Investment Policy for Defined Contribution Plans

Jon C. Chambers, QPFC
Managing Director

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INTRODUCTION

In the late 1990s, many defined contribution plan sponsors seemed reluctant to develop and adopt Investment Policy Statements (IPS) for their plans. Survey information from the Plan Sponsor Council of America (PSCA) indicates that only about half of DC sponsors maintained an IPS in 1999, and that far fewer smaller employers maintained an IPS. A 1999 BARRA RogersCasey/IOMA poll found almost two-thirds (63%) of plan sponsors with less than 250 participants did not have a written IPS for their 401(k) plan.

Since 1999, the written IPS has become far more common. Severe equity market downturns in 2000-02 and 2008-09, along with litigation alleging that participants experienced disproportionate losses from the downturns due to imprudent investment design and fund selection encouraged greater use of IPS. By 2016, PSCA determined that over 80% of DC sponsors had adopted a written IPS, including 92% of sponsors of plans covering over 5,000 participants. But while we are encouraged by the increased rate of IPS adoption, there are still many plan sponsors—particularly those running smaller plans—that have yet to develop an IPS. Additionally, some plans have written policies that are poorly crafted, or that the sponsor is not following. We believe that DC sponsors without an IPS, with a poorly crafted IPS, or with an IPS that isn't being followed, are unnecessarily exposing themselves to fiduciary liability. There is clearly work to be done.

This paper will review legal requirements applicable to IPS, practical reasons for establishing and following an IPS, why it matters how the IPS is developed and who helps draft it, and elements typically included in a defined contribution plan IPS.

IS AN IPS REQUIRED?

Why is it that many DC plan sponsors, including some 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 investable plan assets, you have established an informal investment policy for your plan. Whether or not you formalize the policy, you are always accountable as a fiduciary. The plan sponsor's real choice with respect to policy involves whether to (a) devise and consistently apply a written investment policy developed to address the plan's objectives, or to (b) manage the plan's investment program using an undocumented, ad hoc approach.

NEGLECTING IPS MAY CAUSE UNFORESEEN PROBLEMS

In the BARRA RogersCasey/IOMA poll referenced above, the 63% of sponsors not using a written IPS cite a litany of reasons. 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%)
- Fear that a written IPS would increase the sponsor's liability (3.3%)

As a practical matter, the Department of Labor (DOL) expects that all defined contribution plans will have a written IPS. For example, in a 2007 Interpretive Bulletin relating to written statements of investment policy, DOL explained: "The maintenance by an employee benefit plan of a statement of investment policy designed to further the purposes of the plan and its funding policy is consistent with the fiduciary obligations set forth in ERISA section 404(a)(1)(A) and (B)." Additionally, an 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 IPS or the DOL's expectations in this regard, 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 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."

WHY INVESTMENT POLICY IS SO IMPORTANT

Many plan operational documents stem from compliance requirements. Plan documents, summary plan descriptions (SPDs), summary annual reports, beneficiary designations, and 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 their existence is a regulatory agency's mandate that the sponsor must adopt them as a qualification requirement. Conversely, the principal reason for the IPS'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.
- By establishing quantitative standards for expectations of investment fund performance, it transforms investment decision-making from matters of opinion to generally fact-based conformance with objective criteria, thereby streamlining both the investment selection and the ongoing investment monitoring processes.

Drafting a written investment policy creates additional work for the plan committee. However, once an effective policy statement has been developed, the time required by the Committee to select 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 funds in each category. In today's environment, with tens of thousands of mutual funds available, not to mention the thousands of non-registered products such as collective investment trusts and separately managed accounts 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. Well-designed quantitative filters typically incorporated into a DC plan policy statement can rapidly screen the number of potential funds for consideration down to a reasonable number. Additionally, time committed to managing the investment program may 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 focus their 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 also explain why plan sponsors neglect to develop a policy during a plan's startup 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. 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 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
- De-selection issues
- 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; and regulatory and employee education materials must be written, reviewed, and distributed. Service providers fear that additional time spent on developing a document such as an IPS that isn't absolutely mandated, will make their offering more costly compared to other vendors that don't offer IPS services.

Fiduciary Concerns and Prohibited Transactions

Most plan service vendors believe that helping a plan sponsor develop IPS 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's liability increases.

