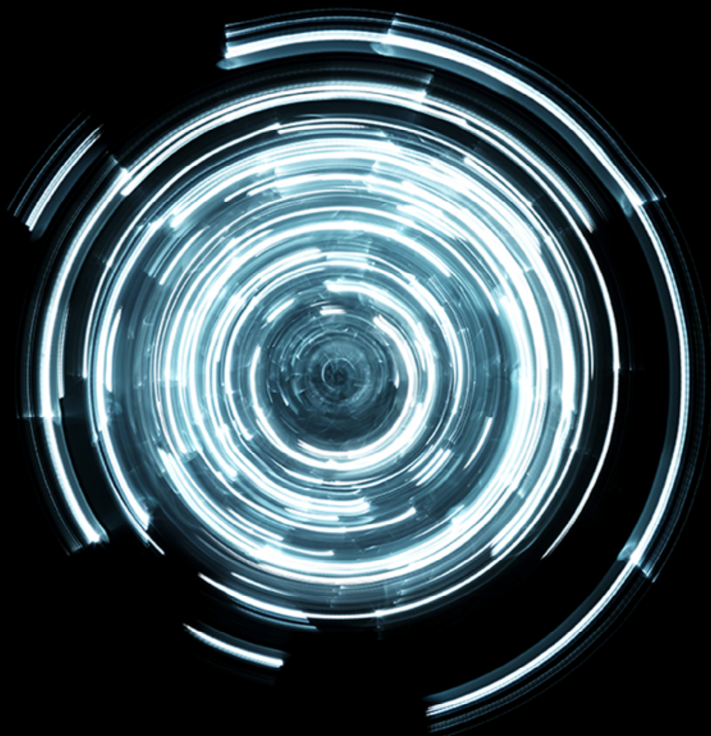
DC outsourcing

A compendium of white papers on OCIO solutions



Russell Investments Research

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Introduction

Defined contribution (DC) plans have become the primary retirement savings vehicle for many American workers. As a result, plan sponsors concerned with helping improve retirement income outcomes for participants are being tasked with an increasing array of plan design and oversight duties. As fiduciaries they are expected to have a high level of specialized knowledge, which requires significant time and resources.

Sponsors also face increasing pressure from policymakers and litigators to:

- Choose a suitable set of investment options, continually monitor fund performance and make sure fees are appropriate
- Select a recordkeeper and other administrators, and then continually monitor their performance and make sure they understand all fee arrangements
- Communicate information to participants extensively in plain language

The argument for outsourcing is clear. Tasks requiring special expertise that is not part of the sponsor's core competency should be outsourced to the experts.

If you are interested in selecting an outsourcing provider to manage certain aspects of your DC plan, you are bound to have questions and concerns: How do I select an outsourcer? What do I outsource? How much protection does outsourcing give me? What is my residual responsibility?

Mike Barry, of Plan Advisory Services Group, has done a great deal of thinking and research on these topics. We asked him to partner with us to assist plan sponsors in thinking through some of these important questions. Together, we produced short papers focusing on various aspects of outsourcing and have consolidated them in this booklet.

Our expectation is that the movement toward the outsourcing model will continue to evolve as demand for these solutions continues to grow. We will continue to follow this trend and provide solutions to plan sponsors looking for a fiduciary partner for their DC plans.

Contents

Why DC fiduciary outsourcing?

Today 77% of U.S. private sector workers with access to a workplace retirement plan will be entirely dependent on their defined contribution plan (DC) – plus Social Security – to meet their retirement income needs.[1]

As a DC plan sponsor you may be faced with the demands of running a company and your DC plan. Many defined benefit sponsors outsource their plan duties when faced with the same dilemma. Is it time for DC plan sponsors to do the same?

The job of a DC plan sponsor has become more complicated

As originally conceived, the "modern" 401(k) retirement account was to be managed mainly by the plan participant. The sponsor picked a provider, selected a fund menu, and that sponsor's job was done. Participants decided whether to join the plan, how much to contribute, and which funds to invest in. This was supposed to be a participant-driven system. For the plan sponsor, compliance with ERISA Section 404(c) was thought to be enough. In some companies, the entire plan was run from the human resources department.

While there may be some plans that still operate like that, for the most part, those days are gone.

As the defined benefit (DB) system has – for most corporate plan sponsors – become at best a legacy system for a limited group of older employees, the DC/401(k) system has become the primary retirement savings vehicle for most private-sector U.S. workers. The transition from DB to DC/401(k) has drawn concern from policymakers, regulators and many sponsors who have begun to realize that the participant-driven model has serious shortcomings. To help improve results for participants – i.e., increase participation and savings rates, improve asset allocation, reduce fees and help employees achieve better retirement income outcomes – the sponsor must be significantly involved.

Now, a DC/401(k) sponsor is expected to consider automatic enrollment; to pick (or design) a set of funds (typically a target date fund series) deemed appropriate for the participant population, into which most participants will be defaulted; evaluate the target date fund glide path; and provide a core menu for participants. To support the plan, the sponsor must arrange for and interface with a recordkeeper, monitor the performance of the plan's other providers and, of course, monitor the investment performance of the plan's funds.

Additionally, the sponsor must continually review the plan's various fee arrangements, and an increasing body of data concerning those arrangements, to make sure fees are competitive. Finally, all of this – how the plan works, what the fund choices are, how the target date funds work, what all of the different fees are, and what are distribution options – must be communicated to the participants extensively and in detail, and in "plain language."

In this context, the sponsor has become a target.

Outsourced investment solutions

As a leading provider of outsourced investment solutions, Russell Investments understands that before DC plan sponsors answer "why DC fiduciary outsourcing?" they need to fully understand what can be outsourced and how outsourcing works in practice.

The DC plan sponsor is the target of litigators, regulators and policymakers

For several years, plaintiffs' lawyers have been targeting DC sponsors. Going forward, sponsors can expect more lawsuits alleging that they have not understood or properly discharged their 401(k) plan duties.

Regulators will also continue to target DC sponsors. In 2012, the U.S. Department of Labor completed its fee disclosure project. In addition to participant disclosure requirements, providers are required to provide sponsors detailed information about a variety of fees and expenses. This information comes with a kicker: sponsors are held accountable for reviewing and understanding it. And if there is (or someone can claim there is) a problem – such as a service provider charging above-market fees – the sponsor will be expected to do something about it.

[1] U.S. Department of Labor, Form 5500 Summary Reports; EBRI Databook 1999-2017

Why is there so much pressure on DC sponsors? DC plans have become the main retirement savings vehicles for U.S. workers, and policymakers and regulators are realizing that the only person capable of driving improvements in the system is the sponsor.

Another big factor: the fiduciary decisions sponsors make in DC plans affect participant accounts. If a DB sponsor, say, picks a bad fund, the losses affect the sponsor, not the participant – the sponsor will have to contribute more to make up the loss. But in a DC plan, a bad fund results in losses to *participants'* accounts. High fees reduce *participant* balances. So, in DC plans, participants are natural plaintiffs.

Why sponsors are now thinking about outsourcing

In a simpler financial world, the new demands and pressures on DC sponsor-fiduciaries might be manageable. Sponsors used to think that just hiring a bundled provider constituted "outsourcing." Not anymore.

Sponsors now live in a world that requires their significant oversight of recordkeepers, trustees and custodians, where emerging markets and small cap are standard components of an investment strategy, and where the complexity of every transaction raises questions about whether they really understand who is paying what fees.

Moreover, there is intense pressure – from policymakers and litigators – to institutionalize DC investments. This involves the use of separate accounts, collective trusts and multi-manager white-label funds, and understanding the associated structural, administrative and participant communications issues. Strategies previously used only in large DB plans.

In this new world, being a fiduciary requires a high level of specialized knowledge. And a good deal of time and resources.

A good manager knows what to delegate and what not to delegate. The argument for outsourcing is clear: tasks requiring special expertise that is not part of the sponsoring firm's core competency should be outsourced to the experts.

What's the difference between outsourcing and just hiring an expert?

