Selecting Service Providers, Competitive Bidding, & RFP's Importance in a Fiduciary Investment Process

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1 . Fiduciary Standard of Care Overview

Surveys of pension consultants published over the last two years by PIMCO reveal that consultants perceive mitigation of fiduciary risk and even litigation risk as major concerns among plan sponsor clients[1]. An increase in the number of successful fiduciary breach lawsuits and out-of-court settlements during the same period may be a contributing factor even among sponsors of retirement plans too small to be likely targets of class action lawsuits. Fear can sometimes act as a positive motivator and, if concerns over fiduciary or litigation risk encourage plan sponsors and plan fiduciaries to improve their retirement plan fiduciary process, everyone wins, particularly plan participants who otherwise bear the brunt of imprudent behavior. Fiduciaries of other entities, such as endowments or foundations, should pay close attention because their fiduciary responsibilities are based on a similar standard of fiduciary care

So what is expected of a fiduciary? For retirement plans, the answer lies in the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, those who act in a fiduciary capacity have important responsibilities which include:

- Acting solely in the interest of plan participants and their beneficiaries and for the exclusive purpose of providing benefits to them;
- Carrying out their duties prudently;
- Following the plan documents (unless inconsistent with ERISA);
- Diversifying plan investments; and
- Paying only reasonable plan expenses.

The duty to act prudently lies at the core of a fiduciary process and it is helpful to remind ourselves that ERISA creates the highest fiduciary standard of care or prudence recognized under the law. This standard requires those who serve in a fiduciary capacity, generally those who are appointed as fiduciaries by the plan document, those to whom fiduciary responsibility is delegated, such as plan committee members, or those who exercise discretion or authority over plan assets or plan management, to act in the same manner as would a "prudent expert". That's a high standard and why so much attention is paid to it, particularly when things go awry.

A Comparable standard of care applies to fiduciaries of other entities governed by uniform state statutes such as the Uniform Prudent Investor Act (UPIA), applicable to private trusts, the Uniform Prudent Management of Investment Funds Act (UPMIFA), applicable to foundations, endowments and government sponsored charities, and the Uniform Management of Public Employee Retirement Systems Act (UMPERSA) applicable to state and local government retirement.

2 . First step – Do you need help and is it OK to get that help from third parties?

Faced with the daunting responsibilities imposed by a fiduciary standard of care, what should fiduciaries do? In response, there are three considerations that are key to successfully managing fiduciary responsibility. The first is that acting prudently is generally about having a **process**. Secondly, to demonstrate you have established a prudent process, you need to document the steps you have taken to arrive at a decision – i.e. create a paper trail!

> **Thirdly, if fiduciaries, particularly the investment committee members, conclude that the committee lacks the competence to act as a prudent expert, particularly on investment matters, fiduciaries are encouraged to hire an independent expert to provide either investment advice or investment management services[2].**

Indeed, in these circumstance, hiring an expert is imperative from a risk management perspective.

3 . The process for selecting investment advisors and other service providers

In order for a decision by fiduciaries to be considered prudent, it must be informed and reasoned. So, when selecting an investment advisor to provide investment consulting or management services, fiduciaries must first perform due diligence to identify suitable candidates. Then, the fiduciaries must evaluate the results.

This must occur in order that the fiduciaries can make a *reasoned* selection decision, i.e. one that is based on investigation and evaluation and, of course, the process must be documented to demonstrate that the selection process is prudent. The same process must also be applied when selecting other service providers, such as custodians, record keepers or third party administrators.

