

OCIO: Thinking like a fiduciary



3 key issues for corporate pensions to consider

Russell Investments Research / Viewpoint



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One of the most notable trends in our industry has been the emergence and growth of the outsourcing of pension investment management, which is often referred to as the outsourced CIO (OCIO) model. According to the most recent annual survey by *Pensions & Investments*, the number of OCIO providers increased from 32 in 2011 to at least 62 in 2020. Further, institutional assets in excess of \$1 trillion are now managed on either a fully or a partially discretionary basis worldwide.¹

Just below the surface of this impressive-growth headline lie some practical considerations that must be addressed by any pension plan sponsors considering outsourcing. These issues tend to fall into one of three categories:

1. **Fiduciary duty** – e.g., how can a plan sponsor ensure that the plan’s participants are protected in an outsourcing arrangement?
2. **Role** – e.g., should the OCIO provider be a fiduciary as defined under ERISA section 3(21), or an investment manager as defined under ERISA section 3(38), or both?
3. **Evaluation** – e.g., how should a sponsor go about evaluating different providers of OCIO services?

This note summarizes Russell Investments’ views in each of these areas and includes a “who does what” worksheet, along with a set of sample interview/RFP questions that may be useful to a plan sponsor considering outsourcing.

1. Fiduciary duty: Expertise, alignment and accountability

There are multiple OCIO providers, with different backgrounds and skills, offering a wide range of services to fill an evolving set of client demands. We think this environment offers a great laboratory for much-needed innovation. We also recognize that it poses real risks. Therefore, we need an organic, three-pillar approach to investment management that achieves a balance of: *fostering service innovation, avoiding pitfalls that would ultimately harm plan participants or plan sponsors and applying regulatory regimes in support of investment outcomes.*

“ We need an organic, three-pillar approach... **”**

Attempts to regulate a quickly evolving market via detailed rules alone are bound to be ineffective. In our experience, effective regulation must begin with statements of principles that clearly set out what is ultimately expected of providers, which means mandating that plan participant interests are always put first.

The good news is that the necessary principles for effective regulation of the OCIO industry are already established under the Employee Retirement Income Security Act of 1974 (ERISA). According to the U.S. Supreme Court, “ERISA’s fiduciary duties are among the highest duties known to law and are more exacting than the duties [imposed on others in positions of trust].” ERISA’s complex subtleties demand a seasoned expert whose “decisions must be made with an eye single to the interests of the [plan] participants and beneficiaries.” Fortunately, the regulatory framework of ERISA supports outsourcing to qualified experts to improve retirement outcomes.

This paper will provide a review of the underlying principles of fiduciary duty.

Expertise

The quality of any professional service depends on the **expertise** of the provider. Indeed, it is often necessary to be reminded that expertise is the primary reason for hiring any professional. Many of the other features of the regulatory framework of ERISA are designed to help manage risk, but no improvement in investment outcome can be expected if an OCIO provider lacks the experience and skill to do the job.

The principle of expertise resides in the duty of care and prudence articulated in ERISA’s well-known “prudent expert” standard. Outsourcing has become more complex, and now demands more expertise. Providers must have the skills, knowledge and tools required to deal with that evolving, rather than static, complexity; and plan sponsors must have the ability to identify the best providers.

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Alignment of interests

Expertise alone is clearly not enough. It must be exercised solely for the benefit of plan participants and beneficiaries, not for the benefit of the OCIO provider (or others) at the expense of the participants and beneficiaries. This is why **alignment of interests** is so important.

The alignment-of-interests principle is found in ERISA’s “exclusive benefit rule” and its hierarchy of “prohibited transactions,” which sets out the strict fiduciary duty of loyalty. It is imperative that all forms of compensation and other incentives be disclosed, and that any potential conflicts of interest are carefully addressed and managed. For example, ERISA prohibits the provision of advice, or taking discretion for decisions, that affects the level of compensation paid to that provider. Therefore, ERISA sets out strict principles for how a fiduciary deals with plan assets and how, and with whom, that fiduciary transacts business.

Meaningful disclosure does not necessitate lengthy and opaque disclaimers designed to protect the provider rather than to inform the investor. Rather, disclosure should act as the basis for an understanding of the business model of the OCIO provider, and of the incentives this model creates. Under ERISA, this is the only permissible use of disclosure.

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Accountability

Finally, **accountability** is the foundation of an effective outsourcing relationship. It is also the place where a collaborative approach among sponsors, providers and regulators is essential.

