Selecting and Monitoring an OCIO

by | **Asad Ali** and **Douglas Lash**

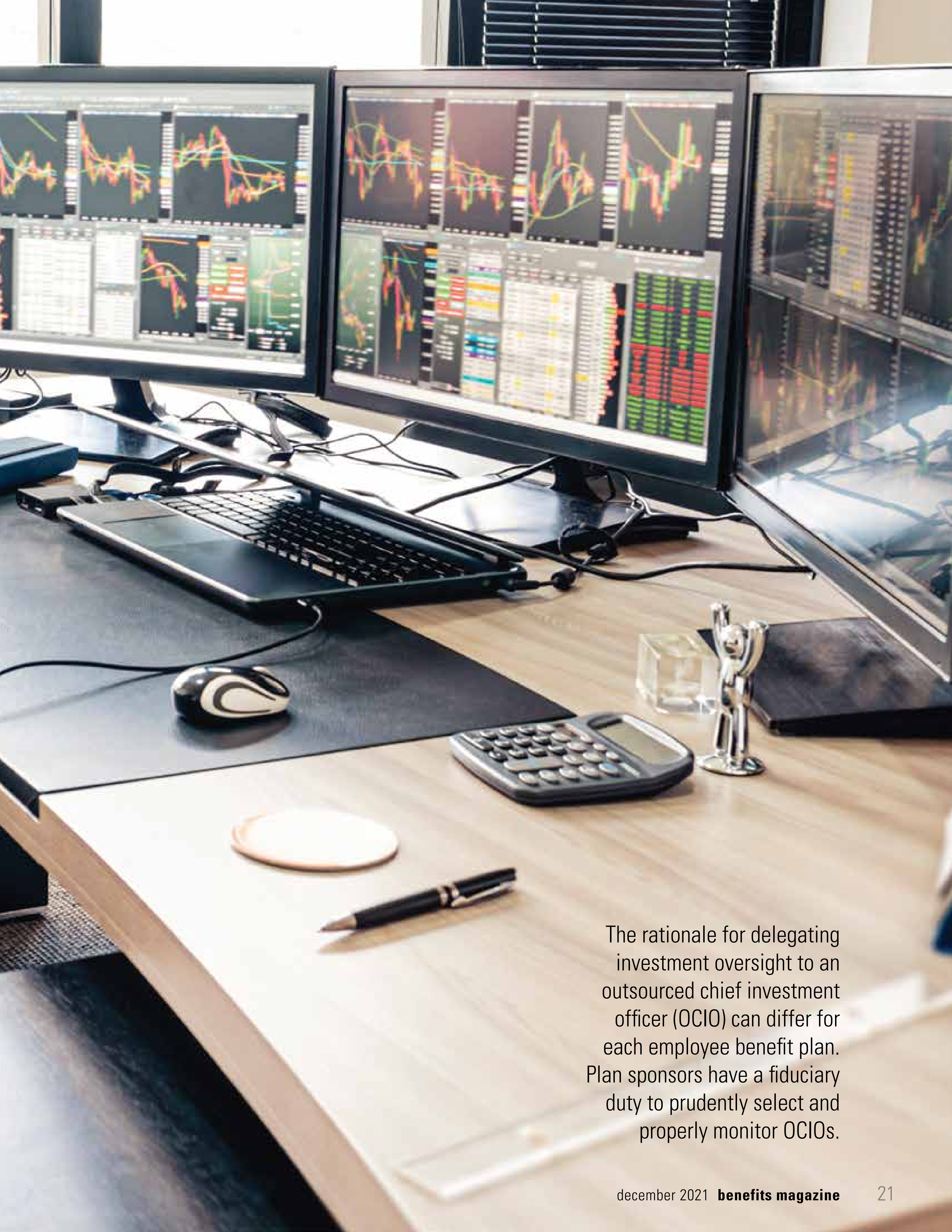
An increasing number of employee benefit plan sponsors are hiring an outsourced chief investment officer (OCIO) with the goal of improving outcomes for their funds and to access fiduciary relief.

