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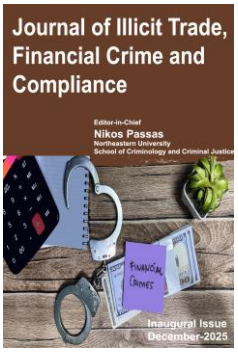

Advisory Misconduct in Mutual Funds: Investor Reactions, Capital Flows, and Governance Responses

Kai Wu*

Central University of Finance and Economics, China

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ABSTRACT

We evaluate the investor flows and company responses following mutual fund advisory misconduct from 2000 to 2015. An average 31.25% reduction in monthly fund flows occurs one year after misconduct, and the effect increases with investor monitoring. Additional analysis shows that sentiment-driven flows and disclosure-related misconduct mainly drive the negative effect. In response, mutual funds reduce contractual incentives, impose investment restrictions, increase liquid assets, or even replace malfeasant advisors. These measures alleviate the adverse effects of misconduct. Overall, our study highlights the impact of misconduct on investor flows and on the development of responsive policies in the mutual fund industry.

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*Corresponding Author
Email: wukai8759@cufe.edu.cn
Tel: +(86) 15606771381

1. Introduction

Institutional misconduct in the mutual fund industry has received considerable academic attention. From 2003 to 2005, numerous mutual fund advisory firms faced accusations of late-trading activities, violating fiduciary duties and security laws. Such scandals led to substantial economic damage, with average annualized investor losses reaching $400 million [1]. Given these consequences, the SEC has emphasized policing misconduct by investment advisory firms. While investor flow responses to misconduct have been extensively studied, mutual funds' strategies to mitigate adverse consequences have received less attention, with exceptions like [2]. Understanding misconduct's role in flow dynamics and responsive policies is crucial for financial regulation and risk management.

This study empirically examines the heterogeneous effects of misconduct on fund flow dynamics and, more importantly, how mutual funds respond to mitigate its negative impact. Assuming homogeneous exposure to advisory misconduct events is unrealistic; for instance, improper adviser licensing differs from market timing in its effect. Thus, a deeper investigation into heterogeneous effects, particularly given the lack of misconduct classification by allegation content, is needed. Furthermore, systematic evidence on advisory contracting and investment strategies post-misconduct is scarce. Mutual fund advisory misconduct's economic consequences extend beyond fund flows. Mutual funds often revise policies to mitigate adverse effects on flows, going beyond fee structure changes documented by [2]. Our study provides novel evidence across marketing, derivative trading, portfolio allocation, and contract termination.

Existing literature consistently documents a negative effect of misconduct on mutual fund net flows, primarily based on late-trading scandals from 2003 to 2005 reported in news media [3,4,5,6,7]. Our study broadens this scope by using Form ADV data, a richer source for mutual fund advisory misconduct cases. Form ADV has been utilized to identify malfeasant hedge funds [8,9], assess their operational risk [10], and predict investment manager fraud [11,12]. This data allows us to provide new evidence on heterogeneous fund flow effects by manually classifying misconduct allegations. We also identify underlying drivers of flow dynamics using an innovative flow decomposition method, separating sentiment-driven from fundamental-value-driven flows.

Mutual fund families often undergo contract changes post-scandal, especially in compensation rates [2]. Fund incentive schemes influence managers' risk-taking [13,14]. Beyond compensation changes, other mitigating measures adopted by mutual funds to counter misconduct's adverse effects on flows are less understood. For example, marketing efforts are vital for fund performance [15,16]. Asset allocation decisions, influenced by incentive schemes, lead managers to adjust risk factor exposure [13,17]. Contract changes can also involve terminating advisory firms for misconduct [18], protecting funds from adverse effects on flows. Building on this, we adopt a risk-based perspective to investigate mutual funds' mitigating actions, including marketing, contractual incentives, investment policies, and advisory relationships, offering novel evidence on responsive policies to misconduct.

We construct a monthly panel dataset (2000-2015) comprising fund flows, misconduct indicators, and fund characteristics. Using a difference-in-differences (DID) framework, we estimate that advisory misconduct leads to a 0.25 percentage-point reduction in monthly fund flows over 12 months, equating to 31.25% of average monthly flows or approximately $87.5 million for a median mutual fund. This negative effect is more pronounced in funds with a high density of vigilant investors, indicating their stronger response to misconduct. Our additional analysis manually classifies advisory misconduct cases from Form ADV into transaction-, disclosure-, and compliance-related categories. Transaction-related misconduct shows a transitory effect on fund flows, while disclosure- and compliance- related misconduct have long-term effects. Decomposing fund flows into sentiment- and fundamental-driven components [19], we find all misconduct types negatively affect sentiment-driven flows, albeit with varying time horizons. Only disclosure-related misconduct negatively impacts fundamental-driven flows. We provide causal evidence using the SEC's 2001 electronic filing mandate, an exogenous shock to misconduct disclosure requirements.

Given misconduct's significant impact, we examine mutual fund responses. [2] found that fund companies revise advisory contract terms and reduce fees post-2004. We broaden this to contractual incentives, investment policies, and advisory relationships. First, mutual funds increase marketing expenditures post-misconduct, primarily through higher payments to underwriters and increased investor solicitation, to mitigate reputational damage and attract

capital. Second, advisory misconduct significantly reduces contractual incentives, evidenced by decreased concavity in compensation contracts, consistent with funds lowering portfolio risk.

Furthermore, we observe a general trend toward stricter investment restrictions and reduced use of derivative products, supporting mutual funds' inclination to mitigate excessive derivative-related risk. Liquid asset holdings also increase. These portfolio allocation changes align with reduced contractual incentives. Finally, mutual funds tend to terminate advisory contracts with malfeasant firms to restore investor confidence and self-protection. These mitigating actions successfully alleviate misconduct's negative effects. Overall, our results align with a risk-based perspective, where mutual funds reduce operational and portfolio risk. Our findings are robust to various sensitivity checks.

Our study contributes to two literature streams. First, it extends research on misconduct's effects in the mutual fund industry [3,1,4,7] by being the first to manually classify misconduct cases from ADV data and document heterogeneous effects based on allegation content. We also apply an innovative flow decomposition to identify sentiment- and fundamental-driven flow dynamics post-misconduct, contributing to studies on social trust and investor sentiment in fund flows [20,21,22,23,24].

Second, our work contributes to understanding how mutual funds mitigate negative shocks post-misconduct. Building on [2]'s documentation of advisory fee rate changes, we establish a systematic framework to examine mutual fund responses across incentives, investment practices, and advisory relationships, evaluating their effectiveness. Our analyses provide evidence that mutual funds generally reduce contractual incentives or replace malfeasant advisory firms, thereby lowering future misconduct probability and supporting the role of managerial incentives in fund risk [25,26,14,27].

The remainder of this paper is organized as follows: Section 2 reports the sample, variable construction, and descriptive statistics; Section 3 presents empirical results for the effect of advisory misconduct on fund flows; Section 4 provides evidence on the response of mutual funds to the misconduct; and Section 5 finally concludes.

2. Data and Summary Statistics

2.1. Data and Sample

Our study uses data from N-SAR filings, the CRSP Mutual Fund Database, and Form ADV. N-SAR filings are semiannual reports providing fund and advisory firm IDs, monthly gross inflows/outflows, contract terms, fees, objectives, and financial statements. We use N-SAR/B for fund characteristics and both N-SAR/A and N-SAR/B for monthly fund flows (2000-2015). N-SAR's unique strength is direct flow measurement based on dollar value.

We match this with the CRSP Mutual Fund Database for returns and other fund characteristics not in N-SAR. [28] reported 40%–50% fund-month matching; [29] achieved 70% fund-month and 80% dollar matching with an improved algorithm. Our method yields comparable matching rates.

Form ADV is the uniform application for investment advisor registration. SEC-regulated investment advisory firms in the U.S. file this form upon initial registration, material business changes, or regularly. It contains firm ID, business description, AUM, clientele, employees, ownership, and disciplinary actions. We merge Form ADV and N-SAR filings in two steps: first by SEC data on advisory firms, then by legal company names for the remainder. This matched approximately 91% of fund-year observations in the N-SAR universe, covering 95% of aggregate mutual fund net assets as of 2015.[1]

Panel A of Figure **A1** (see appendix) illustrates the typical organizational structure of mutual fund advisory businesses. A mutual fund family usually consists of several mutual fund companies, each offering various products. These companies file N-SAR to disclose fund information and delegate portfolio management to advisory firms, which charge advisory fees. Panel B shows Mellon Capital Management as an example managing Vanguard family mutual funds.

