanke, 2006). This task is quite impractical. Thus, it is not rational to think that transparency legislation would provide the information necessary to improve the ethics of the hedge fund industry. On the contrary, it would be likely to generate an entirely new set of issues and create unnecessary bureaucracy in our market system that is already burdened with excessive financial regulation (Macey, 2008).

Finally, mandating a transparent fund would also not be effective because regulations would only apply to hedge fund companies domiciled in the United States. In 2003, an SEC official estimated that nearly 70% of the hedge fund market consisted of offshore funds (Fraser, 2003). Offshore hedge funds are typically domiciled in the Cayman Islands, the British Virgin Islands, or Bermuda. While the Taxpayer Relief Act of 1997 essentially brought these funds under the umbrella of United States tax law, offshore funds can typically circumvent a great deal of American regulation. They can organize as corporations, they are not required to divulge investor information, and they would be likely to be exempt from any mandated transparency guidelines. Given that well over half of the industry’s funds are deemed to be “offshore,” a mandated approach would clearly not be the best way to improve hedge fund ethics in the United States. Furthermore, cumbersome transparency legislation could potentially push current or future funds to move offshore. What little protection investors currently experience would then diminish. Naïve investors who do not know where their funds are domiciled may even be given a false sense of security if onshore funds are forced to disclose strategic information. These investors would assume that they are protected by transparency legislation when, in reality, their funds are domiciled offshore and, thus, outside the scope of U.S. law.

Although regulation would not be an effective approach to increase hedge fund transparency for the three reasons described above, the Dodd-Frank Act demonstrates that
regulators are trying to increase the scope of hedge fund legislation (Brice, 2010). Before passing any future Acts, however, Congress should consider that additional legislative attempts to curb hedge fund opacity would be likely to undergo the same client terminology issues that were exhibited in the *Goldstein v. SEC* Supreme Court case (Zaun, 2007). Currently, the SEC does not have a formal definition for this investment entity. Any fund that is not registered with the SEC is considered to be a hedge fund, so regulation targeting hedge funds would be subjective.

Most importantly, greater regulation would undoubtedly limit hedge funds’ current strategic flexibility that allows them to provide management oversight, reduce investor fraud, and improve operational performance (Macey, 2008). Therefore, it is important to question the research supporting legislation. Are regulatory propositions rooted in thoughtful and proven solutions, or are they knee-jerk responses to issues unearthed during the recession?

If it is the latter, lessons from the Sarbanes-Oxley Act should caution Congress before they move to further regulate hedge funds with any of the regulatory bills detailed above. Sarbanes-Oxley was hastily passed in the wake of the accounting scandals during the Enron era. Although the Act’s intentions to increase trust and accountability were noble, the implementation burden that it placed on companies resulted in a large backlash against unforeseen costs (Dodwell, 2008). For instance, complying with Sarbanes-Oxley resulted in smaller profit margins due to compliance expenditures. It also pushed newly public companies to list their shares overseas, and dissuaded foreign companies from listing in the U.S. in order to evade Sarbanes-Oxley requirements. Thus, although it did promote greater controls and transparency, it could be argued that Sarbanes-Oxley has done little to increase the public’s trust in financial markets, while incurring enormous economic costs.

**PROPOSAL FOR A VOLUNTARY APPROACH**

The government’s intention to improve transparency is a step in the right direction. Investors should be privy to information about the funds in which they invest, and encouraging transparency could reduce externalities associated with information asymmetry, attract institutional investors, and increase market trust. These benefits will be discussed in greater detail below. However, regulation is not the only means to achieve them. An
alternative, and we would argue superior, approach would be to develop a principle-based implementation system rooted in fiduciary duty.

A principle-based system “is one in which guidelines are clear, but compliance with them is voluntary” (Garrett, 2004, p. 150). Some governments and self-regulatory organizations, such as stock exchanges, typically enforce principle-based systems under two dominant models. The first is a “comply-or-disclose” model where organizations must abide by set guidelines or disclose to the public that they choose not to (Ryan, 2005). In a “comply-or-explain” model, organizations must go beyond disclosure and fully explain the reasons why they are noncompliant. The key to a principle-based approach is that “guidelines,” not “laws,” are the basis for the system. Thus, management has greater discretion regarding its disclosure and transparency practices, and investors have the opportunity to choose the level of transparency or information asymmetry that they are comfortable with.

