IMPROVING GOVERNANCE UNDER AN OCIO STRUCTURE

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Bolstering Governance with an Outsourced CIO

Fiduciaries seeking to ensure sound governance for their investment programs are increasingly looking to outsource a substantial portion of their responsibilities to third parties with expertise in the field of fund management and administration. Enter: the Outsourced Chief Investment Officer, or OCIO.

Fiduciaries have a raft of obligations to the investment plans they oversee, on top of their other roles and responsibilities. In addition, investment committees are often comprised of individuals who are not full-time investment professionals, and even those that are may not fully understand the scope of their responsibilities. As a result, governance of an investment program may be overlooked or neglected. Robust governance not only ensures the effective implementation of sound procedures and processes, but it also protects fiduciaries when investment performance falls short of expectations. To this end, outsourcing to a discretionary investment manager or OCIO can help govern investment programs adequately and effectively.

To be sure, there are certain fiduciary functions that remain with the Named Fiduciaries[1]. A vital function is the fiduciary's overall responsibility to prudently hire and monitor the OCIO or discretionary investment manager. This includes periodically reviewing the OCIO's performance, capabilities, systems and staff, and fees charged relative to the services rendered. That said, although there is no short-cut to outsourcing, fiduciaries can alleviate much of their fiduciary duties as they relate to the investment of portfolio assets through the selection of an appropriate OCIO.

The Importance of Effective Governance

As fiduciaries to institutional investment programs, one cannot stress enough the importance of good governance. Governance of an investment program defines and measures the processes and decisions of the organization's fiduciaries. This includes the actions taken by fiduciaries and the fiduciaries' ability to act and grant power to act to others. Governance also includes the verification of the performance of decisions, be it those made directly by the fiduciaries or by those acting through the express consent of the Named Fiduciaries.

ROBUST GOVERNANCE PROTECTS FIDUCIARIES WHEN INVESTMENT PERFORMANCE FALLS SHORT OF EXPECTATIONS

The governance list below is not intended to be exhaustive; rather, it shines a light on the many tasks of fiduciaries to investment programs. Governance covers all aspects of managing an investment program, including:

- Identifying fiduciaries responsible for certain activities
- Establishing appropriate goals and objectives and periodic review thereafter
- Establishing and maintaining an Investment Policy Statement
- Ensuring prudent decisions are made and well documented

[1] Section 402(a)(2) of ERISA defines "named fiduciary"

- Determining and maintaining asset allocation consistent with goals and objectives
- Selecting and unselecting investment managers, advisors and administrative service providers
- Ensuring fees paid for services rendered are reasonable, including all fiduciary activities such as investment management, advisory and administrative
- Ongoing monitoring of all fiduciaries, including directed and discretionary fiduciaries
- Establishing and maintaining a funding policy (for ERISA plans)
- Ensuring regulatory filings are accurate and submitted timely
- Managing real and potential conflicts, including relationships between vendors, investment managers, committee members, and prohibited transactions

Governance does not imply good investment performance. Good governance is relative and subject to interpretation, but there is well documented liability associated with poor or inappropriate governance. To this end, OCIOs can help mitigate potential liability for Named Fiduciaries (among the other potential benefits of investment outsourcing).

Picking an OCIO that's Right for You

OCIO firms provide a broad array of products and services. Most offer daily oversight of an investment program, including allocating assets—either opportunistically or simply rebalancing—and the selection and administrative work that go into hiring investment managers.

