INVESTMENT POLICY STATEMENTS FOR DEFINED CONTRIBUTION PLANS

Although the Investment Policy Statement (IPS) plays an important role in the administration of most defined benefit plans, many defined contribution plan sponsors seem reluctant to develop and adopt an IPS. According to a recent BARRA RogersCasey/IOMA poll, almost two-thirds (63%) of plan sponsors with less than 250 participants don't have an IPS for their 401(k) plan. Additionally, more than half (54%) of plan sponsors with between 1,000 and 5,000 participants, and more than one-third (36%) of plan sponsors with more than 10,000 participants, don't have a written IPS.

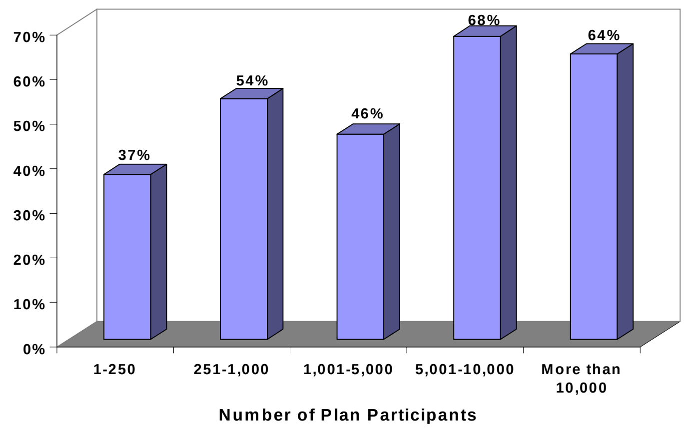
IS AN IPS REQUIRED?

Why is it that so many DC plan sponsors, including numerous very large sponsors, don't have a written IPS? ERISA itself is somewhat ambiguous regarding the requirement for investment policy. The most relevant reference to a "requirement" for investment policy is found under ERISA Section 402(b)(1), which states that plans must "provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan and the requirements of this title." Although most ERISA attorneys believe that an IPS is a useful tool, nowhere in ERISA is there an explicit requirement that any plan, defined benefit or defined contribution, must have a written IPS.

IS AN IPS A GOOD IDEA?

Even if your defined contribution plan doesn't have a written investment policy, if you have a defined contribution plan with investment options, you have what amounts to a tacit investment policy. Julie Jason, JD, LLM, managing director of Jackson, Grant Investment Advisers Inc. notes: "The instant you set up a 401(k) plan and choose investment options, de facto, you have initiated the setting of investment policy for your plan. Whether you formalize the policy in writing or not, you are accountable for your actions as a fiduciary. And your employees can, should, and do rightfully rely on your having prescreened their investment selections." Jeffery Bailey, author of ***Investment Policy: The Missing Link*** draws a similar conclusion: "Regardless of whether a plan sponsor chooses to formally enunciate the investment policy, the [Plan] will operate under a policy. No decision is still a decision. The plan sponsor's real choice involves whether to devise and consistently apply an investment policy consonant with targeted needs or to proceed with an ad hoc approach."

Prevalence of Investment Policy Statements Among Different Sized 401(k) Plan Sponsors



NEGLECTING IPS MAY CAUSE UNFORESEEN PROBLEMS

In the BARRA RogersCasey/IOMA poll referenced above, sponsors cite a litany of reasons for not having a written IPS. These include:

- Lack of sufficient resources to develop an appropriate document (16.7%);
- Lack of time (8.4%);
- Belief that the IPS would add little or no value (7.0%);
- Concern that the IPS would impose unnecessary restrictions (3.1%); and
- Fear that a written IPS would increase the sponsor's liability (3.3%).

Unfortunately, the Department of Labor (DOL) expects that all defined contribution plans will have a written IPS. The IPS is generally at or near the top of the document request list in any DOL audit

But beyond the (somewhat debatable) regulatory requirement that a plan sponsor maintain a written investment policy, most informed observers agree that a well-drafted policy is an invaluable plan management tool. IOMA's Report on Managing 401(k) Plans reasons, "From Managing 401(k) Plans' perspective [not having a written IPS] is gunning for

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Setting investment policy is critical to a 401(k) plan. The potential for employees to achieve security in retirement flows from this strategic step.