This principle is anchored in the delegation and supervision provisions of ERISA, and in its fiduciary principles of prudent governance and oversight. The roles and liabilities of the sponsor, trustee and provider must be clearly defined in contracts and related documents; measurable against clear objectives; and prudently governed with visible and effective policies, processes, self-policing and reporting.

2. Role: Can an OCIO provider fill the role of a fiduciary that provides investment advice and an investment manager?

The short answer is, “yes.”

The longer answer requires us to spend a bit more time on the definitions of, and requirements associated with being, a fiduciary and an investment manager. These roles are often described respectively as “3(21)” and “3(38)” fiduciaries under ERISA, but these labels can be confusing and often raise questions about how an OCIO provider can offer both investment advice and discretionary asset management.

Section 3(21) is typically used to describe an advisory role, but it is actually ERISA's definition of "fiduciary," and it applies to both advice (discretionary or not) and/or investment management. Section 3(38) is the definition of "investment manager," which is a specialized, sophisticated and discretionary fiduciary. OCIO providers are considered fiduciaries if they provide investment advice for a fee, or take discretion over plan assets (i.e., investment management) or are named by a plan document as the plan administrator. A plan sponsor can hire a single OCIO provider to provide a range of services, so long as the provider is qualified, and the contractual roles and responsibilities are clearly defined.

A specific question that is often asked is how an OCIO provider can fulfill its fiduciary obligations while acting both as an advisor and as a discretionary investment management authority. Here are a few rules of thumb:

- Generally, a plan sponsor should ask the provider to accept the prudent expert standard of care for all *expert* advisory or investment management services, including recommendations on overall strategy and asset allocation.
- The contract should contain appropriate provisions that establish the plan sponsor's independent determination to hire the OCIO provider as well as appropriate mechanisms so that the OCIO provider cannot determine its own compensation.
- The OCIO provider's fee structure and responsibility for managing plan expenses should be clear. It is important to note that no fee structure is entirely free of potential conflicts. The key is that all sources of revenue (including direct and indirect) are fully and unambiguously disclosed. An OCIO provider's annual 408(b)(2) ERISA disclosure statement is a key disclosure document.

In addition, it is useful to define the exact functions to be delegated under an OCIO arrangement. The worksheet attached as Appendix 1 has proven very helpful to our clients. The worksheet breaks out the functions associated with managing a pension plan into three categories: plan management, asset management and operations/administration. For each function, we recommend specifying whether it is something the plan sponsor wishes to retain, delegate or be advised on. This exercise is not only useful for the plan sponsor, it also enables the OCIO provider to pull together the right resources for the assignment. Specifically, it gives the provider a clear sense of the "center of gravity" (i.e., plan management, asset management or operations/administration) for situations that are not completely outsourced.

Appendix 1 ... breaks out the functions associated with managing a pension plan...

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3. Evaluation: Finding the right partner

While most plan sponsors are experienced in the evaluation of investment advisors and investment managers, evaluating OCIO providers requires exploring some uncharted waters.

For those who choose to manage the OCIO search process on their own, Appendix 2 includes a table with sample questions and topics that could form the basis of an interview or the construction of a formal RFP. The questions are laid out to follow the previously outlined framework. The rows represent the key areas of fiduciary duty (i.e., expertise, alignment of interests, accountability), while the columns address plan management, asset management and operations/administrative capabilities. A more comprehensive list of potential RFP questions is available at <https://russellinvestments.com/us/contact-us/build-an-rfp>.

Build an RFP

We'd like to provide you with a list of the questions we believe you should ask prospective OCIO providers during the RFP evaluation process.



[CLICK HERE](#)

For those seeking assistance with the provider search process, there is an increasingly large number of OCIO search consultants. In general, these consultants fall into one of three categories:

1. Traditional pension consultants

Most of these consultants have the expertise necessary to conduct a thorough search but, in some cases, also offer OCIO services themselves, which may require additional care in terms of managing potential conflicts of interest.

2. Specialty consultants

These consultants offer expertise in terms of finding OCIO providers while generally not offering OCIO services themselves, which may make managing potential conflicts of interest easier for the plan sponsor.

3. Former pension CIOs

Finally, we have observed the entrance of former pension CIOs into the mix. This is typically a firm of one or two individuals, which means resources may be limited but the prospect of finding a consultant who has direct experience with the plan sponsor's specific situation is appealing. In terms of alignment of interests, there can be more variability in this segment and some former CIOs may not have the depth and breadth of experience for optimal decision making. Some providers stick exclusively to performing searches while others provide OCIO services as well.

