

A Few Bad Apples? Scandalous Behavior of Mutual Fund Managers

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ABSTRACT. Recent scandals in the business world have intensified the demand for an explanation of the causes of corporate wrongdoing. This study empirically tests the effects of mutual fund management fees and control structures on the likelihood of illegal activity within mutual fund organizations. Specific attention is given to the presence of agency duality issues in the mutual fund industry and how this influences the motivations and decisions of fund managers. Findings provide support for the hypothesized relationship that higher levels of management fees decrease the likelihood of illegal behavior. Additionally, control of the mutual fund by external management is found to have a negative impact on the likelihood of illegal activity while also acting as a moderator of the management fee-illegal behavior relationship.

KEY WORDS: agency duality, agency theory, ethics, mutual funds, retirement benefits, reward structures

Introduction

Ethical behavior in organizations, or the lack thereof, has been a widely discussed and researched issue (e.g., Daboub et al., 1995; Kahn, 1990; Schweitzer et al., 2004; Trevino, 1986; Trevino and Youngblood, 1990; Weaver and Trevino, 1999; Weber, 2005). However, recent high-profile corporate scandals, such as Enron, WorldCom, Tyco and HealthSouth, have rekindled interest in this area of study and increased research efforts to identify factors preceding and following unethical and/or illegal behaviors (e.g., Ghoshal, 2005; Houge and Wellman, 2005).

Historically, corporate unethical/illegal activity has been attributed to either unique organizational characteristics or individual employee malfeasance (e.g., Sutherland, 1949; Zahra et al., 2005). Extant theory and research point to leadership inadequacies (Sims and Brinkmann, 2002), job stress (McShulskis, 1997), declining organizations (Lemke and Schminke, 1991), level of bureaucracy (Zimmerman, 2001), financial incentive structures and reward systems (Bilimoria, 1989; Duska, 1999; Hegarty and Sims, 1978), social networks and interorganizational relationships (Brass et al., 1998; Coleman, 1988), corporate culture (Fraedrich, 1992; Victor and Cullen, 1988), and many other related topics. Past findings in these areas have led scholars to ascertain or establish an almost endless list of prescriptive treatments that organizations can utilize to reduce unethical or illegal behaviors; treatments include both formal (Weaver, et al., 1999) and informal mechanisms (Cohen, 1993; Trevino, 1990).

Despite numerous prescriptions specifically designed to reduce unethical or illegal behavior in the workplace, recent corporate scandals suggest this information is either not being fully utilized or is simply ineffective in many business environments.

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For example, in recent years the mutual fund industry has come under the spotlight as several industry-leading companies, such as Putnam, Strong, and AllianceBernstein, have been at the forefront of accusations and investigations of illegal activity (Houge and Wellman, 2005; IFLR, 2004a, c; Maiden, 2003). Recent investigations into these mutual fund companies have resulted in multiple charges by the SEC and other State Attorneys General; in fact, in 2003 and 2004, 25 mutual fund organizations were charged or investigated for illegal trading activities. Most charges have been based on such activities as market-timing, rapid trading, late-trading, mispricing, and insider trading, all of which contribute to violations of the fiduciary responsibility of mutual fund companies and managers within those organizations to mutual fund investors.

While recent research has provided an examination of investor response to fraud in the mutual fund industry (e.g., Houge and Wellman, 2005), many questions related to these issues have been left unanswered. For instance, why have we seen a rise in illegal practices, particularly within mutual fund organizations? Why would top managers, many already individually wealthy, take illegal actions that may result in destroyed careers as well as the demise of the organizations they represent? Are there any particular characteristics of mutual fund companies or the mutual fund industry that promote such behaviors? Such questions are neither trivial nor limited to an academic audience. Indeed, the importance of understanding reasons for illegal activities in the mutual fund industry is far-reaching, as demonstrated by the shear growth of mutual funds as an investment channel. Total assets invested in mutual funds have increased from approximately \$47 billion in the early 1980s to over \$8.6 trillion in 2005. Further, as of 2004, nearly half of all households in the U.S. have invested in mutual funds and over \$1.6 trillion have been invested in mutual funds as part of 401k, 403b, and other retirement plans (a 2300% increase since 1990) (Investment Company Institute, 2005).

One plausible answer to these questions regarding the rise in illegal activities in the mutual fund industry argues that certain pay or reward structures promote illegal behaviors (Matsumara and Shin, 2005). According to agency theory, individuals will act opportunistically (i.e., illegally) if there is inade-

quate monitoring or if incentives are not appropriately accounted for through the construction of proper contracts that align principal and agent objectives (Eisenhardt, 1989). In other words, the reward structure and type of control used by organizations can influence the occurrence of illegal behavior among organizational members. This study examines this explanation for illegal behaviors in the mutual fund industry.

While the relationship between reward structures, control mechanisms, and behaviors has been established in previous research (e.g., Gomez-Mejia and Wiseman, 1997), little research has extended these arguments to empirically test how reward and control structures relate to illegal behaviors. Specifically in this study, we investigate how the likelihood of illegal actions of mutual fund managers varies according to different levels of management fees and whether the mutual fund is controlled internally or externally. Additionally, fund control (i.e., internal or external) is examined as a moderator of the relationship between mutual fund management fees and the likelihood of unethical behavior. Management fees are a percentage of assets paid to the mutual fund for management services provided in the day-to-day operations of the fund. Results of this study demonstrate a strong link between these constructs and lead to important implications that are relevant to society, including researchers of behavior in organizations, managers within and outside the mutual fund industry, individual investors, employees, retirees, and public policy makers.