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trouble. Formal investment policies serve as a benchmark and remind sponsors of their original goals and objectives.... [the IPS provides] critical factors of record in a dispute over whether fiduciary responsibilities have been met." Julie Jason reaches a similar conclusion. "Setting investment policy is critical to a 401(k) plan. The potential for employees to achieve security in retirement flows from this strategic step."

WHY INVESTMENT POLICY IS SO IMPORTANT

Many plan operational documents stem from compliance requirements. Plan documents, summary plan descriptions, summary annual reports, beneficiary designations, even enrollment forms are all required by law. Although these documents (particularly SPDs) may evolve to incorporate functions that go far beyond their simple compliance function, the principal reason for the document's existence is that a regulatory agency's mandate that the sponsor must adopt the document, or they couldn't have a tax-qualified plan. Conversely, the principal reason for the investment policy statement's existence is because it is useful. The IPS provides the following benefits to the DC plan sponsor:

- It documents the procedural prudence of the sponsor's decision-making process, insulating against claims of breaches of fiduciary responsibility;
- It defines how the plan will satisfy ERISA's diversification requirements [404(a) or 404(c)], protecting the sponsor against arguments that investment losses attributable to the exercise of participant control should be the sponsor's responsibility;
- It improves the long-term viability of the program as a valuable employee benefit by ensuring that investment decisions are made from a long-term strategic perspective, not from ad hoc reactions to short-term market vicissitudes;
- By establishing quantitative standards for expectations of investment fund performance, it transforms investment decisionmaking from a matter of opinion to a matter of fact, thereby streamlining the both the investment selection process and the ongoing investment monitoring process.

Initially drafting an investment policy may require additional work for the Plan's Administrative Committee. Once an effective policy statement has been developed, however, the time that the Committee is required to spend selecting appropriate funds should drop significantly. A well-crafted IPS will outline the rationale supporting the investment categories to be offered, and the plan's criteria for selecting among funds in each category. By one estimate, approximately 95% of funds that a Plan sponsor might consider will be screened out through well-designed quantitative filters typically incorporated into a policy statement. In today's environment, with more than 9,000 mutual funds available, not to mention the thousands of collective funds, separately managed accounts and other investment vehicles clamoring for the Plan sponsor's attention, the ability to rapidly focus on the subset of funds most likely to meet the sponsor's needs can be enormously valuable. Additionally, time committed to managing the investment program will also decline. The well-crafted IPS should set standards for reporting on fund performance, and objective criteria for fund retention. Once these monitoring procedures have been established, the Committee can briefly review the periodic performance reports, and can focus attention on just those funds that are not satisfying the retention criteria. Fiduciary responsibilities for ongoing diligence can be met relatively painlessly.

WHY PLAN SPONSORS NEGLECT POLICY

Some of the same reasons that make policy so important explain why plan sponsors neglect policy development during the plan's initial development phase. There are so many documents that must be completed and executed during a plan's initial launch that it is easy to postpone developing documents that are crucial from a strategic perspective, but may be perceived as elective from a compliance perspective. Unlike a plan document, which generally must be submitted to the Internal Revenue Service for a determination as to its tax-qualification, no regulatory agency will ask to review your IPS (or even ask if you have an IPS) unless you are selected for audit.

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This makes it easy to neglect IPS development, in favor of the apparently more urgent compliance-oriented documents with well-defined filing deadlines.

WHY PLAN VENDORS NEGLECT POLICY

Service providers also share the blame for the plan sponsor's lack of focus on investment policy. Most traditional plan service vendors plan don't provide sponsors with much support for developing policy. These vendors cite numerous reasons why they don't want to help sponsors with their investment policy statements. These include:

- Cost concerns;
- Fiduciary liability and prohibited transaction concerns;
- Lack of necessary expertise;
- Deselection issues; and
- Legal constraints restricting investment advice.