Fiduciary duties underlie a principle-based approach. A fiduciary duty is “a duty of a person in a position of trust to serve the interests of others” (Boatright, 2003). They are commonly imposed when precise rules do not exist, and, also, when obligations cannot be completely represented in contracts. Fiduciaries legally owe their clients two things: a duty of loyalty and a duty of care. A duty of loyalty requires that agents have an unbending loyalty to their principals, and that they put the interests of their principals above their own (Boatright, 2010). Fiduciaries are obligated to act in the best interest of their investors, and refrain from engaging in self-dealing. A duty of care, on the other hand, suggests that fiduciaries should gather information in a timely and appropriate manner, exercise due diligence in making decisions, and demonstrate that all reasonable alternatives have been considered.

Recently, it seems that society has lost its confidence in fiduciary duty (Boatright, 2003). Regulation has been heavily pushed in order to safeguard investors from self-seeking fund managers, and the potential effectiveness of a promise not to take advantage of others has been discounted. While, fundamentally, humans do tend to look out for themselves, it is important to remember that they also “often voluntarily align with the interests of others and keep their promises out of a sense of honor, as well as to safeguard their reputations and long-term self-interest” (Hasnas, 1998). For this reason, as well as other reasons described
below, a voluntary approach rooted in fiduciary duty should be considered as a means of improving hedge fund transparency.

**IMPLEMENTING A VOLUNTARY APPROACH**

Now having an understanding of what a voluntary approach entails, it is important to return to the specific implementation of a transparent hedge fund. In order to integrate this new fund into the market, two broad objectives should be considered. First, current or newly founded transparent funds should be able to adhere to transparency guidelines without dramatically disrupting their operations, and increased transparency guidelines should not create an unnecessary burden on hedge fund managers. Second, investors should be given some form of assurance that this new type of fund is a credible and legitimate investment opportunity.

In response to the first objective, a market-driven “comply-or-disclose” model would be the best principle-based model to implement. This model would lend to the smoothest transition to industry transparency, and the least bureaucratic environment, as hedge fund managers that wish to preserve their funds’ current level of opacity in fear of revealing their competitive advantages would simply disclose that they do not act in accordance with transparency guidelines. Alternatively, hedge funds that voluntarily choose to embrace transparency would have industry standards to follow and discretion concerning how they choose to comply with them. These recommended disclosure guidelines were discussed above, and we argued that government’s role in this fund’s creation and compliance process should be limited. Instead, market-based approaches should be used to implement them. For instance, the Hedge Fund Association, a not for profit organization dedicated to increasing transparency and trust in alternative investments, could be responsible for implementing and disseminating guidelines. The government’s role in this fund’s creation and compliance process should be limited.

A principle-based approach would entail that transparent fund managers would be bound by a fiduciary duty to comply with transparency guidelines appropriately. However, investors may still desire a signal that these new hedge funds are, in fact, more transparent and credible than their opaque alternatives. One way to provide such assurance would be to create a seal of approval through an independent auditing group. A seal of approval, legally
referred to as a certification mark, is “a mark used in commerce by a person other than its owner to identify goods or services as being of a particular type or quality” (LII, 2010). Certification marks are managed by third-party associations that are responsible for establishing certification standards, identifying entities that conform to those standards, and monitoring and controlling the use of marks. The Good Housekeeping Seal of Approval is a famous example of a certification mark that verifies quality in other industries.

