Transition Management: Eight guidelines for choosing a trusted provider

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Choosing a transition management provider is a decision that can have significant financial consequences and understanding a candidate's capabilities in risk management, project management, and trading is paramount. Yet there is another aspect of the plan sponsor's decision process that is even more fundamental to choosing the right provider: trust.

Understand "above-the-line" and "below-the-line" fee structures

Distinguishing among transition management providers and choosing the most appropriate remains a challenge. Historical track records are not always available, and even when candidates provide them, a lack of a standard reporting methodology makes it difficult for plan sponsors to make accurate comparisons. This situation helps explain the persistence of non-transparent business models involving hidden fees and insufficient disclosure.

For clients to understand and compare the true costs of different approaches, they need to understand how each candidate would generate revenue from managing the transition event. There are two fee elements to consider: above-the-line fees and below-the-line fees.

- **Above-the-line fees:** Transition management fees agreed to by the client and fully auditable after the event. Most often, this means an explicit commission on each trade or a flat fee for transition services.
- **Below-the-line fees:** Non-transparent fees charged to the client within the trade execution price. These additional fees paid to the transition manager, or to its affiliates, may well turn out to have been neither fully agreed to prior to the event nor fully disclosed after the event. They include riskless principal markups on securities or derivatives transactions; principal trading profits from foreign exchange transactions; and additional commissions for internal or external cross trades, cross trades which originate from a transition manager's aggressive sales trading tactics of leaking order information to the market to manufacture low quality crosses.

If your transition manager is generating below-the-line fees, it may be nearly impossible to know what you are truly paying for in terms of services. This is why we strongly believe that insisting on above-the-line business structures is critical for plan sponsors.

Brokerage commissions Are not the greatest cost

In the absence of comprehensive data, investors often decide to use data that is incomplete but available. One popular evaluation tool of this type is a comparison of explicit commissions. Brokerage commissions are usually the most visible cost, and investors often see them as the only cost they can control. Hidden fees can be significantly larger than stated commissions, however, and it can be difficult or impossible for investors to identify those hidden fees without help. An audit by the Irish National Pensions Reserve Fund found that a transition provider charged the fund 5 ½ times the agreed upon rate through hidden fees[1]

Moreover, focusing primarily on low commission levels can lead investors to ignore execution quality, risk management, project management and client service issues. These are key capabilities of the transition provider and they often determine the quality of the outcome. It is therefore vital that they are major considerations in the hiring decision process.

In the final reckoning, choosing the right provider will always be a subjective decision for staff, committees and fiduciaries. The representatives of investor interest must decide which provider's value proposition is the most convincing. That selection is in no small part a question of trust.

Eight guidelines for choosing a trusted transition provider

1. **Think and plan ahead**. Perform your due diligence up front and choose a provider before the need arises. Contract well in advance of your needs. Last-minute selection and bidding decisions do not permit careful scrutiny and may even result in price-sensitive information leakage to the market.
2. **Thoroughly understand the provider's capabilities, including strengths and weaknesses**. Apply the same principles to transition manager selection that drive investment manager selection decisions, such as team structure and experience, philosophy, process and performance history.
3. **Require the same fiduciary oversight standards as are applicable to ongoing investment managers**. Engage the services of a provider who is obligated to act in the best interests of your plan and its participants by contracting at the highest fiduciary level possible (in the U.S., as a 1940 Act Investment Adviser or an ERISA Fiduciary). Educate yourself about the level of disclosure in the provider's business model, the activities of any of its affiliates, and its sources of explicit and implicit revenue based off your event. Beware of delegation provisions in your contract that may lessen the fiduciary responsibility of affiliates involved in the transition, or that direct the provider to use affiliates or allow for principal trading.
4. **Understand how your providers can generate revenue**. Can the provider trade securities for its own account or act as principal? Can any affiliates of the provider who may be involved in the transition act in this way? Such below-the-line fees come out of your assets and may be subsidizing the commission rates being quoted. There is no free lunch. If a transition provider appears to be offering a very low commission rate, there is a good chance that additional revenue is being drained from your assets in an undisclosed way.

[1] A recent audit by the Irish National Pensions Reserve Fund found that a transition provider charged a fund five and a half times the agreed-upon rate through hidden fees. See "Irish National Pensions Reserve Fund: Report on the Accounts of the Public Services 2011," http://www.audgen.gov.ie/documents/annualreports/2011/report/en/FullReport2011.pdf.

5. **Require disclosure about where trading happens**. Some transition managers choose to deal through an independent network of external brokers and liquidity sources, in a trading process similar to that of a large investment manager. Others internalize trade flow as much as possible, in a trading process similar to that of an investment bank, and often to their benefit rather than the client's. Low commissions may be associated with high levels of *internalization*, which can detract from performance. Internalization models may lead to information leakage, as transition order flow may be revealed to market participants through indications of interest (IOIs). These models may inform the market of the transition client's intentions prior to execution and allow other market participants to benefit from the information, all to the detriment of the transitioning assets.

