# Cross Trades in the Transition Management Marketplace

## William Conlin and Michael Iannucci

**William Conlin**
is president of Abel/Noser Corp. in New York, NY.
**bconlin@abelnoser.com**

**Michael Iannucci**
is vice president of transition services at Abel/Noser Corp. in New York, NY.
**miannucci@abelnoser.com**

Over the last 30 years, the transition management marketplace has seen many changes. The most important of these is that the plan sponsor community has become more acutely aware of what Wall Street can do when not closely watched. In response to this new scrutiny, transition managers have developed tools designed to reduce costs and increase transparency. But in reality, many of these "innovations" can be described more accurately as "sales tools" and not a paradigm shift as advertised. It behooves you to understand what you are being sold, because it is clear, now more than ever, that Wall Street has perfected the art of marketing ideas that sound good for the plan sponsor but are really better for the Street.

All transition management models have inherent conflicts of interest in varying degrees.

This truth is not a disqualification of all providers. But it does point to the need for the plan sponsor to have an understanding of, and confidence in, the chosen transition manager's process and business model. Particular attention should be paid to newer ideas that are offered under the banner of "best practices."

The hazards of some of these "solutions" are well-documented. The practice of prehedging, for example, was once marketed as a benefit to transition accounts. Today, it is widely acknowledged that this process introduces new and significant conflicts into the transition process, and can move the strike price of a trade to the client's detriment. However, there are other practices that can also negatively impact the implicit costs of a transition, but are generally viewed to be an unqualified benefit. The practice of crossing transition orders with inventory or customer flow is perhaps the most common and potentially the most harmful of these.

That crossing has become prevalent is not surprising. It is an easy concept to sell. Instead of taking large and potentially illiquid orders to the open market, a transition manager attempts to find the other side of a trade and match them up without moving the price. This minimizes market impact, and is often done at zero explicit commission cost. However, this apparent win-win situation can create undue implicit costs in myriad ways.

The most fundamental (and the most alarming) of these is that, by definition a cross is a transaction between two parties arranged by a transition manager, and that one of those parties often receives an inequitable price. In other words, like any trade, a cross requires a counter-party to take the other side of the transition client's order. Trading, of course, is a zero-sum game, and it is the exception rather than the rule that these transactions benefit the transition account from a pricing perspective. The counter-parties to these trades are generally investment advisors who have more resources to determine whether a pricing

opportunity is attractive. In any case, they are certainly more aware than the transition client of the profit/loss on these trades. The transition client, after all, is typically not aware of this trade until after the fact, and even then is concerned primarily with the overall results of the transition and not the execution quality of a handful of crossed securities. Even within the strictures of "best execution" regulations, there is enough wiggle room for the transition client to be disadvantaged.

Beyond this problem of the cross requiring the transition manager to serve two masters, undisciplined crossing can also spoil the hedge that a two-sided transition affords. Market exposures must be diligently monitored throughout the transition process in order to avoid making an active market bet. If proportionally more crossing opportunities occur for the legacy portfolio of a transition than the target portfolio, the transition manager can expose the transition account to adverse market movement, creating a risk that was never intended. Forgoing neutrality for crossing opportunities is one of the most damaging moves a transition manager can make, as those market movements can add significantly to the implicit costs of an event.

Crossing is not an unregulated practice. But there is much evidence to suggest that transition managers continue to execute these trades in a way that is in conflict with their mandate to preserve the asset value of the transition account. It is not atypical for a third-party transition review to reveal that, while crossing did afford explicit savings, these savings were dwarfed by the poor execution quality of crossed securities, relative to those that were traded in the open market. Accounting for liquidity and market direction does not significantly reduce this disparity.

This is not to say that crossing is uniformly bad for the transition account and should be prohibited. When crosses are effected with an unsolicited third party, with a mind toward maintaining dollar- and sector-neutrality, and at a fair price, they are unquestionably a benefit to the transition account. However, these conditions are rarely all met. Many crossing strategies flood the market with indications of interest. Many are passive in nature. And many are lamentably predatory.

Ultimately, transitions are straightforward. Plan sponsors should evaluate providers on project-management expertise, trading capabilities, and the quality of their pre-trade and post-trade analytics. Increasingly, plan sponsors should also be wary of firms that advertise a high crossing rate, especially if they are not sufficiently comfortable with the circumstances under which these trades are effected.

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