Theoretical framework

Research examining the relationship between rewards and managerial behavior has historically employed an agency theory perspective (e.g., Demski and Feltham, 1978; Eisenhardt, 1989; Gomez-Mejia and Wiseman, 1997; Jensen and Meckling, 1976). Agency theory directly addresses the issue of the contract between the agent and principal through an agreed-upon reward structure (Jensen and Meckling, 1976). There are two possible scenarios the principal faces that should ultimately determine the reward structure that optimally aligns the goals of both parties and reduces opportunity costs to the principal (Demski and Feltham, 1978;

Gomez-Mejia and Wiseman, 1997). First, if the principal has an existing knowledge of the agent or control over the agent's behavior, uncertainty is reduced as a result of decreased adverse selection risk and diminished monitoring costs. In contrast, if information about the agent is not readily available and the principal has no previous knowledge of agent behaviors, the risk of adverse selection increases and the organization must invest in monitoring mechanisms, resulting in increased costs.

Based on these well-known theoretical principles, normative models of agency theory prescribe two possible mechanisms useful in aligning the interests of the principal and agent: (1) reward structure (i.e., incentive alignment), and (2) monitoring (Gomez-Mejia and Wiseman, 1997). The first of these seeks to find the optimal reward structure that most effectively aligns the parties' interests; this structure can be either behavior-based (i.e., salary-based) or outcomes-based (i.e., incentive-based). In practice, pay contracts are often combined to produce agreements that are either *more* behavior-based or *more* outcomes-based, typically determined as a function of the level of risk to both parties (Stroh et al., 1996).

As discussed by Eisenhardt (1989), risk can come in many forms such as outcome uncertainty, risk aversion of each party, and/or information asymmetries. Outcomes-based contracts are more commonly utilized in riskier situations in an attempt to disperse risk while behavior-based contracts are more commonly found in lower risk situations (Eisenhardt, 1985, 1988). Monitoring, on the other hand, seeks to reduce risk through the restriction of chances for the agent to act opportunistically. For example, monitoring can involve restrictive money exchange processes, extensive video surveillance, or very sophisticated barcode inventory tracking mechanisms, to name a few. Thus, a contract should take into consideration the measured risk, the adverse selection likelihood, and the expected monitoring costs to the organization; an *optimal* contract would result in the effective alignment of interests between the principal and agent (Eisenhardt, 1989; Gomez-Mejia and Wiseman, 1997).

In recent years, risk management strategies have become increasingly dependent upon agent cost evaluations (Tufano, 1998). Previously, Macey (1991) argued that managers of large corporations are less likely to engage in illegal activity due to the

reduced cost-benefit in such a setting. He noted that the actual minimal monetary benefit, compared to the high amount of legal risk, would discourage managers from corporate wrongdoing. However, as outcomes-based total reward packages continue to grow in size for executives, the benefit of wrongdoing can consequently be much greater, as only very slight increases in firm performance can result in monumental individual gains (HR Focus, 1997). Similarly, Kurland (1999, p. 33) contends that outcomes-based pay systems can unintentionally create "a conflict of interest for the agent" and Jenkins et al. (1998) question the effectiveness of financial incentives by demonstrating that financial incentives are not related to the actual quality of performance, but rather the quantity of performance. Consequently, many researchers and business analysts feel that the rising levels of executive rewards, along with the difficulty associated with monitoring top management activities, is creating an ethical dilemma that must be addressed.

Contextual framework

The application of agency theory to the study of the mutual fund industry provides us with a logical explanation for many existing industry practices and problems. Mutual fund organizations have exhibited the use of both behavior-based and outcomes-based contracts, while also often utilizing monitoring mechanisms to improve principal-agent alignment and reduce opportunistic or illegal behaviors. However, many mutual fund organizations have recently been charged with illegal behavior because of activities that sacrifice long-term mutual fund shareholder wealth maximization (Houge and Wellman, 2005). As in most cases of corruption, the recent illegal activities seen in the mutual fund industry are not isolated events but rather ongoing acts that utilize socialization tactics and require "knowing cooperation among numerous employees" (Anand et al., 2004, p. 39). In fact, it has been argued that the discretion that individuals have when faced with ethical situations is very minimal due to the enormous pressures that exist to meet institutional precedents and follow organizational routines and norms (Ashforth and Anand, 2003; Jackall, 1988).

Illegal practices in the mutual fund industry

Market timing and late trading have been the two most commonly cited illegal practices used by mutual fund companies (Houge and Wellman, 2005). Indeed, in many cases, mutual fund organizations charged with one act are also simultaneously charged with the other. Market timing refers to the short-term purchase and sale of fund shares in an attempt to take advantage of anticipated market changes. Typically, market timing is utilized to exploit time zone differences in the trade of international funds; this practice is also known as time zone arbitrage. One important issue related to market timing should be discussed for clarification purposes: market timing, by definition, is *not* an illegal practice. Rather, market timing refers to a common trading strategy used by some investors to capitalize on market inefficiencies. However, while short-term investors using this type of strategy may see profits from market timing, long-term investors suffer the consequences as transaction costs balloon (often benefiting the mutual fund company) and long-term fund performance is jeopardized. Thus, market timing essentially strips long-term mutual fund shareholders of rightful gains. In effect, the market timers see slight gains, while long-term shareholders pay for the transaction costs associated with the additional trades being made. Houge and Wellman (2005) effectively described the benefit of market timing practices to mutual fund organizations, arguing that such companies “‘sold’ market timing capacity to key investors in exchange for large deposits of ‘sticky’ or long-term assets in other high-end funds” (Houge and Wellman, 2005, p. 137).

