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Introduction

Thank you for the opportunity to testify before the ERISA Advisory Council on retirement plan outsourcing. I'm very pleased to see your attention on this topic, because I believe "outsourcing," in all its forms, represents something that we've needed for a long time: A focal point for leading sponsors, providers and regulators, from almost all conceivable perspectives, to address one of the most vexing problems we all face – *retirement income security*.

As noted in the Issue Statement, outsourcing is big, complicated and growing. There are multiple providers, with different backgrounds and skills, offering a wide range of services to fill an increasingly complex set of client demands. There are no clear winners among the many business models, no "best practice" standards for what should or should not be outsourced, no industry consensus on the legal framework and no obvious set of priorities for regulators. There is no one-size-fits all approach.

But that's OK. In fact, we believe this diversity – or chaos, depending on your point of view – is a great laboratory for much-needed innovation. But we also recognize that it poses real risks. So we need an approach to outsourcing that achieves a balance – *fostering innovation while protecting participants*.

In the next 10 minutes or so, I will explain how I think we can do that, starting with a brief, somewhat philosophical description of the approach we should take, and then moving on to:

- A brief background on my firm and on the industry generally;
- A proposed legal framework for outsourcing;
- Some contracting practices and principles; and
- Some recommendations for Department action.

First, the philosophy: We've got a big problem to solve, and we all know it will require fundamental change. The challenge with that kind of change is familiar, and old. Machiavelli put it pretty well:

> "*There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new*

order of things. The innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new. This coolness arises partly from fear of the opponents, who have the laws on their side, and partly from the incredulity of men, who do not readily believe in new things until they have had a long experience of them."

So how do we drive change in retirement income security? Well, based on my experience at Russell, where we've seen a lot of change in my 16 years (albeit on a *somewhat* smaller scale), I've come to believe that it's best to put a common framework in front of a diverse group of people, give them some goals and guardrails they can all relate to, and let them at it – while staying engaged to monitor and course correct. I think outsourcing is an example of this approach, already in motion. We can continue to develop the common framework, staying focused on *fostering innovation while protecting participants*, with emphasis on:

- *Basic principles*, rather than rules, recognizing that detailed rules and safe harbors can't keep pace with an environment as dynamic and complex as outsourcing,
- *An outcome orientation*, rather than "best practice" thinking, remembering that whatever our backgrounds and current position, we're all applying our skills to do things we think will actually improve *retirement income security*, and
- *Creative collaboration*, rather than constant conflict, recognizing that more will be gained if sponsors, providers of all types, and regulators spend their time focusing on participant welfare, rather than working to shift responsibility and risk among themselves.

The *framework* I'm suggesting is designed with this approach in mind, recognizing that the outsourcing phenomenon itself represents an extension of original fiduciary principles. To improve retirement outcomes, we need to encourage the proper use of *expertise*, provided there is appropriate *alignment* and *accountability*.

In *applying that framework*, the *contractual relationship* between providers and sponsors will need to include:

- *Clarity* of roles, responsibilities and liabilities among sponsor and provider,
- A *uniform* standard of care, based on ERISA's "prudent person" rule, and
- *Transparency*, including full disclosure of compensation and other incentives, in all forms.

With that philosophy and framework, our recommendations are:

- *Practical guidance* to help sponsors understand their options and meet their fiduciary obligations in considering and implementing an outsourced solution;
- *Examination and enforcement priorities* that reinforce the principles described above, and get people like me working FOR you rather than against you; and
- *Legal guidance* that supports the framework and the contracting approach I have described.

II. Russell and Industry Background

Russell Investments is a global financial firm that currently provides consulting, asset management and trading implementation and index services to over 2,500 institutional and individual investors in over 40 countries around the world. Russell consults to approximately $2.4 trillion and manages close to $1 trillion per year in transition events. Russell Indexes calculate over 700,000 benchmarks daily, covering 83 countries and more than 10,000 securities. We are also regulated in all those business lines and places, often by multiple regulators. And yet based on surveys and my own impressions, we continue to enjoy a good reputation among clients and regulators alike. And we do all this with less than 2000 people worldwide. Only 25 of those people are lawyers, by the way.

How do we do all that? *We* outsource, to the best experts in the industry.

Russell's experience in outsourcing dates back to 1980. From consulting to the largest pension plans, we began offering manager selection and oversight to small and mid-market plans that lacked the scale or expertise to handle it themselves.

From that point forward, *we were doing what our clients do*. I think that's a critical point, because it was from that perspective – walking a mile in their shoes, you might say - that we learned to appreciate the real challenges and risks of running complex, multi-asset portfolios. And from those observations, we developed many very important risk and cost management capabilities, including overlay and transition management, more disciplined vendor management and operational due diligence, multi-venue derivatives trading and currency management. Even our index business owes itself in large part to the demands of our outsourcing teams, to better evaluate the range of managers they were researching.

