A Practitioner's Guide to Establishing a Prudent Transition Process

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A successful transition is often defined by the ability of asset owners to manage *all* of their risks—operational, fiduciary, performance, and execution. This challenge is exacerbated by the fact that, while transition management firms offer a variety of execution strategies, the lines between their business models are blurring.

As fiduciaries, asset owners are not, of course, expected to have a crystal ball. Rather, the metric by which their decisions are evaluated should be the prudence of their process. That said, portfolio transitions represent one of the few instances where asset owners make active decisions directly affecting the level of costs incurred in their portfolios. Consequently, the asset owner's responsibilities when implementing portfolio transitions entail a level of accountability fundamentally different from traditional oversight duties, and not surprisingly, require a qualitatively different skill set.

It is therefore essential that asset owners have a thorough understanding of each transition manager they consider, as well as the specific needs and exposures of their transition portfolios. Such knowledge is a prerequisite to establishing optimal transition strategies and providing comfort that appropriate safeguards are in place to maximize client confidentiality and minimize conflicts of interest. In practice, this calls for a blend of strategic and tactical considerations that balance theoretical "best practices" against practical necessity.

This of course is easier said than done. What specific issues should asset owners review when trying to construct prudent transition strategies? What are the critical questions asset owners should ask prior to hiring their transition managers? We have identified conflicts of interest, revenue generation, fiduciary responsibility, pre-hedging, cost estimation, pre-transition planning, trade implementation, and post-transition evaluation as essential issues asset owners should consider when faced with the need to transition assets within their funds. This article provides a summary of each of these areas, and identifies key due-diligence action items for asset owners. It further offers a roadmap to asset owners regarding transition management best practices and uniform protocols.

BACKGROUND

Historically, the transition management industry has lacked uniform standards and practices (in contrast, for example, to asset management performance measurement calculated pursuant to CFA Institute standards). Equally important, no regulatory or statutory requirements exist that focus directly on the implementation of portfolio transitions.

Partly in response to this vacuum, in late 2007 a coalition of transition managers in the

United Kingdom agreed to a series of broad principles known as the T Charter. The T Charter is essentially a voluntary code of conduct, presenting a basic framework for transition management that highlights key issues such as conflicts of interest, cost measurement, transparency, and compensation.

In early 2008, the Pension Benefit Guarantee Corporation,[1] in conjunction with Plexus Plan Sponsor Group, Inc.,[2] began working with numerous industry participants to identify appropriate guiding principles for portfolio transitions from the perspective of an asset owner. The primary areas covered by the principles address:

- Conflict Management and Disclosure.
- Revenue Generation and Disclosure.
- Fiduciary Status.
- Pre-hedging.
- Pre-transition Cost Estimation.
- Pre-transition Planning and Selection of Transition Managers.
- Post-Transition Cost Calculation and Evaluation.

With the benefit of commentary on the T-Charter, plus the different forum, these principles ultimately took on a slightly different flavor. The new standards tended to provide greater detail and had a slightly wider scope. But perhaps most important, they established a precedent of an asset owner requesting its transition managers to sign off on these protocols. In this regard, these principles represent the next step forward, and a natural evolution within the transition management industry. A high-level overview of the above principles follows below.

CONFLICT MANAGEMENT

Conflicts of interest may occur throughout the transition, from pre-transition planning through trade execution, and even in the post-transition evaluation stage. Asset owners should also recognize that all transition manager models have inherent conflicts to some degree. It is therefore important that asset owners systematically examine the potential for, and implications of, such conflicts.

These conflicts need to be policed. While the existence of certain conflicts in and of themselves should not be viewed as an immediate cause for disqualification, the asset owner must ultimately have trust in the chosen firm, and must not deviate from their fiduciary responsibilities. This entails, in part, having a deep understanding of each firm's process and business model. From a process perspective, the asset owner should understand all potential conflicts (both real and perceived), and balance the potential for harm against the potential benefit of working with that particular firm.

In this context, asking a firm to act as a fiduciary within the meaning of ERISA or the Investment Advisers Act of 1940, utilizing a transition manager who uses third-party broker-dealers, and/or hiring a third party to help exercise oversight, may all be valuable considerations. Ultimately, however, the most important consideration is the asset owner's overall comfort level that the transition activity will be kept separate and confidential from other operating areas of the transition manager, firm affiliates, and/or third parties not directly involved in the transition.