A word here. We said earlier that acting prudently is generally about "process" but we need to be aware that this is not the whole story because no amount of process will excuse a patently imprudent decision. This caution was best explained by Justice Scalia, when serving as a judge of the Court of Appeals for the District of Columbia Circuit:

> "I know of no case in which a trustee who has happened—through prayer, astrology or just blind luck—to make (or hold) objectively prudent investments ... has been held liable for losses from those investments because of his failure to investigate and evaluate beforehand. Similarly, I know of no case in which a trustee who has made (or held) patently unsound investments has been excused from liability because his objectively imprudent action was preceded by careful investigation and evaluation. In short, there are two related but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently."[3]

The caution also emphasizes the need for fiduciaries to get professional help on investment matters. What better way to ensure that a prudent process leads to prudent investment?

4 . What role should be delegated to an investment advisor?

Traditionally, fiduciaries have engaged investment advisors acting in a consulting capacity to provide investment advice but they have retained the ultimate responsibility for making investment decisions. Whether this results from fiduciaries being reluctant to give up management control or from investment advisors being reluctant to assume that responsibility, fiduciaries are primarily those who are responsible for investment matters.

Where advisors are not granted discretion to make investment decisions, they nonetheless act in a fiduciary capacity and owe a duty of care to plan participants and beneficiaries[4]. Accordingly, the courts will show a measure of deference towards fiduciaries who use independent investment advisors but reliance on an advisor does not immunize the fiduciaries' decisions. Thus, when relying on advice from an expert, fiduciaries must still demonstrate that they employed a prudent process when making their decision. This does not mean that they must duplicate the advisor's work but they must evaluate the advisor's recommendations and reasoning in order for their reliance to be justified as reasonable.

Accordingly, when selecting an investment advisor to act in a consulting capacity, it is essential that the due diligence previously mentioned should be thorough and provide evidence that the advisor is sufficiently qualified and competent to justify reliance on that advisor's recommendations.

Since 2008, many fiduciaries have been said to suffer from "fiduciary fatigue", a deer in the headlights reaction to the increasing complexity of managing investments following the collapse of the capital markets and to the frustration, in the case of retirement plans, of trying to ensure that employees can achieve a secure retirement income. Such a reaction can lead to delays in reaching decisions or even inaction. As a response to this phenomena, many investment advisors now offer to take on the authority to make investment decisions on behalf of their clients and the mantle of investment manager. This is sometimes called “Outsourced CIO” “fiduciary management”, “fiduciary delegation” or, in the case of retirement plans, simply “3(38)” manager, a reference to the definition of “investment manager” under ERISA § 3(38). In this capacity, however described, the advisor will now be responsible to select external fund managers, monitor their performance and make changes when dictated by poor investment performance or other factors. While not achieving “Fiduciary Nirvana”, this delegation represents a number of possible advantages for the other fiduciaries. First, the investment advisor will monitor the plan investments on a continuing basis rather than periodically, such as quarterly when the investment committee meets. As a result decision making should become more nimble. Secondly, the role of other fiduciaries, such as the investment committee, becomes one of oversight. Accordingly, the advisor must still deliver investment reports to the investment committee and meet with them periodically and the investment committee must still evaluate what is presented to them, but the committee is relieved of the decision making burden. Thirdly, and potentially most importantly, the investment committee members are likely to be relieved of fiduciary responsibility for the investment decisions of a prudently selected investment advisor who is properly qualified and appointed to serve in an investment manager capacity. ERISA specifically grants this relief for retirement plan fiduciaries with respect to an investment manager properly qualified and appointed under ERISA § 3(38)[5].

Accordingly, fiduciaries have a choice in how to manage the investment process but, as noted, in order for them to be relieved of fiduciary responsibility for investment decisions the advisor to whom discretionary investment authority is granted must be “prudently” selected in the same way that an investment advisor acting as a consultant is prudently selected. However, the scope of due diligence required where investment authority is being delegated should arguably be more extensive than when seeking a consultant as should be the scrutiny when performing oversight.

5 .   Establishing a prudent process to select an investment advisor and other service providers – using an RFP

Having decided whether to grant discretionary investment authority, fiduciaries must establish a prudent selection process because hiring any service provider is itself a fiduciary function. When entering into a contract with a service provider, ERISA requires that the contract be "reasonable"[6]. This means that the contract should be reasonable taking into account the service provider's fees and services. Similar considerations apply to other forms of entity, such as foundations and endowments. The test is how to determine whether services and fees are reasonable?