While the sponsor will always retain a residual fiduciary responsibility, ERISA clearly contemplates, and provides rules for, the delegation of fiduciary responsibilities. The problem for a plan sponsor is understanding what level of fiduciary responsibility a provider is accepting on their behalf. Many service providers – consultants, financial advisors, trustees, mutual funds – have tried to limit the extent to which they take on fiduciary responsibility. Often the outcome was: "I [the service provider] will take on this very narrow fiduciary task and you [the sponsor] are left with everything else."

That is changing. There are now firms – Russell Investments is one of them – that will take on a robust set of fiduciary responsibilities. This is the difference between real fiduciary outsourcing and the simple bundling of services without fiduciary responsibility: the intention in fiduciary outsourcing is to broadly transfer to the outsourcing firm not only the management of plan services, but also the fiduciary responsibility for those services. The sponsor retains only those responsibilities it intends to – generally, decision-making about overall strategy and design.

For most firms, outsourcing DC fiduciary responsibilities makes a lot of sense. Which responsibilities? Our next article discusses what to outsource.

What to outsource?

In defined contribution (DC) plans, some functions are delegated to outside service providers, if only recordkeeping and some investment management. Before undertaking a formal program of outsourcing fiduciary responsibility, however, a sponsor will want to engage in an explicit decision-making process to determine which functions to outsource and which to retain control over.

Generally, the outsourcing decision will begin with an inventory of the relevant plan responsibilities, functions and a determination of the sponsor's plan objectives and resources.

Inventory of plan responsibilities

The first step in the outsourcing process is to determine what the current responsibilities are.

Russell Investments typically organizes the "what to outsource" analysis into three responsibility/function areas: strategy, investment management and implementation/administration. The following list can serve as a starting point – it's not intended to be comprehensive.

1. Strategy

- Allocation of duties: who does what
- Basic plan design: contribution limits, employer match, auto-enrollment features
- Basic fund menu/investment design: QDIA and core strategy, investment policy

2. Investment management

- Menu construction: QDIA construction, selection of QDIA and core funds investment managers, ongoing monitoring of all investment managers
- Determination of active/passive management strategy
- Selection of investment vehicle type (e.g., mutual fund, commingled fund, separate account)
- Related fee and investment guidelines negotiations

3. Implementation/Administration

- Selection and monitoring of recordkeeper and other service providers (e.g., trustee)
- Related fee negotiations and oversight
- Review and evaluation of provider fee information (e.g., providers' initial and ongoing ERISA 408(b)(2) disclosures')
- Service arrangement (i.e., bundled or unbundled)
- Payment of plan expenses (e.g., whether – or how much of – plan administration fees will be paid by the employer
- Allocation of plan expenses, e.g., how plan administration fees paid by the plan are to be allocated among participants
- Preparation of participant communications, including participant fee disclosure

Determining resources and objectives

The next step is to assess sponsor (internal) capabilities and what you want to accomplish.

Sponsors with different resources and objectives will pursue different outsourcing strategies. For example, a sponsor who also maintains a DB plan may have a well-resourced finance staff that can take on many of the duties with respect to investment manager selection and review. That same sponsor may have an HR staff that is already overtaxed, for whom the question of outsourcing DC plan vendor management is an easy call. Another sponsor may have a robust HR staff, but no DB plan and related investment staff. Or a sponsor may simply want to focus in-house management staff on other, business-related issues.

Approaches to outsourcing

Having inventoried the key responsibilities and assessed current capabilities and objectives, the sponsor is then in a position to make some basic choices. Consider our three key areas – strategy, investment management and implementation/administration.

1. Strategy

Generally, sponsors will want to retain control over strategic decisions – but they may want to engage a consultant for expert advice.

2. Investment management

Does the sponsor want to?

- Retain or outsource investment strategy, e.g., the determination of investment options in the default and core funds of the plan menu?
- Outsource all the work of vetting, hiring, contracting, monitoring and (where necessary) replacing funds/managers, so that the outsourcing provider makes all investment management decisions? This is sometimes referred to as "hiring an ERISA 3(38) investment management fiduciary."
- Or outsource some of the basic work (e.g., vetting) while retaining the final decision-making authority? This is sometimes referred to as "hiring an ERISA 3(21) fiduciary advisor."

3. Implementation/Administration

Does the sponsor want to retain control over?

- Some or all of the RFP process – perhaps only retaining ultimate decision-making authority?
- The recordkeeper/vendor relationship (e.g., assuring compliance with contract standards; coordinating various in-house, recordkeeper and vendor-to-vendor functions)?
- Participant communications – preparation and review of the summary plan description (SPD), fee disclosures, and distribution notices, etc.?

And, critically, given that feeds and the fee disclosure process are becoming significantly more complicated, does the sponsor want to consider outsourcing the collection and auditing of service provider fee disclosure statements?

ERISA Sections 3(16), 3(21), AND 3(38) – How far does outsourcing go?

Often outsourcing is spoken of in terms of ERISA definitions –

Under ERISA section 3(16), the plan's "administrator" must be "designated by the terms of the instrument under which the plan is operated." ERISA assigns certain duties to the administrator, such as filing the plan's annual report (Form 5500) and furnishing participants with the SPD. These duties may be "outsourced" by appropriately designating the outsourcing provider as the plan's administrator.

ERISA section 3(21) gives the general definition of an ERISA "fiduciary." The definition includes (among others) consultants who render investment advice but do not make final investment decisions.

ERISA section 3(38) defines an "investment manager" as a fiduciary who has "power to manage, acquire, or dispose of any asset of a plan" and who meets certain requirements – e.g., a 3(38) fiduciary must generally be a bank, an insurance company or a registered investment advisor. A 3(38) fiduciary can be appointed, for instance, to manage the selection, monitoring and, if necessary, replacement of a plan's fund managers.

These ERISA definitions are sometimes used as shorthand for different outsourcing approaches. A 3(16) outsourcing provider will generally handle administrative duties (including those assigned to the plan's "administrator" as defined under ERISA) that may not necessarily involve any fiduciary responsibility. A 3(21) fiduciary advisor assists with fiduciary decisions, but the sponsor-fiduciary retains ultimate decision-making authority and the related fiduciary responsibility. A 3(38) "investment manager" fiduciary steps into the shoes, so to speak, of the appointing fiduciary and exercises discretion over all or part of the plan assets, while the appointing fiduciary retains only appointment-and-review responsibility.

Case study

Simply listing different functions and tagging them "outsource" and "don't outsource" doesn't give you much of a feel for how the process works and what it actually looks like in practice. So let's take a look at an example, based on Russell Investments' experience with the outsourcing process.

The challenge

ABC Company has 5,000 employees. It maintains a 401(k) plan with a default target date mutual fund and a core menu of 15 mutual fund options. Most plan-related services (e.g., recordkeeping and communications) are provided as part of a "bundled" arrangement with the primary mutual fund provider. ABC Company recently acquired XYZ Company, which maintains a similar 401(k) plan with a different mutual fund provider. ABC intends to merge the XYZ 401(k) plan into the ABC 401(k) plan.

In addition to merging the plans, ABC wants to move away from the current "bundled" mutual fund strategy to an "institutional" strategy. ABC needs help with the design of the merged plan's fund menu. It also has an objective of reducing the amount of time management spends on plan administration and fiduciary oversight.

