

# Investment Policy Statements – A White Paper from the Profit Sharing/401k Council of America



## Introduction

ERISA states that plans must “provide a procedure for establishing and carrying out a funding policy in a method consistent with the objectives of the plan.” This has been interpreted to mean that qualified retirement plans, including defined contribution plans, should have established procedures for plan investment-related decision making.

Approximately half of defined contribution plan sponsors have described their investment decision making procedures in a written form called an investment policy statement, according to studies by PSCA, Hewitt Associates and BARRA Rogers Casey. This contrasts with the situation for defined benefit plans where such investment policy statements are practically universal. PSCA believes that adoption of a formal investment policy process, and documenting that process, will assist sponsors in the prudent management of their defined contribution plan assets and will help them avoid fiduciary liability.

It is the purpose of this paper to provide plan sponsors with the advantages and disadvantages of adopting a written description of the investment process for their defined contribution plans. It also provides a discussion of what might be included should they choose to implement an investment policy statement. An example of an investment policy statement is attached.

## What is an investment policy statement?

An investment policy statement is a written document outlining the process for a plan’s investment-related decision making. Its purpose is to describe formally how investment decisions are related to a plan’s goals and objectives, as well as the plan’s strategic vision for plan investment. A written investment policy statement can also provide a framework for participant education.

It is important to point out that many defined contribution plan documents include a formal process for making investment-related decisions. Plan sponsors are urged to review their official plan document as they already may be committed to a written investment process even if they have not developed a specific investment policy statement for their plan.

## What are the fiduciary implications of a written investment policy?

Fiduciaries who have not described the procedure required by ERISA in a written investment policy statement and documented their implementation of investment-related decisions may render themselves

vulnerable to legal action either from disgruntled plan participants or the Department of Labor. Further, a well-constructed investment policy statement provides evidence that a clear process and a methodology exists for selecting and monitoring plan investments. In fact, the Department of Labor will routinely ask to see a plan's investment policy statement in the process of a plan audit.

## **Are there concerns with having an investment policy statement?**

Some attorneys believe that plan fiduciaries might not properly execute the process specified by a written investment policy statement; or, that the execution of the process, even if proper, might not be sufficiently documented by plan fiduciaries. They believe that this would subject the plan sponsor to greater risk than if an investment policy statement had not been adopted.

## **What are the benefits of an investment policy statement?**

Section 402(b) of ERISA says "Every employee benefit plan shall provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan...". In other word, ERISA stipulates that a well-articulated, documented procedure for investment selection and ongoing investment evaluation is a plan sponsor fiduciary obligation. Without a written description of procedures affecting plan investment decision-making the plan sponsor has an obligation to provide evidence linking plan objectives and the proper exercise of fiduciary responsibility for every plan investment-related decision. The existence of an investment policy statement provides evidence of a prudent investment decision-making process and, in doing so, can serve a risk management role as the first line of defense against potential fiduciary liability.

Beyond the legal and regulatory reasons for adoption of an investment policy statement, the ever-increasing number and variety of defined contribution investment offerings is encouraging many plan sponsors to consider developing an investment policy statement. An expansion of core investment offerings including a variety of investment styles and disciplines, mutual fund windows, and self-directed brokerage products are all available within today's defined contribution investment landscape. This expansion makes a consistent roadmap to navigate through these choices even more important. Furthermore, in creating an investment policy statement, the plan sponsor can help those responsible for investment decisions, now and in the future, avoid the temptation of following short-term "fads" in the financial markets.

Implementing an investment policy statement also has practical advantages for the plan sponsor. For example, an investment policy statement:

- Helps clarify the plan's investment-related goals and objectives
- Provides a framework for evaluating investment performance
- Aids in clear communication of plan investment policy to participants
- Ensures continuity in decision making as plan fiduciaries change
- Protects the sponsor from inadvertently making capricious or arbitrary decisions
- Helps the sponsor manage pressure for change generated by participants, vendors or the media

## **Is developing an investment policy statement difficult?**

There is more assistance available than ever to help plan sponsors with designing and implementing an investment policy statement for their plans. Sponsors can go to attorneys or consultants or use tools provided by financial services companies to create an investment policy statement. Also, PSCA has developed an example of an investment policy process ([web link here](#)) as a benchmark to get you started.

## **What might a typical investment policy statement contain?**

The investment policy statement's content should always be customized to each plan sponsor's specific needs. Some sponsors prefer to adopt a brief investment policy statement summarizing the critical aspects of their plan investment goals and decision-making processes, while others prefer a more detailed version addressing topics more specifically. The following areas are most often addressed in an investment policy statement:

- The plan's purpose
- The purpose of the investment policy statement
- The Plan's investment objectives
- Roles and responsibilities
- Investment and manager selection
- Investment monitoring and reporting
- Investment manager termination
- Participant investment education
- Investment policy statement amendment process
- While no single approach is appropriate for everyone, following are a number of topical areas for consideration by plan sponsors who are embarking on the development of an investment policy statement or who are considering revisions to an existing investment policy statement:
  - Plan objectives and investment philosophy
  - Investment objectives
  - Roles/responsibilities of parties involved in plan investment decisions
    - Company management
    - Investment/Benefits Committee
    - Benefits/Finance staff
  - Investment decision-making process
  - Investment plan design and types of investment options
  - Number of investment options
  - Investment diversification
  - Fund selection criteria — defined process and methodology
    - Criteria for investment managers
    - Selection criteria for investment options
  - Fund monitoring/evaluation criteria — defined process and methodology
  - Benchmarking against indexes and peers
    - Risk measurement
    - Fees
    - Discipline consistency
  - Fund reporting requirements
  - Frequency of reports and meetings

- Extraordinary events
- Options for funds that do not meet evaluation criteria
  - What is unacceptable performance?
  - How long should it continue before action is taken?
  - Decision to hold, add alternatives, or substitute funds
- 404(c) compliance
- Procedures for enforcing and amending the investment policy statement
- Investment communications and education for plan participants

## **Conclusion**

Employers sponsor profit sharing and 401(k) and other defined contribution plans to attract, retain and motivate high quality workers. At the same time, plan sponsors are legally responsible for the assets of their defined contribution plans. In order to accomplish a plan's human resources goals and for sponsors to meet their legal obligation, plan investment offerings must be prudently selected and managed. Plan fiduciaries also must adopt and adhere to a disciplined investment process. The implementation of a written investment policy statement ensures careful consideration of both the formulation and implementation of appropriate investment strategies. It will contribute significantly to the success of an employer's defined contribution program.

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