The notion that market timing does not violate ethical standards would be counterintuitive, as is evidenced by recent increased pressure from the SEC for mutual fund companies to more clearly state their position on market timing. In fact, in 2003, New York Attorney General Eliot Spitzer deemed market timing, in many circumstances, to be a fraudulent activity on the part of the mutual fund organization. Spitzer contended that firms allowing clients to trade more frequently than the formal fund prospectus allowed were committing fraud. The failure of these organizations to adequately penalize mutual fund investors guilty of market timing, given their formal stated position on the issue, is a direct misrepresentation of firm commitment to long-term

shareholders and is actually deemed *illegal* by the SEC. The SEC has taken further regulatory steps to address the problems associated with market timing (IFLR, 2004b). However, some parties place partial blame on the common investor, as most investors remain largely unaware of these problematic issues and fail to reallocate their capital into other funds or alternative investment options when such activities occur (e.g., Barney, 2005).

In response to increased public scrutiny, some mutual fund organizations have implemented mechanisms to discourage mutual fund investors from using market timing investment strategies. Redemption fees, for example, are increasingly being utilized. Redemption fees are a type of sales fee, or commission, charged to the investor for withdrawal of funds within a certain period of time from the initial investment (often 90 days). This fee is implemented with the intent of protecting long-term shareholders from market timers who seek to capitalize on short-term financial gains by rapidly trading in and out of the fund. By discouraging investors from approaching mutual fund investing from a short-term perspective, mutual fund investment managers are, theoretically, discouraged from making trading decisions that only benefit short-term investors, including themselves. While including redemption fees in mutual fund structures has become a more common practice and most mutual funds have stated their disapproval of market timing in their prospectus reports, many companies have still failed to take any action to directly discourage it.

The second illegal practice numerous mutual fund firms have been charged with in recent years is the act of late trading. Late trading is the illegal after-hours trading of mutual fund shares and is prohibited by the Investment Company Act Rule 22c-1. Late trading occurs when a mutual fund manager accepts a trade order to buy or sell mutual fund shares after the 4 PM (EST) market close. The trades are then “backward priced” at that day’s closing price instead of the opening price on the following day. Late trading provides an advantage to traders in that it allows them to react to market information surfacing *after* the 4 PM (EST) market close and respond in kind. The ability to capitalize on the newly available information before the rest of the market gives the guilty parties the ability to make “sure profits” on their transactions. Abnormal returns are again seen at

the expense of the fund's long-term shareholders in these situations.

Agent duality perspective

It is obvious that when market timing and/or late trading occur regularly in a mutual fund company, the long-term mutual fund shareholders unwillingly become the victims. However, the nature of the mutual fund industry creates an issue of agency duality that may contribute to principal-agent alignment problems and mixed allegiances. Restated, two different principal-agent relationships exist in most mutual fund company scenarios because the mutual fund manager is an agent to both the mutual fund company (i.e., the parent) as well as the fund investors. While both of the principals (the mutual fund organization and the individual mutual fund investor) seek to maximize returns on investments, the method for achieving such returns may be at odds. From the mutual fund *company* shareholders' perspective, share value is increased through the growth of assets invested in the company's various funds. Thus, improved revenues are largely obtained through management fees regardless of aggregated mutual fund performance. However, financial returns for mutual fund investors are directly related to the performance of the individual mutual fund, not the mutual fund parent (although ideally there should be a long-term correlation). This creates a real problem for the principal that fails to achieve agent alignment as well as obvious managerial decision-making problems as managers must balance multiple stakeholder interests (Reynolds et al., 2006). Recently, calls have been made for the federal government to rectify this problem by establishing "a federal standard of fiduciary duty for fund directors and officers" (Barney, 2005, p. 10). In essence, this would legally align the interests of the mutual fund investor and the mutual fund manager.

Related to this agency duality perspective is the specific method mutual fund companies use to attract mutual fund investors and how outcomes are evaluated. Golec (2003) discussed the difference between "performance-oriented" and "marketing-oriented" fund companies and noted the difficulty individual investors have in distinguishing between the two types. According to Golec (2003), perfor-

mance-oriented companies focus on the performance of the mutual funds while market-oriented companies focus on the development of brand-name capital and utilize name recognition to attract investors. Most of the brand-name, marketing-based mutual fund companies solicit large organizations who seek comprehensive plans (e.g., 401K, 403b) to offer their employees. Additionally, these same firms market to the general public on various other retirement products (e.g., IRAs, Roth IRAs). As a result, many mutual fund investors are investing on the basis of brand recognition, low management fees (price-shopping), and/or have been provided limited investment options. In these situations, the mutual fund parent and their stockholders tend to be the greatest beneficiaries because of gains in mutual fund total assets, which contribute to an increase in management fee revenues. Thus, actual mutual fund performance vis-à-vis comparable mutual funds is quite possibly *not* a large part of many mutual fund investor decisions. In fact, it has been recently demonstrated that mutual fund favorability rises and falls with stock market performance (ICI, 2005). So although fund performance is cited as the most important factor shaping opinions of the mutual fund industry (ICI, 2005), comparisons seemingly are not made between mutual funds, but between alternative investment options and mutual funds that most likely fall prey to the same issues being presented in this study.