There are a number of different ways to determine reasonableness, including benchmarking services and expert opinion. However, it is a generally accepted prudent practice to employ a competitive bidding process in which proposals are sought from a number of different service providers and a comparison is made.

> **In fact, it is becoming the hallmark of settlements of ERISA fiduciary breach law suits to impose a competitive bidding process on the replacement of service providers who may have been tainted by the fiduciary breach claims[7].**

To initiate a competitive bidding process, the fiduciaries must assemble complete information about their investment program and a description of the services being sought and establish a timeline. This is for distribution to all the service providers who will be invited to submit proposals. Then, the fiduciaries must create a Request for Proposal (RFP) for similar distribution. The RFP must be uniform to allow for valid comparison of responses and it must elicit sufficient information about the respondents, there services and fees that will allow the fiduciaries to make an informed and reasoned selection. The DOL describes the following minimum requirements for retirement plans[8]:

- Information about the firm itself: financial condition and experience with retirement plans of similar size and complexity;
- Information about the quality of the firm's services: the identity, experience, and qualifications of professionals who will be handling the plan's account; any recent litigation or enforcement action that has been taken against the firm; and the firm's experience or performance record;
- A description of business practices: how plan assets will be invested if the firm will manage plan investments or how participant investment directions will be handled; and whether the firm has fiduciary liability insurance.

It is not the purpose of this article to identify all of the content of an RFP, for much will depend on the facts and circumstances of each case. However, fiduciaries should ensure that both the information they supply to RFP candidates and the scope of questions is sufficiently broad to justify the ultimate selection as being informed and reasoned. Having said that, the fiduciaries to the entity submitting the RFP (Submitter) should pay particular attention to the following:

a

a) Conflicts of interest

It is important to verify that the respondent is independent of other firms in the financial services industry, such as broker/dealers and fund management companies. Such relationships give rise to potential conflicts were the respondent to prefer an affiliate when delivering services to the Submitter. For example, if the respondent is to be given full investment discretion, the Submitter needs to know whether the respondent will use proprietary or affiliated funds as external managers. Such arrangements may mask improper fees or be a harbinger of poor investment performance if, as may be likely, proprietary or affiliated funds are less than best in class in each asset category. Further, use by the respondent of an affiliated broker/dealer to execute securities transactions on behalf of the Submitter may also have the potential for undisclosed revenue and a lack of best execution, to say nothing of the potential for an ERISA prohibited transaction for retirement plans. Consider also that if the respondent is to act as a nondiscretionary advisor, the Submitter's fiduciaries need to be satisfied as to the independence of the respondent so that those fiduciaries may place reasonable reliance on the respondent's advice and recommendations. Conflicted advice presents fiduciary risk.

b

b) Commitment to a fiduciary standard of care

Not only must the RFP seek confirmation that the respondent accepts fiduciary responsibility in a manner suited to the mandate, but the Submitter needs to know whether the respondent will provide the Submitter's fiduciaries with fiduciary training, something that is becoming increasingly important particularly in relation to retirement plans. It is also pertinent to ask how the respondent demonstrates its conformity with a fiduciary standard of care, for example, by undergoing assessment and being certified by an independent organization, such as the Center for Fiduciary Excellence (CEFEX).

c

c) Respondent's Sustainability

The RFP should test the resources and sustainability of the respondent, particularly where the respondent is to have delegated investment authority, because such mandates are not easily undone, for example, where large pools of assets are involved. Investigation should include the strength of the back office and research capability, whether the respondent has an investment committee to oversee investment decisions, and whether there is a compliance department to oversee regulatory matters, including conflicts of interest, fee disclosures and transparency.

d

d) Services Agreement and other documents

Respondents should be asked to provide a sample of their services agreement. It will save a lot of time if, before final selection, the Submitter verifies that a respondent will perform contractually as represented in a proposal. After all, it is the agreement that will control the relationship, not the RFP response, and many service providers lose opportunities because their contractual commitment falls short of their earlier representations. Discovering this issue only when a candidate is selected will unnecessarily and, perhaps, imprudently, delay the RFP process. For the same reason, respondents should be asked to supply sample reports and other material in case the Submitter wants customization.