Cost Concerns

Installing a plan is a costly proposition. Documents must be drafted, administrative procedures must be developed, tested and communicated, communications materials must be written, reviewed and distributed. Service providers fear that additional time expended developing a document that isn't absolutely mandated will make establishing their program cost prohibitive, when compared to other vendors.

Fiduciary Concerns and Prohibited Transactions

Most plan service vendors believe that helping a plan sponsor develop an investment policy statement constitutes rendering "investment advice". Vendors that render investment advice for a fee to ERISA plans become fiduciaries responsible for the results of that advice. To the extent that a vendor takes on an additional fiduciary role, the vendor sees their potential liability increase.

Plan vendors are also concerned that becoming and investment advisory fiduciary could lead to prohibited transaction issues. Most bundled service providers receive the bulk of their compensation from managing plan assets. As a fiduciary, however, an investment advisor must act solely in the interest of participants and beneficiaries. If a bundled service provider recommends a fund that has a higher investment management fee, over a fund that has a lower fee, the bundled service provider necessarily increases its revenue. Although this revenue increase might be perceived as representing a potential conflict of interest that could generally be addressed through appropriate disclosure, the Department of Labor (DOL) believes that the revenue increase would constitute a prohibited transaction. The DOL is particularly likely to interpret advice as a prohibited transaction when the bundled service provider also acts as trustee. In effect, the provider is wearing so many hats (investment manager, trustee, advisor) that the various functions that the provider performs cannot be distinguished from each other. By making an investment recommendation that increases its revenue, by definition, the bundled provider increases fees charged against participant accounts, thereby breaching its fiduciary responsibility and creating a prohibited transaction. Thus, the only rational course of action for the bundled provider is to not act as an investment advisory fiduciary.

Lack of Necessary Expertise

It can be extremely difficult for vendors to develop specialized expertise in a broad range of functional areas. Traditional plan service vendors may be very well qualified to help design appropriate benefit programs, draft plan documents and develop, administer and communicate defined contribution plans. However, these skills have relatively little in common with the qualifications necessary to draft investment policy. Traditional providers often find that they lack the necessary in-house expertise to do an effective job of drafting investment policy for defined contribution plans.

Deselection Issues

Bundled service providers have a significant incentive to ensure that their proprietary funds are represented to the greatest extent possible in a plan's investment menu. Proprietary funds tend to be significantly more profitable than funds offered through an alliance with other investment management firms, even after considering revenue sharing arrangements. Bundled service providers' ad-

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ministrative services often tend to be loss leaders for the highly profitable investment management function. Consequently, the bundled equation works best for the vendor when the bulk of a Plan's assets are invested in the vendor's proprietary funds.

A well-crafted policy will tend to restrict funds considered to just those funds that are most appropriate for the plan. Consequently, policy will tend to reduce the number of proprietary funds selected for the plan, in favor of more appropriate outside funds. Additionally, even when a proprietary fund is chosen based on IPS selection criteria, the manager's feet will be held to the fire by the IPS' ongoing retention criteria. Many bundled service providers would prefer to have their sales force recommend proprietary funds based on seemingly relevant, but difficult to quantify, subjective criteria, such as limited downside risk, or superior stock selection algorithms. By avoiding stringent qualitative investment policy criteria, bundled vendors hope to achieve more frequent initial selection of profitable proprietary funds, and longer tenure of the funds once selected.

Legal Constraints

Various regulatory agencies set minimum standards for entities purporting to render advice to qualified plans. ERISA Section 3(38) defines entities that can legally render investment advice to qualified plans. Organizations eligible to provide advice to qualified plans include Securities Exchange Commission (SEC) registered investment advisers (RIAs), banks, and multi-state insurance companies. Thus, many individuals that traditionally assist companies in establishing retirement plans, such as securities brokers, insurance brokers, attorneys, benefits consultants and mutual fund company representatives can't legally provide investment advice to a qualified plan. However, unlike the fund selection process, the policy statement becomes part of the plan's permanent record. Consequently, many companies that look the other way when their sales force participates in the fund selection process will prohibit the sales force from helping clients develop investment policy statements.