[1]See Investment Company Fact Book at http://www.icifactbook.org/ch1/17_fb_ch1#investment

2.2. Variable Construction

2.2.1. Mutual Fund Advisory Misconduct

Regulatory disclosures provide detailed histories of disciplinary actions against advisory firms, including products, agencies, sanctions, allegations, and resolutions[2]. Mutual fund advisory misconduct is defined as malfeasant behavior by advisory firms in fund manage- ment leading to regulatory disciplinary actions. This includes undisclosed compensation, unlicensed employees, unsuitable investment advice, and unauthorized trades. Our main explanatory variable, Misconduct, is a dummy variable: one for the post-misconduct period, zero otherwise. We also measure misconduct by regulatory agency, sanction, and allegation.

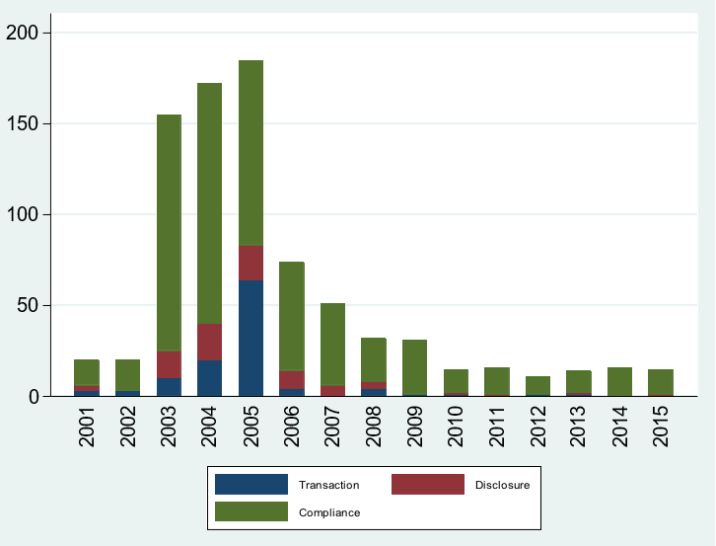

Figure 1: Mutual Fund Advisory Misconduct Cases: The figure reports the number of mutual fund advisory misconduct cases from 2001–2015. Mutual fund advisory misconduct is defined as malicious conduct in mutual fund management that results in disciplinary actions by regulatory agencies. The misconduct cases are classified into transaction-, disclosure-, and compliance-related categories based on the detailed allegations in the Regulatory Disclosure Report of Form ADV.

2.2.2. Fund Flows

Monthly fund flows are constructed from N-SAR Items 28 and 75, which report total dollar amounts of shares sold (inflows) and redeemed (outflows). Following [30] and [31], fund flows are calculated as:

$$NetFlows_{i,t} = \frac{Inflow_{i,t} - Outflow_{i,t}}{TNA_{i,t}} \quad (1)$$

N-SAR Item 75 provides the average fund TNA for the denominator[3].

To understand the driving forces of fund flows after advisory misconduct, we use the EMD-Wilcoxon decomposition method [19]. This method separates fund flows into high-frequency (sentiment-driven) and low-frequency (fundamental-driven) components. Appendix B details the EMD-Wilcoxon method.

Figure **3** shows the time-series average of fund flows and decomposed components. Sentiment-driven flows fluctuate around zero, indicating transitory effects. Fundamental- driven flows strongly correlate with total fund flows, resembling a moving average, suggesting they capture long-term fund value.

[2]We focus solely on mutual fund advisory misconduct, as we have rich mutual fund information. Table **A2** lists partial examples from our sample.

[3]N-SAR Item 75 reports the average fund TNA over the reporting period and is used as the denominator in the calculation.

2.3. Econometric Model

The baseline regression for advisory misconduct's effect on fund flows is:

$$Netflows_{i,t} = \alpha + \beta Misconduct_{i,t} + \gamma X_{i,t} + \theta_i + \delta_t + \epsilon_{i,t}, \quad (2)$$

where $Netflows_{i,t}$ is fund i's net flows in month t. *Misconduct* is a dummy variable (one for the post-misconduct period, zero otherwise) for periods ranging from 3 to 12 months after misconduct. Fund and time fixed effects (θ_i, δ_t) account for unobserved time-invariant fund characteristics or general business cycles. Fund investment styles (e.g., domestic equity, domestic bond) are categorized per [32]. This specification is a generalized difference-in-differences (DID) regression, where β measures the treatment effect. We expect a negative and significant β.

A critical consideration in this framework is the potential for reputational spillover effects within mutual fund families. Prior literature indicates that scandals involving a specific advisor can taint the reputation of the entire fund complex, leading to outflows in ostensibly untreated sister funds within the same family. If funds within the same family as the malfeasant advisor are included in the control group and suffer reputational contagion, the Stable Unit Treatment Value Assumption (SUTVA) could be challenged. However, such spillovers would depress the net flows of the control group, effectively narrowing the gap between the treatment and control groups. Consequently, if spillover effects are present, our estimated coefficient βwill underestimate the magnitude of the investor response. Therefore, our results should be interpreted as a conservative lower bound of the direct economic impact of misconduct. By defining the treatment at the specific advisory firm level, the legal entity responsible for the compliance failure, rather than the family level, we aim to isolate the direct disciplinary response to the specific locus of misconduct, distinguishing it from broader brand erosion [2].

Following literature, we control for common fund characteristics. These include average fund returns over the last 12 months, fund size (natural logarithm of TNA) [13,33,16,34], fund age, expense ratio, and return volatility. Average net flows for each investment style are also included to account for style-specific flow differences.

2.4. Descriptive Statistics

Table **A1** (appendix) shows the breakdown of advisory misconduct events. Panel A reveals 1,086 (5.5%) of 19,790 advisory misconduct cases on Form ADV are linked to mutual funds, consistent with mutual fund advisory firms being 10% of all investment advisory firms.[4] Panel B indicates state authorities (39%), SEC (26%), SROs (23%), and foreign agencies (8%) investigated these cases. Panel C reports civil/administrative penalties (47%).

Figure **1** illustrates the time-series frequency of mutual fund advisory misconduct cases by initiation date. Cases peaked from 2003-2005, coinciding with late-trading scandals. Transaction-related misconduct constituted only 10%-40% of cases then, suggesting prior studies omitted many instances. Misconduct cases have declined to about 20 per year recently, possibly due to increased regulatory oversight by the SEC.

Panel A of Table **1** presents descriptive statistics. Average monthly fund flows are 0.8%. Mutual funds average $1.42 billion in AUM, 6.35 years old, with 1.11% expense ratio and 3.34% return volatility. Institutional funds account for 43% of fund-month observations. Panel B, the Pearson correlation matrix, shows modest correlations, indicating minor multicollinearity.

[4]However, they use a large proportion of finance professionals and manage over 50% of AUM in the asset management industry.

