Financial Conduct Authority

August 2025 update:
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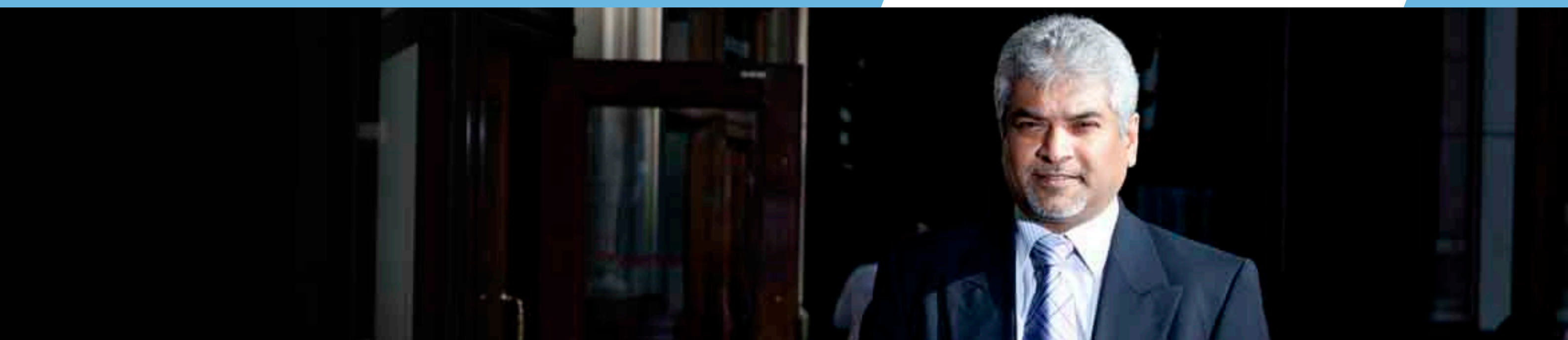
Thematic Review TR14/1

Transition management review

February 2014



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Foreword by Clive Adamson, Director of Supervision

Transition management (TM) is used by asset owners, such as pension funds, to help move investment portfolios between different managers or markets while managing market risk and reducing transaction costs. The main providers of TM are investment banks, custody banks, asset managers and specialist firms.

The size of the TM market is considerable (over £165bn of assets are transitioned in the UK every year). It is an important service for asset owners and to millions of underlying pension fund holders in the UK. Without it, changes between asset class, geography or manager would take longer, be more complex and could result in more risks and higher costs. Poor conduct in TM can have a major impact on underlying clients (e.g. damaging returns for pension holders) while undermining market integrity.

Since 2011, a number of incidents have occurred that have raised questions about the role played by TM providers. We have seen failures to manage conflicts of interest, poor governance and insufficient oversight. As a result, we conducted a high-level review to look at standards across the TM industry.

Our review sought to better understand the TM market, explore potential weaknesses in managing conflicts of interest and examine senior managers' understanding of client requirements and the strength of controls.

While the firms visited in our review were able on the whole to demonstrate the existence of broadly appropriate controls and an understanding of the risks, the quality and effectiveness of controls varied.

While the relevant FCA rules and guidance establish an appropriate standard, and are fit for purpose, we will keep the conduct of firms under review as we carry out our normal supervisory activities. We will continue to apply regulatory sanctions if firms fall short of our requirements.

2.
Overview

What is Transition Management?

Transition Management (TM) is used by asset owners, such as pension funds, to help move investment portfolios between different managers or markets while managing market risk and reducing transaction costs. Without it, changes between asset class, geography or manager would take longer, be more complex and would result in more risks and higher costs.

The process will generally involve the TM provider using hedging instruments to minimise exposure to market movements before selling the existing ('legacy') portfolio and buying a replacement ('target') portfolio through programme trades. The TM provider will look to develop a trading strategy to complete the trades with the least negative impact on the value of the assets being transitioned.

The principal TM providers are investment banks, asset managers, specialist providers and custody banks. At the start of 2013, there were 13 firms conducting such business on a regular basis in the UK. All main providers were involved in our review.

Why have we looked at the TM industry?

Information was received by the Financial Services Authority (FSA) alleging overcharging and a failure to manage conflicts of interest by TM providers, which led us to examine the level of oversight, governance and controls within TM.

The scale of TM in the UK

We obtained data from all the leading TM providers operating in the UK, including figures for the number of mandates conducted and the volume of assets traded.

