Outsourcing: Prudent selection and monitoring of your outsourcing provider

Russell Investments

In our last article,[1] 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)?

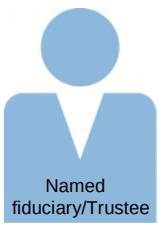
Second, DC outsourcing is a rapidly growing, but relatively new phenomenon. We have almost no guidance from the courts or the Department of Labor (DOL) about how plan fiduciaries should discharge their selection/monitoring responsibilities vis-a-vis an outsourcing provider.

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



Directly invests plan assets

What could go wrong?

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

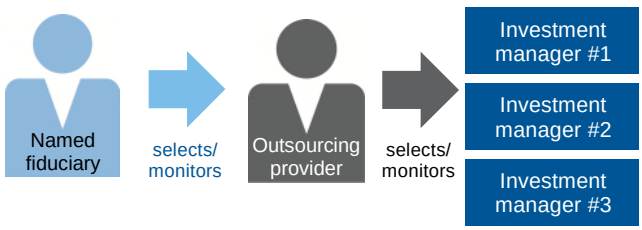
[1] See our article "Fiduciary outsourcing: What liability does the sponsor retain?" available at russellInvestments.com.

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 paparticipants. If the investment manager's fund is not meeting expectations, your participants are losing money.[2]

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.[3] 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

[2] 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.

[3] 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.

About Russell Investments

As a leading provider of outsourced investment solutions, Russell Investments understands that as DC plan sponsors explore fiduciary outsourcing, they need to fully understand what can be outsourced and how outsourcing works in practice. Russell Investments has partnered with retirement plan expert Michael Barry, a nationally recognized ERISA expert, to bring you a series of papers on DC plan outsourcing.

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Important information

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