The transition management firm should be prepared to provide the asset owner with documented policies and procedures, and internal oversight and compliance systems that help govern and police their conflict management safeguards. Further, in those instances where the transition manager utilizes third parties to execute the trades, the asset owner should be comfortable that the transition manager has sufficient tools, skills, and resources to effectively police these third parties.

DISCLOSURE OF POTENTIAL ORGANIZATIONAL CONFLICTS

Related to the transition manager's ability to manage potential conflicts is the upfront disclosure of any potential conflicts associated with its organizational structure and manner of doing business. One way to ensure this occurs is for the asset owner to request a disclosure document from the transition manager. Such a document should not only identify actual and potential conflicts of interest, but also any measures taken by the transition manager to manage them.

For example, the document might set forth the capacity in which the transition manager offers its services (e.g., as a custodian, investment manager, securities firm, or investment advisor); whether it will be acting as "agent" or "principal," or both; and whether trading or other functions are delegated within the firm or to a third party.

In the event the transition manager utilizes affiliated broker-dealers, the disclosure document should describe the steps taken to minimize information leakage and potential conflicts with internal groups (such as proprietary trading desks). Alternatively, where the transition manager utilizes unaffiliated broker-dealers, the document should similarly address the steps taken to minimize information leakage, potential conflicts, higher commissions, and any increased operational or settlement risk incurred by virtue of using the third-party firm. In a similar fashion, if the transition manager commingles the transition portfolio with the trade flow of an affiliated asset manager's trade flow, the document should describe how they balance potential conflicts (associated with the manager's other clients) regarding research needs, the timing of the trade, leakage of information, regular negotiated commission rates, and the solicitation of capital.

REVENUE GENERATION AND DISCLOSURE

Transparency regarding all sources of revenue, whether derived directly or indirectly from the transition, is critical in enabling asset owners to achieve the requisite level of comfort with their transition managers, as well as to devise a prudent transition strategy that properly aligns all interests. In this regard, asset owners should recognize that transition managers, whose revenues are limited to the explicit commissions, can't make a profit if those commissions are too low.

This is not to say that asset owners can't negotiate aggressively on commissions. Asset owners are fiduciaries of their funds, and have an obligation to minimize costs. However, they should also be sensitive to finding the right balance between a commission rate that fairly compensates the transition manager and avoids artificially low rates that may inadvertently incent the transition manager to generate revenue from other areas of the transition.

To facilitate this balancing, asset owners should request certain disclosures from their transition manager in advance of the engagement; and an audit trail of their revenues once the transition is complete. The pre-transition disclosure should include:

a. a description of the transition manager's internal process;
b. their business/revenue models;
c. how revenue is calculated and collected;
d. any and all relationships with third parties and brokers related to the transition;
e. a general description of the compensation arrangements for personnel working with the transition; and
f. all sources of remuneration received by the transition manager and/or its affiliated companies with respect to the asset owner's transition.

To the extent that incentive or other fee arrangements are considered, a comprehensive discussion of potential benefits and harms associated with the proposed formula should also be provided.

Once the transition is competed, the transition manager should be prepared to quantify, as best possible, all revenue derived from the transition (including revenue associated with equity, fixed income, foreign exchange, derivatives, and futures trading). The transition manager should also consider disclosing:

a. the commissions generated from the counterparties to the asset owner's trades;
b. any realized profit/loss associated with security and/or currency trade done on a principal basis;
c. any unrealized profit/loss associated with open positions on security and/or currency trades done on a principal basis;
d. any potential revenue-sharing arrangements and/or payments for order flow with affiliates and/or outside parties; and
e. any agency trading commissions generated through affiliated or third party broker-dealers.

As an aside, asset owners should be aware that for securities executed 1) in Dark Pools, 2) in other trading venues in which the identity of the counterparty is unknown, and 3) in principal trades (which may remain in inventory for extended periods of time), the transition manager may not be able to provide an exact account of all revenue derived from such activity. That said, the transition manager should still be prepared to provide detailed information regarding the percentage of activity, specific names, pricing, and any other information necessary for an accurate assessment of those trades.

Lastly, the final negotiated agreement between the asset owner and transition manager should clearly prohibit:

a. the use of trading activity to influence benchmark prices to enhance performance results or increase fees;
b. the use of execution and benchmark strategies to enhance unrelated business activities or relationships; and
c. the use of commission dollars to address research needs for other products unless specifically agreed to in advance.

