Talking Transitions *with* Penserra

SERIES 1 | ARTICLE VII

Crossing – a tool, not a strategy, in Transition Management

Crossing has received more than its share of attention over the years, yet may still not truly be understood.

For a period of time, crossing was the star of all transition management strategies. Crossing reduced spread and impact costs, and more crossing was almost universally acclaimed as better than less crossing. As bid/offer spreads contracted and the number of crossing venues expanded, more focus was centered on the opportunity costs associated with waiting to cross. Crossing took on more the role of one of several tools to manage transaction costs—the value of crossing becoming more related to the skill and experience of the transition provider.

The advent of high frequency trading and the resulting participation in crossing pools then took a turn in the spotlight –the new concern that dark pools and crossing venues were becoming more the domain of 'shady' characters looking to pick the pockets of institutional order flow as opposed to sources of additional liquidity.

Though continuing to evolve, crossing is still a valuable tool for transition providers to manage trading costs—any security crossed at the bid/offer midpoint or better theoretically incurs zero spread and impact cost. When combined with the reality that it is rarely if ever prudent to wait to cross, or incur opportunity cost in hopes of saving a portion of the bid/offer spread later, crossing becomes an integral part of the quantitative framework for creating a transition strategy. It is important to understand the types of activity that can fall under the umbrella of 'crossing', to be aware of the crossing tools being used by any retained transition provider, and be able to evaluate the benefits and shortcomings of crossing tools included in any transition proposal.

What follows is a list of the primary types of crossing available to transition managers. Based on an evaluation of the positives and negatives, transition managers can then choose which types of crossing makes sense for their clients and their trade strategies.

Though continuing to evolve, crossing is still a valuable tool for transition providers to manage trading costs.

▶ Internal Crossing: Department of Labor (DOL) Exemption

Cross trades making use of the DOL exemption are by definition, crosses between a client transition portfolio and a transition provider's internal index or model driven funds. The crossing price is generally set as the trade date closing price (market-on-close) and no commissions are charged.

Pros - Spread and impact are reduced and there are no commission costs to transition clients.

Cons - Executions at the closing price subjects the crossed security in question to a full day of active market risk when using an implementation shortfall T-1 close benchmark—the increase in opportunity cost is almost always greater than the anticipated spread and impact cost savings. In addition, the inability to constrain crossing results to specific dollar targets opens the door to scenarios where unequal dollars crossed on the buy and sell side creating an exposure mismatch that actually increases short term active risk and generates shortfall in excess of the savings associated with crossing. Though generally offered at zero commission, the appeal of DOL exempt internal crossing often fades as the practical implications of greater opportunity risk plays out in the form of increased implementation shortfall.

PENSERRA

▶ Internal Crossing: Fiduciary

Some transition managers acting as a fiduciary offer the opportunity to cross transition legacy and target portfolios against trade flows from other clients for whom they are also acting as a fiduciary. The key questions are what internal mechanism is created to match trades, who sets the cross prices, and when those prices are set.

Pros - Again, reduced spread and impact and zero commission costs.

Cons - Revolve around muddying the role of fiduciary with concerns about how and when crossing trades are matched and how crossing prices are set.

▶ Internal Cross: Indications of Interest (IOI)

Crossing based on indications of interest, or sales trading order flow, is a crossing technique used by some transition managers. Traders will shop larger block orders to trading counterparties who may have interest in those names. Indications include the security name, general size to trade and side of the market (buy/sell).

Pros - Transition providers with large networks of counterparties may be able to source additional liquidity.

Cons - Significant information leakage that can adversely affect shortfall performance. In addition, there is potential for conflicts of interest as transition managers get paid on both sides of IOI trades and may have unique incentive both in terms of how much IOI trading to do and how to set the crossing prices.

▶ External Cross: Affiliated Dark Pool

Some transition managers own proprietary dark pools or have a financial interest in a collective dark pool. External cross trades in affiliated dark pools generally incur the negotiated commission rate and can represent legitimate sources of additional liquidity.

Pros - Additional liquidity that reduces spread and impact costs.

Cons - The potential financial conflicts associated with routing trade volume first to a venue in which the transition provider has an interest.

External Cross: Unaffiliated Dark Pools or Alternative Trading Systems (ATS)

Dark pools and ATS can be valuable tools for managing trading costs when screened for appropriate counter-parties and used by providers not optimizing order routing for rebates. There are roughly 60 of these liquidity sources available to global equity traders. Orders can be limited to executions at mid-point or better. Trading technology allows smart routers to ‘sweep’ these venues to see if an immediate midpoint or better cross is available. The end result is that every order that makes it to the open market has been screened instantaneously through multiple liquidity sources to determine if a lower spread and impact execution is available.

Pros - The value to external dark pool crossing is that they provide a tool to help actively manage trading costs.

Cons - The existence of predatory counter-parties and the potential to increase opportunity cost. This concern can be managed by experienced traders and a thoughtful transition strategy.

Summary

The bottom line is that crossing continues to be an important tool for managing trading costs, but not all crossing should be considered equal. More specifically, some types of internal crossing have the potential to be problematic for transition management clients. Transition clients should consider requiring revenue attestation documentation to increase transparency and better understand the revenue implications and potential conflicts involved in the use of certain crossing tools. When used by experienced traders and transition managers, transparent crossing strategies can provide significant benefit and should be considered as part of any thorough transition plan.

Turn to Penserra to deliver the investment, trading, and operational expertise you require for a seamless transition.

Contact Us
Penserra Transition Management
(855) 736-7377 | transitions@penserra.com