Expert Q&A on Outsourcing Fiduciary Investment Responsibilities

As retirement plans have become more complex, plan fiduciaries have started to outsource responsibility for selecting and overseeing plan investments by retaining a professional investment service provider. This decision is subject to scrutiny under the fiduciary responsibility and prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Fiduciaries who outsource their investment responsibilities to third-party service providers must do so prudently, considering the interests of the plan and its participants, and in a manner consistent with the terms of the plan documents. Practical Law asked David Levine and Allison Tumilty of Groom Law Group, Chartered to discuss issues employers should consider when outsourcing fiduciary investment responsibilities.

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What does outsourcing fiduciary investment responsibilities relating to retirement plan investments involve?

A named fiduciary of a plan is the person or persons with the authority to control and manage the operation of an employee benefit plan, including the responsibility for plan investment matters. This includes the authority to appoint investment managers and direct the plan trustee regarding the management of plan assets. A retirement plan may provide procedures allowing named fiduciaries to designate other persons to carry out fiduciary responsibilities.

If a named fiduciary appoints an ERISA Section 3(38) "investment manager," the named fiduciary is not usually liable for the manager's acts or omissions, so long as the named fiduciary prudently appoints and monitors the investment manager. The named fiduciary becomes an appointing fiduciary. An ERISA Section 3(38) investment manager must be a registered investment adviser, bank, or insurance company, and must acknowledge in writing that it is a fiduciary to the plan.

Investment management outsourcing can take different forms, such as:

- Naming an investment management firm in the plan document as the plan's named investment fiduciary and providing the investment management firm with broad responsibility for determining investment policy and asset allocation, and for hiring and firing investment managers to implement the investment policy and strategy.

- Retaining an investment management firm. For example, plan fiduciaries might retain authority to approve the plan's investment policy and asset allocation guidelines, to be implemented on a discretionary basis by an investment management firm as a "manager of managers."
- Allocating a portion of plan assets to an investment management firm to act as a manager of managers for a portfolio of alternative assets. As a discretionary manager of plan assets, the investment management firm is a fiduciary under ERISA.
- For participant-directed plans, hiring an investment management firm to select and monitor the designated investment alternatives offered to plan participants under the plan, and depending on investment performance, changing the designated investment alternatives as needed.

Search ERISA Fiduciary Duties for more on fiduciary duties under ERISA.

What are the advantages and disadvantages of outsourcing investment fiduciary responsibilities?

Potential benefits of outsourcing investment fiduciary responsibility include:

- **Access to compliance expertise and technology.** The legal requirements of administering ERISA-covered plans and managing plan assets have grown increasingly complex while the consequences of failing to meet these requirements have become more onerous. Outsourcing may shift responsibilities to service providers with better knowledge of these requirements. Better processes, procedures and technologies may facilitate compliance and result in enhanced services.
- **Ability to focus on core business.** Plan sponsors may focus on their core business rather than on keeping up with changing regulation and technology for plan administration and management.
- **Improved documentation.** The use of third-party service providers may result in improved documentation of investment processes and procedures (as compared to in-house administration).
- **Limiting plan sponsor fiduciary risk.** Fiduciary risk may be further limited to the extent that the third party provides improved plan administration, management and compliance processes.
- **Economies of scale.** A plan may be able to participate in investment opportunities or investment share classes that might not otherwise be available to the plan because of its size.

Possible disadvantages of outsourcing investment fiduciary responsibility include:

- **Cost.** Outsourcing may be more expensive to the plan and plan participants than in-house services. There may be significant initial implementation costs, as well as concern about the effect on employees who are currently performing plan functions.
- **Dissatisfaction with services.** Poor service may result in poor employee relations. A plan sponsor may have less control over services with outsourcing, making it more difficult to immediately improve services if there is a problem. After a function is outsourced, it also may be difficult to switch back.
- **Lack of control.** Some plan fiduciaries may find that they prefer a greater degree of control over the plan's investment options and features.
- **Ongoing monitoring.** In most cases, it will usually be necessary for plan fiduciaries to continue monitoring the general prudence of the outsourced investment manager's activities even though the plan fiduciaries no longer have direct authority over the selection and oversight of plan investments. Depending on in-house expertise, an outside professional also may be needed to help monitor the outsourced investment service provider.

