COMPLIANCE

INVESTMENT POLICY STATEMENTS AND THE FIDUCIARY

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An investment policy statement (IPS) is an essential tool in helping plan sponsors develop and follow a fiduciary governance program. As a best practice, a good fiduciary governance program has an established process, ensures the process is followed, and documents each step in the program.

The purpose of this article is to help plan sponsors understand what actions they need to take before adopting an investment policy, why a policy is necessary, what to include in it, how to use it effectively, and what pitfalls to avoid. Our firm's opinion is that plan sponsors who follow these steps will be better prepared from a fiduciary governance standpoint.

THE FIDUCIARY ROLE

First, it's important to review why fiduciary governance is so important. "Fiduciary" is derived from the Latin word fiduciarius, which means to "hold in trust." Plan sponsors "hold in trust" the retirement assets of the defined contribution and/or defined benefit plans they're responsible for overseeing. The Employee Retirement Income Security Act (ERISA) of

1974 requires that fiduciaries, such as the investment committee members who make decisions about the plans, engage in a prudent process to manage and monitor their retirement plan or plans. As such, plan sponsors are bound to uphold their fiduciary duties as specified by ERISA.

ERISA is very clear that a fiduciary is to act exclusively in the best interest of plan participants and their beneficiaries. Therefore, all fiduciaries involved need to be aware of this when making plan decisions.

There are other key fiduciary considerations as well, such as: ensuring plan assets are diversified; understanding fee structures and paying only reasonable expenses; avoiding conflicts of interest; selecting and monitoring investment managers and service providers; and acting with the necessary skill, prudence, and due diligence. A well written IPS can go a long way in guiding an investment committee in meeting its fiduciary duties.

PRE-INVESTMENT POLICY STATEMENT STEPS

Even before an IPS is drafted, an organization should (if it hasn't already) formally authorize the formation of the investment committee. This can be done through a board resolution or similar authorization establishing the committee and granting its power to oversee and take action on the retirement plan or plans.

Once this has been established, an organization should consider drafting a committee charter. The charter defines the committee's structure, roles, and responsibilities. It should emphasize levels of accountability, lines of authority, and responsibilities of the members as they relate to one another and the IPS. A well written charter will detail items such as what organizational positions will be included as members of the committee, how often it shall meet, and the specific duties of the committee and its members.

Once these two actions have been completed, an IPS can be developed to set forth the guidelines for the committee. As a matter of preference, the charter can be incorporated into the IPS. However, the charter is a document of structure, setting forth the roles of the committee, and the investment policy statement is a document of process, setting forth the guidelines on how those duties are to be executed.

WHY AN INVESTMENT POLICY STATEMENT IS NECESSARY

The most direct answer to why a plan sponsor needs an IPS is to demonstrate it has established a set of guidelines for following a prudent, fiduciary process. The official establishment of the committee, followed by the adoption of a charter, and then finally the adoption of an IPS, is an exercise of due diligence, and necessary for fiduciary protection.

Fiduciaries will face more scrutiny for the process (or lack thereof) that led to a decision than they will the actual outcome of the decision. It can't be overemphasized: Acting in a fiduciary manner is about the process involved in decision-making and properly documenting the decision. The IPS supports this process and, if it's applied consistently, substantiates that a prudent process has been followed.

WHAT TO INCLUDE IN THE INVESTMENT POLICY STATEMENT

An IPS should be written in a way that's specific enough for committees to fulfill their duties, but broad enough to provide them with latitude and deference in making decisions. It needs to avoid ambiguity whenever possible so current and future committee members, as well as outside parties, can understand it. It should be able to stand the test of time, but will be subject to revision from time to time as objectives and/or regulations change.

At a minimum, a well written IPS should include the following:

- Background section: This may include information on the establishment of the plan and it may also refer to the formation of the committee through a resolution and/or mention in the charter.

- A purpose statement: This should give the committee clear direction in what it will oversee and how it will carry out its duties. For example, the committee will be responsible for selecting and monitoring investment options. Or, if it is for a participant-directed plan such as a 401(k), it may reference intent to comply with ERISA Section 404(c).

- Guidelines for fund selection and termination: This section should list the criteria the committee will use to evaluate the addition or removal of funds. It's important to note that factors used in the evaluation process cannot capture all scenarios, so language should be specific but written in a way to still afford the committee latitude in decision-making.

- Monitoring of investment options: This section should describe the frequency of and factors used in the monitoring process. The criteria used in the monitoring process should be consistent with the criteria for adding or removing funds. A best practice is to list the peer group and index used for benchmarking and evaluating each fund in the IPS.