Hypotheses development

Management fee structure and illegal behavior

Some recent research has examined the effects of incentive fees and other reward structures on mutual fund manager behavior (e.g., Berkowitz and Qiu, 2003; Carhart, 1997; Elton et al., 2003; Golec, 2003). As defined by Elton et al. (2003, p. 779), "an incentive fee is a reward structure that makes management compensation a function of investment performance relative to some benchmark"; the most common mutual fund benchmark is the performance of the S&P 500. Elton et al. (2003) found that mutual funds with incentive-based fee (i.e., outcomes-based) structures tend to (1) take on more risk initially, (2) increase risk after periods of poor per-

formance, and (3) receive a greater amount of new cash flows than funds using a non-incentive-based fee (i.e., behavior-based) structure. In other words, the compensation contract for mutual fund managers with an incentive-based fee structure is more performance-based than other mutual funds and this helps explain increased levels of risk and other outcomes. Similarly, Berkowitz and Qiu (2003) recently found that rewards, measured by management fees, influences the way mutual fund managers approach investments (e.g., riskiness) and, as a result, the outcomes they realize (particularly from an individual mutual fund investor perspective).

Following agency theory, the use of an outcomes-based contract is intended to align the incentives of the principal (e.g., mutual fund investors) and agent (e.g., mutual fund manager), particularly in uncertain environments (Eisenhardt, 1988, 1989). However, as previously discussed, agency duality and fee regulations have made pay-for-performance contracts essentially obsolete in the mutual fund industry. Mutual fund companies, particularly the large, publicly owned enterprises, are now driven more by marketing than management values; extreme pressure to increase fee revenues through the growth of fund assets is placed on mutual fund managers by the parent organization. Thus, asset-based fee structures predominate and can be maintained at high levels as "regulations and brand-name capital partly insulate them from competition" (Golec, 2003, p. 19). In fact, only about 3% of mutual funds include performance-based fees as part of their reward structure (Madhur, 2005).¹

Asset-based fee structures place emphasis on attracting assets, which can be achieved, as previously stated, by either strong marketing or strong short-term performance (Golec, 2003; Sirri and Tufano, 1998). Either way, competitive decisions are not made with consideration for the long-term mutual fund investor, but rather center on finding ways to increase the assets of the fund and thus the revenues of the mutual fund company. Additionally, demonstrating the ability to increase the size of a fund may allow a mutual fund manager to earn advisory positions with larger funds or negotiate higher fees and, therefore, realize higher personal returns. To put it simply, the compensation is not based on the *long-term* performance of the fund itself, but rather on the asset base the fund holds.

Clearly, utilizing purely asset-based compensation mechanisms could be considered unethical because the fiduciary duty of the mutual fund manager to the mutual fund investor would suggest that the focus should be on total mutual fund returns. Economies of scale would imply that funds with many assets can be managed the same as funds with fewer. However, minimizing fee expenses is largely in opposition to the reward structures established for a mutual fund manager by the mutual fund company, which sets up these reward structures to support fund asset growth and, therefore, increased revenues from fees. As such, asset-based fee structures deliver larger rewards to mutual fund managers. Alternative mutual fund management structures have been proposed to try to safeguard against the use of inappropriate fees. These safeguards are typically implemented through the use of a pre-defined independent mutual fund director who is primarily responsible for overseeing the mutual fund manager's contract (Tobe, 2000).²

Despite these many changes, little affect has been noticed and fund managers continue to play a major and unmonitored role in the fund's level of risk and subsequent outcomes. Theoretically, mutual fund managers are risk-averse, self-interested individuals seeking to maximize personal benefit (Gomez-Mejia and Wiseman, 1997). Therefore, decisions concerning the selection of stock and the level of risk would be made to further their own interests (i.e., their personal compensation levels or career aspirations), which happen to be aligned with the goals of the mutual fund parent rather than the mutual fund investor (Ludwig and Longenecker, 1993). Realistically, it would not serve the mutual fund parent or the mutual fund manager well to alter these current practices, especially since most investors remain largely unaware of how mutual fund managers and mutual fund companies are rewarded. In fact, many large mutual fund management companies have realized this and lobbied regulators against changing current fee structures. Specifically, mutual fund companies are resisting the required inclusion of performance-based fees (Golec, 2003).

Given the types of incentives present in the mutual fund setting, as well as the relatively small amount of influence that mutual fund investors possess, the most direct method for a mutual fund manager to improve their compensation level would be to grow the assets of the mutual fund. Such

strategies would especially be effective with smaller mutual funds in less marketing-intensive companies following periods where fund performance is relatively poor. Thus, in situations where the level of compensation is low compared to mutual fund managers of comparable funds, the likelihood of illegal trading behaviors (i.e., market timing and late trading) is intensified because of the need to increase assets in the fund. Such a connection is based on the idea that the market timing and late trading are utilized to gain short-term growth in performance and/or asset investment. Such actions play on the general ignorance of the mutual fund investor who places a primary emphasis on the most recent year's performance and has a limited understanding of mutual fund reward mechanisms (Capon et al., 1996).

Given these arguments, our first hypothesis contends that there is a significant relationship between fee structure (i.e., level of management fees) and the likelihood of illegal behavior. However, this relationship can be somewhat conflicting and difficult to understand when consideration is given to the agency duality associated with the mutual fund industry and the specific trading activities that are considered to be illegal. Traditionally, outcomes-based pay structures are used as a mechanism for achieving goal congruence between the principal and agent in uncertain environments (Eisenhardt, 1989). However, this congruence does not preclude illegal trading practices. Thus, illegal-trading activities may emerge because of the intense need to grow mutual fund assets and increase rewards, which is also valued by the mutual fund company. In this way, mutual fund managers receiving lower fee levels can demonstrate their abilities and worthiness to receive higher management fee percentages. Thus, given this context-specific scenario, the mutual fund manager will be more likely to act illegally (i.e., market timing or late trading) when management fees are lower. Hence,

H₁: As the management fees of the mutual fund increase, the likelihood of illegal behavior decreases.

