Establishing a Policy Statement For Your DC Plan

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A comprehensive policy can help reduce some of the potential risk of defined contribution plans.

In the mature pension or employer-directed plan market, it is accepted practice for plan sponsors (the employer or company sponsoring the retirement plan) to follow the standard procedure of having an investment committee and a written investment policy statement. However, participant-directed plans such as profit-sharing, 401(k) plans for corporations, 403(b) plans for nonprofits, and 457 plans for municipalities, are relatively new and are still evolving with regard to regulations and legal case history.

Like traditional pension plans, participant-directed plans fall under the regulations of the Department of Labor (DOL), the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC). These plans carry, in fact, similar levels of fiduciary responsibility for the plan sponsor. Over decades of legal case history, plan sponsors in the employer-directed pension market have moved to reduce their fiduciary liability. Plan sponsors in participant-directed plans, although short on legal case history, can attempt to reduce their fiduciary liability by having a comprehensive investment policy statement.

This issue is especially relevant to the treasury professional because as plan assets have grown, so has the magnitude of potential fiduciary liability to the company. Increased assets have also heightened the involvement of corporate treasury personnel in lending their financial and investment expertise to the selection and monitoring of the plan.

What Is An Investment Policy Statement?

An investment policy statement for a participant-directed plan is a written statement of the plan's goals and objectives to be followed by the investment managers, diversification of investment options, compliance with applicable pension regulations and performance measurement guidelines. This policy allocates responsibilities among the different parties that influence the plan's administration and management.

Plan sponsors or fiduciaries should establish guidelines to govern the investment selection and monitoring process in the participant-directed plans. The policy statement should document that in accordance with ERISA, "care, skill, prudence, and diligence" were applied in the investment selections.

Who Is A Fiduciary?

A plan fiduciary is any person or group with some effective influence, power or discretion over the plan. This includes people who have authority and responsibility for the management of the plan and its assets. ERISA Section 3(21) defines a fiduciary as anyone who either: 1) exercises discretionary authority over the plan's management of assets, 2) offers investment advice for a fee or other compensation, or 3) exercises discretionary authority over the plan's administration. Under this broad definition, fiduciary liability extends to: the investment committee, trustees, members of the Board of Directors, corporate officers and employees, benefits managers, attorneys, accountants, consultants, agents, brokers, and salespersons associated with the plan.

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For purposes of this article, we will focus on how to establish a policy statement that minimizes the plan sponsor's fiduciary liability with regard to the investment selection, monitoring, and participant communications.

Why Every Defined Contribution Plan Needs A Written Investment Policy Statement

There are numerous misconceptions among plan fiduciaries about the responsibilities of plan sponsors in participant-directed plans. Most employer-directed plans that fall under ERISA rules have written investment policy statements. Many employee- or participant-directed plans such as DC plans do not yet have investment policy statements. However, Section 402(b)(1) of ERISA requires that every employee benefit plan, which includes 401(k), 403(b), and 457 plans, shall "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." In plain English, this means an investment policy statement for participant-directed plans.

The key to minimizing one's fiduciary liability is to maintain a well documented paper trail. Fiduciaries must be able to document the process used in making decisions for the plan. They must be able to demonstrate that they monitored the plan via periodic asset, account balance, and performance reports, for example. Documentation is required for the process leading to a decision on the selection of service providers and continued monitoring of the plan. Fiduciary responsibility does not end once the plan providers and investment choices have been made. Ongoing monitoring must occur and be clearly documented.

Again, disclosure and documentation of the process are key as a means of any future potential defense. They also make good business practice and keep the plan focused on the needs of the participants.

ERISA Regulations

In order to develop an effective investment policy, we need to understand the ERISA and DOL regulations and guidelines that apply to a retirement plan. There are numerous cases that highlight the complexity of fiduciary responsibilities under ERISA. DOL monitors ERISA compliance and has an Office of Regulation and Interpretation. Although most plan sponsors are aware of their fiduciary responsibilities, they may not realize that pension regulations are intentionally worded to shift the burden of proof away from DOL to the plan fiduciaries. Not only must fiduciaries be innocent of the charges, but they must prove that they have not violated the law.

