



## Developing an Investment Policy Statement Under ERISA

The creation and implementation of a written investment policy statement is one of the most important steps that plan fiduciaries can take to demonstrate a prudent investment process under the Employee Retirement Income Security Act of 1974 (ERISA), as amended. However, determining what steps may be necessary to develop an investment policy statement can be a significant challenge. To be successful, this process requires ongoing coordination and communication among a company's management, plan fiduciaries, trustees, consultants, actuaries, accountants, auditor and legal advisors.

## A Template for Prudent Investment Decisions

The Employee Retirement Income Security Act of 1974 (ERISA), as amended, mandates that plan fiduciaries act in the best interest of plan participants at all times. Fiduciary breach claims can cast a wide net, snaring sponsoring companies, CEOs and CFOs, boards of directors, plan administrators, members of plan committees, service providers and human resources personnel, among others. Since ERISA allows plan fiduciaries to be held personally responsible for losses resulting from a breach of fiduciary duty, it is an excellent time to take a close look at your plan's policies, procedures and documentation, with special attention given to your investment policy statement.

While an investment policy statement is not required under ERISA, the creation of a written investment policy statement can be one of the most important steps an investment fiduciary can take.

A well-written investment policy statement:

- Provides a framework for all plan investment decisions;
- Guides the selection, monitoring and termination of plan investments;
- Demonstrates a prudent fiduciary process; and
- Assists in protecting plan sponsors and other fiduciaries from complaints, inquiries and alleged violations.

The careful construction, maintenance and ongoing review of the investment policy statement through the following steps can help chart your plan's long-term course toward prudent fiduciary investment decisions.

### STEP 1

#### **Create a Formal Investment Policy Committee and Appoint Appropriate Representatives**

Select experienced and knowledgeable members to serve on your company's investment policy committee.

Typical members often include the company's:

- President or chairman
- Director of human resources
- Chief financial officer or treasurer
- Benefits administrator
- Collective bargaining or employee representatives
- Other key decision-makers

A critical step is to make sure that the plan's legal counsel is involved in the process of setting up the committee and any adoption of a policy. An adopted investment policy statement is part of the ERISA "plan documents," which require legal signoff.

### STEP 2

#### **Educate the Investment Policy Committee and Plan Administrators**

One of the most effective ways to help meet a plan's objectives is to keep the members and administrators informed of current company news. Committee members should be knowledgeable of the plan documents, employee demographics and business needs. They should understand their responsibilities, delegate them appropriately and monitor all decisions made on behalf of the plan. Finally, plan sponsors should be able to demonstrate that their committees are composed of appropriate and well-selected individuals who have access to the tools needed to fulfill their duties.

### STEP 3

#### **Determine Funding Characteristics, Liquidity Requirements, Disbursement Procedures, and Risk and Return Guidelines**

Many pension professionals believe that a fund's ultimate objective is to exceed its expected future liabilities. Managing the balance between future liabilities and determining appropriate investments is critical to meeting future funding obligations. Defined benefit plan sponsors who fail to take into account each year's future cash outlays increase their chances of holding an investment portfolio that is either too risky or too conservative. The relationship between funding, assets, liabilities, risk and return requires statistical data about the capital markets, accurate plan data and sophisticated calculation tools. If this type of assistance is not available internally, a qualified professional should be enlisted.

### STEP 4

#### **Determine a Rate of Return Necessary to Meet Future Liabilities and Develop an Appropriate Asset Allocation Strategy**

While compliance is optional, many plan sponsors will follow ERISA Section 404(c)'s guidelines to protect themselves in a defined contribution plan (e.g., Section 401(k) plans with participants investment decisions). Section 404(c) of ERISA generally allows fiduciaries to be relieved of liability for participants' investment decisions. In addition, the estimates provided to defined benefit plan sponsors by their actuaries include their best estimates of future fund liabilities. However, they often do not lend insight into the amount of assets needed to meet those liabilities. It is a plan sponsor's responsibility to understand the relationship between assets and liabilities and to use that knowledge to develop an appropriate asset allocation strategy. Asset allocation strategies are a crucial component of a successful defined benefit plan and should be covered thoroughly in investment policy statements.

## STEP 5

### **Select Appropriate Plan Investments and Develop Procedures for the Regular Monitoring and Possible Termination of Investment Options**

An investment policy statement is a plan's roadmap to a prudent investment process. One of its most important uses is to establish a framework for the selection, monitoring and termination of a plan's investments. This includes the options that are available for participant-directed investment decisions, to the degree applicable. Within this framework, plan sponsors should clearly document their criteria for the hiring of investment managers, state how those managers will be monitored on a regular basis and indicate which events could trigger the termination of an investment option.

## STEP 6

### **Outline the Procedures for Participant-Directed Investments; Include Self-Directed Brokerage Accounts**

According to ERISA, a self-directed 401(k)-type plan permits a participant to select from a broad range of investment alternatives and choose how any portion of their individual account is invested.

The investment policy statement should clearly state the criteria used in selecting, monitoring and terminating investment options for plan participants. The investment decision-making process for participant-directed investment options should focus on providing participants with an adequate number of investment options (at least three, under ERISA Section 404(c)) so that they can adequately diversify their assets.

