TRANSITION MANAGEMENT

UNDERSTANDING FIDUCIARY OVERSIGHT

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As transition management has evolved as an industry, so too has the concept of serving as a fiduciary. The designation of "fiduciary" is intended to ensure the transition manager is acting unequivocally in its client's best interests. As a result, this practice has grown considerably in frequency. Nearly every transition management provider today has adopted a fiduciary model. However this title can mean different things and does not always afford you the level of protection that you need and expect.

WHY IS THE CONCEPT OF FIDUCIARY IMPORTANT?

A transition manager fills the void between the termination of the outgoing investment manager and the appointment of the new manager as assets are restructured into the target portfolio. Hiring the transition manager as a fiduciary prevents a lapse in fiduciary oversight between investment managers. The alternative would be that the plan sponsor or asset owner would assume full responsibility over the assets during this time as sole fiduciary, a position that few plan sponsors or investment committees are willing, or able, to accept.

To further complicate the matter, transition management is one of the only businesses where providers can make significant hidden profits at their client's detriment without breaking any laws. These invisible profits can be gleaned from transition clients through crossing, sales trading, leaking information by showing indications of interest, principal dealing and payment for order flow. In addition, scope of service and level of protection varies widely among transition management providers. Therefore it is important to protect yourself and minimize potential conflicts of interest when engaging a transition provider.

A purported remedy for this is to hire a transition manager in a fiduciary capacity. Many plan sponsors view hiring a transition manager as "fiduciary" as a panacea for ensuring alignment of interests because the term, by definition, describes a special relationship of entrusting your assets to another party or institution, not unlike an investment manager. The use of the term "fiduciary" in transition management was therefore intended as a way to establish that a provider was acting in your best interest and to describe a certain level of service to be provided.

WHY DO FIDUCIARY MODELS DIFFER?

The simple solution of hiring a transition management provider "as a fiduciary," even in the context of a legal agreement, falls short. As more buyers of transition management services saw the benefit of hiring a transition manager as fiduciary, nearly every provider was forced to develop this capability. Because every provider of transition services has a different revenue and business model, however, each has adopted a unique stance on what fiduciary oversight means that suits their business. As a result, the concept of a fiduciary in transition management is commonly misused and watered down.

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You need to ask a prospective transition manager a few important questions to ascertain the exact level of fiduciary oversight and service you will be receiving.

The term fiduciary can be applied in a number of different contexts and under different legislation. Different providers rely on a range of different legal definitions of fiduciary. Many sellers of transition management services have attempted to sharpen this definition by defining fiduciary under the 1940 Investment Advisor Act or under ERISA. Others have further attempted to rely on certain exemptions to craft their approach to fiduciary transition management around their specific business model. Despite this, many transition management legal agreements do not even contain the word fiduciary nor do they define the extent and scope of their fiduciary duty. In the end, you will not find two approaches which are the same.

HOW CAN I PROTECT MYSELF?

Because there are tremendous variations in the fiduciary models applied across the industry, you cannot rely on the label of "fiduciary" to ensure you are protected. Rather, you need to ask a prospective transition manager a few important questions to ascertain the exact level of fiduciary oversight and service you will be receiving.

Do you advertise your trade flow from transitions to other parties, for example in the form of indications of interest or through sales trading?

This question is designed to understand the level of confidentiality you can expect from your provider. To find crossing opportunities, some transition managers advertise order flow to other traders. While this can help reduce trading costs when a buyer and seller of the same security are lined up for a cross, it creates information leakage that often has a negative performance impact on the transition. You need to ascertain if a provider is doing this and, if so, how it limits damage from information leakage that may result as a consequence.

Do you or your affiliated companies expect to receive additional commissions, spreads, mark-ups or other profits associated with this transition event?

Additional sources of revenue may create a conflict of interest or distraction for the transition manager. While these revenue sources may help the transition manager subsidize commission costs, they may also be detrimental to the transition results. Your goal with this question should be to identify how the transition manager (and affiliated companies) may earn extra profits and evaluate how this could hurt your transition.

Do you ever cross order flow from transition assignments with hedge funds? Do you maintain trading relationships with hedge funds?

Hedge funds, with their high frequency trading volumes, can be a significant source of crossing and liquidity. However, hedge funds are also by their nature highly informed traders. By default, they often will have more insight into the names they are trading than other counterparties, including your transition manager. This leads to adverse selection when you cross with them (i.e., selling strong momentum positions to them and buying weak securities from them). In addition, hedge funds feed on confidential information, such as what a transition manager is trading. If the answer to either of these questions is yes, you need to ensure appropriate safeguards are in place to protect your order flow.

Will trades be executed on a principal, riskless principal or agency basis?

When hiring a fiduciary, all trades should be executed on an agency-only basis. If your transition manager is executing trades on any other basis, find out why.

Do you manage corporate actions and handle proxy voting during the transition event?

The concept of fiduciary does not always encompass oversight of corporate actions and proxy voting. Many providers either do not handle this work or will forward proxies to their clients. Unless you want to be responsible for this function, you should push it back to the transition manager.

Will you monitor cash balances during and after the transition event?

Inevitably, cash balances will accumulate during and after a transition. This cash comes from dividends, interest, mortgage paydowns and the like. If a transition manager affirms that it will indeed monitor cash balances, you should also ask for how long it will do so.

Can you provide time and execution, including counterparty, for all trades executed on our behalf?

Any answer other than in the affirmative should be explored. If a provider cannot provide you trade-level detail for your trades, you should explore the reasoning to ensure the provider is not hiding something.

USE DILIGENCE TO FIND THE SERVICE YOU NEED

Today plan sponsors have access to excellent variety and choice across the transition management industry. One negative side effect of this is that there are a multitude of different business models, each with varying levels of protection and conflicts of interest. Because of this, hiring a transition manager that will serve as "fiduciary" is not enough to ensure alignment of interests. While the term fiduciary may not be the universal remedy for protection when hiring a transition manager, there is still much you can do. Whether or not you hire a transition manager as fiduciary is no longer important. Rather, you should focus on understanding the protection and service you will receive, regardless of the title. Asking the above questions and probing a little deeper can help you understand the level of protection and service you are receiving, as well as help you differentiate among providers. And even if these questions are not answered honestly or directly, at least your provider will know that you are watching carefully.

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FOR MORE INFORMATION

To learn more about managing transitions, please contact the transition management team at 312-557-5173 or email ntgi_transition_management@ntrs.com.

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