In terms of hedge funds, a transparency seal could be developed by an independent third-party auditing agency in order to signal to investors that a specific hedge fund appropriately complies with transparency guidelines. Leading credit rating agencies in the financial world, such as Moody’s, Standard and Poor’s, and Fitch, have all been criticized in the past for acting complacent and for engaging in questionable relationships with their issuers. For instance, all of these agencies saw signs that Enron was deteriorating five months before it declared bankruptcy (Wyatt, 2002). Instead of acting promptly, they waited to lower Enron’s investment ratings until just four days before the company filed for Chapter 11. Additionally, these third-parties had multiple conflicts of interest that contributed to poor credit rating data during the sub-prime mortgage crises of 2008 (Ng, 2010). However, many mortgage-security ratings were paid for by their issuers, and agencies allegedly earned considerable consulting fees to help organize the securities that they rated. Thus, third-party auditing agencies will have to be independent and actively monitor the funds that they grant seals to in order provide investors with the assurance that they need. Furthermore, the development of a transparency seal may also drive competition within the industry. Hedge funds may start to compete with one another in order to earn a seal, and those funds that offer the most transparency would gain a competitive advantage.

Overall, the best means to improve hedge fund transparency would be through a principle-based system that gives hedge funds the option to either remain opaque or voluntarily comply with transparency guidelines developed by market participants and audited by a third-party association. If a principle-based system were used, numerous benefits could be realized. Therefore, the following section will discuss the advantages of transparency, and, moreover, argue that this new, transparent fund would be a positive addition to the market.
ARGUMENT FOR IMPLEMENTING A
TRANSPARENT FUND

A variety of benefits could be realized if select hedge funds increased transparency by adopting the transparency guidelines under a principle-based system. Specifically, as will be discussed below, increased fund transparency would reduce agency costs, risk of moral hazard, and adverse selection associated with asymmetric information; increase generalized trust among investors and market participants; and attract more institutional and individual investment.

REDUCE AGENCY COSTS, RISK OF MORAL HAZARD, AND ADVERSE SELECTION

A transparent hedge fund would give both knowledgeable and less sophisticated investors the necessary means to make sound investment decisions. Investors currently know very little about the hedge funds in which they invest. Strategies are only vaguely communicated in complicated investment contracts that tend to favor general partners, and performance updates are not always representative. In fact, a recent survey found that some funds simply stop reporting when they fail, merge with other funds, or plan to shut down operations (Malkiel & Saha, 2005). Long Term Capital Management is an example of such a fund. In just one year, it lost 92% of its capital, and none of its negative returns was reported to a database provider.

Poor reporting practices like this are, unfortunately, rather common in the hedge fund industry. A study citing an analysis of the TASS database explains poor reporting issues and inflated returns due to two factors: backfill bias and survivorship bias (Malkiel & Saha, 2005). Backfill bias refers to inputting historical returns of a new fund into a database. Managers of new funds only begin reporting when returns prove favorable, and then they “backfill” the positive returns into the database along with current results. Survivorship bias, on the other hand, refers to excluding failing funds from a database (Afyonoğlu, 2010). Thus, struggling funds leave out negative returns, causing reports to be inflated and not
representative of actual performance. The reporting issues associated with the Long Term Capital Management Fund were a prime example of survivorship bias.

If investors knew what fund managers were actually doing with their capital, and, moreover, the actual performance results of those strategies, then they would have the knowledge to make wiser investment decisions. They would also not have to worry about inflated returns in databases, because funds would provide performance information directly. Despite the fact that some current funds report misleading returns to intermediaries, transparent funds would be more likely to report accurate performance results. Misleading results would conflict with other transparent information presented to investors, and, additionally, voluntarily reporting poor information would put a fund at risk of committing common-law fraud.

Furthermore, if investors received more information from the hedge fund itself, the agency costs associated with delegating investment decisions to fund managers would decrease by reducing information asymmetry. An agency cost can be defined as the “sum of the monitoring expenditures by the principal, the bonding expenditures by the agent, and the residual loss” (Jensen & Meckling, 1976, p. 308). So, in the case of hedge funds, investors represent the principal and fund managers are considered agents with decision making authority. According to agency theory, an agent, as a utility maximizer, will not always act in the best interest of the principal. As a result, the principal will incur monitoring costs to ensure that the agent is acting appropriately on behalf of the principal. Agents, in turn, expend bonding costs in order to show the principal that they have principals’ best interests at heart. After monitoring and bonding costs, any remaining divergence between an agent’s decisions and decisions that would potentially maximize the welfare of the principal is called residual loss. These three categories combine to represent total agency costs.