Internal/external control and illegal behavior

Many mutual fund companies manage the day-to-day operations of their funds in-house, while some

outsource these operations to external sub-advisors. The nature of these two basic structures inherently creates differences in the principal-agent relationship and forces greater responsibility or obligation to one principal or the other (i.e., mutual fund parent or mutual fund investors). With internal mutual fund management, the mutual fund company has greater access to information related to mutual fund decision-making. Thus, by having internal mutual fund managers, diagnosticity is increased, which "refers to the ability... to reliably signal a potential error or problem" (Jensen, 2005, p. 54). Alternatively, by outsourcing day-to-day operations to external mutual fund managers, objectivity would be increased, rather than diagnosticity (Jensen, 2005).

Taking a more positivistic agency view (Eisenhardt, 1989), the political or interpersonal aspects of the principal-agent relationship may lend insight into the agency duality issue and help explain the differences between external and internal managers in the mutual fund setting. Internal mutual fund managers are monitored through their personal and professional relationships with the mutual fund company executives; the mutual fund company executives serve as the principals while the mutual fund managers act as agents. Since company executives implement internal controls, the process can be made self-serving and the internal mutual fund managers will be expected to act in the interest of the organization rather than the mutual fund investors. Additionally, the hierarchical authority that mutual fund company executives have over internal mutual fund managers may intensify pressure on these managers to outperform (i.e., outgrow) competing funds in order to gain acceptance and advance internally within the organization. This pressure may be saddled with more subjective mechanisms of control, which may presume that if outcome expectations are being met, nothing is wrong. In other words, top executives of the mutual fund company may "judge compliance in the light of the circumstances at that time" (Gomez-Mejia, 1997, p. 301) and "improperly override internal control and commit management fraud" (Jensen, 2005, p. 55). In addition, larger organizations may lose some of their ability to properly monitor employees (Williamson, 1975), as they must increasingly rely on the employees themselves for information. This may partially explain the increased use of external management of mutual funds as mutual fund companies grow.

Comparatively, external managers, being separated from the company, will tend to act more in the interest of external parties (Williamson, 1975). So, external mutual fund managers are more likely to act in the interest of the mutual fund investor since the internal pressures for asset growth and increased management fee revenue will be reduced and more objectivity will be exerted with regard to illegal trading practices. External mutual fund managers will also be more likely to have a larger personal and visible stake in the success of the mutual fund since it probably represents a large portion of the mutual funds their firm handles and they are more closely tied to its long-term performance and survivability.

Building on the above arguments, the nature of external versus internal management structure suggests that internal mutual fund managers would be more likely to use market timing and late trading activities than external mutual fund managers, whose relationship with the mutual fund parent differs significantly. Thus, we hypothesize that the likelihood of illegal trading activities will be reduced when external fund managers are utilized. Formally, hypothesis two states,

H₂: External control of mutual funds is negatively related to the likelihood of illegal behavior.

Management fees, control and illegal behavior

In the mutual fund industry, studies have examined the relationship between rewards and fund management behaviors (Brown et al., 1996), the importance of mutual funds being a part of a larger fund complex with regards to fund flows (Sirri and Tufano, 1998), and the relationship between mutual fund company structures and the fees charged (Tufano and Sevick, 1997). Related to the current study, Tufano and Sevick (1997) discussed how the industry's characteristics limit the ability of investors to respond to changes in fee structures and how independent fund directors have little direct impact on controlling excessive mutual fund fees. In other words, even if a mutual fund investor wishes to exit the fund, switching costs, back-end loads, and capital gains may limit their ability to do so. Further, although the responsibility of an independent

director is to protect the interests of mutual fund investors, the fund parent has typically selected the independent directors for each fund; this creates a conflict of interest and may limit monitoring activities.

Given these previous studies and our earlier arguments, it is likely that a more sophisticated relationship between fund fees, corporate control, and illegal behavior exists. The use of external mutual fund management (i.e., hiring a sub-advisor) should be accompanied by more objective control mechanisms and greater feelings of responsibility or obligation to the mutual fund investor. Alternatively, internal mutual fund managers would have greater incentives to support various mutual fund parent goals. Therefore, this existing relationship between fund fees and fund control leads to our third hypothesis.

H₃: The type of mutual fund control (internal versus external) will moderate the relationship between management fees and the likelihood of illegal behavior such that the negative relationship between management fees and illegal behavior is intensified in the presence of internal mutual fund control.

Methodology

Sample and data

The data collection process for this study began with the identification of mutual fund organizations either accused, under investigation, or already charged/indicted for illegal trading behavior. Following the initial unveiling of fraud in this industry, Morningstar began tracking all companies being investigated and provided information regarding the type of fraudulent behavior, the current status of the investigation, and recommendations to investors.³ We utilized the database provided by Morningstar, in addition a similar database provided by *Wall Street Journal* and other public databases, to identify organizations accused, under investigation, or already charged/indicted for illegal behavior in the years 2003 and 2004.

The data collected about these mutual fund organizations included their respective management fees charged, the control structures of the individual

funds, and the presence/absence of illegal behavior as previously defined. While the initial list of fraudulent organizations was provided by Morningstar's "Fund Industry Investigation Update", several other resources were used in collecting the required data for this analysis, including *Compustat*, *Mergent Online*, and *Morningstar Funds 500* (2004 Edition). As listed in the Morningstar's report, 25 mutual fund organizations were accused, investigated, or charged/indicted by the SEC or State Attorneys General in the years 2003 and 2004. Of these 25 mutual fund organizations, 20 of them had funds listed on the 2004 Morningstar Funds 500 list. These 20 mutual fund companies represented over 20% (104) of the 500 mutual funds appearing in the *Morningstar Funds 500*.