We've seen a similar evolution across the industry in recent years. As investment programs have grown in complexity in response to developments in the investment and regulatory environment, the demand for expert help has grown with them. There are now several different types of firms providing outsourcing services, including investment consultants, multi-managers, asset managers and, primarily in Europe, insurers and other financial institutions. Each offer different combinations of services and each brings different strengths.

As a result, outsourcing is big and growing fast. Estimates from our marketing team put U.S. DB outsourcing AUM anywhere from $400b to $800b, with expectations that it will more than double in the next few years. Defined contribution plan outsourcing is not quite as large yet - around $100 billion in AUM in 2013, but it is likewise expected to grow dramatically.

We believe that the trend toward more outsourcing, in its many forms, is positive overall. But the broad range of options and styles also brings risks, and the sheer complexity of outsourcing allows room for less principled providers to take advantage of their clients.

As I described above, what's needed is balance. From our experience, we believe we can achieve this balance by applying the legal framework and contracting approach I outline below.

II. A Uniform Legal Framework for Outsourcing

Given the range and complexity of offerings available, outsourcing presents a text-book case for a principles-based approach. The good news is that such a legal framework can based on basic and well understood small "f" fiduciary principles. Those principles are:

- *Alignment*: This principle is found in ERISA's exclusive purpose rule and the general fiduciary duty of loyalty. Outsourcing offers natural alignment in many ways, as it effectively establishes a kind of partnership between sponsor and provider, but it is also very complex. It is therefore imperative that all forms of compensation and other incentives should be disclosed, and all potential conflicts carefully managed.

- *Expertise*: This principle resides in the duty of care and ERISA's prudent expert standard. Unlike some areas of law, outsourcing is an area that is getting *more* complex, demanding more expertise. Providers must have the skills, knowledge and tools to deal with that complexity, and sponsors must have the ability to identify it. I often remind people that expertise is the primary reason to hire a fiduciary. Many of the other features of the legal framework are designed to help manage risk, *but there is no improvement in outcomes if the provider lacks the experience and skill to do the job*.

- *Accountability*: This principle is anchored in the delegation and supervision provisions of ERISA, and the general fiduciary principles of reasonable governance and oversight. The relevant roles and liabilities -- sponsor, trustee, and provider -- must be clearly defined in contracts and related documents, properly governed with visible policies, processes, charters and minutes, and measurable through clear objectives and reporting. Establishing accountability is, in my experience, the most important principle of all. It's the foundation for everything else. It's also the place where a *collaborative* approach among sponsors, providers and regulators is essential. And it starts with taking the right approach to contracting.

III. Contracting for Outsourcing

Contracting is important in any complex commercial relationship, but it is absolutely critical in outsourcing. It's far more than a way for lawyers to haggle over the allocation of legal liabilities. It's the foundation of the legal framework I just described, and it's the roadmap for the complex, customized relationship that sponsors and their providers are establishing. It is one area where a *collaborative* approach is essential – first among the parties, to establish their relationship, and then with the regulators, to support it, by supporting the outcomes intended in the outsourcing contract.

I do my best to keep as much as possible of the contract OUT of the deep recesses of my legal department. We want the key actors – investment professionals, business leaders and operations – to stay engaged throughout. We do that by making contracts as accessible and useful to non-lawyers as we can, using simple forms, written in plain English, in a "modular" structure that moves the "legal" terms to a few short pages in the front, and that provides the descriptions of services, investment guidelines, fees and operating principles in separate schedules. These schedules are then negotiated with the investment and business professionals who will be responsible for implementing them, with only general guidance from the lawyers.

In substance, we keep the focus on three priorities:

Defining the assignment. To be an effective "roadmap" for the relationship, a contract must lay out exactly what elements of the program are outsourced, which fiduciary functions are delegated to the provider and which are retained by the sponsor, and what other services may be provided. This is critical, both legally and practically. Effective delegation under ERISA requires explicit transfer and acceptance of fiduciary duty, and setting clear expectations for roles and responsibilities is essential as the basis for *accountability*.

In my experience too much of the outsourcing discussion focuses on whether or not the provider is "a fiduciary" and not enough on who is actually doing what. Outsourcing assignments usually include a combination of discretionary management and expert advice, along with other services or information that may or may not fit the ERISA definition of "fiduciary."