Agency costs, then, could decrease simply due to a reduction in asymmetric information. Asymmetric information refers to a situation that exists when some parties have better information than others (Marcoux, 2003). Economists cite moral hazard and adverse selection as the two primary costs of information asymmetry. Moral hazard occurs when one party to a contract takes a hidden action that benefits him at the expense of another party. So, for example, moral hazard could occur in a hedge fund context if fund managers made rash investment decisions without following risk policies or if they reported inflated performance
results in order to enhance their image. This type of risk is typically mitigated through either monitoring agents or aligning incentives. As mentioned above, increasing transparency is one way to align the incentives of principals and agents, and, therefore, to reduce the risk of moral hazard.

Alternatively, adverse selection occurs when individuals have hidden characteristics or when a selection process results in a pool of individuals with undesirable characteristics (Marcoux, 2003). With regard to hedge funds, adverse selection would come about if someone invested in a fund with poor or misaligned management interests. Moreover, adverse selection can typically be mitigated with either screening or signaling. Screening involves less-informed parties (the hedge fund investors in this case) gathering information about a fund through some form of due diligence. Signaling, on the other hand, is the effort of the informed party (or the hedge fund managers) to communicate fund values and risks. Therefore, following increased transparency guidelines would act as an effective signal to investors and, thus, reduce the risk of adverse selection.

**Increase Generalized Trust in the Industry**

Next, a more transparent fund also has the potential to increase the generalized trust, or the trust people have with unfamiliar actors, that many lost in the hedge fund industry after the 2008 market crash. As discussed above, in 2008, a variety of hedge funds suffered huge losses and were found guilty of unethical, and illegal, behavior. For example, Lancelot Investment Management closed five of its funds during the crash, lost 100% of its capital, went completely bankrupt, and was allegedly involved in a Ponzi scheme (Weidner, 2010). While the Galleon Diversified Fund only lost 3.04%, it was charged with insider trading and was forced to shut down. Newspapers are filled with similar stories that recount the reckless actions of fund managers leading up to the recent tumultuous economic environment. Although returns may be rebounding, trust issues persist.

As demonstrated in the 2010 study, transparency increases trust in investment settings (Kanagaretnam et al., 2010). Therefore, if hedge fund managers increase transparency, they could potentially restore the trust lost in this industry.

It is also important to remember that greater trust could yield significant benefits for hedge fund companies. It could be a source of competitive advantage over other investment
funds (Barney & Hansen, 2006), and it could also reduce transaction costs associated with hedge fund investment (Dyer & Chu, 2003). These are critical advantages to consider as the hedge fund industry is still recovering from the financial and ethical crises experienced during the 2008 recession.

**ATTRACT INSTITUTIONAL AND INDIVIDUAL INVESTORS**

Finally, proactive funds that voluntarily embrace transparency will also be likely to attract more capital from institutional investors. Since the 1990s, institutional investors have invested in alternative investment classes more frequently in order to diversify their portfolios and increase returns (Afyonoğlu, 2010). Specifically, “institutional investor allocations to hedge funds in North America increased from 2.5% in 2001 to roughly 7.5% in 2007” and “hedge fund assets held by institutional investors steadily rose from $12 billion in 2001 to $40 billion in 2007” (Afyonoğlu, 2010, p. 6). This upward trend is supported by recent academic research that recommends that hedge fund investments be made along with traditional equity vehicles, in order to optimize the risk-and-return benefits in an institutional portfolio (Schneeweiss, Karavas, & Georgiev, 2002).

Still, some may question whether it is appropriate for public investors, such as public pension funds, to make hedge fund investments. In 2006, for instance, the San Diego Retirement Fund lost $100 million when the Amaranth Advisers hedge fund collapsed (Jonna, 2008). Thousands of employees felt the negative consequences of this loss, and many questioned why the fund’s portfolio included investments in high-risk hedge funds. Furthermore, many public institutions, such as the San Diego Retirement Fund, frequently cite “lack of transparency” as one of their top five concerns (Afyonoğlu, 2010).

