Code of Best Practice for Transition Managers: *The T-Charter*

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In October 2007, European transition management providers agreed on a code of best practice that is now accepted by clients and their advisors as a blueprint for conducting business in this marketplace.

From time to time large investment funds need to make significant changes to their investment arrangements; these asset restructurings may be prompted by performance issues, actuarial advice, sponsor changes, new regulatory requirements, or new investment opportunities. To implement the required changes, it has become increasingly commonplace to employ the services of a specialist manager. This "transition manager" reduces costs, controls risks, and provides efficient project management. The number of transition management service providers has grown rapidly as asset managers, investment banks, custodians, and investment advisers compete for these restructuring assignments. This growth in the complexity and in the number of providers meant that trustees and their investment advisers found it increasingly difficult to compare the services, cost estimates, fee quotations, and performance results of the competing transition managers due to the fundamental differences in their business models and dealing practices.

At a transition management conference in December 2004, the industry was accused of poor practice and a lack of standards. The attack was prompted by a number of frustrations with, and suspicions of, transition manager practices. The following list gives a flavor of the complaints:

- Transition managers supply cost estimates that cannot be compared to one another.
- Transition managers have conflicts of interest that are not disclosed.
- Some transition managers may take undisclosed remuneration.
- Some transition managers may provide unrealistic cost estimates to win business.
- Some transition managers may propose dealing strategies that favor themselves.
- Some transition managers may engage in pre-hedging without the client's knowledge.
- Some transition managers may not keep information confidential.
- Some transition managers may not have all the resources required for the task.
- Not all transition managers calculate their performance in the same way.
- Some transition managers may not be reporting their errors.

Six weeks later, the leading transition management firms came together to discuss the issues that had been raised. These were the first tentative steps toward an industry code of best practice. This code, known as the "T-Charter," was finally launched on October 22, 2007, with 17 transition management service providers agreeing to abide by its principles.

The T-Charter sets out the standards of service and behavior that is expected of a transition manager, whether acting as a fund manager, an investment bank, a custodian or an investment adviser. The objectives of the T-Charter are to raise standards and allow clients to compare the proposals and performance results of transition managers.

THE T-CHARTER'S 10 GUIDING PRINCIPLES

Disclosure and Conflicts of Interest

The Transition Manager structures the business to put the client's interest first and minimize and manage conflicts of interest. Transition management activity is kept separate from areas of the firm that have a conflicting interest.

For each transition management assignment, the Transition Manager provides clients with a disclosure document detailing the actual and potential conflicts of interest and the measures taken to manage them. This document, along with any underlying transition management agreement, is clear as to the nature of the services and terms offered by the Transition Manager. In addition, the disclosure document clearly states:

- In what capacity the firm offers transition management services (e.g., custodian, investment manager, securities firm, investment advisor).
- Whether acting as "agent" or "principal," or both.
- Whether trading or other functions are delegated either within the firm, to a third party or offshore.
- How remuneration is calculated and collected.
- Whether the proposed remuneration structure involves a conflict of interest.
- Whether the transition fee includes all dealing charges.
- The experience and expertise of the transition management team.
- Whether non-transition management staff are involved in transitions, whether they are seconded on a full-time basis into the team, or whether members of the transition management team are engaged in non-transition activity.

Client Confidentiality

The Transition Manager has documented policies or procedures, and systems in place to protect client confidentiality.

The Transition Manager safeguards client confidential information, market sensitive information, portfolio and trade lists from other operating areas of the firm, the firm's affiliates, and third parties not directly involved in the transition.

Resources

The Transition Manager has available the appropriate resources to support and efficiently manage the transition process in line with the client's objectives. These resources include staff that are competent to manage the transition in a manner that meets the client's objectives.

Systems and Processes

The Transition Manager maintains a clear audit trail of transition activity and makes this information available to the client upon request. These records include asset transfers, stock and cash positions, transactions undertaken, reconciliations, corporate actions, and performance numbers.