From a process standpoint, the asset owner may also want to incorporate attestations from the transition manager that the transition manager will not use low-cost brokers, low-cost venues, or proprietary and/or low cost dark pools, regardless of best execution, simply to maximize commission profits and/or market share.

FIDUCIARY STATUS

Transition managers should always act in the asset owner's sole best interest, in good faith, with due skill and care and in accordance with best execution rules. That said, asking transition managers to act as an ERISA or '40 Act Fiduciary may sometimes constrain their ability to use certain trading/execution tools and strategies due to prohibited transaction rules. The asset owner must therefore balance the potential benefits against the potential conflicts, as noted earlier. The resulting decision is ultimately a reflection of the asset owner's level of comfort with the transition manager and whether, given the particular circumstances surrounding the transition, the transition manager should take on formal fiduciary responsibility. Asset owners would perform this type of assessment each time they are faced with a transition, taking into account the specific risks and exposures associated with each respective trade and transition manager.

When performing this task, some of the more common considerations that can factor into the asset owner's final determination include: the history of the relationship, the transition manager's reputation, whether the transition manager has a proprietary trading desk, whether the transition manager uses third party broker-dealers, and/or whether the asset owner has hired an independent third party to help exercise oversight. In the event the asset owner decides additional fiduciary protection is needed, there should be a full discussion with the transition manager prior to trading to identify:

a. any disclosures and/or "carve outs" that might impact the scope and nature of their fiduciary responsibilities;
b. whether the firm's process will change by virtue of acting as a fiduciary;
c. whether the firm can now make investment-related decisions (such as interim asset management, proxy voting, and corporate actions);
d. whether acting as a fiduciary would increase the fee (and if so, why and how much);
e. any constraints on the ability to trade (and if so, under what circumstances and the expected impact); and
f. whether such fiduciary status would extend to actual executions, choice of venue, and any third-party brokers (if relevant).

PRE-HEDGING

While pre-hedging may sometimes reduce market risk and overall costs, thereby providing value in certain circumstances, it can often introduce significant conflicts and potential risks to the portfolio. Accordingly, before permitting transition managers to engage in pre-hedging, the asset owner should understand potential benefits and harms, as well as have sufficient expertise, tools, and capabilities to monitor such activity. Without such knowledge and capabilities, asset owners should strongly consider specifically precluding pre-hedging.

In the event an asset owner believes pre-hedging may benefit a portfolio, there should first be an in-depth discussion with the transition manager. The primary goals for such a meeting would be to:

a. fully understand the implications of pre-hedging;
b. formally acknowledge that pre-hedging has been agreed to;
c. determine the extent to which the profit or loss from pre-hedging is to be shared;
d. ensure that the measurement of costs and performance begins prior to the first pre-hedging transaction; and
e. detail the anticipated pre-hedging activity.

After the transition is completed, the transition manager should be required to:

a. provide a detailed accounting of the actual pre-hedging transactions undertaken;
b. include the performance impact due to pre-hedging activity in the post-transition report; and
c. where significant price movements occurred in a name during the pre-hedging period, or at the beginning of the transition, provide sufficient information regarding the transition manager's overall trading activity to enable the asset owner to ascertain whether such activity had an impact on the assets.

PRE-TRANSITION COST ESTIMATION

While forecasting of upcoming transition costs is inherently inexact, the use of cost forecasts prior to implementing the transition is valuable in helping the asset owner assess the likely cost of the transition. Pre-transition cost estimation is also essential to understand the potential trade-offs between impact and opportunity costs. These insights can significantly influence the asset owner's choice of transition strategy.

For these reasons, transition managers should be prepared to provide robust pre-transition cost estimates predicated on a variety of different trading strategies. To ensure apples-to-apples comparisons across different providers, it is important that the asset owner require such estimates to follow certain uniform protocols. In particular, the cost estimates should be calculated utilizing an implementation shortfall format (e.g., the T-Standard), and a start date of T-1 (unless a different format is specifically agreed to beforehand).

Additionally, the asset owner should request that all cost estimations include: a variety of estimates based on different trading strategies; the standard deviation associated with each trading strategy; the material assumptions in each cost estimate checked for realism; and, where available, the distribution of actual costs versus pre-trade estimates on prior transitions.