Although hedge funds are inherently risky compared to other private equity investment options, it is important to note that a transparent hedge fund may decrease risk and yield a slightly lower return. Many investors, however, may prefer a lower returning fund with less risk, including certain institutional investors, such as pension funds, which may be risk averse because of their contractual outflows. Additionally, as the private-equity environment becomes more competitive, transparent funds may be more likely to attract institutional investors currently concerned with opacity. In that case, embracing transparency
would create a competitive advantage, perhaps outweighing the downside of revealing investment strategies.

Beyond attracting increased investment from institutional investors, providing more information could also help individual sophisticated investors to make better decisions. As mentioned earlier, individuals must be “sophisticated,” or “accredited,” in order to invest in hedge funds. According to Rule 501 of Regulation D under the Securities Act of 1933, “accredited” is defined as “a natural person who has individual net worth, or joint net worth with a spouse, that exceeds $1 million at the time of purchase,” or, “a natural person with income exceeding $200,000 in each of the two most recent years, or joint net income with a spouse exceeding $300,000 for those years” (The University of Cincinnati College of Law 2009). Thus, accredited individuals are considered to be sophisticated primarily because they have a high net worth, not because they have particular expertise on financial matters. While the SEC has not adjusted these figures for inflation since 1933, when we do so a very different investment landscape emerges. Individual net worth, income, and joint income would have to exceed roughly $16.8 million, $3.35 million, and $5 million, respectively, in order to gain accredited status (Bureau of Labor Statistics, 2010). Thus, in addition to transparency measures, the net worth requirements to achieve accredited status should be reevaluated.

If hedge funds were to be more transparent, the actual “sophistication” and decision-making abilities of investors could improve. Myriad stories have appeared in the press about financially unsophisticated investors who have lost their life savings in hedge funds. For instance, in the early part of the decade, a 23-year-old fund manager, Mark Yagalla, was caught duping a handful of elderly women into putting their life savings into his fund (Cantrell, 2005). In 2004, a Boston brokerage firm was charged with failing to uphold its fiduciary duties to its investors, which included a UPS driver, an electrician, and a Coast Guard officer, after the Hercules Hedgehog fund and the Agrippa fund lost approximately $3.5 million (Shell, 2004). Just this year, Neal Greenberg was found guilty of selling his high-risk fund to conservative, older investors in or near retirement who wanted low-risk investments (Harden, 2010).

These stories are just a few examples of individuals who lost their savings because they did not understand the dynamics of hedge fund operations. If individuals had the
information that they needed to make better investment decisions, though, at least some of those who do not belong in opaque, high-risk funds may put their money elsewhere. Furthermore, a transparent fund with lower returns and less risk could offer an alternative investment option to appropriate new investors that would balance out their portfolios. In this instance, the overall hedge fund investor base would increase.

Altogether, increased transparency has the potential to reduce agency costs associated with asymmetric information, increase generalized trust in the hedge fund industry, and attract institutional and individual investment. Despite these advantages, some may argue that greater disclosure also has its shortcomings. Therefore, the next section will address the common arguments against a more transparent fund.
COUNTERARGUMENTS TO A TRANSPARENT HEDGE FUND

Industry experts may question the need for transparency and highlight the fact that opacity allows hedge funds to protect their proprietary strategies. Some may go on to suggest that, under a principle-based approach, transparent funds may be at a financial disadvantage compared to opaque funds. Still, others may argue that transparency has the potential to increase bonding costs, that funds of hedge funds already provide due diligence, and that some funds may be tempted to hide behind transparency guidelines. While these objections may seem valid, the following paragraphs will advocate that they do not justify hedge fund opacity.

TRANSPARENCY IS NOT NECESSARY BECAUSE HEDGE FUND INVESTMENT IS INCREASING

Some may question whether transparency is needed if successful hedge funds continue to gain investor interest. As mentioned earlier, hedge fund formation is currently on the rise as these investment vehicles continue to outperform global equity markets (Credit Suisse Tremont Index LLC, 2010). Sixty-nine percent of funds posted positive returns in the first quarter of 2010, and the industry recently experienced capital inflows of approximately $2 billion.