- Investment policy statement review: It's important to include a statement on how often the IPS is formally reviewed.

- Asset allocation targets: For a defined benefit plan, a list of the target asset allocation percentages, how often the asset allocation will be reviewed for rebalancing, and what triggers a rebalancing event should be stated. The clearer an IPS is, the easier it is to follow and document a prudent process.

INTEGRATING THE IPS WITH COMMITTEE FUNCTIONS

The IPS should be integrally linked with committee activities. The committee should review the plan based on the guidelines in the IPS and its review documented in the meeting minutes, proving that the fiduciaries have followed a prudent decision-making process.

One of the many fiduciary duties to uphold is the selection and monitoring of investments within the retirement plans. A recent Vanguard study found that making investment decisions is the top issue committees face. To help illustrate how to do this effectively, consider the following hypothetical scenario:

- A committee's IPS requires investments to be reviewed four times per year.

- In the committee's first quarterly meeting, the ABC Fund reports a change in manager.

- One of the monitoring criteria in the IPS is organizational change, so the committee decides to put the fund on the watch list for additional review at the next quarterly meeting.

- At the next quarterly meeting, the committee learns that the ABC Fund's new manager will be changing the investment strategy from growth to value.

- Therefore the committee decides to search for another growth fund because the plan already has a different value option.

- At the third quarterly meeting, the committee reviews replacement alternatives for the ABC Fund and decides on the XYZ Fund.

- All of this is documented in the meeting minutes.

In this scenario, the committee's process is outlined in the IPS, followed, and the results documented.

Since investment monitoring is a large portion of meeting time, a best practice is to have investment monitoring reports linked directly to the IPS. If the IPS states that investments are measured against a specific index and/or benchmark, any investment-monitoring report should reflect this. If there's a discrepancy, the IPS or investment-monitoring report needs to be modified for consistency.

Another best practice to demonstrate adherence to the IPS is to have an executive summary in an investment-monitoring report that directly states how the investments performed in relation to the IPS criteria. For example, if a fund failed certain criteria and needed to be put on a watch list, it would be documented in the investment-monitoring report.

This is further recorded in the meeting minutes. At the following meeting, this fund should again be documented in the investment-monitoring report executive summary and noted in the minutes. If this is done consistently, it will clearly demonstrate that an IPS was in place; the committee followed the policy and took appropriate action, if any.

PITFALLS TO AVOID

As important as it is to have one, an IPS can be a document that exposes plan sponsors to unnecessary fiduciary risk. It's important, therefore, to be mindful of pitfalls to avoid. This isn't an all-inclusive list, but it represents pitfalls commonly found in investment policy statements.

- Failing to comply with the policy: The most important pitfall to avoid is having written policies within the IPS that aren't being followed. If it states that the committee meets quarterly to review investments, it should not be meeting only semi-annually.

- Overly restrictive language: For example, policy language states that a fund needs to be removed if it falls below the peer median for the five-year trailing return period for two consecutive quarters. A fund that falls below the peer median over a five-year trailing return period will probably remain so for more than two consecutive quarters, as one calendar year of severe underperformance can weigh on this metric. Determining whether these funds should be removed shouldn't hinge on one factor within IPS monitoring criteria, but rather allow the committee the ability to review multiple factors and then determine a cause of action.

- Lack of specific language when necessary: For example, pension plans have target asset-allocation percentages in various asset classes. Not including rebalancing triggers for a pension plan or having unclear rebalancing language, however, will cause issues as well. There are sections of an IPS that need to give the committee some discretion, but there are other sections that need to be specific and non-discretionary. Determining which sections fall into these categories is something each committee needs to address.

- Review process inconsistent with the IPS: For example, if the IPS lists specific indexes and peer groups to monitor investments, it's important that investment-monitoring reports include these indexes and peer groups. A plan sponsor wouldn't be meeting the IPS criteria if the XYZ Fund is stated to be benchmarked to the large-blend peer group and the S&P 500 Index, but instead is monitored against the large-growth peer group and the Russell 1000 Growth Index.

A well-crafted investment policy statement should make it easier to carry out fiduciary duties. The IPS should be written in a way that the committee can understand and use effectively to meet its fiduciary duties. There are no definitive rules about length or format for an IPS. Therefore, with so many ways to create an IPS, plan sponsors should consider relying on outside experts such as consultants and attorneys to develop a policy that meets their needs.

The best way to reduce fiduciary liability is to have a process, follow it, and then document it. The IPS is one part of the fiduciary governance process and one of the first building blocks of an effective fiduciary governance program. PC

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