ERISA requires that plan investments be managed in the sole interest of plan participants and beneficiaries with the "care, skill, prudence and diligence under the circumstances then prevailing that a prudent man, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of a like character and with like aims." The plan sponsor is the "prudent expert" and therefore has fiduciary liability. ERISA also requires that plan investments be diversified so as to minimize the risk of large losses.

The regulations require that the fiduciary, in this case the plan sponsor, consider relevant factors such as diversification, liquidity and projected returns relative to funding objectives. Therefore, as part of their duty as fiduciaries, they should develop investment guidelines to govern plan-asset investment and to monitor those making the investment decisions. Formalized guidelines in the form of a comprehensive Investment Policy should help minimize potential fiduciary liability under ERISA.

Focus of the Statement

The policy statement should focus specifically on the rights and interests of the plan participants or eligible employees, and the plan sponsor's intent to comply with DOL and ERISA regulations.

The investment guidelines should serve as a blueprint for the investment committee to monitor the performance of the investment manager, trustee, investment consultant, investment adviser, actuary and any other service providers. The statement should give the plan's investment objectives such as principal preservation or long-term capital appreciation, and goals such as rates of return relative to indices, peer group rankings or long-term target rates of return. The guidelines may set out asset allocation targets, permissible investments, portfolio

turnover and transaction costs. They should also specify the scope, detail and frequency of reports to management as well as to participants. If the plan complies with ERISA Section 404(c), plan fiduciaries have a responsibility or duty to monitor the selection and performance of investment choices. The guidelines should be tailored to 404(c) compliance and should provide a procedure for regular and objective review of the investment alternatives. If the plan offers self-directed brokerage accounts to its participants, the sponsors still need to monitor the trustee, 404(c) compliance and plan administration. The investment guidelines should be reviewed at least annually.

The investment options offered are the responsibility of the plan sponsor. The plan should have objectives that relate to the asset mix.

The following are some of the steps that should be taken in developing an effective investment policy:

Define Responsibilities or Statement of Duties

As previously mentioned, there are a variety of individuals and groups who may be deemed to be fiduciaries under ERISA regulations. Consequently, it is paramount to identify the various parties exercising influence over the plan assets and delineate their responsibilities as a means of diffusing potential fiduciary liability.

A plan fiduciary is responsible for the selection of the investment managers or funds that are available to participants as investment options in the DC plan. The fiduciary cannot be affiliated with any of the money managers handling the plan. The fiduciary has an ongoing responsibility to continually assess the suitability and to monitor the performance of the chosen investment options.

Guidelines should be drafted to govern the actions of those responsible for plan-investment decisions as well as the actions of those responsible for monitoring the plan's investment performance.

The investment policy statement should identify and allocate the responsibilities of the parties involved in the investment plan. It should establish the members of the investment committee, typically, the Chief Financial Officer, Treasurer, President, Human Resources Director or other nonfinancial members of the committee. The plan sponsor should clearly state whether or not it retains an investment consultant or conducts its search in-house. The plan should explain the rationale for the selection of a bundled or an unbundled, multimanager approach. The choice of active, passive or index management should be documented, and the performance standards that will be required should be clearly stated.

A separate statement should detail the various duties and responsibilities of the different fiduciaries and professional advisers. Trustees, for example, are responsible for the administration of the plan functions and regular reporting. Investment consultants assist the investment committee in establishing and monitoring compliance with the investment policy and in the selection and monitoring of investment managers.

Identify the Types of Investment Options Available

ERISA Section 404(c) sets general standards for the duties and responsibilities of plan fiduciaries that must diversify plan investments to mitigate risk. Each plan's policy statement should identify asset classes, such as bonds, equities, international and nontraditional assets. It should clarify the type of investment vehicles used, namely, commingled trust funds, variable annuities, mutual funds or separate accounts. Plan fiduciaries may be held liable for not acting in their participants' best interests if plan investments are not well diversified or well communicated.

By complying with Section 404(c) safe harbor guidelines, plan sponsors can reduce potential fiduciary risk. To comply with DOL minimal compliance guidelines for Section 404(c), a plan sponsor must offer at least three diversified "core" investment options representing a wide range of risk/return tolerances.

These options typically include a money market fund, a bond fund and an equity fund. Company stock is not considered a core option for participants. Additionally, employees must be able to make their own investment allocation decisions and have access to changing their investment selections at least once every three months at no more than a "reasonable" charge to the participant. Finally, participants must

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receive sufficient information and education about the plan's investment options so that they can make informed decisions.