6. How to identify candidates and manage the process?

Having assembled the RFP and all supporting documents, the Submitter needs to identify suitable candidates to respond. For this purpose, the Submitter may wish to hire a consultant to undertake the RFP process on its behalf. This is fairly common in complex cases and other professional service providers, attorneys or CPAs, may well be able to make recommendations. An internet search will also yield a plethora of opportunities but not much by way of validation.

> **Alternatively, technology such as InHub's eRFP system now allows issue of an RFP via an online service portal that will facilitate (i) creation of the RFP; (ii) selection of pre-vetted candidates; (iii) online delivery of the RFP; (iv) submission of proposals by respondents; and (v) follow up communication. Such a system may accommodate broader distribution of RFPs and improved management of the RFP process than more conventional means, potentially enabling the Submitter to better demonstrate and document the prudence of its selection process.**

There is no rule as to the number of proposals that should be issued. Much will depend on the complexity of the RFP and the nature of the services for which a provider is sought. However, there should be a sufficient number of candidates to allow for meaningful comparison and evaluation and obviously technology may facilitate this. The goal should be to identify, say, three to four firms as finalists who will then be invited for interview by the Submitter before a decision is made.

7 . Evaluating Proposals, Follow-Up and Selection

In order to evaluate proposals in a prudent manner, the RFP Submitter should establish evaluation criteria based on the questions asked in the RFP. Much will depend on the scope of the mandate for which the RFP was issued but fiduciaries should focus on a respondent's capabilities to meet the proposed mandate, its experience, its services and service team, and of course, cost. Matters that could disqualify a candidate, such as conflicts of interest, a history of regulatory investigations or litigation, high management turnover or even corporate acquisitions and divestitures, should be given high priority and should evaluation lead to the need for more information, respondents should be contacted. Finally, the need to focus on fees and their transparency cannot be emphasized enough, particularly for retirement plans where fees must be justified as reasonable to avoid an ERISA prohibited transaction and significant potential fiduciary liability.

Having narrowed the choices to, say, three or four, the finalists should be invited to an interview. It is important that respondents not send only their sales team to the interview but the Submitter should ask for attendance by a senior member of management, preferably one who will work on the Submitter's account. This will be a way to verify that management confirms its commitment and ability to discharge the mandate to be entrusted to their firm. The interviews should be conducted by a committee of three or four of the Submitter's fiduciaries, if possible, and the committee should make its final decision and communicate it.

Once a candidate is selected, any changes required by the Submitter to the candidate's services agreement should be negotiated and an implementation timeline should be established.

Of course, the entire RFP process should be documented and filed, including the fiduciaries' notes of meetings with respondents and minutes of committee meetings that record the reasons on which the final selection is based.

8 . RFP's, RFI's and Benchmarking Services

As relationships with service providers mature, the fiduciary duty to monitor their performance includes a duty to ensure that fees and services remain reasonable. This holds true even where fiduciaries are satisfied with existing arrangements and would be reluctant to make changes. Frequently repeating the RFP for the purpose of simply benchmarking fees may be inappropriate and other service providers in any event become reluctant to put in the effort to complete responses to RFPs if they get wind that the potential client is simply "kicking the tires". Accordingly, fiduciaries can use benchmarking services to periodically benchmark fees and expenses or issue a Request for Information (RFI) which is a limited form of RFP designed to elicit information restricted to particular questions such as fees and expenses. However, it is nonetheless considered prudent practice to issue an RFP on a periodic basis even where there is a reluctance to make changes. In a world where change occurs frequently in the financial services industry, it is only prudent for fiduciaries to test the market. Of course, the incumbent provider may participate and demonstrate the prudence of its remaining in place.