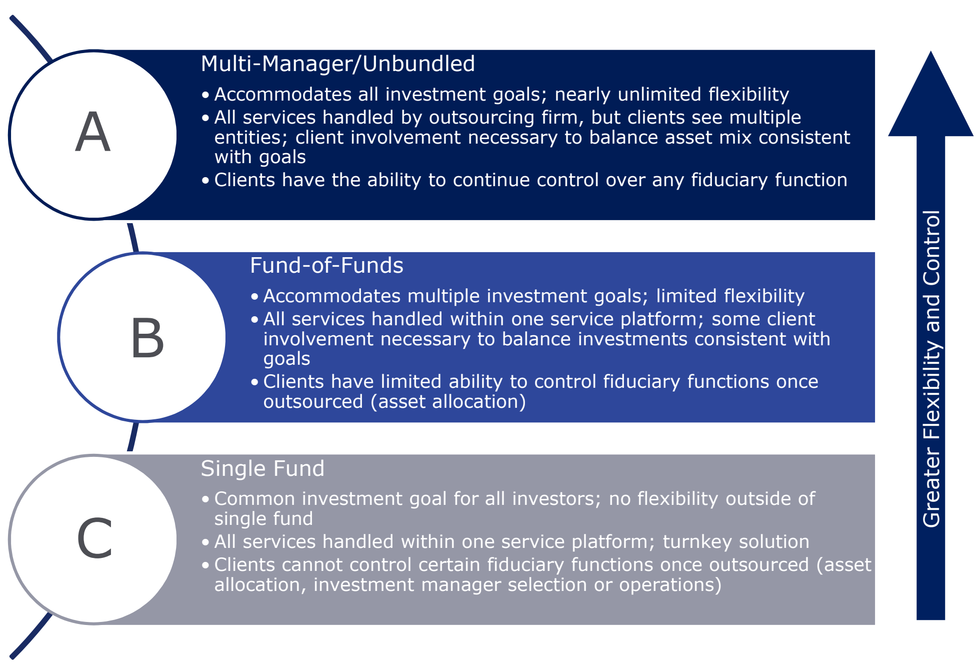
They also come in all shapes and sizes. At NEPC, we broadly categorized the three major types of OCIO firms in a paper[2] published in August. The following are essentially the three main categories of products and solutions currently available in the marketplace:

- Multi-manager/ unbundled solutions
- Fund-of-fund products
- Single-fund products

Exhibit 1[3] summarizes the three categories, with the advantages and disadvantages of each.

Fiduciaries looking to outsource to a discretionary investment manager should first determine which OCIO structure best fits their needs, and then conduct a thorough due diligence process to evaluate the potential providers. If you are starting

Exhibit 1



[2] *"Investment Outsourcing: Evolution of the Industry, Products and Solutions,"* NEPC, August 2014.
[3] Source: NEPC as of June 30, 2014

with an advisory relationship, simply converting your existing relationship to a discretionary OCIO may not be enough to meet your fiduciary duties. Investment committees should solicit competing proposals to evaluate the landscape.

As noted above, regulators and potential litigants will want to know how you evaluated and selected your OCIO. This includes an examination of services, benefits and associated fees. As with any fiduciary decision, the process and decision-making should be well-documented with supporting materials.

FIDUCIARIES SHOULD DOCUMENT WHICH CRITERIA ARE THE MOST IMPORTANT BEFORE SELECTING THE MOST SUITABLE OCIO

Once fiduciaries narrow their focus to one or two of the categories above, the list of what they should look for while evaluating potential OCIOs is potentially long given the importance of the decision. It also depends on what is being outsourced. For example, the ability of the OCIO to determine asset allocation may not seemingly matter if your investment committee decides to maintain control of this duty. That said, your investment committee will still rely heavily on the OCIO's capabilities to provide advice on asset allocation and evaluate appropriate investment strategies within the context of an approved asset allocation decision. Therefore, there are key capabilities that should be examined as part of any OCIO search.