Plan vendors are also concerned that becoming an investment advisory fiduciary could lead to prohibited transaction issues. Most bundled service providers receive the bulk of their compensation from managing plan assets, or through revenue sharing arrangements with other investment firms. 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 or revenue sharing arrangement over another fund that has a lower fee or arrangement, 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 acts in a fiduciary capacity, such as when they serve as trustee. In effect, the provider is wearing so many hats (investment manager, trustee, advisor) that the various functions 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 an IPS, which typically entail expertise with a broad range of investments and a background in fiduciary law. 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 own proprietary funds are represented to the greatest extent possible in a plan's investment menu. Proprietary funds tend to be significantly more profitable for the provider than funds offered through an alliance with other investment management firms, even after considering revenue sharing arrangements. Bundled service providers' administrative services often serve as 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 2013 study by three finance professors from Indiana University and the University of Texas entitled "It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans," found that, "mutual fund families acting as trustees of 401(k) plans display favoritism toward their own funds." The study concluded that, "poorly-performing funds are less likely to be removed from and more likely to be added to a 401(k) menu if they are affiliated with the plan trustee," and "the subsequent performance of poorly-performing affiliated funds indicates that these trustee decisions are not information driven and are costly to retirement savers."

A well-crafted policy will tend to offset any bias towards affiliated funds, helping plan committees to objectively focus on those funds that are most appropriate for the plan. Consequently, policy often tends to reduce the number of proprietary funds selected for the plan, in favor of 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.

COMPONENTS OF AN EFFECTIVE INVESTMENT POLICY STATEMENT

Although there are no regulations governing what specific elements belong in a DC plan IPS, DOL audit practices may help shape the form of many plan sponsors' policy statements. In the late 1990s, as a precursor to the ERISA Section 408(b)(2) fee disclosure regulation published in January 2012, the DOL initiated a research project to determine whether 401(k) fees were adequately disclosed by vendors and properly considered and understood by plan sponsors. In support of this project, the DOL investigated 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 a 401(k) plan 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:
    - 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

Some of these DOL study elements don't apply to most DC plans. For example, "directed brokerage" typically only applies if a plan offers separately managed accounts (SMAs), an approach usually adopted by very large sponsors, or when the plan's assets are managed as a single pool. Other elements, such as "guidelines relating to proxy voting and tenders" have been the subject of subsequent DOL guidance, such as Interpretive Bulletin 2016-01, published on December 29, 2016. The preamble to IB 2016-01 explains that the guidance addresses fiduciary issues relating to "… the maintenance of and compliance with statements of investment policy, including proxy voting policy …" IB 2016-01 is reasonably explicit in illustrating that the DOL believes a prudently developed IPS should address the plan's proxy voting policies.

ELEMENTS OF A DC PLAN IPS

In a 2013 paper, "The Importance of Following an Investment Policy Statement," Ian Kopelman, legal counsel to PSCA and partner at DLA Piper LLP, suggests that "A well-written IPS should:

1. Describe the purpose and general investment objectives of the plan.
2. Identify and allocate responsibilities among the fiduciaries and other parties responsible for selecting, monitoring, and managing plan investments.
3. Describe the asset classes of investment options to be offered, and specific factors and criteria for selecting investment options, such as risk and return characteristics, expenses, and benchmark comparisons.
4. If employer stock is offered as an investment option, describe any limits or standards for its inclusion.
5. Describe standards for investment performance and criteria for measuring performance.
6. If the plan permits participants to direct investments and intends to comply with Section 404(c):
    a. State that the plan intends to comply
    b. List the number of investment options offered under the plan and the asset classes for each option.
    c. Describe the methods and criteria for selecting options, including fees, and for monitoring and replacing funds, if necessary.
    d. Describe investment education and other information offered to participants in connection with investment options.
    e. Describe any restrictions on particular options.
    f. Describe the process and standards for selecting a qualified default investment arrangement.
7. Describe the methods and criteria for selecting, monitoring, and if necessary, replacing plan investment service providers.
8. Describe standards for accounting for and managing investment expenses.
9. Describe how often investment performance will be reviewed and the review process (including the use of outside investment consultants)."

Mr. Kopelman suggests that an "IPS may be as short as three pages or longer than ten pages." In our firm's experience, it is virtually impossible to address the elements outlined by Mr. Kopelman in an IPS that is less than ten pages. Interestingly, Mr. Kopelman's summary does not include any reference to proxy voting policies.

WHEN INVESTMENT POLICY CAN HURT YOU: TUSSEY V. ABB INC.