When hiring an OCIO, an organization outsources its investment strategy to a third party on a full or limited basis. Within the institutional retirement plan market, these third parties are investment consultants and asset management firms. Various outsourcing provider models exist from "one size fits all" to "open architecture" solutions.[1]

The OCIO market is expanding across all plan types, including defined benefit (DB), defined contribution (DC), and health and welfare plans. Estimated at between \$2.1 trillion[2] and \$2.8 trillion,[3] outsourced assets comprise more than 10% of the total \$21 trillion institutional retirement market and have grown 84% over the past five years.[4]

The rationale for delegating oversight to an OCIO can differ by organization and by plan type. Some of the most common reasons include: (1) lack of resources and better risk management, (2) additional fiduciary oversight, (3) fast implementation of investment decisions, (4) enhanced risk management[5] and (5) potential cost savings (Figure).

This article will discuss the Employee Retirement Income Security Act (ERISA) considerations when deciding whether to hire an OCIO and outline fiduciary duties when selecting and monitoring this outsourcing provider.



The rationale for delegating investment oversight to an outsourced chief investment officer (OCIO) can differ for each employee benefit plan. Plan sponsors have a fiduciary duty to prudently select and properly monitor OCIOs.

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ERISA Considerations and Mechanics

When a plan sponsor begins a search for an OCIO partner, it is essential for plan fiduciaries to understand the foundation of discretionary authority under ERISA.

Subject to very limited exceptions, all employee benefit plan assets must be held in trust by one or more trustees. The trustees (or investment committee members) must either be named in the trust instrument or in the plan document or appointed by a person who is a named fiduciary. The board of trustees (or the plan or investment committee) generally has the exclusive authority and discretion to manage and control plan assets, including the investments.[6] In turn, the board is charged with investing plan assets in accordance with the highest standard of care under the law (i.e., the fiduciary standard).

ERISA requires fiduciaries to invest plan assets with the "care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

Accordingly, each member of the board is individually responsible for understanding plan investments and their selection or disposition. These individuals must also possess the necessary expertise and knowledge to analyze the nature of any risks and/or appropriateness of such an investment.

Over time, this fiduciary standard has become more challenging to meet. This is particularly true because (1) most trustees (or investment committee members) are part-time and (2) plan regulations and investing have become more complex. Fortunately, ERISA permits time-constrained boards to delegate investment responsibilities.

There are two available delegation options relating to plan asset investments:

1. Hiring an ERISA §3(21) investment consultant to provide investment advice with the board retaining authority over all investment decisions
2. Hiring an ERISA §3(38) investment manager (i.e., the OCIO) to make discretionary investment strategy-related decisions on behalf of the employee benefit plan. The table describes the difference between a traditional investment consultant and services provided by an OCIO.

If a board hires an investment consultant as an ERISA §3(21) fiduciary, the board will retain ultimate authority over the investments of the plan. The 3(21) fiduciary will only provide investment advice or recommendations to the board.

The consequence of maintaining control is that the board retains full fiduciary responsibility for the difficult job of investing. The risks of doing so have been amplified recently by the proliferation of 401(k) "excessive fee" class action lawsuits that have sought liability against defined contribution plan fiduciaries for breaching their duty of prudence. Many complaints outline that plan fiduciaries breached their fiduciary duty by causing plan participants to pay investment management and/or administrative fees that exceed other available alternatives.

On the other hand, if a board hires an ERISA §3(38) fiduciary (or OCIO), the board can delegate full or partial control over investments to such an "investment manager." The OCIO does not need to seek input from the board in making investment decisions and has the discretion to make investments on behalf of the plan.

If an ERISA §3(38) investment manager is prudently appointed and monitored by the board, the board will not be liable under ERISA for the acts or omissions of the investment manager. The board's only source of liability after prudently selecting an OCIO would stem from its duty to monitor, described later in this article.

Certainly, fiduciaries are now often seeking outsourcing defined contribution decision making (regarding plan investments and oversight), as this segment is a fast-growing market with 56% of plans outsourcing or planning to in the next two years.[7]

Selecting a Provider

An OCIO provider should demonstrate value to any board that is considering whether to delegate some or all of its investment functions. Key factors to look for across the growing pool of providers include:

- **Capabilities.** The board should evaluate the provider's investment research process, track record of picking funds and tools for its in-house professionals.
- **Proactive approach.** Funds should look for an OCIO provider that carefully reviews a plan sponsor's unique needs and offers a custom, evolving approach to the investment program's oversight.
- **Transparent fees.** The provider should provide full disclosure of how the OCIO gets paid. Plan sponsors should be aware that OCIOs have a fiduciary obliga-

tion to act in the plan's best interests. Further, when lower fees are negotiated by the provider, fiduciaries tasked with overseeing retirement or investment programs should expect 100% of the savings to be passed along. There is no reason for an OCIO to keep any of the negotiated fee savings for itself.

