The Plan Sponsor's Guide to Delegating, Part I: Selecting and Supervising 3(38) Investment Managers

*Ronald E. Hagan**

Delegating investment decisions to an ERISA 3(38) Investment Manager ("EIM") can be a huge relief to retirement plan sponsors who are saturated with fiduciary responsibilities and their attendant liabilities. ERISA specifically states, however, that it is imperative to vigorously monitor the actions and recommendations of an EIM. The importance of monitoring is directly correlated to the level of delegation granted to the EIM. In this article, plan fiduciaries will learn the how-to's, benefits and best practices of selecting and supervising EIMs—a role that can be transformational for a plan sponsor fiduciary, if correct and consistent monitoring systems are put in place.

With an increasingly competitive marketplace and dozens of complex business issues swirling around the C-suite, finding a way to gain efficiencies has become a highly sought-after strategy for many of corporate America's leaders. For fiduciaries, an added strain of potential liability lurks within their companies' retirement plans, inherent in many of their own management responsibilities related to the plan—including governance, administration, controls, and the often-times most daunting duty of choosing the right investments for their participants.

For those fiduciaries seeking some relief from this last piece of responsibility, there is good news and bad news associated with the task of selecting investments. The good news: Under ERISA, plan sponsors can outsource the retirement plan investment responsibility to an investment consultant that accepts full discretion and legal responsibility for investment decisions. The bad news: Once outsourced, the plan sponsor still is responsible for monitoring that investment consultant's process and costs to ensure

RONALD E. HAGAN is President and CEO of Roland|Criss, the premier fiduciary manager for retirement plan sponsors, foundations and endowments. Ron has over 25 years of experience in the fiduciary industry, and has pioneered many of the certification and standards practices that are preferred by fiduciary leaders today. He can be reached at ronhagan@rolandcriss.com.

© 2013 Thomson Reuters

they are in the best interest of the plan and its participants. Luckily for plan sponsors, there is a “best practice” process and approach that can be employed to maximize the benefits of utilizing a discretionary investment consultant, while minimizing the risks and hassles associated with constantly monitoring the consultant’s duties.

WHAT IS A 3(38) INVESTMENT MANAGER?

Not to be confused with a mutual fund investment manager, which operates remotely from retirement plans, a 3(38) Investment Manager (“EIM”) works directly with an ERISA plan’s responsible fiduciaries and assumes full discretion for the investment decisions regarding the plan. This means that plan sponsors can, in effect, wholly delegate the responsibility of choosing and altering a retirement plan’s investments to the EIM. Whereas conventional investment consultants are limited to providing recommendations to plan fiduciaries on which the fiduciaries may subsequently act, an EIM effects investment decisions solely at his choosing and without necessary consultation of the plan fiduciary. While the EIM’s autonomy can be an obvious benefit to the plan sponsor who no longer must attempt to be an expert in the area of investments, it also necessitates that the plan sponsor take initiative in regularly monitoring the EIM to ensure his actions are in line with the plan participants’ best interests.

HOW DO EIMS DIFFER FROM CONVENTIONAL INVESTMENT CONSULTANTS?

It is important to distinguish between conventional investment consultants and ERISA Investment Managers. Most significantly, EIMs are able to assume legal liability for the investment decisions they make on behalf of the plan sponsor. The typical investment consultant simply makes recommendations to the plan sponsor regarding investment-related functions that the plan sponsor then must implement, and subsequently for which the plan sponsor must retain full legal responsibility.

Conventional Investment Consultant

More specifically, a conventional investment consultant is limited to making recommendations to the plan sponsor regarding the following investment areas of the plan:

1. Time horizon (the length of time over which an investment is made or held before it is liquidated)
2. Risk/return profile of the portfolio
3. Asset class selections
4. Investment policy structure
5. Tactical asset allocation
6. Funds’ managers selection and replacement
7. Implementation of the investments selected.

The plan sponsor makes all of the above final decisions before implementation, and ultimately can accept or reject any of the investment consultant’s recommendations.

ERISA 3(38) Investment Manager

By contrast, the EIM accepts full discretion and legal responsibility for the following investment areas of the plan on behalf of the plan sponsor:

1. Asset class selections
2. Investment policy structure
3. Tactical asset allocation
4. Funds’ managers selection and replacement
5. Implementation of the investments selected.

So, then, the benefits of EIMs are twofold: 1) EIMs lighten the tactical fiduciary load of the plan sponsors, who no longer must get “in the weeds” regarding specific investment choices,

© 2013 Thomson Reuters

and 2) they accept legal responsibility of ensuring that the investment selections are in line with ERISA regulations (with a caveat that the plan sponsor must regularly monitor the EIM's process and costs). Let's delve deeper into the specific advantages that EIMs offer to plan sponsor fiduciaries in their role as stewards of their plan participants' assets.

WHY DO PLAN FIDUCIARIES HIRE EIMS?

As with most outsourced roles related to ERISA retirement plan management, the benefits of hiring an EIM to handle the investments function of the fiduciary role include gaining:

- Focus
- Efficiencies
- Expertise.

