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Between a rock and a hard place

DC plan fiduciaries are feeling the squeeze

Rod Bare, Defined Contribution Consultant
Brian Golob, Global General Counsel

With all due respect to the Rolling Stones song, defined contribution (DC) plan fiduciaries are increasingly caught between a rock and a hard place. Responsibilities for the role are growing in step with plan participants' increased reliance on DC plans as the primary source of future retirement income. Many fiduciaries are meanwhile challenged to find time to properly discharge their obligations and cultivate the resources needed to navigate today's plan complexities. Industry news suggests that this gap is exposing plan fiduciaries to litigation.[1]

Introduction

This predicament comes from the plan fiduciary's twin obligations to act with "duty of care" and "duty of loyalty" to participants.

- ***Duty of care*** is more involved than many realize. It means ensuring that there is adequate expertise, capacity and structure in place to govern, manage and operate the retirement plan[2,3]. Not just to a "reasonable" level of care, either, but to a "prudent expert" level of care. To be successful, progressive plan sponsors are conducting honest reviews of internal expertise and capabilities to determine which fiduciary responsibilities to retain and which to delegate. Recent changes in investment products, service provider business models and regulations would suggest that this type of review could be helpful, and is perhaps overdue, for a growing number of plan sponsors.
- ***Duty of loyalty*** is straightforward: incentives must align with participants' best interests. This requires fiduciaries to be objective and to have in-depth understanding of the business models, incentives and conflicts of interest, potential or otherwise, embedded within the views of internal and external plan stakeholders.

[1] Steyer, Robert, "Defined Contribution Executives Slow in Catching On," Pensions & Investments, April 1, 2013
[2] Ezra, D. Don (2010), "Investment Governance: A Pragmatic Update," Russell Investments
[3] Golob, Brian, and Aran Murphy (2010), "Due Care – The Forgotten Fiduciary Duty, " Russell Investments

The fiduciary pressure can be uneven, however. While many fiduciaries are comfortable with the tasks of structuring committees and setting plan objectives, many express concerns about the challenges of relying on minimal staff to select and monitor asset managers, respond to capital markets challenges, oversee plan service providers and execute retirement administration duties in conjunction with their other corporate or benefit program duties (e.g., health care).

The upshot, then, is that *strategy* is often a responsibility that fits internal fiduciary strengths. *Implementation* and *plan administration*, on the other hand, can be areas of weakness, as today's fee and performance demands drive the utilization of more institutional-grade investment structures in DC plans.

The goal of this paper is to draw attention to this emerging "responsibility vs. capability" gap, and to highlight options plan fiduciaries have for addressing this situation.