Table 1: Summary Statistics

Panel A. Descriptive Statistics								
	Mean	**S.D.**	**Q5**	**Q25**	**Median**	**Q75**	**Q95**	**N**
Netflow %	0.80	7.57	-6.09	-1.22	-0.04	1.56	10.04	726,775
Sentiflow %	0.03	6.55	-9.32	-1.50	0.00	1.39	8.69	726,775
Fundaflow %	0.78	4.68	-4.71	-1.16	0.00	1.75	9.26	726,775
Fdret %	0.52	1.50	-2.24	0.01	0.49	1.24	2.80	726,775
Size ($bn)	1.42	3.22	0.01	0.08	0.28	1.05	7.56	726,775
Age	6.35	4.44	1.00	3.00	5.00	9.00	16.00	726,775
Expense %	1.11	0.95	0.16	0.59	0.93	1.33	2.60	726,775
Volatility %	3.34	2.66	0.03	1.27	2.90	4.73	8.39	726,775
Styleflow %	-0.92	45.43	-3.67	0.26	1.32	2.54	11.99	726,775
Institutional	0.43	0.50	0.00	0.00	0.00	1.00	1.00	726,775
Panel B. Pearson Correlation Matrix								
	Netflow	**Sentiflow**	**Fundaflow**	**Size**	**Age**	**Expense**	**Volatility**	**Styleflow**
Netflow	1.00							
Sentiflow	0.71***	1.00						
Fundaflow	0.53***	-0.17***	1.00					
Size	-0.10***	-0.01***	-0.13***	1.00				
Age	-0.16***	-0.01***	-0.23***	0.29***	1.00			
Expense	-0.04***	-0.01***	-0.04***	-0.47***	-0.09***	1.00		
Volatility	0.00***	-0.01***	0.02***	-0.14***	-0.07***	0.22***	1.00	
Styleflow	-0.00***	0.00	-0.01***	0.02***	0.02***	0.01***	-0.00***	1.00

This table presents descriptive statistics and Pearson correlation matrix for fund characteristics. The sample consists of the fund-month observations from 2000 to 2015. Netflows is the monthly total NAV of shares sold less total NAV of shares redeemed, scaled by total net assets. Sentiflow and Fundaflow denote sentiment- and fundamental-driven flows decomposed from fund net flows by EMD-Wilcoxon method following Wu et al. [19]. Size is the fund's total net assets. Age is the number of years since the fund's inception in the N-SAR database. Expense is calculated as total expenses over total net assets. Volatility is calculated as standard deviations of fund returns over the last 12 months. Styleflow is the average net flows of funds with the same investment style. Institutional is a dummy variable equals one if the fund is oriented to institutional investors, and zero otherwise.

3. Empirical Results on Fund Flows

3.1. Determinants of Advisory Misconduct

To begin, we examine the determinants of mutual fund advisory misconduct using a predictive logit model. Unlike [11], who studied all advisory misconduct, we focus specifically on mutual fund advisory misconduct. Key drivers fall into two categories: past malfeasance (historical misconduct and regulatory actions) and local fraud culture. [35] notes fraud culture's importance in corporate financial misconduct, and [36] found that neighboring firms' misconduct rates increase a firm's likelihood of financial misconduct. Explanatory variables include *Misconduct* (one if the firm commits at least one mutual fund advisory misconduct case in year *t*, zero otherwise), *Regulatory* (one if the firm receives at least one regulatory action in year *t*, zero otherwise), and *Regionmisintegrity*, which is the total number of historical mutual fund advisory misconduct cases at the zip code level.

Table **2** presents the logit regression results. Consistent with [11], Column (1) finds *Misconduct* is positive and significant at 1%, indicating strong predictive power of past misconduct for future misconduct. Column (2) adds

Table 2: Determinants of Mutual Fund Advisory Misconduct

	(1)	(2)	(3)
Misconduct	1.1192***	0.4506	0.0159
	(2.868)	(1.231)	(0.040)
Regulatory		2.4008***	2.3258***
		(8.800)	(8.501)
Regionmisinty			0.1297***
			(4.434)
Return	0.0372	-0.0669	-0.0993
	(0.081)	(-0.141)	(-0.208)
Flows	-1.4035	-1.0758	-0.7955
	(-0.685)	(-0.576)	(-0.419)
Conflict	0.8139***	0.4979**	0.5628**
	(3.472)	(2.140)	(2.345)
Refer	-0.2266	-0.3827	-0.2692
	(-0.749)	(-1.275)	(-0.864)
Softdollar	0.6273	0.4072	0.3173
	(0.861)	(0.578)	(0.500)
Custody	0.0104	0.0306	0.0114
	(0.045)	(0.135)	(0.050)
FirmAUM	0.2673***	0.1408***	0.1162**
	(4.954)	(2.793)	(2.308)
Firmacct	0.0989*	0.1198**	0.1084**
	(1.669)	(2.155)	(1.968)
Firmage	-0.7047*	-0.7323*	-0.8866**
	(-1.705)	(-1.894)	(-2.286)
Pctinst	0.0104**	0.0103**	0.0098**
	(2.475)	(2.434)	(2.329)
Year FE	Y	Y	Y
Observations	7,207	7,207	7,207
Number of Firms	1,094	1,094	1,094
Pesudo R2	0.15	0.24	0.25

This table presents the logit regression for the determinants of mutual fund advisory misconduct. The sample consists of firm-year observations from 2000 to 2015. The dependent variable is an indicator variable that equals one if an advisory firm commits at least one mutual fund advisory misconduct case in year t + 1 and zero otherwise. The main explanatory variable Misconduct is a dummy variable that equals one if the advisory firm commits at least one mutual fund advisory misconduct in year t and zero otherwise. Regulatory is a dummy variable that equals one if the advisory firm receives at least one regulatory action in year t and zero otherwise. Regionmisinty is the regional misconduct intensity calculated as the total number of historical mutual fund advisory misconduct cases as of year t at the zip code level. Return is the advisory firms' weighted average fund returns in year t. Flows are the advisory firms' weighted average fund flows in year t. Conflict is a dummy variable equals one if the advisory firm has a proprietary interest in client transactions or has employees who are registered representatives of a broker-dealer and zero otherwise. Refer is a dummy variable that equals one if the advisory firm recommends brokers or dealers to clients and zero otherwise. Softdollar is a dummy variable that equals one if the advisory firm receives research or other products or services other than execution from a broker-dealer or a third party and zero otherwise. Custody is a dummy variable that equals one if the advisory firm has custody of any advisory clients and zero otherwise. FirmAUM is the natural logarithm of AUM. Firmacct is the natural logarithm of total number of client accounts. Firmage is the natural logarithm of firm age. Pctinst is the percentage of assets from institutional clients. All regressions include year fixed effects and report original coefficient estimates. The robust t-statistics clustered by the firm are reported in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Regulatory, which is positive and significant at 1% (*t*-statistic=8.80), suggesting regulatory actions predict future misconduct. This persistence likely stems from malfeasant firms employing investment representatives with misconduct records [18]. However, past mis- conduct becomes insignificant when *Regulatory* is included. Column (3) adds *Regionmisinty*, which is positive and significant at 1%, confirming regional fraud culture's role in advisory misconduct.

Other firm characteristics show no predictive power from past flows and returns. Misconduct probability increases with conflicts of interest, firm size, number of firm accounts, and institutional client assets. Conversely, it decreases with firm age, suggesting misconduct is concentrated in large, young firms with many clients. The positive and significant coefficient of *Conflict* indicates that large conflicts of interest with investors raise misconduct probability, supporting the role of good corporate governance in restraining advisory misconduct.

3.2. Advisory Misconduct and Fund Flows

We estimate advisory misconduct's effect on U.S. mutual fund flows from 2000 to 2015. Table **3** shows a significant reduction in fund flows post-misconduct. Column (1) reveals a negative and significant coefficient of -0.0046 (*t*-stat = -6.95) for *Misconduct* over three months, implying a 0.46 percentage-point reduction in monthly

Table 3: Effect of Mutual Fund Advisory Misconduct on Fund Flows

	(1)	(2)	(3)	(4)
	[t+1,t+3]	[t+1,t+6]	[t+1,t+9]	[t+1,t+12]
Misconduct	-0.0046*** (-6.95)	-0.0042*** (-7.43)	-0.0032*** (-6.46)	-0.0025*** (-5.24)
Fdret	0.4820*** (27.12)	0.4821*** (27.13)	0.4821*** (27.13)	0.4820*** (27.13)
Size	-0.0088*** (-20.27)	-0.0088*** (-20.28)	-0.0088*** (-20.28)	-0.0088*** (-20.29)
Age	-0.0163*** (-24.68)	-0.0163*** (-24.67)	-0.0163*** (-24.66)	-0.0163*** (-24.65)
Expense	-1.7808*** (-26.38)	-1.7807*** (-26.38)	-1.7807*** (-26.38)	-1.7810*** (-26.38)
Volatility	0.0529*** (3.33)	0.0533*** (3.36)	0.0534*** (3.36)	0.0534*** (3.36)
Styleflow	0.0002 (0.53)	0.0002 (0.52)	0.0002 (0.53)	0.0002 (0.53)
Fund FE	Y	Y	Y	Y
Time FE	Y	Y	Y	Y
Observations	726,367	726,367	726,367	726,367
Number of Funds	17,089	17,089	17,089	17,089
Adjusted R2	0.14	0.14	0.14	0.14

