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Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry

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March 1, 2007

Abstract:

Business connections can mitigate agency conflicts by facilitating efficient information transfers, but can also be channels for inefficient favoritism. I analyze these two effects in the mutual fund industry and find evidence that connections among agents in this setting foster favoritism, to the detriment of investors. Fund directors and advisory firms that manage the funds hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely. These findings support recent calls for more disclosure regarding the negotiation of advisory contracts by fund boards.

Keywords: Social networks, influence, mutual funds, corporate governance, contracts

JEL Classifications: G2, G34, L14

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