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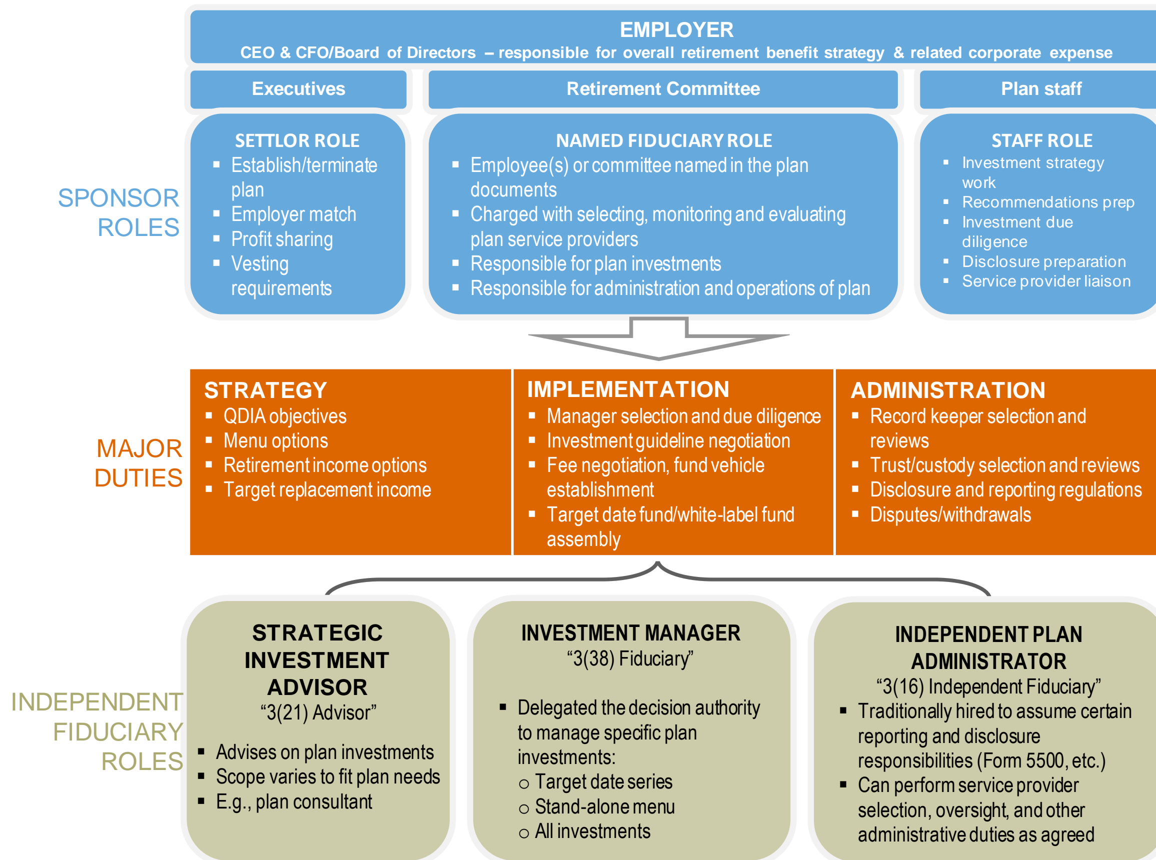
Review of roles

Let's start by reviewing fiduciary vs. settlor roles. Plan sponsor executives are free to make what are called "business judgment" or "settlor" decisions during a retirement plan's life cycle. Example settlor decisions include whether or not to offer a retirement plan, the amount of any employer matching contributions, and any decisions to amend or terminate the plan. Settlor decisions are not subject to ERISA fiduciary rules, even if a fiduciary is making the decision.

Once a decision has been made to offer a retirement plan and participant assets are involved, several fiduciary decisions are required in the areas of investments and plan operations. Examples include the types of options offered to participants, manager selection, disclosures to participants, service provider selection and monitoring, and plan expense evaluation.

A plan fiduciary's role is not a homogeneous one, however. ERISA[4] defines several roles that can be executed by internal staff, external specialists, or a mix of both, as shown in Exhibit 1.

Exhibit 1: Retirement plan roles and responsibilities



[4] Employee Retirement Income Security Act of 1974

Review of responsibilities

The sponsor roles described in Exhibit 1 have responsibilities across three major areas: *strategy*, *implementation* and *administration*.

Some of the decision-making responsibilities in these areas are not exclusively fiduciary responsibilities. Some, such as those concerning retirement benefit objectives or employer match levels, are settlor decisions. Nevertheless, settlor decisions frequently impact fiduciary plan elements and can demand significant attention from plan fiduciaries.

Exhibit 2 highlights these responsibilities and recent issues DC plan fiduciaries have faced. Of the three major areas of responsibility outlined, we see *implementation*, and to various degrees *administration*, as areas challenging today's plan fiduciaries.