6. **Understand how trades will be priced.** This is especially important if a provider is going to act as principal or represent the other side of the trade by using an internal liquidity pool. Additionally, some providers may embed the execution costs paid to trading venues or clearing brokers in the price of the trade. This is a practice often referred to as "net trading" to reduce the above-the-line fees and appear to be cheaper than other options. However, the idea that these trades are in some way less expensive is an illusion, as the costs are just moved below-the-line. In a transparent business model, execution and clearing costs are paid explicitly through commissions, not quietly embedded in the principal of the trade.

7. **Use discretion.** In blunt terms: be secretive. Until you have hired a partner you trust, limit the information you share with potential providers – and the outside world, if possible. The more information that gets out to the market, the greater the danger of sparking activity ahead of your transition. Information leakage can move prices to your disadvantage, driving up the cost of the transition. Better yet, partner with organizations that you know cannot use your information to their gain – those without any form of principal operation or sales trading business models**.**

INTERNALIZATION

The focus on internalizing trade flow is the major differentiator among providers. Transition providers have powerful incentives to internalize trade flow, such as cost savings (crossing internally rather than executing on market), commission generation and trading profits by interacting with proprietary and/or principal flows. While cost savings are certainly a positive marketing benefit, earnings reported by the major banks for commission generation and trading profits are huge and not likely to the advantage of the investor.

Unfortunately, these profits do not materialize from thin air; they are drained from your assets. The lack of transparency and disclosure keeps investors from easily protecting themselves. Without total transparency, "proof" will always be fleeting. But this makes the dangers no less real. From unregulated internal crossing to principal trading, marketed "cost savings" may attract the transition client. But these revenue-generating mechanisms can drain client assets without the client's knowledge.

An egregious example is the use of affiliated, off-shore broker-dealer entities. While the transition provider will market low costs through "crossing" with the affiliate, the revenue potential for the provider is extreme and ultimately reduces the assets in the client's portfolio.

Consider a client looking to purchase an equity that trades in the open market at $30. The affiliate might buy the security at $30, and immediately cross it with the transition client at $30.25. While the reduction of several basis points of commission and spread costs feels good, the true cost diminishes the client's portfolio by an unnecessary $0.25 per share, or 83 basis points. This wealth extraction process directly reduces the portfolio value, often without any knowledge by the client. Caveat emptor!

8. **Use the T Standard.** Excluding certain activities or choosing when to begin the performance calculation are two common ways by which implementation shortfall calculations can be manipulated to your disadvantage. Adherence to the T Standard, which was updated in 2008,[2] ensures objective, complete performance reporting and fixes the start and end dates for measurement, thus constraining the provider from gaming measurement. Properly employed, the T Standard will capture the effects on portfolio performance of all transition activity. This consistency of reporting is critical to clients' ability to effectively compare providers and their estimates.

Summary: Be demanding

Transition management has proven to be a minefield of unseen hazards. Protection from these hazards requires a clear set of demands on your part. Demand fiduciary oversight; transparent revenue reporting; understanding on the timing, location and pricing of trades; and use of the T Standard.

With consolidation of banks and major financial institutions, the transition management marketplace continues to evolve. Several longtime providers have dissolved their transition businesses as increased regulatory scrutiny has reduced their ability to maintain non-transparent fee structures. Unfortunately, transition management still falls behind the rest of the investment industry as regards disclosure standards for the reporting of providers' infrastructure and practices. Plan sponsors' and consultants' in-depth understanding of all aspects of the transaction marketplace is critical. Here are some questions to ask potential transition managers:

- *Will your firm, or any of its affiliates, execute transactions for our transitions on a principal basis?*
- *Will your firm, or any of its affiliates, execute trades in a riskless principal capacity or apply undisclosed markup/markdowns to any transactions for our transitions?*
- *Are your firm's costs of execution (i.e., clearing costs) paid from trade commissions or from the principal of trades done for our transitions?*
- *Will your firm trade through an affiliated electronic communications network (ECN) or alternative trading system (ATS) for our transition? If so, does this generate additional revenue for your firm or its affiliates?*
- *Does your firm or any of its affiliates receive compensation from third parties for participating in their trading venues with our transition orders (i.e., payment of order flow)?*
- *Does your firm employ sales traders? If so, how are they used in the transition trading process?*
- *Are indications of interest (IOIs) used in the transition trading process? If so, how are they used?*

If a transition manager answers yes to any of these questions, plan sponsors should conduct additional inquiries to better assess the prospective manager's opportunity to extract below-the-line fees. The good news is that higher standards are taking root, and the T Standard represents a significant step forward for the industry. By following the guidelines suggested above, institutional investors can better position themselves to improve transparency, manage risk and generate better performance outcomes for their stakeholders.

[2] For further detail on the latest, industry-reviewed version of the T Standard (v. 2.0), and collateral materials, please visit www.russell.com/tstandard .

RELATED READING:

Murphy, Aran. (December 2008). “Introduction: Updating the T Standard,” *Russell Research.*

Murphy, Aran. (December 2008). “T Standard Version 2.0,” *Russell Research.*

For more information:

Call Russell Investments at **800-426-8506** or
visit **russellinvestments.com/institutional**

Important information

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