The plain language of ERISA allows the parties to define (and limit) the scope of the fiduciary role delegated. But in practice the fiduciary label carries very specific expectations and can act as a kind of straight jacket, limiting the parties' ability to design the program as they see fit. In other areas (where the delegation of fiduciary status is less obviously involved), providers may either refuse fiduciary status or turn down the assignment, for fear that fiduciary status may make it impossible for them to avoid liability for areas beyond their control or sphere of influence. In some cases, providers may even choose to withhold information or services that might otherwise be valuable, for fear that, *if* they provide the information or service, they will be held to a fiduciary standard or be treated as engaging in a prohibited transaction. That has more to do with providers and sponsors protecting themselves than promoting participant retirement income security. Taking a different approach, I have found that it is more effective if the parties start with defining their actual roles first, and then deciding which of them should carry the "fiduciary" label.

Providing a clear standard of care. Most clients have a high expectation that we will "stand behind" our work. But, as above, many conversations about responsibility also become confused with fiduciary status. Again, I have found that it is more productive to separate discussions of the standard of care from fiduciary status itself. For functions that are fiduciary by definition, the standard of care is set. But that does *not* mean that the

provider must agree to fiduciary status to agree to the standard of care. Often there are sound reasons that *both* parties might not want to delegate the fiduciary duty (or status) for a particular function, even though the provider has valuable expertise to offer, and both parties agree that the program would be better off if that expertise were part of the process.

We generally apply a uniform standard of care (the ERISA prudent expert standard) for the services provided under a contract, wherever we are offering the service as an expert, whether or not we technically are a "fiduciary" under ERISA. Further to this purpose, we prefer simpler liability and indemnification provisions that do not indirectly modify the agreed standard. We also are clear where we are providing additional "non-expert" information or assistance and in some cases clarify that we are not offering it independently or expertly. Generally, we do not disclaim the prudent expert standard for these additional services, as both the standard itself and the context usually provide us comfort that we are not accepting unreasonable liability. But we believe it is appropriate to offer the industry (including us) the option to disclaim the higher standard of care for non-expert services.

Transparency of consideration. Alignment in an outsourcing relationship requires full, and *understandable*, disclosure of how (and how much) the outsourcer will get paid. Some of the worst examples of abuse are found in compensation that is either not disclosed or obscured in contract language that is simply not "understandable." In simple, AUM-fee based arrangements, contracts can address this fairly simply, by including full compensation on a simple fee schedule and representing that there is no undisclosed compensation. These provisions can be more challenging as outsourcing models become more complex. Even so, with plain English, simplicity and effective engagement by the sponsor (consistent with *its* fiduciary duty), I have found that transparency is not usually a technical challenge.

IV. Recommendations to DOL

The values I outlined in the introduction - principles rather rules, outcome-orientation rather than "best practices" and creative collaboration rather than conflict - might sound like I am advocating a reduced role for regulators. In fact, I believe that regulatory engagement is absolutely critical to *fostering innovation while protecting participants.* The regulator's role includes promoting sponsor awareness of the choices available and the benefits and risks associated with them, establishing clear boundaries and expectations that sponsors and providers can work with, and reinforcing standards of conduct that promote the principles we've outlined.

We have some specific recommendations in three areas:

1. *Practical guidance*. The Department can promote awareness and informed decision making around outsourcing. Sponsors need information and tools to improve their understanding of the basics of the outsourcing process and the outsourcing relationship. The Department should consider providing:

- Industry information about the range of outsourcing options, including the types of expertise available, and the business models and incentives of various types of providers. We can help with examples and information on this.
- Compliance assistance on deciding what to outsource, and selecting, hiring and monitoring outsourcing providers. EBSA's "*Meeting Your Fiduciary Responsibilities*," February 2012, is an excellent example.
- Guidance on "Questions to ask" in doing due diligence and assessing conflicts when selecting an outsourcing provider. A good example of this was: "Selecting and Monitoring Pension Consultants: Tips for Fiduciaries," published jointly in 2005 by the SEC and the Department following their industry review. Many of these questions became standard RFP questions and formed the basis of Russell's annual conflicts disclosure program.
- Reinforcing industry standards of conduct, and the needs of all providers to incorporate them into their training and communications. The CFA institute's Code of Conduct is a good example. Given the wide range of providers, it may be impractical to adopt any particular version, but most are fundamentally similar. In any case, Department attention will help keep ethics top of mind for legal & compliance teams across the industry.
- Guidance on a basic framework for reporting and review standards. One of the first questions we get when discussing outsourcing with sponsors is "How do I measure your performance in this kind of assignment?" Like most providers, we customize the reporting to match the assignment. My impression is that the industry is far from adopting a standardized approach. As with outsourcing in general, this is generally OK, provided we all follow basic fiduciary principles, but I do believe all stakeholders would benefit from a coordinated approach.