Although hedge fund investments are rising, it is important to recognize that this industry is still in the midst of rebounding from the 2008 recession. In 2008, the market was extremely market volatile, many funds experienced significant losses, and investors redeemed nearly $149 billion in industry assets (Credit Suisse Tremont Index LLC, 2010). So, the hedge fund industry is currently stabilizing to pre-crisis levels. An estimated $61 billion in assets remain illiquid, and losses are still being recouped.

Moreover, transparency appears to be increasing as hedge fund investment levels recover. Ninety-four percent of investors have reported that they are receiving more information from managers than they did prior to 2008, and due diligence continues to be highly sought after (Credit Suisse Tremont Index LLC, 2010). Increased transparency could
potentially be propelling this upward trend in hedge fund investment. Furthermore, it is possible that transparency would reduce future volatility in the industry, and improve the ethical environment by reducing information asymmetry and increasing generalized trust.

**TRANSPARENT FUNDS RISK LOSING A COMPETITIVE ADVANTAGE**

Some may argue that hedge funds benefit from operating in an opaque environment (Donaldson, 2008). They hold their financial details close, they safeguard their strategies, and they do not give information to their investors or their governments. In fact, the industry is inherently designed to discourage transparency, because revealing information, no matter how insignificant, could divulge strategies to competitors.

The freedom hedge funds have to block pertinent information also promotes high levels of differentiation within the industry (Macey, 2008). Moreover, some argue that if funds were required to be more transparent, intellectual property rights would be likely to be diluted, and funds would have less of an incentive to engage in activist activity. Thus, the lack of transparency that hedge funds currently enjoy allows them to gain a competitive advantage and to act as an effective mechanism for corporate control.

Although these are legitimate arguments, a transparent hedge fund still has its place in the market for a number of reasons. First, a transparent fund has the potential to reduce agency costs associated with asymmetric information, attract institutional and individual investors, and increase trust in the industry. Second, hedge fund transparency could alleviate concerns about investor duping and systemic risk (Donaldson, 2008).

In the first case,opaque hedge funds are sometimes said to “dupe” investors with misleading claims about performance and valuation (Donaldson, 2008). Hedge funds are generally known for outperforming the market, and the high returns that they often earn entice investors to deviate from traditional, more transparent investment options. Some in the industry, however, argue that no solid evidence supports the claim that hedge funds significantly outperform the market (Kooli, 2005; Malkiel & Saha, 2005). As mentioned earlier, backfill and survivorship bias greatly influence hedge fund reports, which tend to inflate the actual performance of this asset class. In fact, a 2005 study by Malkiel and Saha accounted for these biases and discovered that hedge fund returns are actually much lower
than commonly expected. Thus, allegations of fund managers “duping” their investors by pledging to generate greater returns or failing to report true returns should be taken seriously.

Additionally, opaque hedge funds could theoretically aggravate financial crises by taking on high-risk debt. This idea is commonly referred to as systemic risk, and it entails a financial collapse sparked by the downfall of a series of hedge funds (Jonna, 2008). Some argue that hedge funds pose no systemic risk, however, because of their diversity (Macey, 2008). The industry is composed of thousands of different funds and no two are alike, from either a structural or a strategic standpoint, so the extent to which they could actually cause social harm is debatable. Nevertheless, greater transparency would shed light on those funds that are on the verge of collapse, and give the market a better understanding of which funds could potentially threaten our financial system.

**Funds That Embrace Transparency Will Be Disadvantaged**

Some may suggest that, under a voluntary approach, transparent funds would be at a disadvantage compared to funds that choose to remain opaque. It is important to recognize, however, that it is equally possible that they would have an advantage. Transparency may be more appealing in the eyes of some investors, and a voluntary, principle-based system would allow the market to determine whether a transparent fund is viable. It is likely that opaque and transparent funds could peacefully co-exist, which would simply yield a wider spectrum of investment options in our market.