The Transition Manager supports the transition process with trading, book-keeping, risk, and performance reporting systems that provide and maintain data that is both accurate and timely. The Transition Manager has systems that are capable of managing the transition process and that do not expose clients to the risk of unreasonable delay.

The Transition Manager has documented work flows and clear procedures supporting the transition process. These include a clear understanding of individual responsibilities, and appropriate checks on issues including trade authorization, allocations to mandates, and instructions issued to third parties.

The Transition Manager has implemented appropriate business continuity procedures or other contingency arrangements that are adequate to safeguard the transition process and client records against unforeseen events that may disrupt the Transition Manager's usual business activity.

Cost Estimation

The Transition Manager presents cost estimates in the T-Charter format, unless the client specifically requests a different format.

The Transition Manager clearly states the material assumptions in the cost estimate. These assumptions are realistic and not selected to bring about an unreasonably optimistic low-cost estimate. Similarly, the cost estimate is not inflated in order to flatter the realized result.

The Transition Manager produces a cost estimate that is an objective expectation for the transition's implementation shortfall cost (with a start date at close T-1). Estimates are not biased and are consistent with realized results.

Remuneration

The Transition Manager, both before and after each transition management assignment, fully discloses all the sources of client remuneration received by the Manager and/or its affiliated companies, whether paid explicitly in fees or other charges or earned implicitly through income sharing, rebates, or trading revenue.

The Transition Manager clearly presents the potential benefits and drawbacks to the client of any alternative remuneration structures proposed.

Dealing Strategy and Practices

The Transition Manager proposes strategies that are fair, appropriate, and relevant to the client and presents such strategies in a fair way.

The T-Charter applies to the Transition Manager's dealings with the client, whether it deals as principal or as agent. A change in implementation strategy (for example, agency to principal trading) is discussed and agreed with the client.

The dealing strategy adopted and all trading activity are reasonably expected to obtain the best implementation shortfall result taking into account the potential volatility of the shortfall result and the transition objectives agreed with the client. This trading activity includes crossing and applies to all asset classes.

The Transition Manager does not use trading activity to influence benchmark prices in order to enhance performance results or increase remuneration.

The Transition Manager discloses when pre-hedging transactions are contemplated due to the potential conflicts of interest that can arise. In addition, the Transition Manager is required to:

- Discuss clearly and fairly with clients and their advisors the implications of pre-hedging.
- Disclose in the proposals and the legal agreements that pre-hedging has been agreed.
- Confirm the extent to which the profit or loss is shared between the client and the Transition Manager.
- Ensure that performance measurement starts in advance (previous day's market close) of the first pre-hedging transaction.
- Detail the pre-hedging transactions undertaken.
- Report on the performance impact due to this pre-hedging activity in the implementation report.

The Transition Manager acts in the client's interest, in good faith, with due skill and care and in accordance with best execution rules. The Transition Manager does not apply dealing commission or charges, adjust prices or apply a mark-up or mark-down other than as agreed with the client in the contracting documentation and as disclosed in the disclosure document. The Transition Manager will also seek to achieve the best possible result when delegating execution to third parties or affiliated companies.

The Transition Manager provides upon request the individual market and broker executions making up the execution prices reported.

Evaluation

The Transition Manager calculates and fairly attributes the implementation shortfall (from the close of T-1) to be consistent with pre-trade estimate. Any deviation from the T-Standard methodology is explained. Any additional calculations of performance are clearly disclosed, consistently applied, and presented alongside the implementation shortfall calculation.

The Transition Manager provides a report upon completion of the transition, allowing clients to analyze the actual outcome of the transition. The realized performance result is compared to the cost estimate, and any differences are clearly explained. The Transition Manager also reports on any operational and project management issues affecting the outcome.

The Transition Manager ensures all fees, commissions, and other dealing charges are explicitly included in the implementation shortfall calculation and attribution.