The solution

To accomplish these objectives, ABC Company hires a fiduciary outsourcing partner to:

- **Provide strategic advice on fund menu design.** ABC needs to design a new menu for the merged plans. Its fiduciary partner recommends:
    1. a target date fund with institutional asset management;
    2. a scaled-back set of institutional core options; and
    3. a new (unbundled) recordkeeper for the combined plan.
- **Search for a recordkeeper.** ABC needs a recordkeeper who can operate in the new, unbundled/institutional environment. In this regard, ABC is particularly concerned about fees, functionality and monitoring ongoing compliance with contract standards. In furtherance of these objectives, ABC delegates some of the search responsibility to its outsourced provider, who prepares an RFP, sorts the responses and narrows the field to the two or three choices that will likely work best, and prepares a fee comparison. In addition, on an ongoing basis, the outsourced provider will ensure that statements are on time, transactions are accurate and the vendor's costs are reasonable. Finally, the outsourced provider will collect and review the vendor's ERISA 408(b)(2) statements and will ensure that the vendor audit is done correctly.
- **Manage all investment decisions.** Moving to institutional investments will require expertise in both investment management and in the construction of, for example, multi-manager funds. Other than the strategic issues of plan and fund menu design, ABC has decided to delegate investment management authority: its outsourced fiduciary (acting as a "3(38) fiduciary") will identify, hire and fire fund managers, contract for and negotiate management fees, and manage cash flows and transitions between managers. The outsourced fiduciary will also review 408(b)(2) fee disclosure compliance.
- **Manage the new suite of plan vendors.** ABC does not have (and does not want to build) sufficient staff to manage the relationships between the recordkeeper, custodian and investment managers. As part of the outsourcing partnership, the outsourced provider will coordinate the activity between different vendors; problem-solve issues that come up between vendors, or between a vendor and ABC (e.g., ABC's payroll department); determine vendor compliance with contract performance targets; recommend vendor changes, where appropriate; and determine whether fees charged by plan vendors remain reasonable.
- **Prepare plan communications.** Again, ABC does not have sufficient staff or expertise (e.g., with respect to communicating white-label fund information) to prepare participant communications. ABC asks its outsourced provider to work with the recordkeeper to develop a plan for communicating with the participants and to create all communications materials.

Outcome

We would characterize this as a "robust" outsourcing strategy. ABC has retained control of basic strategy, but has outsourced:

- Most of the "leg work" involved in selecting the plan's recordkeeper, and all of the ongoing monitoring of that relationship.
- All investment decision making – selection of investment managers, execution (e.g., contract negotiation), ongoing monitoring. The outsourced provider will design the target date fund (and related glide path) and select and monitor the funds to be included in it and will select and monitor the institutional funds for the core menu.
- All responsibility for managing and monitoring the other plan service providers.
- The development and review of participant communications.

What about fiduciary responsibility/litigation risk? ABC's outsourcing partner is taking on fiduciary responsibility with respect to the selection and monitoring of the plan's investment managers and the ongoing monitoring of the plan's vendors. ABC has retained responsibility with respect to the selection of the plan's recordkeeper. Finally, ABC retains responsibility for the selection and monitoring of the fiduciary outsourcing provider: it is responsible for reviewing the outsourcer's work. ABC's corporate executives, fiduciary committee and staff should realize a substantial reduction in time spent on plan oversight duties – time that can then be allocated to other corporate duties and strategic initiatives.

Concluding thoughts

Fiduciary outsourcing is both a process – involving determination of tasks, resources and objectives – and a relationship. The process works best where the relationship is strong and where the DC plan sponsor has a high level of confidence in its fiduciary partner.

In our next article we discuss different outsourced fiduciary models – what sorts of outsourcing models are available, and the strengths and weaknesses of each.

Exhibit 1: Fiduciary responsibility coverage options

		IN-HOUSE/ADVISOR MODEL	OUTSOURCING MODEL (FULL/A LA CARTE)
Strategy	**Core menu design**	In-house, or with 3(21) Advisor	Typically retained in-house
	QDIA strategy and objectives	In-house, or with 3(21) Advisor	Typically retained in-house
	Retirement income solution	In-house, or with 3(21) Advisor	Typically retained in-house
	Loans/QDRO settlements/ hardship withdrawals	In-house	Typically retained in-house
	Participation/auto-features	In-house, or with 3(21) Advisor	Typically retained in-house
Implementation	**QDIA selection/construction**	In-house, or with 3(21) Advisor	3(38) Investment Manager
	Active management usage	In-house, or with 3(21) Advisor	3(38) Investment Manager
	Manager/fund selection	In-house, or with 3(21) Advisor	3(38) Investment Manager
	Transition management	In-house, or service provider	3(38) Investment Manager
	Fee negotiation	In-house	3(38) Investment Manager
Administration	**Service provider selection and ongoing evaluation**	In-house, or specialist consultant	3(16) Independent Administrator, except self
	Fee disclosures	In-house	3(16) Independent Administrator
	Employer match/vesting	Settlor decision	Settlor decision
	Expense allocation	In-house	3(16) Independent Administrator

Source: Russell Investments

Selecting a DC plan outsourcer

Turning over significant responsibility for plan management is a big decision. There are a lot of different firms providing outsourcing services. How do you choose among them?

Basic principles

We believe there are three basic principles that should guide the selection of a defined contribution (DC) outsourcing provider:

1. **Expertise**

   As the plan fiduciary, you are responsible for making sure the outsourcing firm you select has the knowledge and experience to take on the duties you delegate. Some outsourcing firms are strong in one area – like investments or administration – and weak in another. Others can do it all. Consider the specific functions you are outsourcing as you evaluate the qualifications of any firm.

2. **Alignment**

   A critical problem for sponsors – and a focus of regulators – is the alignment of fiduciary interests with participants' interests. That's why, under ERISA, a fiduciary's first duty is the duty of loyalty. You will not be able to scrutinize every transaction the outsourcing fiduciary engages in. You must have confidence that when it acts it will be acting for your participants' benefit. Conflicts are inevitable. But, because they are inevitable, transparency – a theme that cuts across all three of these principles – is absolutely essential. The outsourcing provider should be able to explain potential conflicts to you, and there should be an agreed-upon process for their resolution.

3. **Accountability**

   Both the sponsor and the outsourcing provider should have a clear understanding of what is expected and how results will be measured. Explicit performance standards, measurement criteria and reporting procedures should be agreed upon and adhered to. This is not an impossible task, but it does take discipline. Without *transparency* and *follow-through,* the entire process is likely to fail.

Types of firms providing outsourcing services

There are, generally, three types of firms that provide outsourcing services.

1. **Consultants**

   Even before ERISA became law, consultants used to provide expert advice on plan design asset allocation strategy and manager recommendations, typically leaving plan sponsors to do the work of implementation. There's a difference between recommending a strategy and actually executing it. As consultants have moved into "full" outsourcing – that is, taking on responsibility for investment decision-making and management – they have had to hire people with experience in portfolio construction and trading – experience not typically found in a traditional consulting organization.

   Questions for consultants

   Consulting firms that make the foray into outsourcing need to build out the infrastructure and expertise to offer new services and products. Before hiring a consulting firm as an outsourcing provider, you will want to consider:

   - Their track record. How long have they been in the business? How many clients do they have?
   - Do they have outside validation of their success in moving from merely advising to execution (industry awards and client validation)?

2. **Investment managers**

   Investment managers, obviously have experience managing money, making investment decisions and providing investment-related services, such as brokerage and foreign exchange. Some firms have specific areas of expertise (e.g., U.S. small cap or U.S. fixed income). Their focus is not necessarily on an entire portfolio. Other firms offer a greater breadth of services, including funds and recordkeeping, which may present conflicts issues.

Questions for investment managers

- How broad is their asset management experience?
- What is their approach to managing risk across asset classes?
- What procedures do they have in place to deal with conflicts and how do they make conflicts issues transparent to the client?

3. Multi-managers

The multi-manager model originally evolved out of efforts to provide small-to-medium sized defined benefit (DB) plans with greater diversification and access to money managers typically only available to large plan sponsors. This “manager of managers” model developed, naturally over time, into something that looks very much like investment outsourcing – the selection and oversight of investment managers. Unlike traditional investment managers, multi-managers generally focus on managing overall exposures within the entire portfolio rather than pure security selection within specific asset classes. In an outsourced DC structure, a multi-manager will typically determine fund menu design, asset class strategies, target date fund design and strategy, and will then select investment firms with focused expertise on specific elements within specific assets.

Questions for multi-managers

- Are they limited to just manager selection oversight?
- Do they have a strong consulting capability – the necessary problem-solving skills to meet the inevitable challenges and to develop fresh approaches?