While the business models vary, the principles of expertise, alignment of interests and accountability should be applied to identifying an OCIO search consultant in the same way that they are applied to evaluating an OCIO provider.

Summary

Clearly, outsourcing should be considered only when a better outcome (i.e., better holistic investment outcomes, risk mitigation, lower fees and/or reduced demands on internal resources) is more likely achievable under the OCIO model than under an internally managed approach. It is incumbent on the industry to deliver demonstrable value along this dimension.

The next hurdles to clear are the regulatory and fiduciary requirements. A properly qualified OCIO provider can fulfill the fiduciary roles of both a 3(21) fiduciary and a 3(38) investment manager, so long as roles and responsibilities are clearly specified – and the relationship is structured such that the plan sponsor retains decision-making authority over the broad strategic asset allocation, and that any discretionary asset management decisions the OCIO provider makes do not affect its compensation.

The final step for a plan sponsor is to identify an OCIO provider with a philosophy that is aligned with that of the sponsor. This means having a culture consistent with that of the plan sponsor, experience with the plan's specific issues and resources sufficient for the handling of diverse tasks, which can range from strategic asset allocation to administering monthly benefits payments. As with any business relationship, the legal agreements, governance structure and reporting must be in place to provide appropriate legal protection to clearly document accountability for all parties.

¹ *Pensions & Investments*, "OCIO growth assisted by volatile times," June 29, 2020.

Appendix 1: Roles and responsibilities worksheet

Plan Management

1. INVESTMENT COMMITTEE MANAGEMENT	RETAIN / DELEGATE / PARTNER
Establish Investment Policy Statement	Sponsor should retain
Approve annual strategic plan	Sponsor should retain
Manage investment committee meeting agenda	
Monitor plan service providers (supported by monitoring and oversight efforts listed below)	Sponsor should retain
Prepare custom investment committee and board reporting	
2. CORPORATE FINANCIAL SUPPORT	RETAIN / DELEGATE / PARTNER
Approve contribution policy	Sponsor should retain
Perform audit and Sarbanes-Oxley (SOX) internal control testing	Sponsor should retain
Decide on Expected Long Term Return on Assets (ELTRA) assumption (auditor ultimately approves)	Sponsor should retain
Provide corporate budgeting and cash-flow forecasting assistance	
3. STRATEGIC ASSET ALLOCATION (SAA)	RETAIN / DELEGATE / PARTNER
Approve SAA/glide path plus any tactical discretion bands around glide path	Sponsor should retain
Advise/recommend SAA, de-risking glide path schedule and end game (e.g., risk transfer where appropriate) – includes working closely with the plan's actuary	
Implement shifts between return-seeking and liability-hedging portfolios according to glide path	
Monitor daily funded status relative to glide path, downside risk associated with current SAA and relative attractiveness of return-seeking vs. liability-hedging portfolios	
Implement tactical tilts within discretion bands	
Recommend additional periodic downside protection outside tactical discretion bands	
4. AD HOC REQUESTS	RETAIN / DELEGATE / PARTNER
Support investor relations	Sponsor should retain
Respond to inquiries from rating agencies	Sponsor should retain

Asset Management

1. RETURN-SEEKING PORTFOLIO	RETAIN / DELEGATE / PARTNER
Approve fee budget and specify investment objectives (e.g., benchmark, tolerance for/definition of risk)	Sponsor should retain
Research and rank managers (including operational due diligence assessment)	
Determine overall portfolio structure	
Select managers and manage portfolio within fee budget and investment objectives	
Conduct ongoing evaluation of the attractiveness of active/passive, alternative strategies/instruments and portfolio factors	
Recommend portfolio changes based on the risks/opportunities identified above	
Monitor performance of return-seeking portfolio relative to objectives	Sponsor should retain
2. LIABILITY-HEDGING PORTFOLIO	RETAIN / DELEGATE / PARTNER
Approve fee budget and specify investment objectives/eligible instruments for liability-hedging portfolio	Sponsor should retain
Research and rank managers (including operational due diligence assessment)	
Determine strategic composition of liability-hedging portfolio	
Select managers/instruments and manage portfolio within fee budget and investment objectives	
Conduct ongoing evaluation of the relative attractiveness of credit vs. Treasuries, physicals vs. derivatives, and key rate exposure vs. liabilities	
Recommend portfolio changes based on risks/opportunities identified above	
Monitor performance of hedging portfolio relative to objectives	Sponsor should retain

