

The Investment Policy Statement: A Shield Against Fiduciary Liability in 401(k) Plans

In the 1990s, a robust stock market rewarded most participants in 401(k) plans with healthy rates of return on investments. Healthy rates of return made for happy participants, and lawsuits against employers for poor 401(k) plan investment performance were rare. With today's more turbulent investment environment, things have changed.

Over the last three years most participants in 401(k) plans have seen their account balances shrink instead of grow. While sophisticated investors know and expect market downturns, many participants in 401(k) plans were caught by surprise. As a result, some plan sponsors are concerned about unhappy participants bringing lawsuits. Fortunately, ERISA does not make the plan sponsor a guarantor of good investment performance. What it does require is a good decision-making process for choosing investments or, in plans with participant-directed investments, choosing investment options.

This article describes the basic ERISA requirements for selecting investments or investment options and the important role a written investment policy statement (“IPS”) can play in satisfying those requirements. Indeed, adopting and following such a statement can go a long way toward inoculating the plan sponsor (and other fiduciaries) against liability for plan investment performance.

What are the general ERISA requirements for choosing plan investments or plan investment options?

ERISA requires those who manage retirement plans to make investment decisions prudently and for the sole interest of the participants and their beneficiaries. These requirements—and a third requirement, that plan investments generally be diversified—are intended to shape the decision-making process of plan officials who invest plan assets or, in self-directed plans, choose the various investment options made available to plan participants. A fiduciary whose investment decision-making (or choice of investment options) fails to satisfy these requirements can be liable for any resulting plan losses.

As already noted, the good news is that ERISA judges a fiduciary not by the plan's actual investment results, but rather by the quality of the fiduciary's decision-making process. A fiduciary is not expected to be a seer but is expected to be careful, deliberate, and thoughtful in its decisions. ERISA asks for defensible investment decisions, not perfect outcomes. In short, ERISA requires procedural prudence—a good procedure.

Does this mean that if I use a good procedure to choose plan investments or plan investment options, I am doing all that ERISA requires?

Here it depends what you mean by “choosing” plan investments or investment options. Under ERISA, the process of choosing is a continuous one: you must not only initially select investments (or investment options), you must also *monitor* those choices to ensure that they continue to be the right ones for your plan and plan participants.

What are my responsibilities if my employees choose among investment options?

ERISA includes a provision—section 404(c)—that relieves a plan sponsor (and other fiduciaries) from responsibility for investment choices made by participants, if certain regulatory conditions are satisfied. The requirements, which are collected in a lengthy and technical regulation, include that the plan provides at least three diversified investment alternatives, which have different return and risk characteristics and which in the aggregate enable the participant to develop a portfolio with aggregate risk and return characteristics within the range normally appropriate for the participant.

While section 404(c) can relieve the plan fiduciary of liability resulting from a participant's instructions allocating his or her account among available plan investment options, it does not relieve the fiduciary from liability for the selection and monitoring of the plan investment options.

What is an investment policy statement and how can it protect me from liability?

As just explained, ERISA requires a fiduciary to engage in procedural prudence. This means, in effect, that the fiduciary should have a thoughtfully developed plan for making investments or selecting investment options; should follow that plan; and should periodically review and, if necessary, revise the plan. The investment policy statement is that plan—to use a sports analogy, it is the plan's playbook for choosing investments. The investment policy statement, if properly designed, shows that the plan has put in place a reasonable strategy for selecting, monitoring, and when necessary, altering plan investments or investment options. If the investment policy is reasonable, and if the policy is followed, the plan fiduciary will have complied with ERISA's fiduciary strictures, even if investments did not perform as well as expected. Moreover, following an investment policy creates an important paper trail documenting that the fiduciary's behavior was prudent. Such documentation can be critically important when disputes arise concerning ERISA compliance.

On the other hand, if the plan does not have an investment policy, it may be difficult to demonstrate compliance with the ERISA demands of procedural prudence.

Does ERISA actually require an investment policy statement?