Final thoughts

Different outsourcer models, with different backgrounds and core businesses, provide different strengths and have different weaknesses. Some firms struggle to compensate for gaps in expertise and functionality.

The good firms have been able to develop a robust set of skills, resources and services to comprehensively address the outsourcing challenge.

You're going to be living with your outsourcer for a long time. Your outsourcer will be making decisions that directly affect your plan and the retirement well-being of your plan participants. In selecting an outsourcer, it's critical to understand the issues, understand your outsourcing partner and what it can and cannot do, and rely on a well-designed, thorough selection process.

The outsourcing contract

One of the critical tools for both DC plan sponsors and their outsourcing providers is the outsourcing contract. The contract serves three purposes. First, and perhaps most important: During the process of negotiating the terms of the contract, the sponsor and the outsourcing provider can clarify the terms of their relationship. Second, the contract serves as a guide to "who does what" – a roadmap for the outsourcing relationship. Finally, a well-written contract should describe how any disputes between the parties will be resolved.

Style

Before we discuss the substance of the outsourcing contract, a brief note about style: Different firms favor different approaches. Some favor highly detailed rules and definitions often accompanied by copious legal jargon. Others prefer plain English.

Both approaches have their virtues. But given the importance of the day-to-day operations of an outsourcing relationship and the interaction of sponsor and outsourcing provider officials, an outsourcing contract should at minimum be *useable* by the non-lawyers who have to make that relationship work. The use of technical, non-intuitive legal terms should, generally, be limited. Indeed, ideally the business operations people who will be living with the outsourcing relationship should be significantly involved in contractually defining it.

Such a business-driven approach will not only make the contract easier to understand; it will also make it more likely that, when problems arise, there won't be a wrangle over contract language but rather a solution generated by those with their hands on the practical issues.

Whatever contracting style is used – technical or plain language – sponsors must be comfortable that they understand clearly what they are getting and what they are giving up. Thus, the most important "style" objective is *clarity*.

The keys to an effective outsourcing contract

To be an effective "roadmap for the relationship," a contract must lay out exactly what elements of the program are outsourced, which functions are delegated to the provider and which are retained by the sponsor, and what other services may be provided. This is critical, both legally and practically. Effective delegation under ERISA requires explicit transfer and acceptance of fiduciary duty. Setting clear expectations for roles and responsibilities is essential as the basis for accountability.

Defining the assignment

There is a temptation, in defining an outsourcing assignment, to immediately start with the issue of ERISA fiduciary status. While this issue – whether the outsourcing provider is an "ERISA fiduciary," and for what functions – is critical, beginning with it can result in a contract that is driven by legal, rather than business, issues.

Outsourcing assignments usually include a combination of discretionary management and expert advice, along with other services or information that may or may not fit the ERISA definition of "fiduciary."

Rather than getting sidetracked by issues of ERISA interpretation, it is generally more effective to start by first defining the parties' actual, "real life" roles – what they are actually going to do – and then decide for which of those purposes the outsourcing provider is going to carry the "fiduciary" label. Having business officials (rather than lawyers) at the sponsor and outsourcing provider organizations spell out their operational responsibilities encourages them to develop the procedures, controls and reports that will make the contract work and not be just something that lawyers haggle over and then put in a drawer, never to be looked at again.

Thus, the focus of contracting should be how the two parties will operate together, not who has which rights when they sue each other.

All of that said, there is one critical, technical "i" to dot: If the outsourcing provider is to serve as a fiduciary with respect to a particular function, it should explicitly acknowledge that it is doing so – that it is an ERISA "fiduciary."

Getting clarity about how the provider will be paid

The *alignment* of the interests of the outsourcing provider and the sponsor is absolutely critical in any outsourcing relationship. The contract cannot spell out every single action the outsourcing provider must take. The sponsor must have confidence that, when the outsourcing provider makes a judgment call, that call will be made in the interests of the plan and plan participants.

A critical element of alignment (perhaps *the* critical element) is how the provider will be paid. The contract should include a clear, understandable fee section, with supporting representations.

In some arrangements, getting “clear and understandable fee disclosure” may be relatively easy – it may simply involve a specification of an assets-under-management fee and a representation that there is no undisclosed compensation. As arrangements become more complicated, however, achieving clarity and understandability can be more challenging. In these cases, stick to the fundamentals: plain English and careful review by the sponsor.

Providing a clear standard of care

Sponsors should expect that an outsourcing provider will stand behind its work, regardless of whether, for ERISA purposes, it is a fiduciary. For functions that are fiduciary by definition, the standard of care is set by ERISA. But that does not mean that where the provider is not a fiduciary there is no standard. The contract should spell out exactly what that means. Typically, the standard of care and any related limit on the damages the sponsor may seek are more important than the indemnification provision (which often just establishes a right to attorneys’ fees). And, with respect to the issue of remedies, a critical element may not always be the sponsor's ability to sue, but rather the provider's ability to pay.

Rules for partners

A healthy outsourcing relationship should be a partnership between the sponsor and the outsourcing provider. The critical elements of the outsourcing contract are that both partners understand their roles and expectations of what they are to do; that the compensation supports the alignment of the interests of the outsourcing partners; and that the outsourcing provider stands behind the services it is delivering. If the contract is clear on these points, then the rest is a matter of business and operations people at the sponsor and provider organizations determining how they will work together.

The many faces of fiduciary outsourcing

ERISA sections 3(16), 3(21) and 3(38)

Many employers and outsourcing providers speak in terms of outsourcing fiduciary duties to an ERISA section 3(16), 3(21) or 3(38) "fiduciary." When they do, they generally are speaking of: outsourcing administrative responsibilities (3(16)); retaining a fiduciary to advise about and assist with fiduciary decisions that they (the plan sponsor) will ultimately make (3(21)); and outsourcing discretionary authority over plan investments (3(38)).

In our experience, these terms are used "colloquially" in discussions about outsourcing in ways that don't always correspond to the way they are defined by ERISA. For employers, it's critical to be clear about what authority they are transferring to the outsourcing provider and what duties and liabilities they are retaining. In that regard, terminology matters.

In this article we review the meaning under ERISA of the terms "fiduciary" (ERISA 3(21)), "administrator" (ERISA 3(16)) and "investment manager" (ERISA 3(38)). We then consider, in each case, how those terms are used when discussing outsourcing. Finally, we briefly discuss the significance of these distinctions for purposes of the outsourcing relationship and contracting. We're providing a separate article on the critical question: "Fiduciary outsourcing: What liability does the sponsor retain?"

Who is a fiduciary? ERISA section 3(21) generally

We begin with ERISA section 3(21) because it defines who a "fiduciary" is, an issue that is relevant for all types of fiduciary outsourcing.

ERISA section 3(21) generally defines a person as a fiduciary to the extent he or she:

1. Exercises any discretionary authority over or control of the management of the plan or the management or disposition of its assets.
2. Renders (or has authority to render) investment advice, for a fee, with respect to plan assets.
3. Has any discretionary authority or discretionary responsibility for plan administration.

Boiling this technical description down: You're a fiduciary if you (1) have discretion over plan assets, (2) give investment advice for a fee, or (3) have discretion over plan administration.

"Investment advice fiduciaries" under ERISA section 3(21)(A)(ii)

As noted, a person who renders investment advice for a fee is a fiduciary, under ERISA section 3(21)(A)(ii). As we'll see, this sort of investment advice fiduciary is usually what is meant when the broader term "3(21) fiduciary" is used in colloquial discussions of outsourcing.

"ERISA 3(21) fiduciaries" – in outsourcing

Colloquially, the term "3(21) fiduciary," when used in connection with outsourcing, is as much a negative designation as a positive one. Positively, it means the outsourcing provider is undertaking, as a fiduciary, to assist and provide advice to, for instance, the plan's named fiduciary. Negatively, the 3(21) fiduciary generally does not have discretion to make final plan fiduciary decisions.