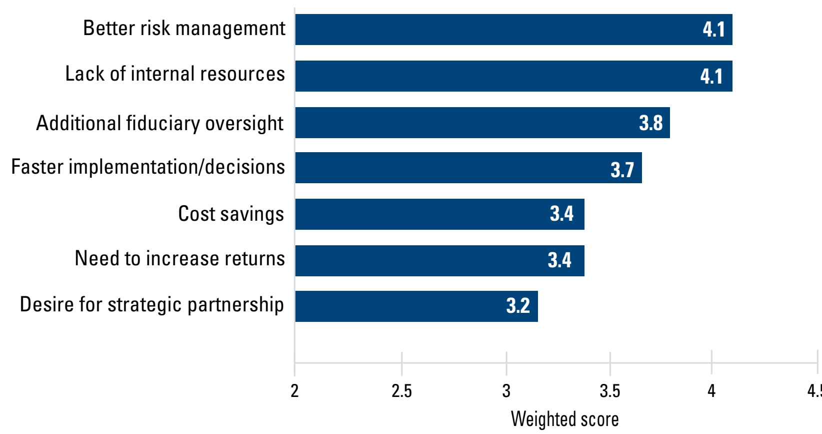
- **Additional services provided by OCIO staff.** OCIOs typically employ strong back-office capabilities, and their operational staff may help streamline processes such as coordinating with service providers, plan administrators and benefits office staff members.
- **Governance approach.** The OCIO should outline how it will provide fiduciary relief and go about the day-to-day fiduciary management of the plan's investments.

More importantly, from a fiduciary standpoint, the actual diligence performed before hiring an OCIO or ERISA 3(38) investment manager is critical. A primary benefit of hiring an OCIO (e.g., the shifting of fiduciary responsibilities for investing) is lessened if the board does not engage in a thorough and diligent search for a provider that fits the plan's specific needs.

The board will not be relieved from liability for investment decisions made by an investment manager if the investment manager was not first prudently selected or monitored. The appropriate process for ensuring that a board meets its fiduciary responsibilities in hiring an OCIO is to engage in a comprehensive search or request for proposal (RFP) process.

FIGURE

Reasons for Hiring an Outsourced Chief Investment Officer



Source: Ai-CIO. *2021 Outsourced-Chief Investment Officer Survey.*

TABLE

Comparison of Traditional Investment Consultant and Outsourced Chief Investment Officer (OCIO) Duties

	Traditional	Limited Discretion	Full Discretion
Determining investment policy	Trustees	Trustees	OCIO
Establishing asset allocation	Trustees	Trustees	OCIO
Appointing, retaining and removing investment managers	Trustees	OCIO	OCIO
Producing total plan reporting	Consultant	OCIO	OCIO
Delivering trustee education	Consultant	OCIO	OCIO

Note: Retention of an OCIO does not imply that the plan terminates the custodial, recordkeeping, third-party administrator (TPA) and/or investment managers. An OCIO is specifically an investment advisor granted partial or full discretion for the investment strategy.

Some questions to ask an OCIO during an RFP process include, but are not limited to, the following.

- What is your experience in managing assets for plans of comparable sizes and in similar industries?
- Describe the composition and credentials of the team that will oversee selecting investments.
- Describe any potential conflicts of interest.
- Are the investments available through open architecture or limited to certain proprietary investments?
- Describe your errors and omissions insurance coverage.
- Has the OCIO been subject to an investigation by any regulatory body?
- Has the OCIO been sued or settled claims involving alleged malpractice?
- Will the OCIO contractually acknowledge appointment as an ERISA § 3(38) investment manager?
- Describe both direct and indirect compensation.
- Is there a contractual limitation on liability and, if so, what is the amount?

In addition to the above questions, it is prudent to ask for sample reporting and educational materials that the board (or investment committee) can expect to receive on at least a quarterly basis from the provider. It is also prudent to ask the investment manager to provide references that the board may contact.