Good governance dictates that some capabilities and criteria are more important than others consistent with your goals and objectives, so fiduciaries should document which criteria are the most important before selecting the most suitable OCIO. As part of a transition, an OCIO's product or services should be assessed to understand their strengths and weaknesses, and then evaluated relative to the fees charged. Here's our 'top 10' checklist:

1. Performance -- Is performance in-line with expectations and consistent through different market environments?
2. Staying power -- Does the OCIO have the financial resources to be your long-term partner?
3. Client expertise -- Does the OCIO have deep expertise managing assets similar to your investment pool?
4. Stability of the investment team -- Has the management team been together for a reasonable period of time and is it stable?
5. Resources -- Does the OCIO possess sufficient research capabilities to support its investment philosophy and client base, and provide service and communications consistent with your expectations?
6. Investment decision making – Are your goals and objectives consistent with the OCIO's investment philosophy and decision-making criteria?
7. Risk management -- What capabilities does your OCIO have in place to manage and monitor portfolio risk?
8. Conflict management -- Does the OCIO have strong policies in place to manage and mitigate existing and potential conflicts?
9. Back office -- Does the OCIO have well-developed back-office capabilities, offering robust quality controls, security of client information and minimal manual processing?
10. Fees -- Are the OCIO's investment management fees reasonable relative to the services provided, including the OCIO fee, any underlying investment manager fees, and custodial and legal fees? Importantly, are there any hidden fees such as trading fees or fund management/ service fees?

Good governance requires a deeper dive into each of the areas we outlined in the 10 points above. Sound governance dictates a well thought-out evaluation process and periodic monitoring thereafter. This may be achieved by the internal resources at most organizations; however, there is a small but growing number of third parties that can help fiduciaries navigate and document the evaluation and decision-making process when hiring an OCIO.

What Entails Good Governance as Fiduciaries Look to Outsource?

As noted earlier, fiduciaries can alleviate a substantial part of their fiduciary duties through outsourcing, but there is much due diligence involved in finding the appropriate OCIO. Fiduciaries should pursue a prudent process that evaluates all relevant aspects of the potential outsourcing firms and their associated fees. Importantly, this process should even contemplate whether or not it is prudent to outsource.

Fiduciaries should go through a thorough process in setting goals and objectives to define the scope of responsibilities to be outsourced to the third party. Since not all fiduciaries are familiar with the concept of what can be outsourced and to whom, fiduciaries will likely benefit from introductory meetings with outsourcing firms to gain a better understanding of the pros and cons of outsourcing certain fiduciary functions.

As the decision committee or person(s) become more familiar with the concept of outsourcing, plan documents should also be examined. This evaluation should determine whether the documents allow for outsourcing of any or most of the fiduciary functions. The plan documents may need to be revised if they are inconsistent with the desired outsourcing approach.

The plan documents should also be reviewed to ensure plan assets are being used appropriately. Most outsourcing firms will charge fees based on total investable assets of the investment program, and fiduciaries often want to use program assets to pay these fees. There are instances where investment programs are prohibited from paying for certain services with program assets. If this is the case, the plan documents may need to be revised as needed.

Once the fiduciaries have established the desired form of outsourcing and the plan documents are revised, as necessary, it is then appropriate to send out a request for proposal, or RFP, for a competitive evaluation of the candidates. We provided a summary list of areas to be assessed earlier in this paper. Fiduciaries should ensure the documentation of the evaluation process and provide a competitive analysis that fueled the final decision. Finally, the contract negotiated between the named fiduciary and the outsourcing firm should clearly spell out the items delegated and level of fiduciary duty for the appropriate parties.

Conclusion

Outsourcing to a discretionary investment manager or OCIO can help govern your investment program more effectively. To be sure, there are certain fiduciary functions that remain with the Named Fiduciary. It is the fiduciaries' responsibility to evaluate whether delegation of their responsibilities is judicious. Fiduciaries should exercise proper caution and due diligence in selecting an OCIO as it is the evaluation process and documentation thereof that will be examined by regulators and potential litigants to be sure they are consistent with the end result. Fiduciaries are also responsible for monitoring the OCIO or discretionary manager. Among other items, this includes periodic reviews of the OCIO's performance, its capabilities, systems and staff, and fees charged relative to the services rendered. Fiduciaries must demonstrate effective governance through a well-documented selection process and on-going monitoring. Although there is no short-cut to outsourcing, an OCIO can help ease the responsibilities of a fiduciary while enhancing governance.

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