For example, a 3(21) fiduciary might assist with a manager search, identifying and narrowing the field to three candidates; the final decision about which manager to hire would, however, be made by the plan fiduciary. Thus, generally, for outsourcing, when a person says she is a 3(21) fiduciary, it means that she is an investment fiduciary who does not have discretion. The sponsor is outsourcing research and market insights to an outside party but is retaining decision making authority. As we said above, it's probably best to think of this sort of fiduciary as a 3(21)(A)(ii) investment advice fiduciary.

The plan administrator – ERISA section 3(16) generally

ERISA section 3(16) identifies an ERISA retirement plan's "administrator" as the person so designated by the plan; where the plan does not identify the administrator, the plan sponsor is the administrator. ERISA imposes a number of duties on the administrator, including responsibility for: filing the plan's Form 5500; providing participants with a summary plan description and summaries of material modifications; engaging a plan accountant and (where necessary) a plan actuary; and providing participant fee disclosures.

While ERISA appears generally to treat the plan administrator as a fiduciary, many of an administrator's duties are "non-discretionary." Thus, a plan administrator may be a "fiduciary" for some purposes and not for others, and it is not always clear when an administrator is acting as a fiduciary and when it is not. Moreover, a person (e.g., the plan's "named fiduciary" or a claims appeal committee) may be considered to have "discretionary responsibility for plan administration" even though he, she or it is not the "plan administrator" as designated in the plan document. Such a person would, however, be a fiduciary by virtue of that discretion.

"ERISA 3(16) fiduciaries" – in outsourcing

Colloquially, the designation "3(16) fiduciary," when used in connection with outsourcing, generally means that the outsourcing provider has undertaken to act as the plan administrator for all, or a limited set of, purposes. For example, a 3(16) fiduciary may undertake to handle all participant communications. Some of the outsourcing provider's activity may be non-discretionary in character, e.g., the sending out of a routine plan announcement. Some may be fiduciary in character.

We understand that some of the foregoing discussion may be confusing; that reflects the current lack of clarity in the law. As a practical matter, here is the bottom line: If you want to delegate 3(16) duties (filing the 5500, providing Summary Plan Descriptions, etc.), you generally should do so in the plan document, identifying the outsourcing provider as the plan administrator and clearly describing the duties it will assume. You should also clearly identify who (e.g., which company official or plan committee) will be responsible for the "administrative" duties the outsourcing provider is not assuming.

If you want to delegate 3(16) duties (filing the 5500, providing Summary Plan Descriptions, etc.), you generally should do so in the plan document, identifying the outsourcing provider as the plan administrator and clearly describing the duties it will assume.

The investment manager – ERISA section 3(38) generally

ERISA section 3(38) identifies a special subset of fiduciaries called "investment managers." An investment manager is a person who is appointed by the plan's named fiduciary to manage, acquire or dispose of plan assets (or a subset of plan assets) and who acknowledges fiduciary status in writing. Only certain persons may be investment managers – banks, insurance companies and investment advisors registered under the 1940 Act or state law.

Where an investment manager is appointed, the plan's trustee is generally relieved of its duty to manage plan assets. The named fiduciary who designates the investment manager, however, remains responsible for the prudent selection and monitoring of the investment manager. That responsibility is generally no different in principle than for any other delegation/appointment.

"ERISA 3(38) fiduciaries" – in outsourcing

Colloquially, the designation "3(38) fiduciary," when used in connection with outsourcing, generally means the fiduciary exercises discretionary fiduciary authority with respect to all or a subset of plan assets. For example, and in contrast with a 3(21) fiduciary, a 3(38) fiduciary would not only undertake a manager search but would also select the managers.

Significance of terminology for the outsourcing relationship

Lawyers may be uncomfortable with the use of, for instance, the term "3(21) fiduciary" to describe an outsourcing provider "without discretion." After all, a "3(38) fiduciary" is *also* a fiduciary under ERISA section 3(21). The point, however, is not to be technically "right" about ERISA, but to make sure that all parties understand what is meant and to create a contract (and a relationship) that is enforceable on that basis – that is, that legally reflects the parties' intentions.

As we discuss in our article “The outsourcing contract,” rather than getting sidetracked by issues of ERISA interpretation, a better approach is to start by first defining the parties’ actual, “real life” roles – what they are actually going to do. Similarly, when you are searching for an outsourcing provider, your focus should be on the services and capabilities of different candidates. The last step (not the first) is to decide for which purposes the outsourcing provider is going to carry the “fiduciary,” “administrator” or “investment manager” label.

In the end, however, technical requirements have to be observed. For instance, as noted, a 3(16) administrator must be designated in the plan document. So, generally, a plan amendment would be necessary to appoint an outsourcing provider as an administrator for purposes of those duties (generally, reporting and disclosure) explicitly assigned to the plan administrator under ERISA.

Fiduciary outsourcing: What liability does the sponsor retain?

In an “ordinary” outsourcing transaction, the basic (substantive) question is: “How much of what I do now can I stop doing after outsourcing is implemented?” In an ERISA fiduciary outsourcing transaction, it’s just as important to ask: “How much of my current ERISA fiduciary liability will I no longer have after outsourcing is implemented?”

In this article we address that second question – the extent to which fiduciary liability may be “outsourced” (avoided by the employer/plan sponsor) in an outsourcing transaction. We discuss three different approaches: (1) the “traditional” approach, using plan delegation provisions; (2) designating the outsourcer as the “named fiduciary” in the plan document; and (3) providing contractual remedies to allocate the “cost” of any fiduciary liability to the outsourcer.

The “traditional” approach – the named fiduciary delegates to the outsourcing fiduciary

ERISA specifies that each plan identify a “named fiduciary” with “authority to control and manage the operation and administration of the plan.” ERISA further provides that, generally, the named fiduciary may “designate persons other than named fiduciaries to carry out fiduciary responsibilities.” When a named fiduciary designates another fiduciary to carry out its responsibilities, it generally retains liability only for the designation itself. For instance, if a named fiduciary (NF) designates another fiduciary (DF) to carry out investment responsibilities under the plan, the NF remains liable for the *prudent selection and ongoing monitoring* of the DF.

We are going to call this (delegation) the “traditional” approach to fiduciary “outsourcing.”

Application of the “traditional” approach to “3(21) fiduciaries”

As we noted in our article “The many faces of fiduciary outsourcing – ERISA sections 3(16), 3(21) and 3(38),” when duties are outsourced to a “3(21) fiduciary,” what is colloquially meant is that the DF will advise and assist the NF, but that the NF will retain ultimate decision-making authority. Because the NF has retained decision-making authority, it has generally not outsourced any of its fiduciary liability when it appoints a “3(21) fiduciary” (as colloquially understood). It may, however, generally be entitled to reasonably rely on the advice the 3(21) fiduciary gives, provided that the fiduciary was prudently selected.

Application of the “traditional” approach to “3(38) fiduciaries”

When the NF appoints a “3(38) investment manager” (as colloquially understood), it generally cedes its decision-making authority to the investment manager (IM). In that case, the NF’s fiduciary responsibility is generally limited to the selection and monitoring of the IM. This is, by definition, a “smaller” fiduciary responsibility than the responsibility the NF would have if it made those decisions itself.

How much “smaller” is that responsibility – i.e., what does prudent selection and monitoring entail? Generally, most would view as appropriate the regular review of the IM's performance, cost, competence and suitability. The frequency and extent of that review will vary with the relevant facts and circumstances. In a subsequent article in this series we will consider these issues in detail.

Special case: “3(16) administrator”

As we discussed in our article “The many faces of fiduciary outsourcing – ERISA sections 3(16), 3(21) and 3(38),” the plan administrator may in certain respects be a fiduciary, to the extent it “has any discretionary authority or discretionary responsibility for [ERISA] plan administration.” But the plan administrator also has certain specific duties under ERISA – generally with respect to reporting and disclosure. There are specific dollar penalties for reporting and disclosure failures, not directly related to any fiduciary liability. For example, a plan administrator is liable for a penalty of $100 per day for a failure to comply with certain participant information requests.