In practice, most new plans offer four to five investment options, typically, money market, bond or stable value, growth equity, aggressive growth equity, and international investment options. Some plans have taken diversification further by offering brokerage accounts and asset allocation funds.

Allocate Assets

Numerous empirical studies have shown that over long periods of time, the appropriate asset mix accounts for more than 90 percent of the variance in portfolio returns. In other words, being invested in the right asset class, bonds, stocks, international, etc., has a greater impact on overall returns than investing in the perfect fund or security. Consequently, the investment policy statement should address the need for broad diversification within and across different asset classes and investment styles. The guidelines should define the acceptable level of risk and yield for the overall plan assets and the significance of yield relative to the safety of principal and the participant's cash-flow needs. The risk of each investment option should also be clearly explained.

Establish the Appropriate Asset Classes and Their Investment Objectives

Plan sponsors should articulate the types of investment categories that will be offered to participants as investment options of the plan. Within each asset class such as bonds or stocks, there is a management style that should be defined and described in the context of the other investment options available since the plan sponsor is making an asset allocation decision for the participants. The plan sponsor would discuss the inclusion of asset allocation or lifestyle funds as investment options.

The investment options should be distinct and not overlap in investment holdings. The purity of the funds' style and holdings should be clearly presented in the investment policy. For each investment option, the plan sponsor should define the fund's investment objective, applicable time horizon, investment guidelines, permissible securities, and portfolio turnover.

Establish Specific Performance Measurement Standards

The investment managers and investment committee should develop concrete performance objectives as benchmarks against which each fund's investment performance will be measured. The indices used should be identified as to whether they measure long- or short-term performance. Typically, a general market benchmark such as the S&P 500 should be selected as a performance target and appropriate style and portfolio benchmarks should then be designated. For example, a benchmark could be the Russell 2000 Growth Index for a small cap growth strategy or the Wilshire Large Cap Value Index for a value-oriented fund.

Define Procedures for Annual Review, Manager Termination, and Comprehensive, Ongoing Monitoring

The policy should establish a periodic review process of the investment manager performance and the continued appropriateness of the investment selections. The same criteria that were applied in the selection of competent investment managers should be applied on an ongoing basis. Semi-annual plan sponsor reviews should include investment management performance comparisons with benchmarks, the manager's peer group, review of the asset mix, Betas of the funds, risk adjusted returns, and the manager's conformance with its investment guidelines. Over time, with the growth of assets and increased sophistication of the participants, new options such as brokerage, real estate or asset allocation funds may be valuable additions. A clearly defined procedure for continuous monitoring of investment managers, as well as an action plan for removing managers when potential problems are spotted, should be articulated in the policy.

Set Guidelines To Ensure Participant Control

Participant-directed plans need to provide the employees with an ability to exercise control over their assets. In accordance with DOL regulations, participants should be able to change their investment choices at least quarterly, receive statements on their

account balances, and receive sufficient information on their investment options to make informed investment decisions.

Participants must be informed of any asset charges imposed. These charges must be reasonable expenses for permitting them reasonable control over their assets.

Establish Participant Communications Procedures

Many plan sponsors do not typically provide investment advice to participants in DC plans. However, some organizations choose to retain outside professionals to perform this function. If they choose to render investment advice, it is advisable to include within the policy the permissibility of rendering investment advice, a description of who is permitted to render investment advice and under what conditions such advice will be given. The policy should state that enrollment and information meetings are mandatory and that attendance should be documented. The policy should set a procedure to ensure that all appropriate materials are distributed and adequately explained. Materials should include detailed prospectus and disclosure materials and periodic investment communications.

Specify Reporting Requirements

Finally, the policy should specify the form and type of written reports and face-to-face meetings required to properly monitor the plan. The frequency, detail and responsible parties should be named.

Conclusion

Because most new retirement plans are participant-directed, many plan sponsors or companies have become complacent about the potential fiduciary liability associated with these retirement plans. Many are not aware of the fact that many of the same ERISA, DOL and IRS rules and regulations that apply to traditional pension plans or employer-directed plans also apply to relatively new participant-directed plans such as 401(k), 403(b), and 457 plans. A comprehensive investment policy statement is one tool available to plan sponsors to mitigate some of the potential fiduciary risk. ■

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