This table presents the panel regression for the effect of mutual fund advisory misconduct on monthly fund flows. The sample consists of fund-month observations from 2000 to 2015. The dependent variable is net flows of fund i in month t, calculated as the inflows less outflows scaled by TNA. The main explanatory variable Misconduct equals one in the post-misconduct period of a mutual fund advisory misconduct case and zero otherwise. The post-misconduct period is 3, 6, 9, or 12 months following misconduct. Fdret is average fund return over the last 12 months. Size is the natural logarithm of fund TNA. Age is the natural logarithm of years since the fund's inception in the N-SAR database. Expense is the fund expense ratio calculated as total fund expenses over TNA. Volatility is calculated as standard deviations of fund returns over the last 12 months. Styleflow is the average net flows of funds with the same investment style in month t. All regressions include fund and time fixed effects. The robust t-statistics clustered by the fund are reported in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

fund flows. Over 12 months, the coefficient remains negative and significant at the 1% level. The control variables generally align with expectations. Increased fund flows with returns suggest investors chase past performance [33]. Fund flows decrease with size, age, and expense ratio, indicating younger, smaller funds with lower expense ratios attract more flows.

Figure **2** presents parallel trend test results. No significant flow difference is observed between misconduct and non-misconduct funds pre-misconduct, confirming the parallel trend assumption for DID regression. Post-misconduct, the effect is negative and significant at 5% from *t*+1 to *t*+6, then returns to normal, suggesting a temporary effect on flows.

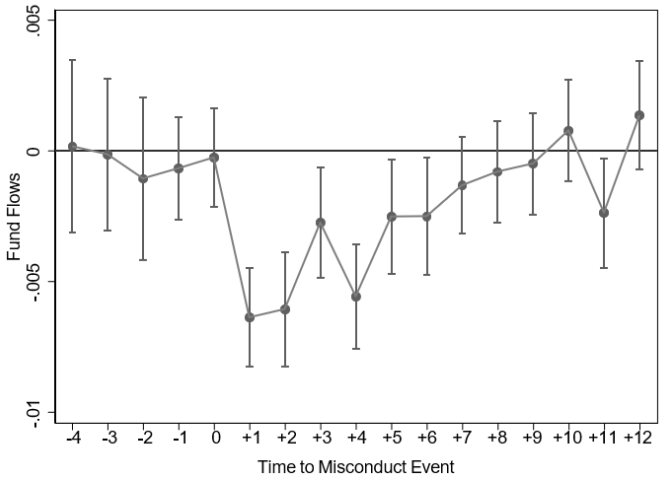

Figure 2: Effect of Advisory Misconduct on Fund Flows: The figure plots the coefficient estimate and 95% confidence interval for the effect of misconduct from month *t*-4 to *t*+12 around mutual fund advisory misconduct. Month t denotes the disclosure time of the misconduct. The sample consists of fund-month observations from 2000-2015.

3.3. Investor Monitoring

To examine investor response heterogenity, we classify samples by median investor vigilance, measured by flow-performance sensitivity following [37]:

$$Netflows_{i,t} = \alpha_i + \beta_i Styleflow_{j,t} + \gamma_i CumAlpha_{i,t-1} + \varepsilon_{i,t}, \quad (3)$$

where *Styleflow* is the average flows of funds with style *j*, *CumAlpha* is fund *i*'s cumulative fund alpha from *t*-3 to *t*-1, and γ_i is fund *i*'s investor vigilance. We estimate Eq. (3) using a 24-month rolling window for each fund, expecting a larger misconduct effect on fund flows in funds with high vigilant investor density.

Studies highlight mutual fund investors' monitoring effect [38,37,17]. M. Qian [37] found highly vigilant investors avoid opportunistic trading due to low arbitrage potential and few abnormal flows. Investors' ability to withdraw or add assets disciplines mutual fund managers. As institutional investors are vigilant, we anticipate stronger flow responses to misconduct in institution-oriented funds than retail-oriented funds. Table **4** presents subsample analysis by investor vigilance. Columns (1)–(3) show that for low-vigilance funds, misconduct's effect on fund flows is small and insignificant, indicating these investors do not respond to public misconduct disclosures.

Columns (4)–(6) show that for funds with high vigilant investor density, advisory misconduct significantly negatively affects fund flows. Misconduct coefficients are negative and highly significant at the 1% level in the post-misconduct period, diminishing from 3 to 12 months. The effect amounts to 80% of monthly fund flows over 12 months, more than double the baseline average effect. Equality tests for Misconduct coefficients across samples yield nearly zero p-values, confirming significant differences. These findings demonstrate that investor monitoring serves as a critical informal enforcement mechanism within the mutual fund industry. Unlike regulatory fines, which may be viewed as a cost of doing business, the severe capital withdrawals triggered by vigilant investors impose a

substantial market-based penalty on malfeasant firms. This phenomenon illustrates that market discipline acts as a potent deterrent; the threat of massive asset redemption compels advisory firms to internalize the costs of misconduct, incentivizing stricter adherence to compliance protocols and fiduciary duties to retain the trust of sophisticated capital.

Consequently, Table **4** shows that the high density of vigilant investors functions not only as a mechanism for capital allocation but also as a decentralized governance structure that punishes operational failures and reinforces financial integrity.

Table 4: Effect of Misconduct on Fund Flows by Monitoring Type

	Low Investor Monitoring			High Investor Monitoring		
	(1)	(2)	(3)	(4)	(5)	(6)
	[t+1,t+3]	[t+1,t+6]	[t+1,t+12]	[t+1,t+3]	[t+1,t+6]	[t+1,t+12]
Misconduct	-0.0005 (-0.51)	0.0002 (0.32)	-0.0006 (-0.99)	-0.0099*** (-9.60)	-0.0103*** (-11.58)	-0.0064*** (-9.14)
Fdret	0.1586*** (6.33)	0.1587*** (6.33)	0.1586*** (6.33)	0.8302*** (25.55)	0.8301*** (25.55)	0.8292*** (25.52)
Size	-0.0048*** (-7.03)	-0.0048*** (-7.03)	-0.0048*** (-7.03)	-0.0073*** (-10.56)	-0.0074*** (-10.59)	-0.0074*** (-10.60)
Age	-0.0130*** (-10.09)	-0.0130*** (-10.08)	-0.0130*** (-10.09)	-0.0174*** (-12.14)	-0.0175*** (-12.17)	-0.0175*** (-12.21)
Expense	-1.4955*** (-13.71)	-1.4956*** (-13.71)	-1.4955*** (-13.72)	-2.1466*** (-19.42)	-2.1460*** (-19.42)	-2.1464*** (-19.42)
Volatility	0.0808*** (3.58)	0.0807*** (3.58)	0.0811*** (3.59)	-0.0379 (-1.33)	-0.0370 (-1.30)	-0.0349 (-1.23)
Styleflow	0.0002 (0.37)	0.0002 (0.37)	0.0002 (0.37)	0.0008 (1.32)	0.0008 (1.30)	0.0008 (1.31)
Fund FE	Y	Y	Y	Y	Y	Y
Time FE	Y	Y	Y	Y	Y	Y
Observations	275,838	275,838	275,838	276,663	276,663	276,663
Number of Funds	10,726	10,726	10,726	10,708	10,708	10,708
Adjusted R2	0.15	0.15	0.15	0.14	0.14	0.14
Coefficient Equality						
(1) vs. (4)	0.00					
(2) vs. (5)	0.00					
(3) vs. (6)	0.00					