EIMs have been trained to select investments for retirement plans, and in the majority of cases, this is their primary and/or sole professional focus. For many plan sponsors (who are tasked with overseeing their company's retirement plan in addition to excelling in their primary role in the corporation), the idea of having an individual dedicated solely to retirement plan investments is a welcome one. This often means more quality time—for both the investment manager and the plan sponsor—spent on those respective areas in which they can make the most positive impact for the organization.

Gaining efficiencies is another tremendous advantage to engaging an EIM. The reason fiduciary responsibility can be such an overwhelming undertaking is due to the complex and expansive nature of the role, as well as the ever-evolving regulations that keep even the most adept fiduciary on her toes. The notion of enabling the plan sponsor fiduciary to focus on a few key management tasks—as opposed to a laundry list of tactical to-do items—via outsourcing is an increasingly widespread practice within organizations that have retirement plans. In addition, outsourcing specific fiduciary duties is proclaimed by ERISA as a leading practice (if, of course, the correct providers are selected).

The final advantage of an EIM is perhaps the most critical one, particularly in relation to the investments function. Gaining qualified expertise in the area of investments is invaluable for a retirement plan sponsor. The vast majority of plan sponsors have not been trained in the intricacies of investment strategy and analysis, as they are leaders in their trade. Thus, to ask a plan sponsor to address (or to have a significant understanding of) complex investment selections for their plan participants is akin to asking a 20-year international healthcare executive in Virginia to make strategy decisions for an Internet start-up company in California. There are nuances and best practices within the investments arena that hardly any executive (without specific investment training) would be able to comprehend. Hiring an EIM alleviates the pressure for corporate executive-level management to try to school themselves in an area that is not a part of their core expertise.

WHY SHOULD EIMS BE VIGOROUSLY SUPERVISED?

The U.S. Department of Labor ("DOL") requires retirement plan sponsors to select and monitor service providers prudently. Prudence requires that each class of provider pass through a diligent screening process before being hired, and be subject to a robust supervision process ongoing. The requirement of prudent monitoring is a safeguard against predatory vendor pricing and other practices that could potentially harm the interests of the plan participants. As the primary fiduciary, a plan sponsor is the party under ERISA legally responsible for acting in a role as steward of the plan participants. Therefore, diligent monitoring of the plan's service providers fits neatly under the umbrella of this function.

© 2013 Thomson Reuters

WHAT STEPS COMPRISE A VIGOROUS SUPERVISION APPROACH?

Supervision of an EIM involves two categories of factors: qualitative and quantitative. While it could be interpreted that quantitative factors should take precedence (as they can be directly linked to ERISA-defined supervision), we will demonstrate that both quantitative and qualitative factors should be considered jointly in order to meet ERISA's supervision mandate.

Qualitative Factors

The qualitative factors for a plan sponsor to consider in his supervision approach of an EIM include:

1. **Quality management system**—Does the EIM have a proven system for monitoring investment selections and measuring ROI?
2. **Administrative support**—How many online tools or other resources are available to the plan sponsor to help facilitate his supervision role?
3. **Servicing**—How does the EIM's service quality compare to other similar vendors, and/or how does it fit the needs of the plan sponsor's organization?
4. **Ideas**—How well does the EIM develop and communicate investment ideas that are aligned with the strategic direction of the company's retirement plan and/or that can be linked directly to plan participant benefits?

While most of these areas help to determine the EIM's "fit" within a particular plan sponsor's organization, the above factors also help to assess the EIM's overall service quality. Service quality is important in determining the "reasonableness" of the EIM's fees (a direct mandate of ERISA's most recent regulation 408(b)(2), commonly referred to as the "fee disclosure" rule). In order to determine fee "reasonableness," service quality must be assessed as compared to the EIM's costs, which will be revealed as one of the factors in our quantitative supervision section.