As a general matter, the plan administrator (PA) may delegate administrative duties, including fiduciary duties (e.g., discretionary responsibility for plan administration), to a DF. Where there is such a delegation, the PA would retain selection and monitoring liability similar to the liability discussed with respect to outsourcing to a 3(38) fiduciary. The reporting and disclosure duties formally assigned to the PA by ERISA, however, are probably un-delegable, although the PA can hire persons to assist with them.

Outsourcing in the plan document

Outsourcing via delegation is to some extent unsatisfying: It may not reflect the parties' intention in cases where the sponsor wishes to outsource, and the outsourcing provider wants to take on, *all* responsibility. To address this issue, some have suggested that the plan sponsor may outsource responsibility to the outsourcing provider in the plan document. Advocates of this approach argue that the sponsor is functioning as a "settlor" (in effect, the "founder" of the plan) and not as a fiduciary, and that, therefore, the "outsourced named fiduciary" has all responsibility (and liability) and the sponsor has none. This theory is controversial – it would seem to put no limit, e.g., as to competence or solvency, on who the settlor/sponsor could designate as the named fiduciary.

Allocation of responsibility in the outsourcing contract

As a general matter, however ERISA allocates responsibility the parties – the plan sponsor, the plan's named fiduciary and plan administrator, and the outsourcing provider – may "reallocate" responsibility in the outsourcing contract. That is, for instance, where an outsourcing provider has undertaken to handle all investment decisions in a 3(38) outsourcing transaction), and ERISA imposes selection and monitoring liability on the plan's named fiduciary, the contract may simply provide that the outsourcing provider will reimburse the plan's named fiduciary for any liability the named fiduciary actually has to pay.

This approach presents two issues, one practical and one legal. The practical issue is: The sponsor/named fiduciary will want to be satisfied that the outsourcing provider is adequately capitalized. So that, if the sponsor/named fiduciary has to seek reimbursement for liability the outsourcing provider agreed to pay, the outsourcing provider will actually have enough money to pay it.

The legal issue is: ERISA generally prohibits any "agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty." Thus, there may be limits on the enforceability of a contract provision like this.

Concluding thoughts

The U.S. Supreme Court's 2015 decision in *Tibble v. Edison International* reaffirmed the plan fiduciary's obligation to regularly review investment decisions in the context of fund menu selection, however, no specific guidance exists regarding monitoring outsourcing providers specifically.

In practice at least, precedent has been set as the trend to use an outsourced chief investment officer (OCIO) has accelerated and consultants are increasingly involved in the search and monitoring process. The widely held view is that in an OCIO arrangement, the sponsor retains fiduciary responsibility for reviewing the OCIO provider at selection, and on an ongoing basis. Plan sponsors that have selected an OCIO provider through an RFP process may find it useful to periodically compare the OCIO's actions to their RFP responses to continually monitor competence and effectiveness (i.e. organization, team, philosophy, performance results and fees). A growing number of OCIO search consultants have developed databases and capabilities to assist plan sponsors with OCIO provider benchmarking and ongoing OCIO monitoring responsibilities.

Sponsors will want to consult with their counsel on these issues.

Outsourcing: Prudent selection and monitoring of your outsourcing provider

In our last article,[2] we addressed the question: "How much of what I do now can I stop doing after outsourcing is implemented?" In the "maximal" situation, where decision-making is ceded to the outsourcing provider (sometimes called ERISA 3(38) outsourcing), we said the named fiduciary's "residual" fiduciary responsibility is generally limited to the *prudent selection and monitoring of the outsourcing provider*.

This article discusses what prudent selection and monitoring of an outsourcing provider involves.

The current absence of legal guidance

Before we begin, we'd like to make two points about the current state of the law. First, ERISA prudence litigation involving defined contribution (DC) plans has generally concentrated on three areas: fees; cases involving prohibited transactions or some sort of fiduciary self-dealing; and company stock. There is not a lot of guidance from the courts on the issue that is generally front-of-mind for plan fiduciaries considering outsourcing: under what circumstances might I be held liable for acting imprudently (in the absence of fee, self-dealing or company stock issues)?

Second, DC outsourcing is a rapidly growing, but relatively new phenomenon. We have almost no guidance from the courts or the Department of Labor (DOL) about how plan fiduciaries should discharge their selection/monitoring responsibilities vis-a-vis an outsourcing provider.

Because of this present lack of explicit guidance from the courts and regulators, and of cases applying ERISA prudence rules to the selection and monitoring of an outsourcing provider, what follows is a practical application of existing fiduciary norms to outsourcing. It is not a description of "the law," how the courts have ruled or the DOL's position.

Three cases: Direct investment, appointing investment managers and outsourcing

We are going to begin our discussion with a review of the basic framework: the ERISA prudence obligation. And we are going to frame our analysis in the context of one (very typical) example: the prudent investment of plan assets. Let's consider three different cases.

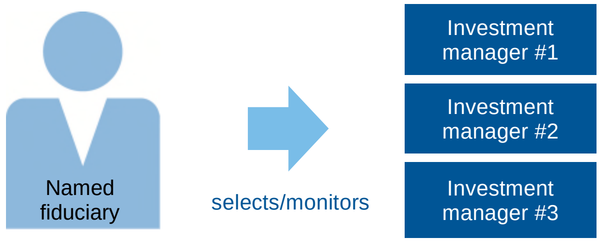
Case study 1: No delegation

What could go wrong?

The named fiduciary (e.g., lacking sufficient expertise) imprudently invests plan assets, participants lose money and sue the trustee.

[2] See our article "Fiduciary outsourcing: What liability does the sponsor retrain?" available at russellinvestments.com.

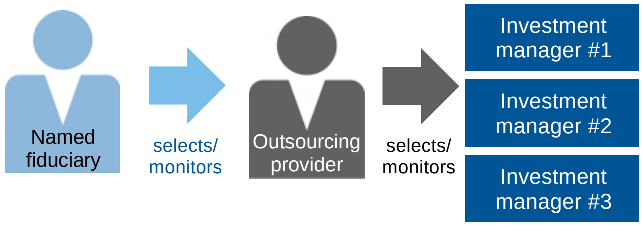
Case 2: Appointment of investment managers



What could go wrong?

One (or more) investment managers imprudently invest plan assets, participants lose money and sue (1) the investment manager(s) for the imprudent investment and (2) the named fiduciary for imprudently selecting/monitoring the investment manager(s).

Case 3: Outsourcing



What could go wrong?

One (or more) investment managers imprudently invest plan assets, participants lose money and sue (1) the investment manager(s) for the imprudent investment, (2) the outsourcing provider for imprudently selecting/monitoring the investment manager(s) and (3) the named fiduciary for imprudently selecting/monitoring the outsourcing provider.

Before we proceed, let's clear up a technical point. When a named fiduciary chooses a menu of mutual funds for participants to invest in, that is technically Case 1. Under ERISA, mutual fund shares are generally treated like other securities – the plan is buying the mutual fund shares, not the underlying assets in the mutual fund portfolio, and the mutual fund managers are not plan fiduciaries. From the point of view of the named fiduciary, however, the evaluation of a mutual fund looks a lot like Case 2: The named fiduciary is generally evaluating the performance of the mutual fund managers.

Differing named fiduciary roles and duties in outsourcing

We outlined these three "cases" to illustrate a couple of points: the same "incident" is the subject of the lawsuit in each case (an imprudent investment); and in both Case 2 and Case 3, the named fiduciary has a selection/monitoring duty. In this article, we are focusing on how the named fiduciary's roles and duties differ in outsourcing. For this purpose, it is probably most useful to consider the difference between Case 2 and Case 3. What we want to discuss is: (1) How does the selection/monitoring duty in Case 3 differ from the selection/monitoring duty in Case 2? And: (2) What is the Case 3 selection/monitoring duty – what does it look like?