This table presents the effect of mutual fund advisory misconduct on monthly fund flows depending on the investor monitoring nature. The sample consists of fund-month observations from 2000 to 2015. The sample is divided into two parts based on the median level of investor vigilance, which is measured by flow sensitivity as the time series regression coefficients between flows and past performance:

$$Netflows_{i,t} = \alpha_i + \beta_i Styleflow_{j,t} + \gamma_i CumAlpha_{i,t-1} + \varepsilon_{i,t}$$

where Styleflow is average fund flows of the funds with the same investment style *j, CumAlpha* is the cumulative fund alpha of fund i from month t-3 to t-1. yi denotes investor vigilance of fund i. The dependent variable is fund net flows in month t, calculated as the inflows less outflows scaled by TNA. The main explanatory variable Misconduct equals one in the post- misconduct period of a mutual fund advisory misconduct case and zero otherwise. The post-misconduct period is 3, 6, or 12 months following mutual fund advisory misconduct. Fdret is average fund return over the last 12 months. Size is the natural logarithm of fund TNA. Age is the natural logarithm of years since the fund's inception in the N-SAR database. Expense is the fund expense ratio calculated as total fund expenses over TNA. Volatility is calculated as standard deviations of fund returns over the last 12 months. Styleflows is the average net flows of funds with the same investment style in month t. All regressions include fund and time fixed effects. The robust t-statistics clustered by the fund are reported in parentheses. Coefficient Equality reports the p-value of the equality test for the coefficient Misconduct between two columns with the same post-misconduct period. The p-value is calculated by seemingly unrelated estimation for two regressions and reported in the last three rows. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

3.4. Misconduct Allegations and Flow Decomposition

The *Misconduct* variable in the primary specification aggregates all mutual fund advisory misconduct, potentially obscuring the specific nature of different violations. To assess heterogeneous effects on fund flows, we manually classify cases from Form ADV's Regulatory Action Reporting section into transaction-, disclosure-, and compliance-related misconduct[5]. As detailed in Appendix A, this classification process uses keyword-based text analysis, validated by independent manual coding. Transaction-related misconduct primarily encompasses late-trading and market-timing activities, which peaked between 2003 and 2005. Unlike other forms of malfeasance, these actions might not uniformly harm investor welfare and can occasionally benefit a subset of investors at the expense of others. Conversely, disclosure- and compliance-related misconduct reflect deeper malfeasance regarding information transparency and operational integrity, which likely exerts a persistent negative effect on flows due to their association with weak corporate governance and conflicts of interest.

Following [39,40,19], we decompose flow series into high- and low-frequency components. The high-frequency component, with its mean-reverting property, represents sentiment-driven flows. The low-frequency component, reflecting long-term trends, represents fundamental-driven flows. We hypothesize that all three misconduct types affect sentiment-driven flows, as disclosure erodes trust. Transaction-related misconduct may have a transitory effect on sentiment-driven flows as investor sentiment can reverse. Disclosure- and compliance-related misconduct, reflecting governance weaknesses or conflicts of interest, should affect fundamental-driven flows, undermining fund value.

Table **5** shows mutual fund advisory misconduct's effect on fund flows by allegation type. Three dummy variables—*Transaction*, *Disclosure*, and *Compliance*—are used for the post-misconduct period. Column (1) reports 3-month post-misconduct effects. All three types significantly negatively affect fund flows. *Transaction* is negative and significant (coef = -0.0055, *t*-stat = -2.61). Disclosure-related misconduct has a comparable negative effect. Compliance-related misconduct has a smaller negative effect. Thus, all types adversely affect short-run fund flows.

Columns (2) and (3) show results for decomposed flows over 3 months. Column (2) indicates all three misconduct types negatively and significantly affect sentiment-driven flows. *Transaction*'s coefficient is larger than others, possibly due to extensive news coverage of market-timing scandals (2003-2005) driving sentiment. Column (3) shows only disclosure- related misconduct significantly negatively affects fundamental-driven flows (coef = -0.0022; *t*-stat = -3.17), implying it degrades fundamental value-driven flows.

Columns (4)–(6) report 12-month post-misconduct effects. Transaction-related miscon- duct's effect on fund flows becomes insignificant with a smaller magnitude. Compliance- related misconduct is negative but insignificant. Disclosure-related misconduct, however, has a significant long-term negative effect, reducing monthly flows by 42%. This suggests transaction-related misconduct (late-trading/market-timing) has a transitory effect, while disclosure- and compliance-related misconduct have persistent effects. Columns (5) and (6) reiterate that transaction-related misconduct doesn't affect fund flows long-term, while disclosure-related misconduct negatively impacts fundamental-driven flows, and compliance- related misconduct reduces sentiment-driven flows.

Overall, our evidence confirms transaction-related misconduct has a transitory effect. Disclosure- and compliance-related misconduct, however, persist. Misconduct cases indicating weak corporate governance or conflicts of interest (e.g., disclosure-related) negatively affect both decomposed flow components. In contrast, well-studied transaction-related cases have a transitory effect on sentiment-driven flows.

3.5. Natural Experiment

We provide additional causal evidence using the SEC's electronic filing mandate, effective January 2001, as a quasi-natural experiment. Before this mandate, obtaining advisory misconduct records required cumbersome

[5]Appendix A details this classification. For accuracy, cases with multiple categories are assigned to the predominant allegation type.

requests for paper filings, creating significant information asymmetry and prohibiting high search costs for the average investor. The 2001 implementation of the Investment Adviser Registration Depository (IARD) and the subsequent public availability of data through the Investment Adviser Public Disclosure (IAPD) website marked a fundamental shift toward regulation by disclosure. By transitioning to a mandatory electronic filing system, the SEC effectively utilized transparency as a primary regulatory tool to curb malfeasance. This policy was designed to protect investors by drastically reducing the cost of acquiring information regarding an advisor's disciplinary history, facilitating more informed capital allocation decisions. Theoretical literature supports the view that such enhanced disclosure acts as a sunshine mechanism; when misconduct records become frictionless to access, the reputational costs of malfeasance increase exponentially. Consequently, the mandate empowered investors to exert market discipline more effectively, serving as a deterrent against future violations. We posit that the significant reduction in fund flows observed post-2001 for firms with historical misconduct is a direct result of this enhanced information environment. Investors, newly equipped with low-cost access to advisor track records, were able to identify and penalize past transgressions that were previously obscured by the friction of paper-based reporting mechanisms.

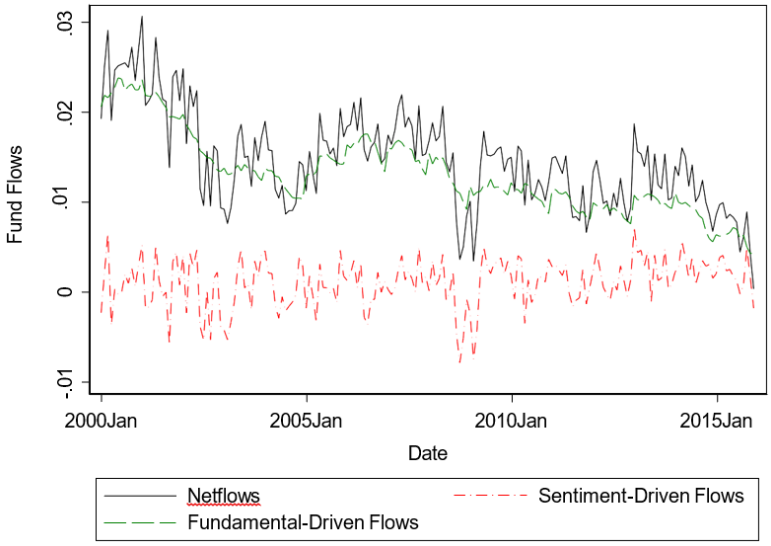

Figure 3: Decomposed Components of Fund Flows: The figure shows the time-series average of the decomposed components of fund flows from 2000–2015. Fund flows are calculated as inflows minus outflows, scaled by TNA. The fund flows are decomposed into two components following the methodology proposed in Wu et al. [19]. The sentiment-driven flows reflect the high-frequency component, whereas the fundamental-driven flows reflect the low-frequency component.

In our DID specification, January 2001 is the event date with a 12-month pre- and post- event window. The treatment group consists of mutual funds managed by advisory firms with at least one advisory misconduct case reported on Form ADV by January 2001. The control group comprises funds managed by advisory firms without such cases.[6] A propensity score matching technique creates a matched sample, minimizing fund heterogeneity. Panel A of Table **6** shows no statistically significant differences in major observable attributes between groups post-matching, indicating similarity.

Panel B shows the treatment effect of the SEC mandate on fund flows. Misconduct, a dummy for the 12 months post-mandate for funds managed by malfeasant firms, is the primary explanatory variable. Column (1) for the unmatched sample shows a negative and significant coefficient for Misconduct (coef = -0.0039; t-stat = -1.68, 10% level), suggesting historical misconduct disclosure negatively affects fund flows. Column (2) for the matched sample shows a stronger negative and significant effect (coef = -0.0114, 5% level) from the mandate. This economic magnitude is greater than in the unmatched sample and primary specification.

