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

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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