General remarks about prudent selection/monitoring

Let's begin with a discussion of the ERISA prudent selection/monitoring duty in Case 2 – a situation with which many plan sponsors are familiar. In our example, the named fiduciary must select and, on an ongoing basis, monitor three investment managers. What, under ERISA's prudence standard, does "Case 2" selection/monitoring entail? Generally, the named fiduciary must review the performance, cost, competence and suitability of *each investment manager*. Consideration of these factors is always relative. Performance is tested relative to a benchmark. Cost is not simply a matter of choosing the "cheapest" fund with the lowest fees; cost is always relative to what others are paying for the same product/service. Competence is generally determined by the standards of the relevant community (e.g., the investment or service provider community).

Why monitoring may be the bigger challenge

In many ways, "prudent monitoring" is more problematic than "prudent selection." Generally, when appointing an investment manager, significant effort is put into the evaluation of candidates e.g., alternatives are considered and compared, references checked. Thus, in the ordinary course, generally, the named fiduciary creates a solid record for the prudence of the selection. Moreover, in the selection process, the (prospective) investment manager's performance is an abstract issue: the investment manager has not yet made any decisions that affect plan participants. What is reviewed in the selection process is what the investment manager has done for other plans and its reputation generally. Finally, in selecting a "new" investment manager, you (as the named fiduciary) are starting with a "blank slate" and picking from an array of (vetted) candidates.

In contrast to the thorough one-time analysis you do when you select an investment manager, the monitoring process is less clear-cut. Several questions are presented: (1) How often should the investment manager be reviewed (monthly/quarterly/annually)? (2) How thorough should the review be? Certainly, not as thorough as the process for the initial selection, but then, what is the standard? (3) When, and under what circumstances, should a new selection process be initiated (e.g., a new RFP issued)?

Furthermore, in monitoring, you are dealing with decisions that the investment manager has made for your plan participants. If the investment manager's fund is not meeting expectations, your participants are losing money.[3]

Finally, in monitoring, the ultimate question is, "Should I fire the investment manager?" This is an inherently more difficult question than the selection-from-a-group-of-candidates question. You are dealing with an installed investment manager, and you have to decide whether you must terminate the plan's (and conceivably the participants') relationship with that manager and "go back to the drawing board."

How is the selection/monitoring duty in Case 3 (outsourcing) different from the selection/ monitoring duty in Case 2 (appointment/review of investment managers)?

Having considered prudent monitoring and selection in the context of (the more typical) Case 2, let's consider Case 3.

With respect to the named fiduciary's ERISA prudence obligation, there are two key differences between Case 2 and Case 3. First, in Case 2, the named fiduciary is at one remove from the "thing that went wrong." The imprudent investment was made by the investment manager; the named fiduciary's violation (if there was one) was in failing to prudently monitor the investment manager. In Case 3 – the outsourcing case – the named fiduciary is at *two removes* from the "thing that went wrong." The named fiduciary's violation (if there was one) was in failing to prudently monitor the outsourcing provider, who in turn failed to monitor the investment manager.

This may seem like a theoretical point. As a practical matter, however, what this should mean (remembering that we have no litigation on these issues) is that, the named fiduciary's duty in Case 3 is more general and less hands-on than in Case 2. Nevertheless, even in Case 3, the named fiduciary is still concerned (at two removes) about the same "incident" – an imprudent investment made by an investment manager.

Second, in Case 2, the named fiduciary is selecting/monitoring three persons – investment managers #1, #2 and #3. In Case 3, the named fiduciary is selecting /monitoring only one person, the outsourcing provider. As a practical matter, this should simplify the named fiduciary's prudence "job" under ERISA.

What is the named fiduciary's selection/monitoring duty in an outsourcing arrangement?

This question is intended to get to the practical bottom line: what, exactly, the named fiduciary should do to monitor the outsourcing provider.

Here's the short answer: as a general matter (and a general guide), the named fiduciary should use a process in selecting and monitoring the outsourcing provider that looks pretty much like the process it would use if it were appointing an investment manager. Thus, generally, when selecting and monitoring an outsourcing provider, the named fiduciary should review the outsourcing provider's performance history, fees, people, experience and organizational capabilities.

What follows is the longer version.

Selection

As has been discussed above, the selection process should be relatively intuitive, and much of what we have written in our earlier articles will apply.[4] We do, however, want to say something about the issue of the cost/fees charged by the outsourcing provider. The named fiduciary, in appointing an outsourcing provider, should review alternative providers, what services are offered and at what price. Cost is, of course, only one factor, and the quality of the services offered and the reliability of the provider (both of which factors we would lump under the term "performance") must always be considered. Cheapest does not always equal prudent. But let's be clear: fees are a litigation target. The named fiduciary should be prepared with solid documentation of the reasonableness of the outsourcing provider fee relationship. (We discuss the issue of fees further, below.)

Monitoring

As we have said, monitoring is, generally, more problematic and challenging. We would identify the following as key elements of a named fiduciary's regular review of an outsourcing provider:

Review the outsourcing provider's investment process. ERISA prudence is about having the right process and the documentation to prove it. The outsourcing provider should be able to produce this documentation for the named fiduciary's review. The named fiduciary will want to consider requiring the outsourcing provider to adopt an investment policy statement (IPS) with a process for identifying and dealing with "problem" investment managers. Part of the named fiduciary's review of

[3] When a fund underperforms in a certain time period, there may be a good reason, and the DC plan sponsor may want to stay the course over a longer term. There may also be cases where a fund that has historically outperformed is no longer deemed a prudent investment going forward; the outperformance may have been achieved by a manager's taking very risky bets or perhaps there are organization changes at the manager that cause you to want to make a change. Participant education and communications may be of help in such circumstances, but they are not the subject of this paper.

[4] See our article "Selecting a DC plan outsourcer," available at russellInvestments.com.

the outsourcing provider's process would then be a review of the outsourcing provider's conformance with the IPS.

Establish and review agreed-upon benchmarks for performance. This will provide the named fiduciary with indicators, at a summary level, of "how the plan is doing." Plan sponsors that have selected an OCIO provider through an RFP process may find it useful to periodically compare the OCIO's actions to their RFP responses to continually monitor competence and effectiveness.

Sampling. While it may not generally be necessary to regularly audit the outsourcing provider, the named fiduciary will want to consider "sampling" the outsourcing provider's performance, to actually take a look at how the outsourcing provider has handled, e.g., a particular investment manager. A growing number of OCIO search consultants have developed databases and capabilities to assist plan sponsors with OCIO provider benchmarking and ongoing OCIO monitoring responsibilities.

Fees

Thus far, we have discussed the named fiduciary's selection and monitoring duties with respect to a possible imprudent investment. More typical of ERISA DC prudence litigation to date, however, has been a claim that the fiduciary "paid too much" for an investment. Consider *Tibble v. Edison* (reviewed in 2015 by the U.S. Supreme Court), in which the court held that plan fiduciaries violated ERISA by imprudently selecting "higher-priced" retail mutual funds when lower-fee institutional funds were available.

As a general matter, there is no "easy answer" (e.g., "just pick the cheapest fund") to the ERISA fee issue. In investment management, fees are almost always entangled with the issue of performance. Moreover, while it may be possible to analyze the performance of U.S. large cap equity as if it were a commodity, diversification beyond that particular asset class may often involve assets that behave in a very un-commodity like manner – that is, they may require investment analysis, research and judgment that will "cost more."

Moreover, in an outsourcing context, the issue of fees and how they are analyzed may depend on the structure of the outsourcing arrangement/service model itself. Flat-fee, all-in fee and cost-plus fee arrangements each involve a different fee "dynamic." And an outsourcing providers' use of different fee structures may complicate attempts at apples-to-apples fee comparisons.

Revenue-sharing and all-in fee arrangements, and their related service models, may complicate the process of understanding which fees are being paid to whom, but they may also make fees more stable and predictable. Named fiduciaries should understand that there are different structures that produce different fee results, they should consider the pros and cons of each, and they should make sure that any cost comparisons adequately reflect the different features of different fee models.