The data shows that over £165bn of assets in legacy portfolios was transitioned annually in the three years 2010-12 by 13 TM providers. Around 700 individual transition mandates occurred per annum during the same period.

Our research confirmed the concentration of the industry, with the top five of the firms reviewed accounting for 68% of transitions by number and nearly 80% by volume of assets traded.

3.
The TM environment

The structure and complexity of TM

The asset owner or client can be unfamiliar with the TM process, as it is not carried out often. Also, the client may be focused on the decision to shift asset manager or allocation, rather than the practicalities of doing so.

TM clients are used to dealing with asset managers who act as an agent for them (where the asset manager contractually commits to act in the best interests of the client). In contrast, the duties owed by a TM provider under its agreement may be different since that TM provider may act as counterparty to elements of the trading. TM clients may therefore not be aware of the potential conflicts in the TM relationship and how it might impact on the service provided.

Regulatory obligations on TM providers

The project management elements of TM business are not regulated. The regulated activities are:

- investment services of dealing on own account (dealing as principal)
- execution of orders on behalf of clients
- reception and transmission of orders (dealing as agent)
- arranging deals in investments.

TM may be provided to clients who are classified as professional clients or as eligible counterparties. If the TM provider is also an eligible counterparty these services are, collectively, considered to be eligible counterparty business. This means that several detailed conduct of business rules are not applicable, which are covered below.

However, regardless of the classification of their client, TM providers are required to comply with the provisions set out in SYSC 10 requiring that a firm must take all reasonable steps to identify conflicts of interest between:

1. the firm, including its managers, employees and appointed representatives, or any person directly or indirectly linked to them by control, and a client of the firm
2. one client of the firm and another client.

We set out below several of the inherent conflicts of interest that may arise in the provision of TM services. This list is not exhaustive and it remains the responsibility of firms to identify, record, manage and (where the arrangements made to manage conflicts are not sufficient to ensure that the risks of damage to the interests of clients will be prevented) disclose any conflicts constituting or giving rise to a material risk of damage to the interests of its clients.

It is important to note that disclosure must be made to a client before the provision of a service and must include sufficient detail to enable that client to make an informed decision about whether to proceed [SYSC 10.1.8R]. Disclosure does not exempt the firm from the obligation to maintain and operate effective conflict management arrangements and an over-reliance on disclosure without considering how conflicts may be appropriately managed is not permitted [SYSC 10.1.9G].

TM providers acting on behalf of professional clients will also need to comply with additional conduct of business rules, including the clients' best interest rule (COBS 2.1) and the best execution rule (COBS 11.2). The clients' best interest rule goes to the heart of our expectations regarding the conduct of agency relationships on behalf of clients.

The best execution rule is of particular relevance to TM performance. When executing orders, firms must take all reasonable steps to get the best possible result for their clients on a consistent basis, taking into account various execution factors.

Firms that retain TM services on an eligible counterparty basis will also need to consider any relevant duties that they owe to their own underlying clients. These may require them to opt up to a higher level of regulatory protection (by requesting treatment as professional clients) or to secure contractual protections for their clients that have an equivalent effect to those regulatory protections. Whichever route firms choose, we expect firms that act in an agency capacity to be able to carry out all of their obligations to their underlying clients.

The inherent risks in TM

TM mandates are particularly vulnerable to conflicts of interest, such as:

Pre-trade information – A conflict between what the client needs from pre-trade information (an accurate assessment of the complexity of the trade and an estimate of likely costs of the trade) and the TM provider's desire to win business with an unrealistically low estimate or, potentially, to over-deliver (e.g. over-estimate likely costs to ensure a good performance relative to the chosen benchmark).

Mis-use of information – One of the drivers behind the use of TM is the clients' need to alter exposure to particular markets by executing a large volume of trading in a short period. It is critical that where information of such trading could be used in a manner contrary to our rules or other regulatory and statutory provisions (such as front running or market abuse) controls are in place to manage that risk.

Principal trading – Some TM providers and associates are able to act both as agent (as TM provider) and principal (as counterparty to the transactions themselves). Client and TM providers may have a direct conflict over the provider's choice of how (and with whom) it executes client orders.

Internal crossing – This can give rise to conflicts of interest between different clients if, for example, trading is delayed to allow the buy and sell orders in the same securities to be matched (crossed) with another client, or where crosses occur internally at a worse price than could have been obtained in the open market.