Is outsourcing investment fiduciary responsibilities a good idea for companies (and plans) of all sizes or is one type of company (or plan) more suited to this type of outsourcing than others?

Investment fiduciary outsourcing can be appropriate for defined benefit and defined contribution plans of all sizes. In the past 18 months, investment management outsourcing of all types has continued to grow in the small, medium and large size markets. However, the best solution for plans of a particular size can vary widely.

What steps should a company take to implement outsourcing?

The following steps should generally be taken to implement outsourcing:

- Identify the scope of responsibilities that are to be outsourced.
- Review applicable plan documents to determine whether:
  - the plan permits the use of plan assets to pay for outsourced services, if plan assets will be used to pay (directly or indirectly) for the services; and
  - the plan documents permit delegation or allocation of fiduciary responsibilities to the extent that may be required to accomplish outsourcing (for example, determine if the plan authorizes appointment of a named fiduciary service provider with authority to appoint plan investment managers).

- Consider the "duty of prudence" which measures fiduciaries against a prudent person experienced with the matter under consideration. Prudent fiduciaries are required to engage in a prudent process that generally includes identifying and considering relevant information and alternative courses of action, making decisions consistent with this information and documenting decisions and using experts where appropriate. Under the duty of prudence, plan fiduciaries selecting service providers should consider:
  - the services required by the plan;
  - the service provider's experience and qualifications; and
  - fee and expense arrangements, including direct and indirect compensation that may be received by the service provider.
- Conduct a request for proposal (RFP) if the business of the plan is highly desirable. Otherwise, the named fiduciary may wish to proactively seek certain information from service providers in its analysis, such as:
  - experience with employee benefit plans;
  - fees and expenses;
  - customer references; and
  - other information relating to the quality of their services and customer satisfaction with these services.
- Once an outsourced fiduciary candidate has been selected, the parties should engage in a thorough contract negotiation process to document their agreement. Care should be given to properly document the fiduciary nature of the services being provided and the requirements of ERISA. Legal counsel will be able to assist the named fiduciary through this process.

(See *US Department of Labor, Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan and Selecting and Maintaining Pension Consultants – Tips for Plan Fiduciaries*, available at *dol.gov*.)

Search Request for Proposal (RFP) Checklist for Retirement Plans for more on conducting RFPs.

Search Negotiating ERISA Service Provider Agreements for guidance on negotiating agreements between plan fiduciaries and service providers.

What fiduciary responsibilities, if any, remain with the plan's investment committee once outsourcing has been completed?

As an appointing fiduciary and a co-fiduciary, the named fiduciary responsible for selecting and contracting with the outsourced fiduciary (such as a plan's investment committee) will retain some fiduciary responsibilities and liability. As a co-fiduciary, the named fiduciary can be liable for the outsourced fiduciary's breach under certain limited circumstances. An appointing fiduciary also is responsible for monitoring whether the delegation of authority continues to be prudent.

A named fiduciary should establish and follow a formal review process at reasonable intervals to decide if it wants to continue using the current service providers or look for replacements.

PRACTICE NOTES

The following related Practice Notes can be found on practicallaw.com

>> Simply search the resource title

- Service Provider Disclosure Requirements for Pension Plans
- Disclosure Requirements for Participant-Directed Defined Contribution Plans
- Selecting and Hiring an Investment Manager
- Negotiating ERISA Service Provider Agreements
- ERISA Fiduciary Duties: Overview

When monitoring service providers, actions to take to ensure they are performing the agreed-upon services include:

- Reviewing the service providers' performance.
- Reading any reports provided by the service providers.
- Checking actual fees charged.
- Asking about policies and practices.
- Ensuring that plan records are properly maintained.

Search Selecting and Hiring an Investment Manager for more on selecting an investment manager for an employee benefit plan.

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