[6]The emphasis here is that the misconduct events can take place before 2001. We examine the existence of historical misconduct cases reported on Form ADV as of January 2001, when the electronic filing mandate took effect.

Table 5: Misconduct Allegations and Fund Flows

	[t+1,t+3]			[t+1,t+12]		
	(1)	(2)	(3)	(4)	(5)	(6)
	Netflow	Sentiflow	Fundaflow	Netflow	Sentiflow	Fundaflow
Transaction	-0.0055***	-0.0060**	-0.0003	-0.0017	-0.0004	-0.0015
	(-2.61)	(-2.55)	(-0.17)	(-1.24)	(-0.25)	(-0.90)
Disclosure	-0.0061***	-0.0045***	-0.0022***	-0.0042***	-0.0014*	-0.0026***
	(-5.42)	(-3.88)	(-3.17)	(-5.31)	(-1.69)	(-3.43)
Compliance	-0.0019**	-0.0045***	0.0001	-0.0006	-0.0032***	0.0010*
	(-2.34)	(-5.62)	(0.27)	(-1.14)	(-5.43)	(1.68)
Fdret	0.4821***	0.2944***	0.1656***	0.4821***	0.2945***	0.1656***
	(27.13)	(19.45)	(11.13)	(27.13)	(19.45)	(11.13)
Size	-0.0088***	-0.0004	-0.0080***	-0.0088***	-0.0005	-0.0080***
	(-20.27)	(-0.95)	(-13.52)	(-20.30)	(-0.99)	(-13.53)
Age	-0.0163***	0.0066***	-0.0219***	-0.0163***	0.0067***	-0.0219***
	(-24.64)	(9.58)	(-24.76)	(-24.57)	(9.64)	(-24.74)
Expense	-1.7810***	-0.4485***	-1.2382***	-1.7815***	-0.4494***	-1.2382***
	(-26.38)	(-8.74)	(-19.16)	(-26.38)	(-8.76)	(-19.16)
Volatility	0.0529***	0.0311**	0.0141	0.0531***	0.0317**	0.0139
	(3.33)	(2.03)	(0.79)	(3.34)	(2.07)	(0.78)
Styleflow	0.0002	0.0002	0.0001	0.0002	0.0002	0.0001
	(0.51)	(0.78)	(0.45)	(0.52)	(0.79)	(0.46)
Fund FE	Y	Y	Y	Y	Y	Y
Time FE	Y	Y	Y	Y	Y	Y
Observations	726,367	726,367	726,367	726,367	726,367	726,367
Number of Funds	17,089	17,089	17,089	17,089	17,089	17,089
Adjusted R^2	0.14	0.08	0.48	0.14	0.08	0.48

This table presents the effect of mutual fund advisory misconduct on monthly fund flows concerning misconduct allegations. The sample consists of fund-month observations from 2000 to 2015. The dependent variable Netflow is fund net flows in month t, calculated as the inflows less outflows scaled by TNA. The dependent variables Sentiflow and Fundaflow are the sentiment-driven flows that reflect the high-frequency component of fund flows and the fundamental-driven flows that reflect the low-frequency component of fund flows. The fund flows are decomposed following the methodology proposed in Wu et al. [19]. The main explanatory variables Transaction equals one in the post-misconduct period of transaction-related advisory misconduct and zero otherwise. Disclosure equals one in the post-misconduct period of disclosure-related advisory misconduct and zero otherwise. Compliance equals one in the post-misconduct period of compliance-related advisory misconduct and zero otherwise. The post-misconduct period is 3, 6, 9, or 12 months following the mutual fund advisory misconduct. Fdret is the average fund returns over the last 12 months. Size is the natural logarithm of fund TNA. Age is the natural logarithm of years since the fund's inception in the N-SAR database. Expense is the fund expense ratio calculated as total fund expenses over TNA. Volatility is calculated as standard deviations of fund returns over the last 12 months. Styleflow is the average net flows of funds with the same investment style in month t. All regressions include fund and time fixed effects. The robust t-statistics clustered by the fund are reported in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Placebo tests in Columns (3)–(5) assign January 2004, 2006, and 2011 as artificial event dates. Insignificant treatment effects across these scenarios suggest the observed effect is primarily due to the 2001 SEC mandate, not other shocks. In conclusion, these findings demonstrate misconduct's effect on fund flows and that increased information transparency acts as a disciplinary force in the mutual fund industry.

4. How Do Mutual Funds Respond to Misconduct?

The economic consequences of mutual fund advisory misconduct extend beyond fund flows, necessitating a comprehensive analysis of how funds adjust their operations to survive such shocks. While Warner and Wu [2]

Table 6: Effect of Exogenous Shock to Misconduct Disclosure on Fund Flows

Panel A: Test of Covariate Balance					
	Sample	**Control**	**Treatment**	**Diff**	**T-stats**
Fdret	Full	0.01	0.01	0.00	3.85
	Matched	0.01	0.01	0.00	0.79
Size	Full	11.50	12.56	-1.06	-16.20
	Matched	13.03	13.12	-0.09	-0.44
Age	Full	1.04	1.16	-0.12	-5.06
	Matched	1.37	1.50	-0.13	-2.04
Expense	Full	0.01	0.01	0.00	5.05
	Matched	0.01	0.01	0.00	3.68
Volatility	Full	0.04	0.04	-0.00	-0.26
	Matched	0.06	0.04	0.02	4.88
Panel B: Treatment Effect					
	Unmatched Sample	**Matched Sample**	**Placebo Tests**		
	(1)	**(2)**	**(3)**	**(4)**	**(5)**
	Netflow	**Netflow**	**2004**	**2006**	**2011**
Misconduct	-0.0039* (-1.68)	-0.0114** (-2.01)	-0.0030 (-0.92)	0.0007 (0.23)	0.0010 (0.22)
Fdret	0.5873*** (11.96)	0.4373*** (4.09)	0.5982*** (7.60)	1.6326*** (10.66)	0.3947*** (5.49)
Size	-0.0002 (-0.04)	0.0105 (0.77)	-0.0195** (-2.55)	-0.0044 (-0.81)	-0.0144** (-2.42)
Age	-0.0077 (-0.92)	-0.0251 (-1.51)	-0.0127 (-1.50)	-0.0128* (-1.68)	-0.0123** (-2.20)
Expense	-0.9599*** (-3.81)	-1.9263** (-2.26)	-2.2066*** (-4.15)	-0.9300 (-1.19)	-2.7089*** (-5.91)
Volatility	0.0086 (0.13)	-0.0423 (-0.25)	0.0823 (0.95)	-0.3954** (-2.10)	-0.1548** (-2.10)
Styleflow	0.0004 (0.69)	-0.0012 (-0.68)	-0.0006 (-0.33)	-0.0003 (-0.25)	0.0124** (2.36)
Fund FE	Y	Y	Y	Y	Y
Time FE	Y	Y	Y	Y	Y
Observations	44,293	6,998	15,470	22,182	31,879
Number of Funds	3,822	425	791	1,101	1,581
Adjusted R2	0.29	0.21	0.21	0.27	0.17