Errors

The Transition Manager reports errors involving material financial loss during the transition as soon as is practicable to the client (and, if applicable, the client's investment advisors). This includes errors caused by the

Transition Manager, or by other parties involved in the transition (custodian, investment manager, etc.).

T-Charter Compliance

The Transition Manager ensures that their business is subject to oversight and review by the Compliance function.

The Transition Manager is responsible for ensuring adherence to all provisions of the T-Charter.

The Transition manager, upon client request, confirms adherence to the T-Charter.

T-CHARTER ENDORSEMENT

An early criticism of the T-Charter was that it was conceived and drafted by the transition management providers and not by the users. But this argument was weakened when the National Association of Pension Funds (NAPF) in May 2008 issued a press release announcing its endorsement of the T-Charter. Indeed, the press release went further with the following quote from the NAPF Investment Council Chairman:

> "[A]s part of our position statement, the NAPF recommends that pension fund trustees and other asset owners should consider compliance with the T-Charter becoming a requirement within all transition manager agreements."

In September 2008 the Pension Benefit Guaranty Corporation (PBGC) introduced its own standard for transition managers, acknowledging the European T-Charter as the starting point for its document. The T-Charter received further recognition in North America when the publication *Operations Management* gave the best teamwork 2008 award to the T-Charter signatories.

Many pension schemes and their investment advisers are now using the T-Charter in their selection and evaluation of transition managers. It defines the high level of service and behavior that all transition management clients deserve. Our belief is that the T-Charter will continue to find widespread support because:

- It protects clients (not providers) and provides evidence of due diligence.
- It has been widely accepted by the transition management providers.
- It promotes greater disclosure and transparency.
- If it needs to be enhanced or strengthened it can and will be through its governance structure.
- It is already being used by pension funds.
- The "cost estimation template" allows direct comparison of the cost estimates of the competing providers.
- The "disclosure document" provides clarity on conflicts of interest and remuneration.
- It brings greater disclosure and transparency to any pre-hedging activity.
- It provides disclosure on all the sources of remuneration.
- It delivers an agreed performance measurement methodology.

TRANSITION MANAGEMENT—THE FUTURE

Competition is generally good for clients as it brings about better products, wider choice and lower prices. Investment restructuring costs have fallen markedly. In the early 1990s, the WM Company, a European pension fund performance measurer, estimated these costs to be 2.7% of the assets in transfer. Today, many funds are able to make the equivalent changes to their schemes for less than 0.5%. The increasing use of transition management is responsible for some of this cost saving. In the future, clients will want to see these costs fall even further.

The T-Charter will continue to exert an influence on the transition management industry. Transition managers will begin to compete on disclosure and transparency. It will be much easier to compare and differentiate the services and results of one transition manager against another. This will be particularly important in the area of transition manager remuneration, where clients will demand greater disclosure and transparency of fees.

The transition management industry is maturing and it may be time to revisit the issue of transition management performance analysis. In the same way that the Global Investment Performance Standards (GIPS) improved the fund management industry, the time has come for transition investment performance standards to exert a similar discipline on our industry. We believe that a more rigorous analysis of the cost estimates (pre-trade) and the subsequent implementation results (post-trade) of the transition management providers would bring about significant benefits to the transition management industry in terms of openness and transparency:

- Transition managers would better meet the objectives of their clients for due diligence.
- Transition managers would be able to clearly differentiate and evidence their areas of relative competitive advantage.
- Investment advisors could enhance their research analysis, which would lead to improved transition manager selection recommendations to their clients.
- Trustees could ask the right questions at the right time of their transition managers.
- Trustees and their advisors would not be led astray by an overly optimistic ("lowball") cost estimate.
- Trustees would have more realistic expectations about the volatility of performance results.
- Trustees would have greater confidence in their due diligence, and a clear audit trail of their decision making would be available for later scrutiny if required.

Transition management did not really exist two decades ago. Today, most investment fund restructurings call upon the services of a transition management specialist. Transition managers have delivered better risk management, lower restructuring costs, accountability, and better project management. This is a success story within the investment industry that looks set to continue.