9 . Other Thoughts

We spoke initially of the increase in fiduciary litigation and the consequential fiduciary risk to which fiduciaries are exposed. Much of the focus has been on fees paid by participants in 401(k) plans and conflicts of interest where plan sponsors use affiliated funds as options in the plan fund lineup. Such litigation is likely to broaden and so fiduciaries to 401(k) plans need to be particularly vigilant to ensure the prudence of their investment process. But that experience also serves as a caution to all fiduciaries to establish, follow and document their fiduciary process.

As for the future, who can say? But an area of considerable growth and one, therefore, that can expect scrutiny from the class action bar lies in the Target Date Fund (TDF) arena. TDFs, which have become popular as the investment option to which 401(k) participants are defaulted if they fail to select other investment options available under their plan now account for some $1 trillion in assets and are expected to grow significantly. TDFs are intended to manage a portfolio according to a participant's projected retirement and a "glidepath" established to manage the transition in investments between asset classes to mitigate risk. From the perspective of prudence, prior to selecting particular TDFs, fiduciaries need to understand the level of risk that TDFs incur around the retirement date, bearing in mind that many participants close to retirement in 2008 saw losses in their TDFs of 25% to 35%. Concentration of TDF assets is among three industry providers, T. Rowe Price, Fidelity and Vanguard but there are many other providers, each with a different approach to establishing the TDF glidepath.

Using an RFP process to select and evaluate a plan's TDF is therefore essential to a fiduciary's understanding of the differences between alternative providers and to the fiduciaries' ability to select a TDF which offers an appropriate level of risk around a participant's retirement date.

10 . Conclusion

Throughout this article, we have emphasized the need for a documented "process" to support the prudence of a fiduciary's decisions. Much is simply common sense but often some aspect of the process gets neglected. Accordingly, fiduciaries should periodically monitor prior decisions and if an error has occurred it should be corrected. For example, if in selecting a mutual fund for inclusion in a 401(k) plan lineup, the fiduciaries inadvertently selected an expensive share class when a less expensive class was available, monitoring will identify the error and allow for correction[9]. On the other hand, this is an issue that use of a well-crafted RFP will likely prevent.

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[1] Defined Contribution Consulting Support and Trends Survey, PIMCO 2014 and 2015, and "Litigation heavy on minds of defined contribution execs", Pensions & Investments, March 23, 2015
[2] See for example "Meeting Your Fiduciary Responsibilities": Employee Benefits Security Administration, DOL, February 2012
[3] *Fink v. National Savings and Trust Co.*, 772 F.2d 951, 962 (D.C. Cir. 1985) (Scalia concurring in part and dissenting in part).
[4] For retirement plans, see ERISA § 3(21).
[5] ERISA § 405(d)(1)
[6] ERISA § 408(b)(2)
[7] See, for example, *Martin v. Caterpillar Inc.* 1: 07-cv-01009; *Nolte v. CIGNA Corp*. 2:07-ev-02046-HAB-DGB; *Abbott v. Lockheed Martin,* No: 12-3736, 7th Circuit Court of Appeals.
[8] "Meeting Your Fiduciary Responsibilities": Employee Benefits Security Administration, DOL, February 2012
[9] Tibble v. Edison, No. 13-550, U.S. Supreme Court Slip Opinion (May, 18, 2015)