Operations and Administration

1. OVERSIGHT AND MANAGEMENT OF CUSTODIAN

RETAIN / DELEGATE / PARTNER

Serve as day-to-day contact with custodian

Manage liquidity to meet operational requirements (e.g., contribution investment, benefit payments, capital calls)

Establish new accounts/close old accounts as asset class and investment manager structures evolve

Manage asset transitions

Oversee implementation of security valuation policy (ex-legacy/retained assets)

Monitor and evaluate use of custodian trading capabilities (e.g., FX)

Conduct proxy voting, engagement and class action oversight

Process vendor invoices (excluding those vendors hired/retained directly by the sponsor)

Conduct oversight of monthly and quarterly trust reporting

Create and implement custody/accounting scorecard and make annual oversight and due diligence visit

2. PERFORMANCE MEASUREMENT AND ANALYTICS

RETAIN / DELEGATE / PARTNER

Conduct oversight of performance and analytics reporting

Monitor investment manager compliance with guidelines

Establish new accounts/close old accounts and composites as asset class and investment manager structures evolve

Oversee calculation of custom benchmarks

3. SECURITIES LENDING MANAGEMENT

RETAIN / DELEGATE / PARTNER

Determine securities and borrowers' eligibility for lending

Set collateral investment guidelines

Evaluate and report results

4. REGULATORY FILING REQUIREMENTS

RETAIN / DELEGATE / PARTNER

Support employee benefit plan financial statement preparation and audits

Support Form 5500 reporting

Appendix 2: Sample interview & RFP questions

	BUSINESS MODEL	PLAN MANAGEMENT	ASSET MANAGEMENT	OPERATIONS AND ADMINISTRATION
Expertise – Assess the provider’s ability to meet the fiduciary duty standard of care (ERISA’s “prudent expert” standard)	<ul style="list-style-type: none"> Describe the functions your firm typically assumes in an OCIO relationship and the resources you assign to manage each function. What internal resources does the plan sponsor need to retain in order to oversee your OCIO services? Describe your firm’s conflicts-of-interest policies and mitigation of potential or actual conflicts. 	<ul style="list-style-type: none"> Describe your firm’s overall philosophy as it pertains to plan management, including strategic asset allocation and governance. Provide an example of how this philosophy has been put into practice across your client base, including a historical track record. How do you adapt these beliefs to the objectives of plans like ours? 	<ul style="list-style-type: none"> Describe your firm’s beliefs as they pertain to asset management. Provide an example of how these beliefs are reflected across your client base, including historical track record. Describe your firm’s approach to evaluating external investment managers. 	<ul style="list-style-type: none"> Describe your firm’s experience with the operational and administrative aspects associated with managing a [insert plan type]. How long have you been offering such services to plans like ours?
Alignment - Assess the provider’s ability to meet the fiduciary duty of loyalty	<ul style="list-style-type: none"> Describe how your firm is compensated in an OCIO relationship, including any direct or indirect means of generating revenue. Describe internal compensation structures for all teams and professionals involved in OCIO. Describe how your firm manages any potential conflicts of interest. 	<ul style="list-style-type: none"> Describe how your firm will ensure that the plan is managed for the exclusive purpose of providing benefits to the participants, in light of the economic realities of maintaining the economic viability of the plan sponsors. 	<ul style="list-style-type: none"> How does your firm balance the use of internally and externally managed investment solutions? 	<ul style="list-style-type: none"> Describe your approach to ensuring that expenses associated with administering the plan are reasonable.
Accountability - Assess the provider’s level of fiduciary responsibility	<ul style="list-style-type: none"> Describe the specific fiduciary responsibility your firm assumes in an OCIO relationship. Provide sample contracts. Describe the governance structure and specific processes in place to ensure that this fiduciary responsibility is met. 	<ul style="list-style-type: none"> Describe the plan management decisions your firm typically advises on, versus those that you take discretion for. How does your firm measure success in an OCIO relationship? 	<ul style="list-style-type: none"> Describe the asset management decisions your firm typically advises on versus those that you take discretion for. How does your firm measure success of the asset management aspect of an OCIO relationship? 	<ul style="list-style-type: none"> Describe the oversight your firm conducts for other service providers including the custodian and actuary. How does your firm measure the success of the operational and administrative aspects in an OCIO relationship?



Scoring matrix template

We have seen the benefit a well-defined scoring matrix can have on the process of selecting an OCIO provider. We’d like to share the template we have created.

[REACH OUT](#)

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For more information

Call Russell Investments at **855-771-2966** or visit russellinvestments.com/OCIO

Important information

Contributing authors include Mike Thomas and Brian Golob.

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