A control group of mutual funds that had not been accused, investigated, or charged/indicted for fraudulent activity was selected from the remaining 396 funds listed on the 2004 *Morningstar Funds 500* list. This control group was selected based on comparable asset-value, number of funds represented by the parent, and specialization type of mutual fund (i.e., large-value, small-growth, etc.). This enabled the comparison of funds based on the presence or absence of suspected corporate illegal behavior as 104 mutual funds had been accused, investigated, or charged/indicted for illegal behavior, while the control group of 104 mutual funds was comprised of companies not accused, investigated, or charged/indicted.

Measures

Management fees

Consistent with Berkowitz and Qiu (2003), we use the percentage of management fees charged as a proxy for the reward structure of mutual fund managers. This proxy was also utilized in a previous study by the SEC (Securities and Exchange Commission, 2000) due to the inaccessible nature of actual portfolio management service costs. The SEC study concluded that the use of management fees charged to a fund by its parent was the best available proxy for the actual mutual fund's cost of providing portfolio management services (U.S. Securities and Exchange Commission, 2000). Following these previous studies, higher management fees are intended to represent better, or

more valued, management of the fund. As previously discussed, a management fee refers to "the maximum percentage deducted from a fund's average net assets to pay an advisor or sub-advisor" (*Morningstar Funds 500*, 2004, p. 567). The management fees in this study range from 0% to 2.5% of total fund assets. Management fees include the costs of investment management, administration and record keeping, and other fees paid for the services of the mutual fund manager.

Mutual fund control

The second independent variable, mutual fund control, is hypothesized to have a direct relationship with illegal trading activities while also serving as a moderator in the relationship between the management fee and the likelihood of illegal activities. We use the type of management, either internal or external, as a binomial proxy for the amount of control exerted on decision-making of professional investment managers.

Illegal trading activities

For the dependent variable, we assigned codes to those previously identified mutual fund organizations that were accused, investigated, or charged/indicted for illegal behavior by the SEC or individual State Attorneys General in the years 2003 and 2004 and their respective matching counterparts. Mutual funds that were managed by organizations being accused, investigated, or charged/indicted for illegal behavior received a coding of 1, while the matching, non-accused or uncharged mutual funds received a coding of 0.

Control variables

Several control variables have been used in the analysis to reduce variance caused by external factors. Given the previous discussion on the importance of fund assets, asset size is an important control variable in our analyses. In addition to the asset size of each mutual fund, specialization type (i.e., large-value, small-growth, etc.) and previous mutual fund performance have been found to be important factors in mutual fund research (Volkman and Wohar, 1995). Asset value of individual mutual funds was measured based on the total assets invested in a fund as reported by 2004 Morningstar 500 (Benz and Kinnel, 2004). Specialization type of mutual funds was measured by analyzing the chosen trading strategy pursued

by the individual mutual fund, as indicated by the current investment style of the fund (as reported by 2004 Morningstar 500). These nine style classifications, analyzed using dummy variables, are derived from the cross-section of the fund's market capitalization (i.e., large, medium, small) and the fund's investment style (i.e., growth, value, and blend). The final control variable, mutual fund performance, was gathered from recent data found in the Morningstar 500 reports (Benz and Kinnel, 2004). Specifically, we used an average percentage yield for the previous 3 years (i.e., 2001–2003). By using average percentage yield as a proxy for performance, we avoid any issues related to the effects of firm and fund size on absolute financial returns.

Analyses and results

Given the discrete nature of the dependent variable, OLS regression could be used to fit a linear probability model. However, the linear probability model is heteroskedastic and could possibly predict values outside the range used for the binary coding of this categorical variable (0, 1). As a result, the logistic regression model is used in this analysis to estimate the factors influencing the occurrence of illegal trading activities in mutual fund organizations. Table I shows the descriptive statistics and correlations for all variables utilized in the analyses, while Table II shows the results from the logistic regression analyses. In Table II, Model 1 reports

the base model, taking only the control variables into consideration (assets, mutual fund specialization, and mutual fund performance), Model 2 reports the main effects model (testing Hypotheses 1 and 2), and Model 3 includes the interaction term (testing Hypothesis 3).

The base model (Model 1) is significant ($p \leq 0.01$) according to the χ^2 -statistic. This initial model, only representing the effects of the control variables, correctly classified 62.0% of the funds. Results indicate that significant relationships exist between two of the control variables in the model and the dependent variable (illegal trading). First, a significant positive relationship ($p \leq 0.01$) exists between the amount of assets in a fund and the likelihood of illegal trading activities on the part of the mutual fund organization. As the level of assets in a fund increases, the likelihood of illegal behavior correspondingly increases. This relationship is demonstrated in Model 1 and also supported by the strong correlation between the two variables (0.20, $p \leq 0.01$) shown in Table I.

Results of Model 1 also indicate a significant negative relationship between mutual fund performance and the likelihood of illegal trading activities (-0.26 , $p \leq 0.001$). The negative relationship indicates that as prior fund performance decreases, the likelihood of illegal trading behavior increases. The third control, mutual fund specialization, showed no significant relationships with any of the variables and was thus not reported in Tables I or II.⁴

TABLE I
Descriptive statistics and bivariate correlations^{a,b}

	Variables	Mean	σ	1	2	3	4	5
1	Mgt fee	0.76	0.34	–				
2	Fund control	0.21	0.41	–0.05	–			
3	Assets (1,000)	5117	9163	–0.32***	0.26***	–		
4	Performance	3.38	9.45	0.15*	0.16**	–0.09	–	
5	Illegal trading	0.50	0.50	–0.24***	0.19**	0.20**	–0.26***	–

^aValues are Pearson correlation coefficients based on standardized values.