Exhibit 2: Illustrative demands – DC plan fiduciaries

		RECENT ISSUES	FOLLOW-UPS
Strategy	**Core menu design**	Implications of choice architecture on participant decisions	Streamlining the menu, yet retaining the power of diversification. White-labeling
	QDIA strategy & objectives	Selecting the most appropriate solution from Target Risk, Target Date, Managed Accounts	Embracing recent innovations in portfolio design; how to protect participants from market, inflation, longevity, and sequential risks. Glide path (de-risking) philosophy
	Retirement income solution	Use of guaranteed income solutions	Evaluating fit of insurance-based solutions, cost-effectiveness of alternative income structures, strategies for effective communications
	Loans/QDRO settlements/ hardship withdrawals	Plan leakage	Balancing savings with liquidity
	Participation	Auto-enrollment; auto-escalation of savings	Using participant inertia in a positive way with auto-features
Implementation	**QDIA selection/ construction**	Open architecture, fit with participants	Understanding available structure options
	Active management usage	Decision to invest in active management, or not to	Reviewing, asset-class-by-asset-class, the potential for reward vs. the expense
	Manager/fund selection	New asset classes; new strategies in traditional asset classes/regions	Honestly assessing the resources and expertise available for executing due diligence
	Transition management	Plan redesigns, re-enrollment, manager swaps in new white-label structures	Selecting providers, documenting process, developing transition strategy that fits with other plan dynamics
	Fee negotiation and benchmarking	Importance of constant focus on these key areas	Evaluating investment vehicle options, mandate consolidation, zero revenue sharing vehicles
Administration	**Service provider selection and ongoing evaluation**	Fee transparency, conflicts of interest, direct vs. indirect compensation	Assessing new provider compensation disclosures
	Fee disclosures	Greater fee transparency	Evaluating reasonableness of all fees
	Employer match/ vesting	Role of default rate and corporate match on outcomes	Re-confirming plan objectives, corporate budget
	Expense allocation	Unfair allocation of expenses via revenue-sharing levies	Moving to per-head allocation scheme for plan expenses

Source: Russell Investments

The case for implementation excellence

What is implementation excellence? It is a collection of several capabilities. Like other dynamics in the retirement plan space, the larger the plan, the longer (usually) the list. Here are some key attributes:

- It is access to economies of scale and specialized expertise in negotiating fees to keep expenses reasonable and "on-market" for the benefit of plan participants.
- It is having the experience to draft effective investment guidelines and conduct serious manager due diligence across a growing array of asset classes.
- It increasingly requires experience in engineering portfolios of multi-manager funds and multi-asset-class funds, such as target date funds.
- It requires the ability to make decisions quickly. The importance of overall retirement investing excellence is becoming clear enough now that fiduciaries may want to adopt decision cycles that are measured in days or a few weeks, not quarters.
- It demands knowledge of how to evaluate traditional and emerging service provider business models, so as to understand compensation, the use of affiliates and other less-apparent potential conflicts.
- It necessitates cost-effective asset transitions when changes are made.
- It also requires an understanding of how to produce and/or interpret a growing list of regulatory agencies' required disclosure documents.

Many readers will recognize that these capabilities are fairly standard expectations for the conduct of business. Our recommendation is that plan fiduciaries treat the execution of an investment program as they would any other important business process – by transplanting, in a sense, the culture of *shareholder* value maximization into the retirement plan as *participant* value maximization, with the attendant commitments to urgency and rigor.

Our recommendation is that plan fiduciaries treat the execution of an investment program as they would any other important business process – by transplanting, in a sense, the culture of shareholder value maximization into the retirement plan as participant value maximization, with the attendant commitments to urgency and rigor.

Implementation excellence adds value, because lower fees and diversification benefits help improve overall results for plan participants, moving them toward better retirement outcomes. (On a related note, poor implementation is quite visible and measurable by those looking for fiduciary weaknesses.)

The good news is that DC plan implementation has improved considerably in recent years, to the benefit of participants. In the past, implementation has relied heavily on the use of retail mutual funds, revenue sharing, bundled service agreements and blanket decisions about use of active or passive management. Today, the focus is increasingly on plan menu choice architecture, institutional-grade investment vehicles, service unbundling, fee transparency, equality via per-head expense allocations, and thoughtful deployment of active and passive management.

As fee litigation exerts more pressure on fiduciaries[5], trends for larger 401(k) plans are clearly pointed toward wider use of institutional investment vehicles such as collective trusts and separate accounts. These investment structures, some of which may be shared by the DB plan, can be effective in lowering plans' investment management expenses and improving investment guideline flexibility, as well as in enabling access to more institutional-quality managers.

Another benefit growing in popularity among mid-size and larger DC plans is the ability to "white-label" these investment vehicles. Fiduciaries can then use these asset-class funds as easy-to-understand building blocks for the core plan menu, or for use inside the plan's cornerstone Qualified Default Investment Alternative (QDIA) solution (e.g., a target date series).

