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No surprise at backroom dealing charge

By Steve Johnson

A few industry figures have expressed surprise at revelations, aired in last week's FTfm, that some asset managers appear to be engaging in dubious – and potentially illegal – in-house trades to protect funds facing heavy redemptions from having to sell assets at fire-sale prices.

But the most common reaction has been a knowing nod.

"It has happened many times in the past, often in times of market pressure, particularly with short-term bond and money market funds. In 2008 it was one way to ensure that prime money market funds would be protected," says Jean-Baptiste de Franssu, chairman of Incipit, a strategy consulting company, and a former chief executive of Invesco Europe.

"I'm aware that it happens, generally in equity funds but not always. I suspect it's quite widespread," says another senior European industry figure who wishes to remain anonymous. "It is totally unacceptable. If it's purely bailing out a poorly performing manager it's completely wrong."

These comments are telling, given that the academic research cited, *Co-Insurance in Mutual Fund Families* , authored by Luis Goncalves-Pinto of the National University of Singapore and Breno Schmidt of Emory University, focused on US equity funds.

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.

Indeed, even regulators have seen this behaviour in other asset classes.

Douglas Scheidt, chief counsel in the US Securities and Exchange Commission's division of investment management, is aware of similar trades between funds operating in the $2.9tn US municipal bond market.

"There is often not a lot of trading in these bonds. There will be times that a fund needs to meet redemption requests and sell a bond they really don't want to sell, and if they do they maybe can't buy it back. So they prefer to sell it to a sister fund, then buy it back when they can. It's like a parking system," says Mr Scheidt.

"There have been a few occasions like that. The adviser to the two funds is the same. It really should be in the best interests of the buying fund to buy it but it's hard to detect."

The difficulty arises because internal cross-trading between funds is not illegal. And even consumer advocates such as Guillaume Prache, managing director of the European Federation of Financial Services Users, a lobby group that represents 4m individual investors, argues it can be beneficial.

"It's not always wrong to sell to funds within the same group. As long as it's favourable to the interest of [investors in the buying fund] then it's fine," says Mr Prache.

"When it's detrimental to investors it should be forbidden."

The Ucits regulations state that trades between sister funds are permissible but must be conducted "on normal commercial terms negotiated at arms length" and "must be in the interests of the unitholders".

The SEC has similar rules. "There is a general prohibition on one sister fund selling to another sister fund. There is a rule that a sister fund can rely on to engage in this type of transaction in limited circumstances, at the independently established market price," says Mr Scheidt.

But he admits it is difficult to "get into people's heads" to determine the real reason a fund manager is buying securities from a sister fund; ie whether he genuinely believes the transaction is good for his investors or whether he is acting to support a sister fund that has to sell to meet redemption requests but does not want to precipitate a fall in the market price.

"It's really hard for a regulator [but] any affiliated transaction is a high level focus for the SEC exam staff. They would routinely look at this kind of transaction.

"We would look at whether it was really in the best interest of the buying fund and whether the board of the fund was aware of this and independently analysed the appropriateness of the trades," he says.

In the UK, the Financial Services Authority, which last month announced a crackdown on conflicts of interest between asset managers and their customers, has the issue of cross trading in its sights.

"We have asked asset management firms to review their current policies on managing conflicts of interest, of which cross trading is one," says Ed Harley, head of asset management supervision.

"We expect firms to have robust systems. We will continue to challenge firms to justify how regular and significant cross trading is beneficial for customers."

Some fund groups have taken the decision never to engage in cross trades.

"We would never cross trade, we would only trade through the markets. It's better to do it transparently," says Robin Creswell, managing principal of Payden & Rygel Global, the London-based arm of a $70bn US fund house.

"If a trade does not go through the market, how can you price it?" asks Mr Creswell, pointing to the illiquidity that crippled markets during the peak of the financial crisis in 2008.

"In theory you could cross a trade at [the market] price, but often those prices were not representative of what could be done in the market."