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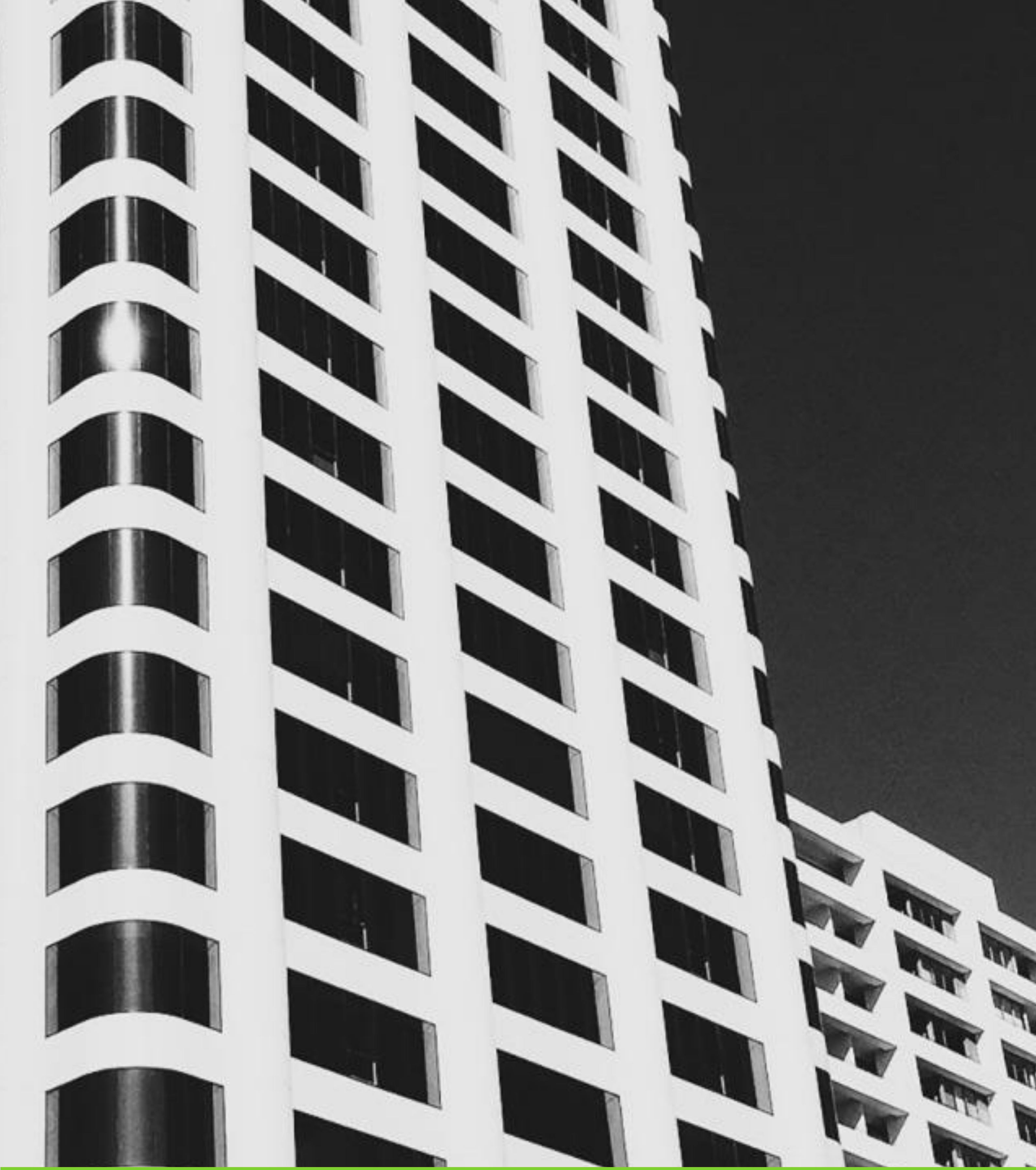
InHub™

InHub is a web-based service assisting investment fiduciaries and consultants through the request for proposal process. InHub's online RFP tool 'eRFP' offers a modern solution to a proven due diligence process, saving investment committees and consultants countless hours and headache while still demonstrating fiduciary prudence.



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