This table presents the treatment effect of the SEC electronic filing mandate on fund flows. Panel A reports test of covariate balance before and after matching. Panel B reports the regression results of the treatment effect of misconduct disclosure on fund flows. The matched sample is constructed based on fund size, age, return, expense ratio, return volatility, style, and time. Panel B reports the results of difference-in-difference regressions. The dependent variable is fund net flows in month t, calculated as the inflows less outflows scaled by TNA. Column (1) and (2) cover fund sample from January 2000 to January 2002. Columns (3)–(5) report placebo tests in which the event date is set to be January of 2004, 2006, and 2011, respectively. The main explanatory variable Misconduct is a dummy variable that equals one for funds managed by malfeasant advisory firms in the 12 months following the SEC electronic filing mandate and zero otherwise. The malfeasant advisory firms have at least one mutual fund advisory misconduct case reported in Form ADV as of January 2001 when the SEC electronic filing mandate took effect. Fdret is average fund return over the last 12 months. Size is the natural logarithm of fund TNA. Age is the natural logarithm of years since the fund's inception in the N-SAR database. Expense is the fund expense ratio calculated as total fund expenses over TNA. Volatility is calculated as standard deviations of fund returns over the last 12 months. Styleflow is the average net flows of funds with the same investment style in month t. All regressions include fund and time fixed effects. All regressions include fund and time fixed effects. The robust t-statistics clustered by the fund are reported in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

explored post-misconduct changes in fund families' fee rates, evidence on other advisory contracting changes is limited. We broaden this scope by distinguishing between two categories of organizational response: reputation-management strategies and compliance-driven corrective actions. This distinction is crucial for understanding the regulatory implications of fund behavior. Reputation-management strategies, such as increasing marketing expenditures (Section 4.1), are primarily designed to repair damaged public trust and mitigate capital outflows through signaling. In contrast, compliance-driven corrective actions—including reducing contractual incentives (Section 4.2), restricting derivative use (Section 4.3), increasing liquidity (Section 4.4), and terminating advisory relationships (Section 4.5)—represent substantive governance restructuring. These latter measures directly address the agency problems that facilitate misconduct, aligning with regulatory objectives to reduce operational risk and enhance fiduciary oversight. By examining these distinct pathways, we provide consistent evidence that funds employ a dual approach: aggressively marketing to retain assets while simultaneously implementing rigorous governance reforms to prevent future malfeasance.

4.1. Market Expenditures

The negative effect of advisory misconduct primarily affects fund flows, leading to a significant reduction in flows to the funds. One of the most important measures taken by mutual funds is to increase marketing expenditures, i.e., 12b-1 fees. Increased marketing expenditures would restore investor trust, repair the company's compromised

Table 7: Misconduct and Advisory Firm Replacement

	(1)	(2)	(3)
	t	t+1	t+2
Misconduct	0.0222***	0.0112***	0.0120***
	(6.24)	(3.40)	(2.79)
Fdret	0.0089**	0.0069	0.0063
	(2.08)	(1.52)	(1.15)
Size	0.0000	0.0019***	0.0019***
	(0.09)	(4.51)	(3.94)
Age	0.0074***	-0.0042***	-0.0036***
	(10.41)	(-4.55)	(-3.33)
Expense	0.3501***	0.3498***	0.2673**
	(5.03)	(3.98)	(2.39)
Volatility	-0.0064	-0.0022	-0.0296**
	(-0.75)	(-0.22)	(-2.40)
Styleflow	0.0055***	0.0006	-0.0017
	(11.50)	(1.16)	(-1.50)
Fund Style FE	Y	Y	Y
Year FE	Y	Y	Y
Observations	83,383	65,079	50,027
Number of Funds	19,517	15,544	12,163
Adjusted R2	0.01	0.01	0.01

This table presents the effect of advisory misconduct on advisory firm replacement. The sample consists of fund-year observations from 2000 to 2015. The dependent variable is a dummy variable that equals one if the fund replaces its current advisory firm in year t+0, t+1, and t+2 and zero otherwise. The main explanatory variable Misconduct equals one in the post-misconduct period of a mutual fund advisory misconduct case and zero otherwise. The post-misconduct period is 2 years following misconduct. Fdret is annual fund return in year t. Size is the natural logarithm of fund TNA. Age is the natural logarithm of years since the fund's inception in the N-SAR database. Expense is the fund expense ratio calculated as total fund expenses over TNA. Volatility is calculated as standard deviations of fund returns in year t. Styleflow is the average net flows of funds with the same investment style in year t. All regressions include fund and time fixed effects. The robust t-statistics clustered by the fund are reported in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

profile, and attract new inflows of capital. Therefore, we expect to find increased 12b-1 fees following misconduct. Moreover, the specific marketing activity matters because it reflects the fund's marketing strategy. The analysis of marketing expenditures is detailed in Table **A4** in the Appendix. Overall, mutual funds increase expenditures either to maintain existing underwriting channels or to expand their clientele through extensive solicitation of new investors.

4.2. Contractual Incentives

Mutual fund companies negotiate advisory contracts with terms impacting advisors' investment decisions. Incentive schemes are key to fund performance and risk. [13] and [14] found high-incentive contracts yield persistent high risk-adjusted returns but also induce excessive risk-taking, potentially jeopardizing fund survival. If misconduct causes significant outflows, mutual funds might react oppositely to contractual incentives. One view: higher incentives, leading to better risk-adjusted performance [14], could boost flows despite risk. Another view: post-misconduct, funds might reduce incentives to deter advisors from inflating returns via excessive risk. These hypotheses offer conflicting predictions; the net effect on contractual incentives is empirical. [2] documented compensation reductions in fund families during 2003-2005 market-timing scandals. Our study sheds light on advisory misconduct's effect on contractual incentives, as shown in Table **A5** in the Appendix. Overall, mutual funds significantly reduce contractual incentives following misconduct, indicating they tend to reduce portfolio risk by lowering incentives for advisory firms.

4.3. Investment in Derivative Products

We examine how investment policies on derivative products change following advisory misconduct, considering two hypotheses. The disciplinary hypothesis suggests mutual funds impose strict investment restrictions to prevent excessive speculation, minimizing monitoring costs where direct oversight is difficult [41]. Conversely, the hedging hypothesis proposes greater flexibility in derivative use post-misconduct, as derivatives can hedge against unfavorable price impacts from potential asset fire sales. [42] found hedge funds using derivatives exhibit lower average and downside risk. Thus, under this hypothesis, mutual funds might relax restrictions. However, literature shows mixed findings on derivative use and fund performance; [43] found complex vehicles don't necessarily lead to higher performance, while [44] showed bond funds using options had higher risk-adjusted returns. Table **A6** in the Appendix reports how advisory misconduct affects the investment policies on the derivative products of mutual funds. Overall, the findings indicate a general trend toward strict investment restrictions and reduced use of derivative products.

4.4. Portfolio Allocations

The change in contractual incentives for advisory firms aims to reduce excessive portfolio risk. From a risk-based perspective, advisory firms are expected to adjust allocations by increasing cash and liquid assets while decreasing risky or illiquid assets. These allocation changes align with the reduced contractual incentives post-misconduct. Table **A7** in the Appendix reports the changes in portfolio allocations following misconduct. The findings demonstrate mutual funds' tendency to increase portfolio liquidity and reduce portfolio risk by holding more cash and short-term debt securities while holding less illiquid and riskier assets. The change in portfolio allocations is consistent with the reduced contractual incentives for advisory firms following misconduct.

4.5. Advisory Firm Replacement

Mutual funds' responses to mitigate the adverse effects of advisory misconduct are not limited to changes in specific contract terms. Examining the business relationship between advisory firms and mutual funds is a natural extension, as advisory misconduct significantly reduces fund flows. If the costs of associating with malfeasant firms outweigh benefits, mutual funds will replace them to restore trust and flows. We conjecture that mutual funds terminate contracts with malfeasant advisory firms to restore investor confidence and shield themselves from the adverse effects of misconduct.

