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Cross trading by investment advisers: Implications for mutual fund performance ☆

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ABSTRACT

Using a unique dataset we provide new evidence on the significant penalty on client fund performance due to conflicts of interest related to the cross trading (*TCT*) activities of mutual fund advisers: funds managed by advisers in the top *TCT* quintile significantly underperform funds managed by advisers in the bottom *TCT* quintile by 1% per year. Adviser incentives to engage in cross trading are directly related to their opportunities for generating revenues from affiliated trading operations. Additional tests suggest that the significantly higher trading commissions paid by client funds of high-*TCT* advisers are a major source of their under-performance.

"When an adviser engages in an agency transaction on behalf of a client, it is primarily the incentive to earn additional compensation that creates the adviser's conflict of interest."

[– SEC Interpretive Release No. IA-1732 of Section 206(3), Investment Advisers Act of 1940]

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1. Introduction

The mutual fund literature has extensively investigated the characteristics and performance of mutual funds. However, little is still known about the behavior of mutual fund advisers. The analysis of the relationship between mutual fund clients (principals) and their advisers (agents) is clearly important to further our understanding of the structure of the mutual fund industry. A better understanding of fund advisers' incentives is also important in light of the potential risks to investors from advisers' conflicts of interest in certain client transactions referred to as cross trades. Cross trading refers to transactions between the fund adviser or its affiliated broker, and one or more client funds, or transactions among multiple client funds in which the adviser acts as an intermediary. In the past twenty years cross transactions have increasingly attracted the attention of the U.S. Securities and Exchange Commission (SEC), resulting in a number of enforcement actions.[2] Despite the relevance of the issue, we are not aware of any study that has directly investigated the advisers' incentives to engage in these transactions and, more importantly, their implications for mutual fund investors. In this paper, using a unique dataset, we document for the first time the nature of fund advisers' cross trading operations, the underlying motivation, and the implications of such transactions for investors.

The SEC requires fund advisers to report on two types of cross trading practices where the advisers serve in dual roles. In the first, referred to as *principal* cross trading, the adviser (or its affiliated broker), acting as a principal, engages in off-market transactions in which it buys (or sells) securities for (from) the adviser's own inventory from (to) the client fund's portfolio. In the second type of trading practice, referred to as *agency* cross trading, an adviser (or its affiliated broker), acting as agent, arranges off-market transactions between different advisory clients or between a brokerage customer and an advisory client. In this case, the adviser serves as a broker for compensation on behalf of his mutual fund client as well as another party (another client or affiliated entity) to the transaction. In contrast to principal cross trading, agency cross trading involves the advisers operating on behalf of multiple interests.

It is clear that the practice of cross trading presents some inherent risks in terms of the potential for another party to be favored over the client. For example, the SEC has expressed the concern that principal cross trading can lead to price manipulation or the placement of unwanted securities in client portfolios. Similarly, the incentive to earn additional compensation may create the adviser's conflict of interest when facilitating agency transactions among clients. We would like to stress at this point that engagement by an adviser in principal or agency transactions does not necessarily translate into unfair dealing and breach of adviser's fiduciary duty to their fund clients. Indeed, these transactions could also be conducted in the best interests of fund clients, for instance by reducing or completely eliminating commission costs. However, if these transactions are systematically and negatively related to client performance, it is more likely that they proxy for material agency conflicts between advisers and their fund clients. Whether the benefits of cross trading outweigh the potential risks is of course an empirical question. The goal of this study is to provide evidence on this issue.

In this paper we use data on investment advisers contained in the uniform application for investment adviser registration (form ADV). The data include information on the advisers' organizational form, compensation, assets under management, clientele, disciplinary history, governance, and responses to questions relating to advisers' cross trading practices. We link the data on fund advisers to performance data for their client mutual funds obtained from the CRSP Survivorship-Bias Free Mutual Fund Database. Our final sample includes 1636 actively managed equity mutual fund portfolios that are uniquely linked to 560 investment advisers. We construct different proxies for the intensity of cross trading by each investment advisory firm as identified by the SEC based on their responses to questions under Item 8 of form ADV in which they are required to disclose any (principal and agency) financial interest in client transactions.

[2] Examples of major enforcement actions include: No. 1583 (1995) against Feldman Investment Group; No. 1585 (1996) against Concord Investment; No. 1767 (1998) against ABN AMRO; No. 1714 (1998) against Rothschild Investment; No. 1732 (2002) against Gintel Asset Management; No. 18950 (2004) against Beacon Hill Asset Management; and No. 2888 (2009) against Evergreen Investment Management Co., LLC.