The Need for an Investment Policy Statement

Many plan sponsors believe they have no liability when sponsoring a 401(k) program. Yet upon further review, plan sponsors should note that the Employee Retirement Income Security Act (ERISA) of 1974 makes a fiduciary potentially personally liable for account losses when a plan permits participant-directed accounts. Despite this rule, qualified plans are not required to craft a written Investment Policy Statement (IPS). However, it may be wise to do so, because an IPS serves as an invaluable tool by acting as a potential shield that may reduce or possibly eliminate fiduciary liability in this context. Creating an IPS streamlines a plan fiduciary's process of prudently selecting, monitoring, and evaluating the investment lineup. In its simplest terms, an IPS is a written document outlining the fiduciary's investment decision-making process. In addition, it lays out how the account will be managed, the type of investments available, performance measurement, and estimated fees. It should be easy to understand and yet provide decision-making latitude.

A sponsor's election (it's voluntary) to be an ERISA "404(c) plan, "whereby participants control their plan accounts, complements the IPS. A 404(c) compliant plan makes employee education and diverse investment choices available. To ensure that this potential additional liability protection passes muster, it is generally recommended that a plan fiduciary continually adhere to a 404(c)'s compliance regimen. When sponsors choose to comply with ERISA 404(c), the IPS should lay out clearly how the plan investment menu, participant account controls, employee communications, and education processes satisfy the requirements.

Is this important? Anytime one has the potential opportunity to reduce his liability, it's important. A November 2006 Government Accountability Office Report cited Department of Labor (DoL) statistics, revealing 87 percent of 401(k) plans covering 92 percent of participants, allow self-directed accounts, and yet only 54 percent of plans consider themselves a 404(c) plan. Apparently, a serious judgment gap exists.

The process is more crucial than the results of the investment decision. Consequently, fiduciaries that have not constructed a process using a written IPS may leave themselves exposed, especially if the DoL or a plaintiff's attorney comes knocking. Plan fiduciaries afford themselves greater liability protection when the process is documented demonstrating reasonable, good-faith actions.

The following are a few of the many questions plan fiduciaries often ask regarding the selection and monitoring of the investment menu process:

- Are the investments diversified?
- What monitoring requirements are being followed?
- When do investments need to be placed on a "watch list" or removed?
- Do the investments offered represent asset classes across a risk/reward spectrum?

The IPS creation helps plan fiduciaries answer these questions and others while memorializing the methodology. Defined procedures, implemented and executed, assist in ensuring that the investment options satisfy the plan's investment policy.

ERISA imposes investment evaluation on plan fiduciaries. Utilizing a financial advisor can add value by assisting the fiduciary in developing, monitoring, and evaluating the process. Benchmarking and category peer review are integral parts where an advisor can also be of assistance. These aspects help determine how performance stacks up against alternative investment options and confirm that the investments are appropriate given current market circumstances. It should be noted, however, that the IPS offers guidelines, not specific directions regarding investment purchases or sales. Periodic IPS evaluations should be considered annually, and perhaps more frequently during periods of increased market volatility.

In general, an IPS is created and maintained by a formal investment committee.

The committee meets regularly, conducts investment reviews, and makes decisions documenting the thought process. Interestingly, both ERISA and the DoL offer flexibility in creating an IPS, because a specific format, template, and wording are not required.

A well-executed IPS expands the following core topics:

1. underlying purpose;
2. plan investment philosophy;
3. plan investment selection and monitoring;
4. investment classes or categories, risk and return characteristics;
5. identification of parties involved in the investment selection process, managing and monitoring investments; and
6. describing how service providers, including money managers, will be selected.

An IPS crafted on behalf of a participant-directed plan also should include the following information (and ensure that this information is distributed to plan participants):

1. a statement that the plan intends to comply with ERISA 404(c)
2. a description of asset classes for each investment alternative and the number of investment alternatives;
3. the methodology used to select and monitor investment alternatives and process to replace an investment, an overview of the default investment option; and
4. participant education materials.

Fiduciaries must be cognizant that the IPS follows plan terms, unless it runs contrary to ERISA. Compliance plays a significant role in assessing whether the fiduciary has breached obligations.

The fiduciary should not be misled into believing that drafting an IPS is the beginning and end of his responsibility. Instead, the fiduciary should consider focusing his attention and energy on communications and education. As we said, ERISA judges a fiduciary on the process, not performance or results.