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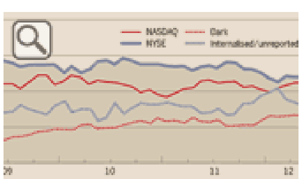
Backroom dealing exposed

By Steve Johnson

Large asset management groups appear to be routinely co-ordinating internal trades in order to protect funds that are suffering heavy redemptions from being forced to sell stock at fire-sale prices.

The findings raise serious questions as to whether fund managers engaging in such "backroom dealing" are violating their fiduciary duty to their own investors by buying stock in order to aid a colleague.



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"Unless there was a clear investment rationale, something like that would be so obviously wrong," said Daniel Godfrey, incoming chief executive of the UK's Investment Management Association.

Shiv Taneja, managing director of Cerulli Associates, a consultancy, added: "Part of the reason why funds are set up as separate entities with their own boards is to protect against this sort of thing. Anywhere else this would be cheating at the minimum, collusion at the worst."

The research, Co-Insurance in Mutual Fund Families, by Luis Goncalves-Pinto of the National University of Singapore and Breno Schmidt of Emory University, looked at the US market between 1995 and 2009. It found strong evidence that large houses were using internal, off-exchange trades to absorb stock from sister funds facing heavy redemption requests that would otherwise be forced to sell often large, illiquid positions into the market, potentially at fire sale prices.

"Our tests indicate that the degree of absorption displayed ... is significantly higher than one would expect in the absence of co-ordination," the paper said.

The authors found funds were more likely to be helped if they were more "valuable" to the company, for example if they charge high fees or have strong past performance.

Artificial price support is also more commonplace when all the fund managers involved have been working for the company for at least three years, and if the buying fund has experienced distress in the recent past.

"There seems to be an implicit agreement between funds affiliated with the same family ... with the tacit understanding that, if the first fund is in trouble, the second one will come to its rescue," said Mr Goncalves-Pinto.

Earlier this year Martin Currie, the UK fund manager, was fined £8.6m by the UK and US regulators after one of its China funds bought three unlisted investments from a sister fund that was facing "serious liquidity concerns" in 2009, creating a "clear conflict of interest", according to the UK Financial Services Authority.

In 2009, Oddo et Cie, the French investment bank, and its asset management arm were fined €300,000 by the French regulator after four of its enhanced cash funds bought three credit default swaps from a sister money market fund, some 13.7 per cent of the latter fund's net assets, to "protect [Oddo's] commercial reputation".

"This practice exists but it can be punished if it is not carried out in conditions that protect investors," said Noël Amenc, director of the Edhec Risk Institute.

The study suggests such incidents have become more commonplace in recent years as the proportion of internal, off-exchange trades has risen.

Douglas Scheidt, chief counsel in the US Securities and Exchange Commission's division of investment management, said he was aware of inappropriate trades of this nature occurring in municipal bond funds.

"Any affiliated transaction is a high level focus for the SEC," he said.