If self-directed brokerage accounts are allowed under the company's plan, the investment policy statement should specify any limitations on the amount or percentage that must remain in the plan's traditional investment vehicles. It should also specify how much may be placed in individual, separate brokerage accounts. The investment policy statement should be provided to plan administrators in order to develop participant communication materials.

## STEP 7

### **Tailor the Investment Policy Statement to the Specific Type of Plan; Create Separate Investment Policy Statements for Each Plan Sponsored**

Different types of plans often mean different plan investments and asset allocation strategies. Many fiduciaries seek to manage their plan-related responsibilities by delegating investment discretion to their company's human resources or benefits departments, or to the individual participants or investment

management firms. The investment policy statement then becomes a framework which these groups or individuals can follow. Many defined contribution plan sponsors delegate responsibility for plan investments to individual employees themselves. But even this type of plan design can benefit from a formal investment policy statement.

Even when investment discretions are delegated to employees, company management retains the responsibility to select and monitor the investment options available to employees and to select those investments using a defined process. This is especially true when participants can invest in employer securities or real property.

## STEP 8

### **Determine the Use and Guidelines for Employer Securities and Employer Real Property**

One of the most complicated areas of ERISA is the investment of plan assets in employer securities and employer real property. These areas have the greatest ability to affect design and administration. The investments are subject to a number of specific restrictions such as the type of employer securities or real property that may be held and the percentage of plan assets that may be invested in these assets.

Employer securities in retirement plans and the investment of employee savings in those securities have received a great deal of press and legislative scrutiny. It's a complicated issue which faces possible changing legislation.

In light of this scrutiny, it may be helpful to understand that publicly traded company stock in defined contribution plans is common. If employer securities are permitted in a company's retirement plans, plan fiduciaries can take a significant step toward a prudent process by adopting a formal investment policy statement that includes guidelines for investment in employer securities or employer real property.

## STEP 9

### **Ensure Coordination Among the Investment Policy Statement, the Plan's Administrative Procedures and Employee Communications**

Plan fiduciaries often encounter trouble when there is limited coordination among the plan's investment policy statement, the company's administrative procedures and the individuals responsible for different plan-related tasks. While an investment policy statement does not need to be constrained by a company's administrative policies, it should be adaptable enough to permit nimble changes in volatile market conditions or changing business environments. Timely and regular communication among all individuals involved with setting and fulfilling plan policy and administration is often the best defense in a changing climate.

The potential for employee demographic dispersion often makes it difficult to generalize a specific model to follow for employee communications. For larger, national or global organizations, communications could be delivered through various channels such as the internet, printed materials and by those responsible for employee-related communications at each location. For smaller companies, employee communication could fall to one individual. Regardless of the number of employees, the prompt communication of investment decisions related to the plan, including how those decisions could affect participants, may help document investment prudence.

## STEP 10

### **Delegate Authority Appropriately and Establish Guidelines for Monitoring That Delegation**

As mentioned, plan sponsors often seek to manage their fiduciary responsibilities by delegating authority to other parties. On this point, ERISA is clear: The delegation of that responsibility is itself a fiduciary function and must be carried out prudently. Additionally, the plan sponsor always retains the fiduciary duty to monitor those appointed to carry out the delegated functions.

Plan sponsors should bear in mind that the prudent standard requires that a fiduciary lacking in the requisite education, experience and skill necessary to perform fiduciary functions, such as investment decisions, should seek expert assistance.

## STEP 11

### **Establish Procedures to Review the Investment Policy Statement on a Regular Basis to Ensure All Guidelines and Provisions Are Appropriately Followed; Modify and Enhance the Statement as Needed**

Because the investment policy statement can be perceived as a blueprint for prudent investment decisions, it should be regularly reviewed and adjusted. It may be wise to revise or create a new document when:

- A new plan or plan benefit structure is adopted;
- The plan's investment funding status, asset allocation strategy or investment objectives change;
- There is a change to the plan's risk profile or liquidity needs;
- There is a change in service providers or a company's administrative procedures are revised;
- The company acquires another firm or disposes of a subsidiary or business unit;
- Performance evaluation guidelines, investment manager selection, or risk and return parameters change; or
- A significant event in the economic or business environment warrants a substantial change in investment direction.

## STEP 12

### **Enlist the Assistance of Investment Consulting Firms and Investment Managers If the Skill and Experience to Perform Investment Functions Prudently Is Not Available Internally**

Plan sponsors often have the right to delegate many fiduciary functions to other parties. However, they can also retain the duty to monitor all decisions. One area where authority is often delegated is investment responsibilities. In fact, delegating investment authority to professional investment management firms may shield fiduciaries from liability with regard to investment decisions. The investment policy statement should clearly state the process with which investment managers and consultants are selected, hired and monitored. The process should contain clear guidelines not only on the selection and monitoring, but which responsibilities are explicitly delegated.

## Conclusion

In today's fast-paced and evolving investment environment, complying with ERISA's requirements can be more complicated. A carefully crafted investment policy statement may help your company document its investment and fiduciary course. To be successful, an investment policy statement requires coordination and communication among a company's management, fiduciaries, trustees, consultants, actuaries, accountants, auditor and legal advisors.





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