Established OCIOs can typically also provide the board or investment committee with a detailed summary of how their organization will work with plan professionals and will also outline a time line for implementation.

takeaways

- Over the past decade, an increasing number of employee benefit plan sponsors are hiring outsourced chief investment officers (OCIOs). Reasons for their retention include the ability of an OCIO to provide fiduciary relief, a better governance approach, cost savings and the ability to manage various forms of risk.
- When a plan sponsor engages its advisor in an ERISA 3(21) capacity, the plan sponsor retains decision-making authority over plan investments. Alternatively, the plan can engage an ERISA 3(38) investment manager (or OCIO) and delegate all or most functions associated with plan investments.
- Plan sponsors should carefully compare providers when selecting an OCIO. A request for proposal (RFP) process for selection should be thorough and well-documented, and fiduciaries must review all available sources of information before awarding any mandate.
- Monitoring an OCIO requires plan sponsors to carefully review all material and ensure they are following a robust oversight process.

Monitoring an OCIO

The duty to monitor—a key element of ERISA fiduciary responsibility—entails evaluating such measures as adherence to the plan's investment policy statement, reasonableness of fees, suitability of investment results and whether the OCIO can articulate adequate rationale and documentation for any of the investment decisions made.

A recent federal district court decision for *Scalia v. WPN Corporation et al.* (WPN)[8] offers fiduciaries a particularly useful road map for monitoring an OCIO. The retirement committee of Severstal Wheeling, a steel manufacturer headquartered in Wheeling, West Virginia, hired an OCIO (WPN Corporation) and gave it "complete, unlimited and unrestricted management authority with respect to the investment of the [trust]."

WPN was appointed during the global economic downturn in 2008, when the pension funds under the committee's care sustained losses. Forgoing direction from the retirement committee, WPN unilaterally decided to invest in an undiversified portfolio of 11 large capitalization energy stocks. The investment committee did not discover that the portfolio's assets remained undiversified until more than two months had passed. The net cost to the pension plans totaled about $7 million in market losses.

The Department of Labor (DOL) subsequently brought suit against the retirement committee (including two of the retirement committee individual members) alleging failure to properly monitor the OCIO.

The Court subsequently disagreed with the DOL allegation and granted summary judgment to the investment committee on the duty to monitor issue, using DOL regulatory guidance as the basis for its decision.

As such, the DOL has advised that it expects OCIO appointing authorities to perform their duty to monitor, as follows.

1. The appointing authority must adopt routine monitoring procedures.
2. The appointing authority must adhere to the routine monitoring procedures.
3. The appointing authority must review the results of the monitoring procedures.

4. The monitoring procedures must alert the appointing authorities to possible deficiencies.
5. The appointing authority must act to take required corrective action.

The court further noted that "the duty to monitor does not carry with it the duty to review an investment fiduciary's every decision . . . because to do otherwise would defeat the purpose of hiring investment fiduciaries to run a benefit plan in the first place." Rather, an appointing authority that has instituted monitoring procedures in accordance with the DOL's guidelines above must "review and evaluate what is reported through such procedures and take corrective action when required."

The "obligation to act is triggered when a [fiduciary] has notice of" misconduct or has information available to it around which any misconduct would be made apparent.

The court in *WPN* concluded that (1) the investment committee had the necessary monitoring infrastructure in place, (2) it did not have notice of the OCIO's failure to diversify until it reviewed a routine quarterly report and (3) the investment committee promptly responded to the information in the quarterly report by contacting the OCIO and trust attorney immediately after learning that the funds were not diversified.

As demonstrated in the *WPN* decision, it is incumbent for an appointing fiduciary to implement and use a robust monitoring process to evaluate an OCIO. Promptly acting upon information discovered through the monitoring process will likely insulate a fiduciary from a duty-to-monitor claim.

Conclusion

Retention of OCIOs is becoming more common in the institutional retirement plan market as plans seek fiduciary relief, access to a nimble investment strategy and lower cost investments. Plan fiduciaries should follow a detailed process in the selection of a vendor. Staying true to a detailed monitoring process and documenting that process will ensure that the delegation of an OCIO is working well.

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Endnotes

1. Asad Ali and Kenny Kelley, "The Outsourcing Decision." August 2020. *Benefits Magazine.*
2. *2021 Outsourced-Chief Investment Officer Survey.* Ai-CIO. April 2021.
3. "Investment Outsourcing Special Report." *Pensions & Investments.* June 28, 2021.
4. Ibid.
5. *2021 Outsourced-Chief Investment Officer Survey.* Ai-CIO. April 2021.
6. The focus of this article is on the options available to discretionary trustees. ERISA acknowledges the concept of a "directed trustee," but this scenario is beyond the scope of the article.
7. Ai-CIO.
8. *Scalia v. WPN Corporation et al.*, https://casetext.com/case/scalia-v-wpn-corp.