2. *Examination and enforcement.* The Department should use its examination and enforcement programs to get providers – and their legal departments - working *with* the Department, rather than against it. I see two ways to do this:

- *First*, and generally, by publishing clear examination and enforcement priorities and following up with publication of relevant examination findings. Folks in my line of work pay close attention to this. The Department's priorities could include, for example: hidden compensation; misrepresentations of skills and experience; and misrepresentations about which fiduciary liabilities and risks can and cannot be transferred.

- *Second*, by continuing to deepen Department's understanding of outsourcing through less formal contacts such as "sweeps" or "thematic reviews."

Sweeps have been common practice for many years. In fact, the 2003/2004 SEC examination of consultants mentioned above was a sweep, and as noted it produced a useful tool. Nevertheless, it was very burdensome (as I recall, Russell's legal department at that time "deputized" 50 people to help assemble the requested documents, over the Christmas holiday, as I recall). And the tone and approach was very much that of a traditional "examination."

Recently we have seen several regulators adopt a more collaborative approach. In 2003, for example, the UK Financial Conduct Authority conducted a "thematic review" of transition management. Like outsourcing, transition management is characterized by a range of providers offering different models in a complex environment. Following a widely-publicized scandal and several other allegations of hidden compensation in the industry, the FCA decided to visit each of 10 major transition management providers, to learn more about their business models. They scheduled a one-day visit, with requests to see representatives of all areas of the business (from sales to operations). They sent a reasonable document request list and gave everyone a month or so to prepare. The onsite visit was high-level and business-oriented but clearly focused on investor protection issues. They reviewed marketing materials and contracts, as well as policies and procedures. They then published findings noting where firms' practices fell short of (1) the firms' promises to their clients, or (2) fundamental principles of fiduciary duty, transparency and best execution. They then put the industry on notice that these findings would remain priorities for future examinations, and they expected the transition management companies to bring practices in line.

This approach was principles-based, collaborative and very focused on improving outcomes for investors. The key message was that different approaches would be tolerated, ALL providers were expected to do what they say and say what they do. This effectively got provider legal and compliance teams working *for* regulatory objectives rather than preparing defenses. I can tell you we made changes that will likely improve our practices as a result of this process.

3. *Legal guidance*. This framework depends in large part on the parties' confidence that the law, as interpreted and enforced by the Department, will support their informed decisions about how to define their respective roles, duties and liabilities. We suggest clarifying positions on:

- *Allocation of duties*. The Department should clarify its support for the parties' rights (and obligations) to control the *scope* of assignment to which the fiduciary duties apply. Among other things, this would provide legal incentives for sponsors and providers to get past the distracting focus on fiduciary "status" described above and focus their efforts on really understanding who does what.
- *Uniform standard of care.* The Department should establish that the parties may (and should, in our view) apply the "prudent expert" standard of care to the expert services offered, even where activities may not fit a specifically enumerated ERISA "fiduciary" role. The Department can also clarify that the parties may also choose a more arms' length standard where the provider is offering additional information or general assistance and is not presenting itself as an independent expert.
- *Transparency.* The Department should continue to promote transparency with informed legal guidance on the provider's obligations to disclose all forms and amounts of compensation in clear, understandable means, and the sponsor's obligations to read and understand those disclosures.

These suggestions are only a few of the many options available to the Department to support the parties critical roles in managing their own risks, while ensuring that responsibilities for each outsourced program end up with those who have the required expertise.

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I began with philosophy (the love of ideas). I'll end with a thought from the dismal science. This notion that sponsors and outsourcing providers should, within a broad regulatory framework, be supported and encouraged in allocating fiduciary responsibility to those with the relevant expertise follows a basic principle of regulation first articulated by Ronald Coase. Again, I emphasize that we are not advocating no rules -- we strongly support regulation that protects participants and their rights. What we are advocating is principles-based regulation to which sponsors and providers can *adapt* and within the framework of which they can *innovate*. That approach is best for all concerned, very much including the Department, which would otherwise be burdened with auditing the conformance of a complex industry to detailed, command-style rules.

As Cass Sunstein (former administrator of the White House Office of Information and Regulatory Affairs) writes: "The claim on behalf of privately adaptable rules is not that laissez-faire is a possibility for law. It is instead that law can choose rules with certain characteristics -- rules that will reduce the risks of rules, by allowing private adaptation and by harnessing market and private forces in such a way as to minimize the informational and political burden imposed on government."

Thank you again for the opportunity to share our views on this exciting and challenging new approach to improving retirement security. I hope you found at least some of this useful. If you have any questions, please feel free to contact me at Bgolob@russell.com.