Execution venues – TM providers may direct the transactional flow from TM mandates towards particular execution venues (e.g. multi-lateral trading facilities or dark pools) in which they have a commercial interest. This could lead to transactions being made in the interests of the TM provider at the cost of the client.

Affiliates/revenue sharing agreements – Execution of the TM mandate via an entity affiliated to the TM provider can give rise to conflicts, with the affiliate potentially seeking to maximise revenue rather than act in the client's best interests. TM clients may also find it harder to ascertain whether best execution has occurred, while costs may be increased by additional layers of fees.

***'In specie'*/substitution –** Where there are common securities in the legacy and target portfolios, it may be in the client's interest for these to be transferred via an *'in specie'* transfer, but if the TM provider is remunerated by commission (as is industry standard), it may not be incentivised to choose the lower-cost option. On fixed income TM mandates, TM providers may not be incentivised to look for substitution opportunities that may be in a client's best interest, as this would result in fewer trades being conducted.

4.
Key findings

Clarity of role

There are often clear asymmetries of information and expertise between TM providers and their clients, which can be addressed through improved transparency.

The best execution rule also places obligations on firm to regularly monitor and review their execution policies and procedures, and to take action required to correct any deficiencies. Monitoring performance, and being able to demonstrate to clients that reasonable steps to achieve best execution have been taken, is a crucial component of the regulatory regime because it empowers clients to hold firms to account for the quality of their TM service. Clients have a continuing role to play in ensuring that they receive an adequate service from TM providers and that regulatory tools are available to facilitate scrutiny of performance.

We noted that this is still an area where TM providers can improve. We found instances of poorly worded and potentially misleading marketing materials. Several firms were also found to be issuing materials to clients stating that they would act as a 'fiduciary' during the transition process, even though the standard legal agreement governing transition arrangements at those firms had expressly excluded the existence of a fiduciary relationship. We have made clear our concerns to the firms involved.

TM providers' oversight and governance

We found that all TM providers were aware of the conduct risks that might crystallise through insufficient oversight and we have set out above a selection of the sort of conflicts of interest issues that present themselves. However, the relatively small scale of TM at many firms is such that it is easy for senior managers and control functions to underplay oversight of TM in the belief that it is low-risk, quasi-project management business. Before our review, some TM desks appeared to have had limited contact with their control functions or senior management.

When problems have occurred these have often been compounded by basic failures in oversight. This can take many forms:

- failure of the legal function in overseeing the contractual process
- failure to ensure appropriate segregation of duties at firms
- failure to reconcile amounts agreed with clients with amounts invoiced
- failure to question large increases in revenues generated
- a general lack of senior management challenge and oversight.

Accountability

TM providers look to demonstrate their level of control over the risks noted above by providing disclosures, management information and data during the course of a given TM mandate. Pre and post-implementation reports are an important element for the provision of transparency for TM clients.

However, our review noted that such reports vary in the level of detail and clarity provided.

Also, there is often no internal segregation of duties (between those effecting the transition and those reporting to the client on performance) which may affect the degree of reliance that can be placed on such reports.

We noted that some clients recognise this weakness and choose to employ an independent third-party to conduct such performance measurement validation as an independent control. However, this does not remove the TM provider from any obligation to meet the requirements of our rules and principles for businesses.

5.
Next steps

We believe our existing rules and guidance establish a high standard and are fit to govern TM practices. We expect TM providers to be vigilant in monitoring the application of their controls to meet their obligations. A full appreciation of the complexity of TM will be required to establish appropriate first, second and third line of defence controls.

In the normal course of our supervisory work we will focus on:

Management of conflicts of interest
Our review found that multiple conflicts of interest can exist within TM. Supervisors will continue to pay close attention to how TM providers manage and mitigate such conflicts.

Oversight, governance and controls at TM firms
The complexity of TM services requires the senior management of firms to ensure that there are appropriate controls and oversight.

Transparency and communication
Our review found deficiencies in transparency and communication by some TM providers with their clients and differences in the level of control around reporting on performance. Our supervision work will include requiring firms to demonstrate appropriate communications and effective performance reporting.

Client understanding
We will look to see if firms better understand the information requirements of their clients and expect clients also to consider what assistance, education or guidance might best prepare them to carry out their obligations to underlying investors.

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PUB REF: 004850

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