Hedge fund companies may also be more willing than most expect to voluntarily report information in order to increase transparency. According to a 2008 study by the United States Government Accountability Office, about 1,991 hedge fund advisers are already voluntarily registered with the SEC. Forty-nine of these funds represent the largest hedge funds in the U.S., and they collectively account for about one-third of hedge funds’ assets under management (Williams, 2008). Registered funds conform to a rather invasive process of record keeping, reporting, and compliance with SEC examinations, so if hedge fund companies are currently willing to subject themselves to increased oversight, a voluntary transparency reporting system may also fit well within the industry.
**INCREASING TRANSPARENCY INCREASES BONDING COSTS**

One could also argue that increased transparency would increase the bonding costs incurred by the agent (fund managers). This statement may be true in the sense that providing information to investors is one way to ensure that fund managers will not make decisions that would disadvantage the principals (investors). Greater transparency, though, could simultaneously reduce both monitoring costs and residual losses, as investors armed with knowledge would be likely to gravitate toward funds whose managers’ interests align with their own. Therefore, investors would have less of an incentive to monitor fund managers and managers would be more likely to make optimal decisions from the principals’ viewpoint. The overall result would be a reduction in agency costs, due to a greater initial alignment of interests.

**FUNDS OF HEDGE FUNDS ALREADY PROVIDE DUE DILIGENCE**

Industry experts may also counter that “funds of hedge funds” simply cancel out any need for a new, transparent hedge fund. A fund of hedge funds (FOHF) is an investment vehicle that invests in multiple hedge funds (Jonna, 2008). Through a process called “retailization,” FOHFs allow smaller, less sophisticated investors to indirectly invest in risky hedge funds. The greatest benefit of investing in FOHFs is that they typically provide due diligence on the individual hedge funds in which they invest (Afyonoglu, 2010). Therefore, investors with less financial sophistication could simply invest in FOHFs in order to reduce information asymmetry and investment risk.

It is important to remember, however, that FOHFs subject investors to two layers of fees (Jonna, 2008). Investors pay fees charged by the FOHF, and, additionally, the underlying fees charged by the hedge funds. FOHFs, therefore, are really only a viable option for investors willing to pay a premium for due diligence. It is also worth noting that due diligence does not have as broad a scope as transparency. Due diligence would alleviate some investor concerns, but transparency would provide a much more complete picture and allow investors to make more informed investment decisions.
Funds May be Tempted to Hide Behind Transparency

Finally, another possible concern is that non-transparent funds could hide behind transparency guidelines. If funds that choose to be more transparent were to gain a competitive advantage, then some fund managers may be tempted to disclose inaccurate information in order to create an illusion of transparency. This illusory transparency would degrade trust in the industry and compound existing ethical issues.

It is important to recognize, though, that third-party auditing agencies that endorse transparency seals would help verify that pseudo-transparent funds do not proliferate in the market. Furthermore, active, independent, third-party auditing agencies will have the greatest success overseeing transparent funds and preventing non-transparent funds from hiding behind compliance guidelines.

Overall, many valid arguments exist against hedge fund transparency. However, as trust in our financial market degrades and as regulation creeps into the industry, some action must be taken. We have argued that a voluntary, principle-based system of transparency is the best solution. The following section will elucidate some potential effects if such a system transpired.
CONCLUSION

Although our economy is rebounding from the 2008 financial meltdown, ethical issues concerning trust persist in the hedge fund industry. We have proposed the introduction of a new, more transparent type of hedge fund in order to address this trust crisis and to improve information flow between hedge fund companies and their investors. This transparent investment fund would address a gap that we suggest exists along the regulatory continuum by providing information like a regulated mutual fund, yet retaining the strategic freedom of an unregulated hedge fund.

If this fund were to materialize, market participants would realize numerous benefits. Agency costs associated with information asymmetry would reduce. The investment market would broaden as a result of increased institutional and individual interest in a lower risk fund. Most importantly, generalized trust would increase. This benefit is critical, now more than ever, as the hedge fund industry recovers from the tumultuous economic environment of 2008. With greater trust, hedge funds could gain a competitive advantage, transaction costs could decrease, and, overall, this investment class would be able to compete more effectively and efficiently.

Many believe that regulation is the only means to realize these benefits and improve industry ethics. However, we have recommended a voluntary, principle-based approach rooted in fiduciary duty as the best implementation method for this new type of fund. As regulation creeps into this industry, Congress should consider the viability of this approach as it would preserve the current strategic freedom that hedge funds enjoy, and, simultaneously, improve trust in our financial markets.
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