^b $N = 208$.

* $p \leq 0.05$.

** $p \leq 0.01$.

*** $p \leq 0.001$.

TABLE II
Logistic regression models for likelihood of illegal trading activities^a

Variables	Model 1			Model 2			Model 3		
	Beta	(SE)	Wald	Beta	(SE)	Wald	Beta	(SE)	Wald
Control variables ^b									
Assets in Fund	0.00*	(0.00)	5.34	-0.06**	(0.02)	8.17	0.00	(0.00)	1.48
Fund performance	-0.08***	(0.03)	10.47	0.00	(0.00)	0.23	-0.08**	(0.03)	9.43
Management fee	-1.32*	(0.57)	5.43	-0.71	(0.56)	1.61			
Mutual fund control	-1.35**	(0.43)	9.74	-8.80***	(2.95)	8.88			
Interaction: Mgt fee × Mutual fund control							-8.71***	(3.17)	7.54
Model summary									
χ^2	25.10**			15.83***			14.38***		
-2 Log likelihood	263.25			247.42			233.04		
Nagelkerke R^2 (Pseudo R^2)	0.15			0.24			0.31		
% Correctly classified	62.0%			65.4%			69.2%		

^a $N = 208$.

^bNo significance found for mutual fund specification control variable (not shown).

* $p \leq 0.05$.

** $p \leq 0.01$.

*** $p \leq 0.001$.

Model 2 tests Hypotheses 1 and 2 by including the two independent variables, management fee and mutual fund control, in the model. Management fee shows a negative relationship to the likelihood of illegal trading ($p \leq 0.01$). Thus, as the percentage of management fees increases, the likelihood of illegal trading correspondingly decreases. This finding provides strong support for our first hypothesis. The second hypothesis argues for a relationship between mutual fund control and the likelihood of illegal trading behavior. Findings from the logistic regression analysis, labeled as Model 2, also provide strong support for Hypothesis 2 as mutual fund control is found to have a significant negative relationship with likelihood of illegal trading ($p \leq 0.001$). Thus, the use of external management is negatively related to the likelihood of illegal trading activities.

Model 3 introduces the interaction term, which tests for moderating effects of mutual fund control on the relationship between the management fee percentage and the likelihood of illegal trading. The moderator shows a significant negative effect on the relationship between management fee percentage and the likelihood of illegal trading ($p \leq 0.001$), supporting Hypothesis 3. Thus, in the presence of

high management fees and external control, the likelihood of illegal trading behavior is minimized.

Further examination of Model 2 and Model 3 also illuminates the importance of the independent variables and the interaction term in contributing to the predictive capability of the overall model. According to the likelihood ratio test statistic, Model 2 is superior to Model 1 in terms of overall model fit. Likewise, Model 3 is superior to Model 2. The -2LL value decreased with each new model, first to 247.42 (Model 2) and then to 233.04 (Model 3); this indicates a progressively better fit of each model and greater predictive ability. Additionally, each model demonstrated significant increases in both the Nagelkerke R^2 and correct classification percentages. The Nagelkerke R^2 progressively increased from 0.15 to 0.31 (from Model 1 to Model 3) and the percentage of correct predictions increased by a total of 7.2% across the three models.

Discussion

Of course, a number of limitations exist within this study, thereby limiting the generalizability and

applicability of these findings. Many of the limitations can be attributed to the secondary data used, which limits the validity and reliability of the variables. Additionally, we are limited by the number of companies currently accused, investigated, or charged/indicted for illegal activities. Further, we are limited in our ability to ensure that the comparison mutual funds are true representations of “ethical” mutual funds. We can only assume these organizations do not foster this same trading culture. Further, the measurement of the costs of managing a fund is very difficult, given the limited amount of information which companies must report. With this limitation, however, it is also important to note that previous empirical studies have identified the use of management fees as the best available proxy for measuring the costs of a mutual fund’s management (U.S. Securities and Exchange Commission, 2000) and that this proxy has been accepted and utilized in past academic literature (e.g., Berkowitz and Qiu, 2003).

Despite these limitations, the results of this research seem to clearly demonstrate that both the management fee and control structure of the fund are related to the likelihood of illegal trading behavior. These findings support previous agency studies examining the relationship between pay structures, control mechanisms, and opportunistic behaviors (Eisenhardt, 1989; Gomez-Mejia and Wiseman, 1997). In addition to this broader support for agency theory and unethical/illegal behaviors, these results draw attention to a variety of important issues that have far-reaching implications relevant to scholars, managers, and even the public at large.

Central to concerns surrounding the mutual fund industry is the issue of agency duality. As previously discussed, since mutual fund managers are responsible to two different principals, an inherent conflict arises. In other words, there seems to be a “tug of war” at work between the mutual fund organization and the mutual fund investor, with the mutual fund manager (i.e., the agent) attempting to maintain allegiance to both principals. As long as the methods for achieving investment returns are at odds (asset increases versus long-term fund performance outcomes), conflict from the perspective of one principal or the other is seemingly inevitable.

Additionally, conflicts of interest may also arise when large investment companies hold significant

blocks of ownership in large corporations (e.g., Disney, Microsoft) or when incentives are given to external investment managers (e.g., retirement fund managers) for investing their clients’ money in specific mutual funds. Unfortunately, in each of these cases, the general long-term mutual fund investor is penalized and has no real voice in changing such activities.