PRE-TRANSITION PLANNING AND SELECTION OF TRANSITION MANAGERS

How the asset owner assesses and addresses its transition-related risks will be manifested during pre-transition planning. Just as the majority of a fund's performance is explained by its strategic asset allocation, the efficiency and effectiveness of a transition is largely driven by the pre-transition planning and strategy.

As the named fiduciary of the fund, it is critically important that the asset owner put together a coherent and thoughtful strategy. This requires both a comprehensive knowledge of the transition's risks and exposures and a thorough understanding of each transition manager that is engaged. This knowledge is a prerequisite for both establishing effective transition strategies and providing comfort that appropriate safeguards are in place to maximize client confidentiality and minimize conflicts of interest.

As noted earlier, transition managers have different strengths and weaknesses (whether driven by the model, approach, culture, institutional preferences, technology, human intellectual capital, risk-management technology, etc.). More to the point, transition managers have differing areas of expertise, investments in technology, human capital, and specializations in particular assets or asset classes.

The development of a transition strategy and choice of transition manager should therefore be a function of the asset owner systematically matching the needs of each transition to the various skill sets of the respective transition managers. To assist in this matching exercise, asset owners should request that prospective transition managers provide a wide spectrum of information. Some of the more important pieces of data can include:

a. a description of internal work flows and procedures (including individual responsibilities and appropriate checks);
b. a description and demonstration of risk-management capabilities (tools and software, skill, expertise, process, and staffing necessary to employ tools/software effectively);
c. historical track records of aggregate transition activity, as well as transitions similar in character to the subject transition;
d. an attestation that they have appropriate resources to support and efficiently manage the transition process in line with the client's objectives;
e. an attestation that they have systems capable of managing the transition process and do not expose the client to the risk of unreasonable delay;
f. an attestation that they have implemented appropriate business continuity procedures or other contingency arrangements;
g. a description of the size and capabilities of their dedicated transition team; and
h. how the team manages information leakage and potential conflicts when interacting with other internal groups and/or outside firms.

To minimize information leakage and avoid potential conflicts, holdings should not be disclosed to transition managers until a bid is awarded. Where holdings are disclosed in advance, the transition managers should be required to sign a non-disclosure agreement.

Once a transition manager has been retained, the asset owner should then be able to look to the transition manager for more specific tactical recommendations. These recommendations should take into account a variety of considerations, including:

a. fund objectives and investment philosophy;
b. time frame;
c. potential costs;

d. risks and risk-mitigation strategies;
e. execution strategy;
f. appropriateness of hedging instruments and strategies;
g. operational risks and constraints;
h. documentation process;
i. minimizing performance drag;
j. market conditions and calendar;
k. taxes and regulatory issues;
l. coordination of all parties; and
m. potential individual security outliers.

TRADE IMPLEMENTATION

Asset owners should recognize that their selection of a transition manager is a fiduciary decision. Accordingly, the asset owner should ensure that the transition manager has the requisite approach, skills, expertise, and tools to successfully implement the asset owner's transition. From a trading perspective, the asset owner should therefore be comfortable with the strategy adopted, and that all trading activity is reasonably expected to obtain the best implementation shortfall result. This requires an ability on the part of the transition manager to determine and implement the optimal combination of liquidity sources (including principal trades, FX, derivatives), and means of sourcing that liquidity.

Before engaging a transition manager, asset owners should require the firm to demonstrate that it has the ability to propose strategies that are fair, appropriate, and relevant to the client; have sufficient human capital and expertise for portfolio oversight; and the ability to adjust strategy if necessary. This entails the capability to:

a. balance the expected benefits of crossing against the associated volatility risk/opportunity cost, information leakage, and potential counter-party risk;
b. trade and/or closely monitor FX (and provide a full shortfall analysis);
c. balance the expected benefits of derivatives in reducing risk and/or gaining market exposure, against the associated added expense and administrative burden; and
d. with respect to fixed-income trades, manage the risks associated with lack of transparency and information leakage.

It is also important that asset owners recognize that transitions can fail from an operational standpoint without proper preparation and attention to detail. For this reason, transition managers should demonstrate their ability to act as a "project manager," in coordinating and overseeing the various parties involved throughout the transition process.