These building blocks give plan fiduciaries important levels of control over underlying managers, costs (via control of the mix of active and passive management utilized) and risk management, in terms of factor exposures or single-manager risks. The ability to incorporate investment innovations is also much easier with these structures. While these benefits are old

[5] Ross, Nancy, "Recent Developments in 401(k) Fees Litigation," McDermott Will & Emory LLP presentation, 26th Annual ERISA Litigation Conference, September 2013

news to defined benefit plan and endowment and foundation CIOs, they are increasingly being embraced by DC plan decision makers as well.

Unfortunately, there is no free lunch here. Unlocking the value of investment implementation and administration best practices requires addressing some challenges.

The challenge of implementation excellence

The problem for DC plan fiduciaries is that while expectations continue to rise, the ability to achieve *implementation excellence* is moving beyond the capabilities of many plans. This is due to limited resources, increased complexity of investment solutions and sub-scale fee-negotiating power. A few examples illustrate this emerging challenge:

- *Manager selection and monitoring*. Manager due diligence is an important task, and doing it right requires specialized experience. Plan staff and in-house fiduciaries generally do not have enough experience in manager replacement to be able to quickly and competently complete this work. Other plan sponsors do rely on advisors to help plan fiduciaries make decisions, but as the related decision-support analyses grow in complexity, many plan fiduciaries struggle to synthesize the material presented.
- *Decision speed*. The status quo for many plan fiduciaries is to address a situation via a series of meetings scheduled across a few quarters. A decision cycle of this length often delays committees' arrival at consensus on issues, options and recommendations, and can leave participant assets exposed in suboptimal situations.
- *Fee negotiations*. Traditionally, plan sponsors accept the base rate or negotiate fees on single-investment mandates. Negotiating power is often limited or strengthened by the extent of a plan's assets, however.

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Considerations for fiduciaries

In the past, DC plan fiduciaries may have attempted to go it alone and have likely had difficulty in achieving implementation excellence. However, there are other approaches: invest more in in-house expertise and/or consulting support to get the job done, or consider outsourcing certain non-strategic or risky fiduciary tasks to a third-party specialist.

In addition to freeing plan fiduciaries and staff to spend more time on strategy and the management of increasingly complex settlor issues, delegation to a qualified expert offers one of ERISA's fundamental legal benefits. So long as the provider is properly selected and monitored, no plan fiduciary is liable for the acts or omissions of the provider, or under any obligation to co-manage any asset of the plan for which management has been delegated to the provider. It is important to reiterate that it remains the fiduciary's duty to monitor the selected independent fiduciary services provider, to ensure that the provider is following plan processes and procedures as per agreement.

Exhibit 3 illustrates some differences between the traditional in-house/advisor resource model and an outsourcing model. Readers can tie these options to the roles in Exhibit 1.

Exhibit 3: Fiduciary responsibility coverage options

		IN-HOUSE/ADVISOR MODEL	OUTSOURCING MODEL (FULL/À LA CARTE)
Strategy	**Core menu design**	In-house, or with 3(21) Advisor	Typically retained in-house
	QDIA strategy & 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

Conclusion

Plan sponsors are frequently finding that their fiduciary responsibilities are increasing beyond their in-house capabilities, especially when it comes to implementing and administering next-generation investment solutions. And yet the business case for investing in additional internal specialist resources often goes unsupported. Retaining maximum exposure to fiduciary risk in today's litigious environment is of no benefit to the plan sponsor, and in this paper we have highlighted some consulting and outsourcing options that address this issue.

Evaluating the plan's fiduciary strategy may also be prescient at this time, given the range of investment innovations and regulations that have emerged in recent years. These changes have served as effective catalysts for business model change among many retirement plan service providers. Even though incentives and capabilities may not align with plan objectives as readily as they used to, the fiduciary responsibility to achieve and maintain such alignment remains sizeable.

Under ERISA, plan fiduciaries have a high degree of flexibility in terms of defining roles. The plan can delegate responsibility on the basis of relative strengths and plan needs. For some sponsors of large DB and DC plans, it may make sense to invest more in internal specialists who can handle today's plan investment and administrative challenges. Traditional investment consultants can continue to support these efforts. For other plans, it may make sense to outsource certain responsibilities to independent providers.

While there is no one-size-fits-all answer, there is strong value in exploring the available options for specific plans.

Retaining maximum exposure to fiduciary risk in today's litigious environment is of no benefit to the plan sponsor, and in this paper we have highlighted some consulting and outsourcing options that address this issue.

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