Although the federal government has recently been called upon to alleviate dual principal conflict in support of the general mutual fund investor, little real change in these practices has occurred. This is not all that surprising since the highly anticipated 2002 Sarbanes-Oxley Act has not seemingly had any noticeable impact on the occurrence of corporate unethical behaviors, particularly in the financial markets. This suggests serious issues surrounding the question of who can and should serve as the primary advocate for the general investor; generally speaking, the average investor is largely uninformed about specific investment activities and has serious entry/exit costs to investments (Barney, 2005; Sirri and Tufano, 1998). Future research should examine the role of corporate governance and/or external organizations (i.e., the federal government) in representing and protecting mutual fund investors. For instance, it would be interesting to determine if specific changes to public policy do occur in response to the emergence of these issues and if they impact mutual fund management policies and the occurrence of illegal trading activities over time.

In addition to who should serve as the mutual fund investors’ advocate, our study highlights the related question of how organizations can reduce the incidence of unethical or illegal practices. Our study demonstrates that illegal trading behavior is more likely to occur in mutual funds that have lower management fees and internal management. The initial finding of this study is that as the management fee charged decreases, a mutual fund investment is at higher risk of illegal trading behavior. However, illegal trading activities will not be reduced by simply altering the percentage management fee (this may even increase the occurrence of late trading and market timing), but by changing the incentives behind these fees. Therefore, it seems reasonable that changes in mutual fund fee structures are needed that incorporate some level of pay-for-performance mechanisms into the overall reward system.

The second finding in this study demonstrates the differences in illegal trading behavior incidence between internally managed and externally managed mutual funds. This difference may suggest that the type of monitoring mechanisms utilized to oversee outside mutual fund advisors may be better suited to ensure legal trading practices. The monitoring mechanisms that are present within the mutual fund company may not be as rigorous or as objective as those imposed on the external fund managers. Future research in this area could compare the specific mechanisms used in monitoring internal and external firms to determine if such differences exist and have an impact on behavior. Such studies do not necessarily have to come within the mutual fund industry, but could be operationalized within many different contexts where activities are handled within the firm or outsourced to others. For instance, one might examine a related context by analyzing the trading recommendations of in-house investment analysts against independent analysts, which have shown to differ significantly in their level of performance (Jennings, 2005). Indeed, such a study may find similar findings to those shown here since the analyst is not compensated for advice, but as a portion of the trading commissions from the broker.

Conclusion

On February 25, 2004, Don Phillips, a Managing Director of Morningstar, Inc., testified before the US. Senate Committee on Banking, Housing, and Urban Affairs in Washington, DC regarding the recent problems observed in the mutual fund industry. His testimony succinctly summarizes many of the issues highlighted in this study. A portion of Don Phillip's testimony reads:

Given the privileged and highly important role that mutual funds now play, it would behoove the industry to redouble its commitment to the effective stewardship of the public's assets. Most individuals who work for mutual fund companies embrace this challenge, but the recent scandals make it abundantly clear that too many people in this industry are willing to forsake their responsibility in exchange for short-term personal profit. Sadly, these were not the acts of a few, low-level

employees, but instead were violations of trust that took place at the highest levels, including company founders, CEOs, portfolio managers, and several current or former members of the Investment Company Institute's Board of Governors (Phillips, 2004).

This study empirically supports these statements and, therefore, makes an important contribution to the literature. As we demonstrate here, there is clear support that unethical/illegal business behavior and the goals of investor wealth maximization are not compatible (Long and Rao, 1995). This study also demonstrates that specific characteristics of an industry may create vulnerability to possible misconduct and that managers should take note of the conflicts of interest that exist in their respective industries and design structures and policies in ways that eliminate or reduce the possibility of illegal activities. However, as we explained earlier, there is very little financial incentive for mutual fund companies to develop organization-level changes to promote behaviors on behalf of the common investor. Thus, a key part of the restructuring of the mutual fund industry will likely come through increased regulation by the SEC and other entities. Of course, an important part of any regulation change should and will likely come in the form of alterations in how fund companies account for manager rewards and fund expenses. Already, there is an ongoing debate over the appropriate level of mutual fund fees and expenses, which should be of interest to *all* investors since it directly impacts the use of institutional and individual investments, actual fund performance, the stability of retirement planning, and potentially, the social security of all.

Notes

¹ We consider both performance-based fees and asset-based fees to be outcomes-oriented. However, performance-based fund fees are returns-dependent fees over the long-term (for a year or more), rather than fees based on fund assets. Despite this specific difference, even funds that include performance-based fees in their compensation structures often define performance by the growth in fund assets. Further, the level of assets (e.g., current or average) is commonly determined and

calculated by the mutual fund managers themselves (Pizzani, 2005).

² To address some public and regulatory concerns about the inflation of management fees, many funds have lowered management fees slightly and/or used breakpoints to lower the percentage of management fee with the growth of the fund. Basically, breakpoints are sliding scales that incrementally lower the management fee with the asset growth of the firm. Breakpoints refer to the level of dollar investment at which an investor receives a discount on the sales fees charged for transactions. However, breakpoints are not typically incorporated in management contracts and many do not have an upper cap beyond the final breakpoint, which limits their effectiveness (U.S. Securities and Exchange Commission, 2000).

³ The control variable, mutual fund Specialization, had no significant effects and is not reported in either Tables I or II due to space limitations. The variable was dummy coded for nine separate possible specializations; none were found to be significantly related to the likelihood of illegal behavior.

⁴ See Morningstar's "Fund Industry Investigation Update" (<http://www.morningstar.com/fii/fundindustryinvestigation.html>).

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