Qualitative

© 2013 Thomson Reuters

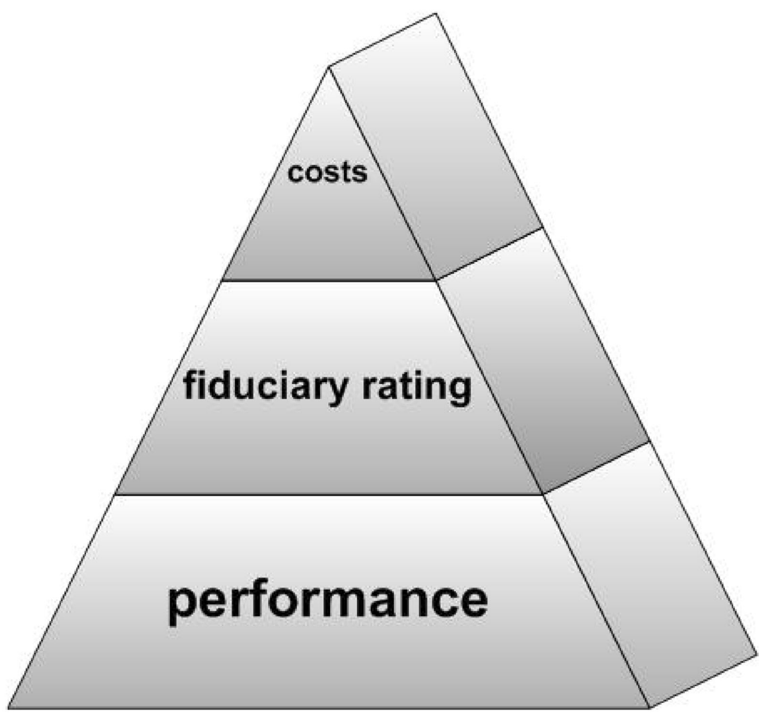
Quantitative Factors

The quantitative factors for a plan sponsor to consider in his supervision approach of an EIM include:

1. **Performance**—How do the EIM's investment selections perform on an annual basis? Does he make appropriate alternative suggestions for those investments that perform below the anticipated return rate? Are the financial objectives of the retirement plan being met?
2. **Fiduciary rating**—What rating or accreditation does the EIM hold? How recent was the rating acquired and/or what continuing education activities has the EIM been involved with since the rating?
3. **Costs**—How do the EIM's costs benchmark against industry standards? More importantly, how do the EIM's costs compare to services rendered to the plan sponsor organization over the past year?

The most significant quantitative measurement for most plan sponsors is cost. In the post-fee disclosure era, it is important to remember the distinction between benchmarking and assessing overall vendor value. While benchmarking can provide insight on a broader scale regarding an EIM's cost structure, <u>benchmarking alone does not determine a vendor's fee reasonableness</u> (the mandate previously referenced as ERISA's 408(b)(2) or "fee disclosure" rule). A plan sponsor must also take into consideration the qualitative factors mentioned above—service quality—when determining whether an EIM's fees are reasonable. A measure of value is the real test to ensure an EIM is charging the appropriate cost for investment services—and this is the reason that both qualitative and quantitative factors are equally important in the supervision of the EIM role.

Quantitative



© 2013 Thomson Reuters

THE BENEFITS OF VIGOROUS EIM SUPERVISION

We have defined an EIM, revealed how this role differs from that of a conventional investment consultant, uncovered the benefits of hiring an EIM, and identified the key components of supervising the EIM role. The last question to address is: What are the benefits to plan sponsors of supervising this role (or, in other words, why should plan sponsors bother to supervise their EIM)?

Required Under ERISA

First and foremost, plan sponsors should monitor their EIM because it is mandated under ERISA. Without documented "proof" that plan sponsors are following a prudent process of supervising their EIM's process and costs, plan sponsors place themselves at regulatory risk.

Preempts Investment Issues

Regularly monitoring the EIM ensures that any faulty investment strategy or questionable fee is detected early enough to prevent future additional harm to the plan sponsor or the plan's participants. An annual review checklist can provide the plan sponsor with an easy-to-follow guide for assessing the EIM's progress, process and plans for the upcoming year.

Lightens Plan Sponsor Responsibility

Perhaps the easiest (or most persuasive) reason to diligently supervise an EIM is to unburden the plan sponsor of the full load of investment management responsibility. By choosing to monitor an EIM, the plan sponsor enables much of the investment liability to be absorbed by this qualified third party.

Aligns with Industry Best Practices

As noted earlier, ERISA distinctly approves and endorses the idea of outsourcing specific fiduciary tasks to those experts most qualified to handle them. By choosing an EIM who is rated in the area of investments, plan sponsors are more closely aligning with the preferred fiduciary model under ERISA.

Increases Likelihood for Positive Plan Participant Outcomes

The best reason, perhaps, to engage and monitor an EIM is to increase the likelihood that plan participants garner ideal outcomes for their investments. In the role of steward, plan sponsors can feel more confident that they are acting in the best interest of their participants by partnering with expert providers who can provide the focus, expertise, and efficiencies that will benefit the plan organization and its participants for years to come.

BE SURE BEFORE YOU HIRE

You should do some homework before signing-up with an EIM. Not all investment consultants are qualified to serve as an ERISA 3(38) Investment Manager, in spite of what their market literature may claim. The Department of Labor does not maintain a registry of EIMs, but there is help. Roland|Criss Ratings, LLC is a rating agency for the EIM market. You may obtain a rating report about candidates that you may be considering for the EIM role at www.rolandcriss.com/ratings.

CONCLUSION

Overall, the benefits of outsourcing the investment function to an EIM can greatly outweigh the costs of supervising that EIM, as they are far-reaching and can positively impact not only the plan sponsor, but also the interests of the plan participants. Properly delegating fiduciary functions can be one of the best strategies for a plan sponsor to employ in order to manage her fiduciary duty. Our upcoming articles will continue to provide tips and tactics for plan sponsors who want to excel in their fiduciary role and engage partners who can help them strive toward stewardship excellence.

© 2013 Thomson Reuters