COMPONENTS OF AN EFFECTIVE INVESTMENT POLICY STATEMENT

Just as ERISA is ambiguous in defining whether an investment policy statement is definitively required for a qualified retirement plan, discussions continue about the important components of an effective IPS. Further, policy statements for DC plans are new relative to their defined benefit plan counterparts. The first policy statements for 401(k) plans emerged just over a decade ago; many defined benefit plans have had policy statements for forty years or more. Some DC policy statements are incredibly brief, running just a few paragraphs.

Although there are no regulations governing what elements belong in a DC plan IPS. DOL audit practices may help shape the form of many plan sponsors' policy statements. Recently, the DOL initiated a research project to determine whether 401(k) fees are adequately disclosed by vendors and properly considered and understood by plan sponsors. In support of this project, the DOL investigated the internal procedures of 50 randomly selected 401(k) plan sponsors. The DOL's document request letter for this project provides significant insight into the elements that the Department believes belong in an IPS.

According to the DOL document request letter, some of the plan investment guidelines that might be addressed by a Statement of Investment Policy include:

- Evaluation of the specific needs of the plan and its participants;
- Statement of investment objectives and goals;
- Standards of investment performance/benchmarks to which the investments are compared;
- Classes and styles of investment authorized;
- Diversification of the portfolio within and among classes of investment, and investment styles;
- Restrictions on investments ;
- Guidelines relating to directed brokerage;
- Guidelines relating to proxy voting and tenders;
- Standards for reports by investment managers, investment consultants and administrative service providers relating to the format, content and frequency of reports on:

A good investment consultant will also assist with choosing funds and will provide periodic fund performance monitoring services to ensure that selected funds continue to meet the criteria set forth in the policy.

- ⇒ investment performance,
- ⇒ fees and commissions charged to the plan, the participants and the plan sponsor;
- ⇒ compliance with investment guidelines,
- ⇒ disclosure of actual and potential conflicts of interest.

- Policies and procedures relating to the hiring and monitoring of investment managers and other service providers;
- Procedures for identifying prospective investment managers and/or administrative service providers for the plan.

WHERE TO TURN?: HOW TO GET HELP WITH AN INVESTMENT POLICY STATEMENT

Once a plan sponsor has decided that developing an investment policy statement makes sense, where can the sponsor turn for help? As previously indicated, most traditional bundled service providers don't offer much support for sponsors interested in investment policy. However, there are some relatively inexpensive approaches. For example, Ibbotson Associates in Chicago markets a CD-ROM with model policy statements that can be customized for client needs. A web search turns up several less familiar vendors that offer boilerplate language for investment policy. But the best resource for developing investment policy may be a qualified independent investment consultant. In hiring a consultant to help develop policy for a defined contribution plan, be sure to select an advisor that is registered with the SEC. The advisor should also be intimately familiar with the intricacies of plan design and administration. This will help ensure that the policy drafted will function operationally, in addition to providing appropriate fiduciary protection and investment insight. A good investment consultant will also assist with choosing funds and will provide periodic fund performance monitoring services to ensure that selected funds continue to meet the criteria set forth in the policy.

CONCLUSIONS

Although investment policy statements are routinely used by defined benefit plans, many defined contribution plan sponsors have not yet formally implemented policy for their plans. Although the specific components of a DC plan policy statement will differ significantly from a DB policy, the statements' primary objectives are similar:

- To demonstrate procedural prudence on the part of the Plan's fiduciaries;
- To provide guidance in evaluating investment alternatives; and
- To ensure that the Plan's investments are appropriate for the Plan population.

In the aggregate, 401(k) plan assets now total more than $1 trillion, with the average participant account balance approaching $45,000, and more than 10% of accounts holding over $100,000. As this asset pool expands, responsibility and concomitant liability for managing these assets also increases. Section 404(c) of ERISA provides some limited relief from liability, but was never intended to address the underlying issues of selecting, monitoring and making ongoing suitability determinations concerning plan investments. A well-crafted investment policy statement furnishes the plan sponsor with the best vehicle available for demonstrating prudent fiduciary conduct.

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