Table 8: Effectiveness of Mutual Funds' Mitigating Actions

	(1)	(2)	(3)	(4)
Misconduct	-0.0409*** (-4.80)	-0.0425*** (-5.69)	-0.0285*** (-3.77)	-0.0300*** (-4.19)
Misconduct*FeeIncrease	0.0326*** (3.34)			
Misconduct*IncentCut		0.0667*** (6.70)		
Misconduct*DerivBan			0.0331** (2.06)	
Misconduct*Replacement				0.0422*** (3.81)
FeeIncrease	0.0295*** (5.76)			
IncentCut		-0.0136** (-2.55)		
DerivBan			-0.0271** (-2.50)	
Replacement				-0.0533*** (-8.21)
Fdret	0.1571*** (7.39)	0.1581*** (7.43)	0.1591*** (7.48)	0.1565*** (7.35)
Size	-0.1439*** (-26.05)	-0.1454*** (-26.30)	-0.1454*** (-26.32)	-0.1470*** (-26.56)
Age	-0.3109*** (-36.77)	-0.3033*** (-35.90)	-0.3066*** (-36.74)	-0.2956*** (-34.54)
Expense	-21.8270*** (-28.64)	-21.9156*** (-28.63)	-21.9213*** (-28.72)	-22.0831*** (-28.78)
Volatility	-0.0281 (-0.47)	-0.0327 (-0.55)	-0.0361 (-0.61)	-0.0334 (-0.57)
Styleflow	0.0069*** (3.14)	0.0068*** (3.09)	0.0064*** (2.91)	0.0069*** (3.11)
Fund FE	Y	Y	Y	Y
Year FE	Y	Y	Y	Y
Observations	78,904	78,904	78,904	78,904
Number of Funds	15,051	15,051	15,051	15,051
Adjusted R2	0.36	0.36	0.36	0.36

This table presents the how the mutual funds' mitigating actions alleviate the negative effect of advisory misconduct on fund flows. The sample consists of fund-year observations from 2000 to 2015. The dependent variable is the fund net flows in year

t. The main explanatory variable Misconduct equals one in the post-misconduct period of a mutual fund advisory misconduct case and zero otherwise. The post-misconduct period is 2 years following misconduct. FeeIncrease is a dummy variable that equals one if the fund increase 12b-1 fees in year t+1 and zero otherwise. IncentCut is a dummy variable that equals one if the fund cuts the Cole's incentive rate in year t+1 and zero otherwise. DerivBan is a dummy variable that equals one if the fund does not allow writing or investment in the options and futures products in year t and zero otherwise. Replacement is a dummy variable that equals one if the fund replace its current advisory firm and zero otherwise. Fdret is annual fund return in year

t. Size is the natural logarithm of fund TNA. Age is the natural logarithm of years since the fund's inception in the N-SAR database. Expense is the fund expense ratio calculated as total fund expenses over TNA. Volatility is calculated as standard deviations of fund returns in year t. Styleflow is the average net flows of funds with the same investment style in year t. All regressions include fund and time fixed effects. The robust t-statistics clustered by the fund are reported in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Table **7** presents the result of the logit regression for advisory firm replacement, where the dependent variable $Replacement_{i,t+k}$ is a dummy variable that equals one if the advisory firm of fund *i* is replaced in year *t* + *k* (*k*=0,1,2). If mutual fund advisory misconduct is associated with a higher likelihood of advisory firm replacement, we would expect a positive and significant coefficient for *Misconduct*. The estimated coefficient of the main explanatory variable *Misconduct* in Column (1) is 0.0222 with a *t*-statistic of 6.24, which is significant at the 1% level. The result suggests that advisory firms that commit advisory misconduct in year *t* are associated with a 2.2 percentage point increase in the probability of being replaced in the current year. When we examine the long-term effect of advisory misconduct on future replacement of malfeasant advisory firms, Columns (2) and (3) show similar results that advisory misconduct has a significant and positive effect on the replacement of advisory firms in the subsequent 1 or 2 years. The results are consistent with [18], who found that nearly half of financial advisers with misconduct do not retain their jobs. However, our results are aggregated at the advisory firm level. Therefore, the results demonstrate that mutual funds protect themselves by disassociating with malfeasant advisory firms following misconduct.

4.6. Effectiveness of Mitigating Actions

Finally, we evaluate the effectiveness of mutual funds' responses to advisory misconduct. Specifically, we examine whether the mitigating actions taken by mutual funds are effective in alleviating the negative effect of advisory misconduct on fund flows. Specifically, we construct interaction terms between *Misconduct* and respective measures in incentives, investment restrictions, and advisory firm replacement. *FeeIncrease* is a dummy variable that equals one if the fund increase 12b-1 fees in year *t*+1 and zero otherwise. *IncentCut* is a dummy variable that equals one if the fund cuts the Cole's incentive rate in year *t*+1 and zero otherwise. *DerivBan* is a dummy variable that equals one if the fund does not allow writing or investment in the options and futures products in year *t* and zero otherwise. *Replacement* is a dummy variable that equals one if the fund replaces its current advisory firm and zero otherwise. If the mutual funds' responses to misconduct are effective, we expect to find positive and significant coefficients on the interaction terms.

Table **5** presents the effectiveness of mutual funds' responses to advisory misconduct. We find that increases in marketing expenditures following misconduct help mitigate the negative effect of misconduct on fund flows. The estimated coefficient of *Misconduct*FeeIncrease* is positive with a *t*-statistic of 3.34, which is significant at the 1% level. The result in Column (2) shows that mutual funds that reduce contractual incentives alleviate the negative effect of misconduct on fund flows, as indicated by the positive coefficient of *Misconduct*IncentCut*, which is significant at the 1% level. Similarly, we find that mutual funds that prohibit investments in derivative products are associated with less negative effects of misconduct. The estimated coefficient of *Misconduct*DerivBan* in Column (3) has a positive and significant coefficient with a *t*-statistic of 2.06. Finally, the result in Column (4) demonstrates that mutual funds that replace malfeasant advisory firms are associated with reduced negative effects brought by advisory misconduct. In sum, the findings in Table **8** demonstrate that the responses from mutual funds are effective in mitigating the negative effect of misconduct on fund flows.

5. Conclusion

Advisory misconduct significantly impacts investor flows and firm reputation within the asset management industry. Given its substantial economic consequences, the SEC emphasizes policing such misconduct. Thus, understanding its role in mutual fund flow dynamics offers critical policy implications.

This study estimated the effect of mutual fund advisory misconduct on fund flows, examining heterogeneous investor responses using Form ADV data, which covers a broad range of misconduct cases. We are the first to document heterogeneous effects on fund flows by manually classifying misconduct allegations. We also identified underlying drivers of fund-flow dynamics post-misconduct by decomposing flows into sentiment- and fundamental-driven components. Furthermore, we examined mutual funds' mitigating measures, providing novel evidence of policy changes due to misconduct incidents.

We found a significant, negative effect of mutual fund advisory misconduct on fund flows in a difference-in-differences framework, leading to a 31.25% reduction in flows 12 months post-misconduct. This economically

significant effect translates to an $87.5 million loss in net assets for a median mutual fund. The negative impact is concentrated in funds with vigilant investors and high monitoring incentives. Differentiating misconduct types, transaction-related misconduct negatively affects sentiment-driven flows, while disclosure-related misconduct negatively impacts fundamental-driven flows. Additional evidence from the 2001 SEC electronic filing mandate confirms a causal effect of misconduct disclosure on fund flows.

Regarding fund responses, we found consistent evidence of reduced operational and portfolio risk. Mutual funds increase marketing expenditures and reduce contractual incentives to repair reputations and curb excessive risk-taking. Investment policies and portfolio allocations show similar patterns, with stricter derivative use restrictions and increased cash/liquid asset holdings. The advising relationship also becomes unstable, with a higher likelihood of replacement post-misconduct. These mitigating actions effectively alleviate misconduct's adverse effects. Overall, our results align with mutual funds reducing contractual incentives for advisory firms to mitigate portfolio and operational risk.

Our findings offer critical implications for regulators, supervisory authorities, and fund governance boards aiming to enhance the detection, deterrence, and mitigation of advisory misconduct. First, the heterogeneity in flow responses suggests that regulators should prioritize the enforcement of disclosure and compliance standards. Since disclosure-related misconduct creates persistent negative pressure on fundamental-driven flows, unlike the transitory effects of transaction-related issues, regulatory bodies like the SEC are justified in maintaining rigorous transparency mandates such as the electronic filing requirements. Second, our analysis of firm responses provides a data-driven framework for remediation and governance. The tendency of funds to reduce contractual incentives and impose stricter derivative restrictions post-misconduct highlights the role of high-powered compensation and complex instruments as potential risk factors. Compliance officers and fund directors should therefore scrutinize convex incentive structures and derivative usage *ex-ante* as part of their risk management protocols to prevent malfeasance. Finally, the significant market discipline exercised by vigilant investors demonstrates that informal enforcement mechanisms can complement formal supervision. Regulators should consider policies that further lower information search costs for investors, thereby strengthening the "sunshine" effect that deters misconduct. By aligning internal governance reforms, such as replacing malfeasant advisors or adjusting compensation, with external market discipline, the industry can more effectively safeguard investor welfare and maintain market integrity.

Conflict of Interest

The authors declare that they have no known competing financial interests or personal relationships that could have appeared to influence the work reported in this paper.

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