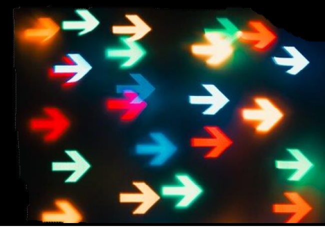
What to outsource?



In all defined contribution (DC) plans, some functions are delegated to outside service providers, if only record keeping 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 record keeper 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 3 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 record keeper/vendor relationship (e.g., assuring compliance with contract standards; coordinating various in-house, record keeper 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 statemen

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 of 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., record keeping 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) record keeper for the combined plan.
- **Search for a record keeper.** ABC needs a record keeper 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 record keeper, 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 record keeper 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 record keeper, 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 record keeper. 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 will 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

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.

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

Author: Mike Barry, President, Plan Advisory Services Group

First used: July 2014. (Reviewed for continued use: August 2019) AI-27746-08-22