In late 2012, a Missouri federal district court held that 401(k) plan fiduciaries were liable for more than $35 million in plan losses due to fiduciary breaches, which resulted in large part from their failure to follow the plan's IPS. The case, *Tussey v. ABB Inc.*, was one of the first successful excessive fees lawsuits that emphasized the importance of having and following an IPS. ABB Inc. had implemented a highly detailed IPS that mandated certain specific actions by the plan's fiduciaries. For example, when multiple share classes of the same mutual fund were offered, the ABB fiduciaries were required to choose the share class with the lowest "cost of participation". Similarly, the IPS included a structured procedure for placing funds on "watch list" status prior to replacement. However, the ABB fiduciaries not only failed to follow their IPS by selecting higher cost share classes when lower cost classes were available, they also replaced solidly performing low cost funds with higher cost alternatives that were proprietary to the plan's trustee. Further, the ABB fiduciaries did not amend the IPS document when their internal practices differed from the written specifications. By failing to follow the IPS, the ABB fiduciaries created a far less defensible situation than they would have faced if they had never adopted an IPS. By implementing an IPS, ABB Inc. established guidelines for how the investments would be handled within the plan. Not complying with the IPS guidelines was one of the key factors cited by U.S. District Court Judge Nanette Laughrey in her 2012 decision in favor of the plaintiffs.

The *Tussey v. ABB* decision illustrates that a well-crafted IPS should not mandate any specific fiduciary decision that the plan committee must follow. Rather, the IPS should outline the factors fiduciaries should consider in reaching a decision. Finally, fiduciaries should be familiar with standards imposed by the IPS and should strive to operate the plan's investment program in conformance with procedures defined in the IPS.

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

Once a plan sponsor has decided that developing an IPS makes sense, where should the sponsor turn for help? As previously indicated, most traditional bundled service providers don't offer much support for sponsors interested in formalizing investment policy. However, there are some relatively inexpensive approaches. For example, the Plan Sponsor Council of America (PSCA) offers a model 401(k) investment policy statement that can be customized for plan sponsor needs. Similarly, fiduciary compliance services, like fi360, also offer model 401(k) investment policy statements. We recommend caution in basing any specific plan's investment policy on a model template because 401(k) plans are subject to significant operational complexities, and your plan's policy needs may not fit neatly into a set of assumptions used to develop the model template.

Consequently, the best resource for developing investment policy may be a qualified independent investment consultant. When hiring a consultant to help develop a written policy for a DC 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. Next, check to see whether the consultant has developed their own IPS or is repackaging a template document initially drafted by a third party. Finally, a good investment consultant will also be interested in helping you apply the policy terms, assisting with fund selection, and providing periodic fund performance monitoring services to ensure selected funds continue to meet the criteria set forth in your policy.

ELEMENTS OFTEN MISSING FROM DC PLAN INVESTMENT POLICY

In reviewing IPS developed by other advisors, or adopted by sponsors without the assistance of an advisor, we see the following elements regularly omitted from many DC plan IPS:

- Policy for voting proxies
- Designation of the plan's qualified default investment alternative (QDIA)
- Standards for selecting and monitoring the plan's QDIA
- List of approved asset classes and related index benchmark comparisons
- Mapping procedures for fund replacements
- Standards for accounting for and managing investment expenses
- Standards for selecting and monitoring index funds
- Standards for selecting and monitoring capital preservation/stable value options
- Standards for selecting and monitoring managed accounts

We recommend an annual review of all DC plan investment policy statements, with updates as necessary to address any missing elements, and to reflect changes in practice standards, plan operations, investment menus or committee membership.

CONCLUSIONS

Although investment policy statements are routinely used by defined benefit plans, some defined contribution plan sponsors have not yet formally implemented policy for their plans. Other DC sponsors have an IPS, but don't follow it, or have adopted an IPS that omits one or more important elements.

Although the specific components of a DC plan policy statement will differ significantly from a DB policy, their primary objectives are similar:

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

According to the Investment Company Institute, 401(k) plans held an estimated $5.3 trillion in assets as of December 31, 2017. Fidelity reports that the average 401(k) balance rose 13% during 2017, to $104,300 at year end. As the 401(k) asset pool expands, responsibility and concomitant liability for managing these assets also increases. In 2009 and 2010, there was just one retirement plan "excessive fee" lawsuit filed in each year. Investment News reported that in 2016, 29 excessive fee lawsuits were filed in the first nine months alone. As affirmed by the March 21, 2013 Ninth Circuit decision in *Tibble v. Edison International*, Section 404(c) of ERISA provides some limited relief from fiduciary liability but was never intended to address the underlying issues of selecting, monitoring and making ongoing suitability determinations concerning plan investments. A well-crafted IPS provides the plan sponsor with the best vehicle available for demonstrating prudent fiduciary conduct.