It should be explicitly stated and understood, as part of the arrangement between the named fiduciary and the outsourcing provider, that fees will be considered in any investment manager appointment (or, e.g., selection of a mutual fund). And the outsourcing provider should, with respect to every investment, have a good (and well documented) explanation of the fees with respect to plan investments and why it believes they are reasonable.

Concluding thoughts

It's fair to say that when a named fiduciary fully outsources plan investments, (1) the fiduciary retains a selection/monitoring duty, but (2) that duty is "less" than the fiduciary's selection/monitoring duty where it has appointed an investment manager. How much less will be determined by future legal developments – DOL guidance, and case law. As a practical matter, in any case, the named fiduciary has reduced the number of persons it must monitor to one.

The future of DC outsourcing

Many plan sponsors have moved from a DB to a DC model for delivering retirement benefits to their employees. There are a number of reasons for this, perhaps most significantly, the greater transparency of DC plans: their economics are more straightforward and their benefits easier to understand. In the transition to DC plans – shifting from the DB, sponsor-managed retirement model to the DC, participant-managed model – sponsors have focused on how to add value for their DC plan participants. As DC plans have evolved, more sophisticated investment solutions have developed to accomplish this – institutionalized, non-retail fund structures are replacing mutual funds "you can read about in the newspaper."

These new fund structures provide obvious benefits – critically, lower costs and more robust diversification. But they lack the built-in infrastructure that the retail mutual fund system provides. The result: sponsors are challenged to provide an infrastructure – fund menu construction, participant communications, and coordination of service providers – that requires an expertise and functionality that sponsors don't necessarily have or want to build.

DC outsourcing has emerged as a solution to these trends. It allows sponsors to exploit scale and buying power to provide their employees with sophisticated retirement solutions without having to build the necessary expertise and functionality in-house. In what follows, we provide an overview of our series of articles on DC outsourcing – covering everything from the fundamentals (why, what and how to outsource) to contracting to issues of residual fiduciary liability – with links to our more detailed discussions.

Why, what and how

As we discuss in our article ***Why DC fiduciary outsourcing?***, in addition to the need for greater expertise and functionality, the other factor driving outsourcing is concern about legal exposure. The DC sponsor is the target of litigators, regulators and policymakers. With the success of plaintiffs in *Tussey v. ABB* and *Tibble v. Edison* (which went all the way to the Supreme Court), sponsors can expect DC fee/prudence litigation to continue. With the adoption of its fee disclosure regulations, DOL has made the plan fiduciary *the* critical person charged with monitoring the fairness of fees paid by participants.

Those two issues – the need for greater expertise and functionality and sponsors' desire to reduce fiduciary exposure – are, of course, inter-related. Hiring an outside person with the necessary expertise and infrastructure reduces the possibility – when dealing with more sophisticated DC investment solutions and a more complex and difficult legal environment – that a problem will arise. And it puts the outsourcer between the sponsor and many legal challenges.

In our article ***What to outsource?***, we discuss a basic process for determining which functions to outsource and which to retain, by:

- **Inventorying plan responsibilities** – focusing on the key areas of strategy, investment management and implementation/administration.
- **Determining resources and objectives** – sponsors with different resources and objectives will have different outsourcing strategies.
- **Determining in which of the key areas outsourcing is appropriate** – sponsors will generally want to retain control over strategy; how much discretion with respect to investment management and administration the sponsor cedes to an outsourcer will depend on the sponsor's resources, its employee relations philosophy and its approach to fiduciary risk.

As with all emerging business solutions, DC outsourcing provides sponsors both opportunities and risks. The market has not yet "shaken out," and thus sponsors must choose, from an array of different provider models and outsourcing solutions, the approach that will work best for them. In our article ***Selecting a DC plan outsourcer***, we discuss the three key elements driving this decision: the outsourcer's expertise, its alignment with participant interests and its accountability. We then discuss the different outsourcing business models – consultants, investment managers and multi-managers –and the strengths and issues each model presents, as well as the questions a sponsor will want to ask different outsourcing candidates.

In our article ***The outsourcing contract***, we discuss our philosophy of the outsourcing contract – the basic structure for how you, as the plan sponsor, will interact with, and hold accountable, your outsourcer. We believe the contract should clearly state the terms of the sponsor-outsourcer relationship, provide a guide to "who does what" and provide a rational process for the resolution of any disputes between the parties.

With those objectives in view, we believe that the outsourcing contract should use a “plain language” style. It should focus first on functionality – who, as a practical matter, is responsible for what functions. And only after that should technical issues of legal status – e.g., will the outsourcer be an ERISA 3(38) fiduciary? – be addressed. There should be a clear standard of care: sponsors should expect that an outsourcing provider will stand behind its work, regardless of whether it is, for ERISA purposes, a fiduciary. Finally (and emphatically), there should be clarity about how the provider will be paid: you need to know that your outsourcing provider is working for you and your participants.

Critical legal issues

In our article ***The many faces of fiduciary outsourcing: ERISA sections 3(16), 3(21) and 3(38)***, we unpack the distinctions – in law and in common parlance – between different sorts of outsourcing assignments. In our view, the technical ERISA distinctions are secondary to sponsor decisions about which functions a sponsor wishes to outsource or retain. But they do matter – and not always in an intuitive way – in the determination of who has primary legal liability and what the scope of the sponsor’s secondary liability is with respect to outsourcer decisions.

In our article ***Fiduciary outsourcing: What liability does the sponsor retain?***, we discuss one of the two basic objectives sponsors have when they outsource: reduction of ERISA fiduciary exposure. We discuss the “traditional” approach, in which primary fiduciary responsibility is delegated and the sponsor remains responsible for the prudent selection and ongoing monitoring of the outsourcer. We also discuss alternatives, including designating the outsourcer as the “named fiduciary” in the plan document and providing contractual remedies to allocate the cost of any fiduciary liability to the outsourcer.

The law of DC outsourcing is relatively undeveloped. In that context, in our view, most sponsors will want to continue using the traditional “delegation” approach, retaining residual liability for prudent selection and monitoring of the outsourcer. What does that mean for the sponsor? As we discuss in our article ***Outsourcing: Prudent selection and monitoring of your outsourcing provider***, in the absence of litigation or guidance from the DOL on the issue, what can be said is that, where fiduciary discretion has been properly delegated to an outsourcer, the sponsor has reduced its legal exposure. As a practical matter, rather than having, e.g., to prudently select and monitor multiple plan managers and service providers, the sponsor has reduced its selection/monitoring duty to one firm: the outsourcer. And any liability it may have will be based solely on that selection/monitoring duty: the outsourcer will be primarily responsible for its fiduciary errors.

A real-life solution to a real-life challenge

Outsourcing is not a fad. It has emerged as a way to meet the challenges of an increasingly sophisticated and complicated DC ecosystem. The gains for participants that institutionalization and other DC innovations have produced – in more efficient, more diverse investments – are real. But so are the challenges for plan sponsors – of evaluating complex investment structures, explaining them to their participants and managing relationships between a diverse set of providers. Outsourcing providers meet this need, by providing an “installed” base of expertise and functionality.

Outsourcing is not a gimmick. It’s not a “trick” that gets you out of ERISA exposure. Instead, it’s a straightforward and transparent process of delegating the responsibility for making certain key decisions with respect to your company’s DC plan to one outside firm with special expertise and capabilities – the outsourcer.

Outsourcing is not for everyone. But for those companies willing to take the time to understand the process and pick the right outsourcing partner, it can add great value – in increased expertise, better choices for your participants and smoother plan operations. Perhaps most importantly, it can free up critical management time for those things that matter most to your company.

About Russell Investments

Russell Investments is a global asset manager with a unique set of capabilities that we believe is essential to managing your total portfolio and to meeting your desired outcome. At Russell Investments, we stand with you, whether you're an institutional investor, a financial adviser, or an individual guided by an advisor's personalized advice. We believe the best way to reach your desired outcomes is with a multi-asset approach that combines: asset allocation, capital markets insights, factor exposures, manager research and portfolio implementation.

For more information

Call Russell Investments at **800-426-8506** or visit **russellinvestments.com/institutional**

Important information

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