No, and perhaps no more than half of section 401(k) plans have formal investment policy statements. But the Department of Labor, in an interpretation of ERISA, has written that "the maintenance by an employee benefit plan of a statement of investment policy designed to further the purposes of the plan . . . is consistent with the fiduciary obligations set forth in ERISA." Most ERISA experts believe that all ERISA retirement plans should have such a policy statement. For example, Donald B. Trone, President of the Foundation for Fiduciary Studies, has said that "the preparation and maintenance of the investment policy statement is one of the most critical functions of the fiduciary."

What should an investment policy statement look like and what should it cover?

There is no single form or template for an investment policy statement. But the idea of an investment policy statement is to provide a blueprint of investment strategy and practice intelligible to a third party.

Most well-drafted investment policy statements for 401(k) plans will include:

1. The underlying purpose of the plan and the general plan investment philosophy.
2. Description of factors a plan will take into account in selecting investments, including risk/return characteristics, guidelines for asset classes (including any excluded asset classes), and plan diversification. The factors should reflect a consideration of participant demographics, likely plan liquidity needs over plan's life, and the purpose of the plan. If the plan will invest in employer stock, the investment policy statement should provide parameters for such investment, consistent with the plan instrument.
3. Description of how plan will select service providers, including money managers. The selection process should consider both qualitative and expense factors. (The Department of Labor's ERISA Advisory Council issued a report on the selection and monitoring of service providers, which is available online at <http://www.dol.gov/ebsa/publications/srvpro.htm>.)
4. Description of the methodology the plan will use to monitor service providers.
5. Criteria for evaluating investment performance.
6. Description of how (and how frequently) the plan will rebalance its investment portfolio.
7. Description of procedures for controlling and accounting for investment-related expenses.
8. Identification of the various parties involved in the process of selecting, managing, and monitoring investments, and their particular responsibilities.
9. For plans that permit participants to instruct how their account balances are invested:
 - i. that the plan intends to comply with section 404(c) and description of how the plan will satisfy each of section 404(c)'s requirements, including adequate communication with employees;
 - ii. the number of investment options offered;

- iii. the assets classes for each investment option;
- iv. the method and criteria used to select particular investment options, including fund expense and other fees;
- v. methodology to monitor fund performance and criteria for deciding whether to replace funds;
- vi. description of investment education or advice available to participants;
- vii. restrictions on particular investment options, especially if a brokerage account or employer stock option is provided;
- viii. description of how any default funds are chosen for participants who do not provide investment instructions.

How do I draft an investment policy statement?

A good way to start is to look at some sample investment policy statements. Many are available on the internet. It is also likely that one or more plan service providers or mutual funds will be able to provide you with a template. Consultation with an independent financial expert and a professional advisor well versed in ERISA fiduciary compliance is important. But it is generally not a good idea to have the statement drafted by a mutual fund company or a fund manager used by the plan, since they might have a business stake in the statement's content, although all plan service and product providers should review the statement before the plan adopts it. Getting employee input, particularly in cases of self-directed plans, can also be valuable and can give employees a sense of ownership in the IPS.

What happens once a plan adopts an investment policy statement?

In real estate the buzz words are location, location, location. With an IPS the buzz words should be "follow it, follow it, follow it." Indeed, adopting an IPS and then ignoring it will often be worse than never having adopted the IPS in the first place, since ignoring the plan might itself be evidence of lack of care.

It is also important to communicate the plan to all those with a role in plan investments, including plan participants, and to monitor compliance with the plan by service providers. Thus, we might revise the buzz words from "follow it, follow it, follow it" to "communicate it, follow it."

Finally, the needs and expectations of the plan and its participants, and the investment climate itself, might change over time, which means that the plan should be reviewed periodically and if necessary revised. Thus, the final buzz words for an IPS might be "communicate it, follow it, review it, and, if necessary, modify it."

Concluding Thoughts

An IPS is the proverbial stitch in time in the fabric of ERISA fiduciary responsibility. Adopting and following an IPS can prevent problems before they hatch. And not only does a properly drafted and carefully implemented IPS shield the employer and plan officials from potential fiduciary liability, it also increases the odds of strong investment performance over time and, in doing so, increases employees' satisfaction with their plan and their prospects for retirement. And ultimately, that is what a retirement plan is all about.

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