The transition manager should state whether it will be transacting as "agent," "principal," or both, and attest that any changes in that approach will be discussed with and agreed to by the client in advance of trading. The transition manager should also be prepared to report errors involving material financial loss during the transition as soon as practicable. This includes errors caused by the transition manager or by other parties involved in the transition (e.g., custodian, investment manager, etc.).

POST-TRANSITION COST CALCULATION AND EVALUATION

The asset owner should ensure the transition manager can support the transition process with adequate trading, book-keeping, risk, and performance reporting systems. In a post-transition context, these functions should be capable of providing and maintaining data that is both accurate and timely. To this end, the transition manager should be expected to maintain a clear audit trail of transition activity and make this information available to the asset owner. Such information would include:

a. asset transfers;
b. stock and cash positions;
c. time-stamped execution data for all transactions undertaken;
d. reconciliations;
e. corporate actions;
f. individual market and broker executions making up the execution prices reported;
g. allocations to mandates;
h. instructions issued to third parties; and
i. performance numbers.

In addition to an accurate accounting of transaction activity, a qualitative post-mortem assessment is also a critical part of every transition management engagement. While the asset owner may want to obtain an independent third-party evaluation, transition managers should also be expected to provide a comprehensive analysis of the transition. The specific structure of each post-mortem report will vary depending on the provider and the nature of the transition. However, the content should be sufficiently detailed to enable the asset owner to assess the overall outcome of the transition and review both cost and operational issues.

With respect to costs and performance, the post-transition analysis should include:

a. the actual implementation shortfall cost (calculated from the close of T-1);
b. an attribution of the total implement shortfall cost (i.e., commissions, fees/taxes, impact, delays/opportunity, performance);
c. a comparison of the actual costs to pre-transition cost estimates (and explanation regarding any significant deviation); and
d. commentary as to whether there were any significant price reversions.

With respect to fixed income trades, the post-mortem report should also include the results of any solicited bids.

While it is certainly appropriate for a transition manager to offer additional cost calculations using formulas other than implementation shortfall, those calculations should be clearly disclosed, consistently applied, and presented alongside the implementation shortfall calculation.

The post-transition reports should also provide a review of the operational and contextual issues associated with the transition. This would include:

a. operational results;
b. whether the approved transition plan was followed (and/or did deviations have a reasonable explanation);
c. successful timeline delivery;
d. market conditions during the trade;
e. disposition of assets and accounts; and
f. commentary regarding the comfort level of asset managers and custodians.

CONCLUSION

Successful transitions don't happen on their own. They require dedication and commitment from both transition managers and asset owners. It is not enough for transition managers to simply bring the requisite expertise, skills, and tools. They must also provide an organizational structure with sufficient transparency and disclosure to give asset owners comfort that they will work solely in the fund's best interest and adequately manage all potential conflicts.

The asset owner also has responsibilities. As the named fiduciary, the asset owner must ultimately decide which transition manager is best suited for each respective transition. This choice may be different from one transition to the next, depending on administrative needs, market conditions, and/or the characteristics of the portfolio. This is a fiduciary decision that must be made in a prudent, systematic fashion. Accordingly, the asset owner's approach should be structured so as to facilitate a prudent and effective decision-making process.

The standards above are intended as an initial blueprint for hiring transition managers and/or constructing RFPs. Clearly every asset owner will have its own unique needs and requirements. And not everything noted in this article will be germane. But the considerations described above offer a good starting point for asset owners to develop their own processes through which they can foster competition, improve transparency, and minimize potential conflicts. In today's environment, investor comfort and confidence has to be our goal.

In conclusion, there is never a guarantee that a transition will run smoothly and efficiently. However, employing a systematic, informed, and prudent approach provides the greatest likelihood that the asset owner will minimize the risk of performance, trading, or operational problems, and maximize the likelihood of a well-run and cost-efficient event. Asset owners who conduct and document the due diligence detailed above have done their jobs. At day's end, trading is still more art than science, and costs can occur despite the best efforts of everyone. This is why process is key. It is important in establishing asset allocations, it is important in hiring new managers, and it is important in implementing portfolio transitions.

ENDNOTES

[1]Reference to Pension Benefit Guarantee Corporation ("PBGC") as the recipient of the services described herein shall not be deemed to be an endorsement by PBGC of PPSG's investment advisory services.

[2]Plexus Plan Sponsor Group, Inc. ("PPSG") is a wholly owned subsidiary of Investment Technology Group.