

## Do You Understand Your Investment Policy Statement?

by Eric D. Altholz on July 29, 2021

The Acme Rocket Sled Company Retirement Plan Administration Committee recently selected a new investment advisor for the company's 401(k) plan. During the RFP process, the new advisor observed that the Investment Policy Statement (IPS) that the committee adopted many years ago was a bit thin and out of date. The new advisor has prepared a new IPS, which is much longer and more detailed. The new IPS looks like a substantial upgrade from the old model, but the document is a bit daunting. To some of the committee members, the new IPS seems so dense and jargon-filled that they struggle to understand the document and what it is telling the committee to do. Other committee members are tempted to "check the box" and move on – the investment advisor has provided an IPS that they say is appropriate, and that should be sufficient. They know, however, that is not the best approach from a fiduciary compliance standpoint, so they ask legal counsel for advice. In response to a request from the committee chair, we offer the following observations and recommendations.

### What should an IPS contain?

As many readers will know, the failure to adopt an IPS is not a violation of the fiduciary standards of ERISA. However, the Department of Labor (DOL) has said that the adoption of an IPS is "consistent with the fiduciary obligations set forth in ERISA," the DOL clearly encourages fiduciaries with investment responsibility to adopt an IPS, and it has certainly become a best practice to do so. See DOL Interpretive Bulletin 2016-01 ("IB 2016-01").

The DOL has not prescribed content requirements for an IPS, but it has stated that an IPS should "provide [] the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories of investment management decisions." (IB 2016-01.) Consistent with that description, a typical IPS will:

- Identify the type of plan involved (e.g., a defined contribution plan with individual accounts).
- Describe the investment objectives of the plan, which effectively become the goals of the committee.
- Identify the fiduciary who is charged with overseeing the investment of plan assets and who will be adopting the IPS.
- Describe the criteria and processes for selecting, and deselecting, plan investments (including qualified default investment alternatives).
- Establish performance standards and the process that will be followed to monitor the performance of plan investments.
- Describe the proxy voting policy of the committee.

A few refinements to the content list are worth offering. First, the IPS must be suitable and appropriate for the plan. The operative terms of an IPS for a defined benefit pension plan will be very different from those for a defined contribution plan that allows participants to direct the investment of their accounts. Second, the IPS should state that the committee has engaged an investment advisory firm (assuming it has) and explain the role that firm is playing with respect to the plan. For the typical defined contribution plan, the investment advisor is likely to be serving as a “Section 3(21)” fiduciary – essentially, a co-fiduciary of the committee (described in shorthand by reference to the section of ERISA that defines the term “fiduciary”). An increasing number of plan committees, however, are opting for an outsourced model in which the investment advisor, functioning as a “Section 3(38)” investment manager, will have complete discretion to select investment options. Either way the role and status of the investment advisor should be noted in the IPS.

Finally, picking up on the DOL’s formulation, the IPS should establish guidelines and procedures that can be followed in a methodical way, not unduly restrictive directions that may box fiduciaries into a course of action that could produce undesirable results. For this reason, most well written IPS documents speak in terms that are somewhat aspirational and process oriented.

### **How should an IPS read?**

Even the most thorough and detailed IPS will be of limited utility unless the plan fiduciaries who are adopting the IPS can understand the document. (Imagine answering questions about the content of the IPS in a deposition conducted by counsel representing aggrieved participants in a breach of fiduciary duty case.) For that reason, an IPS should: (1) provide meaningful guidelines that committee members can apply in fulfilling their duties; and (2) be written a way that an intelligent and engaged committee member can understand and implement.

Here are a couple of sentences taken from a statement of purpose for a defined contribution plan IPS:

*“The purpose of this Investment Policy is to outline the objectives and principles that will guide the Retirement Plan Investment Committee in selecting and monitoring the investment options available to participants in the Plan.”*

*“The Committee intends to provide participants with a diverse set of investment options, encompassing a variety of risk/return characteristics, which can be selected by participants in order to determine how to invest their Plan accounts in a diversified manner in planning for their retirement.”*

Statements like these are commonly found in investment policies adopted for defined contribution plans. The instructions given to the committee through these statements are

clear and understandable: the committee intends to select an array of mutual funds that can help participants diversify their investments over many years, rather than chasing returns in the short term. Guidelines regarding the quality and expenses of the selected funds are, of course, provided elsewhere in the document. And that's where the trouble may start.

Given the nature of the endeavor, it is not surprising that many IPS documents contain specialized or technical language of investments, but the document should not be rife with jargon that is meaningful to investment professionals but confounding to committee members. Technical jargon is often sprinkled liberally in portions of the IPS dealing with the selection, monitoring, and deselection of funds (e.g., describing the kind of performance that could land a fund on the "watch list"). Here is a sentence from a provision of an IPS dealing with the selection of index funds: "Passively managed products should have a tracking error consistent with their respective strategies." That sounds like a good and specific bit of guidance, but what does it actually mean and will it be understood by committee members?

Here is another example: An IPS references "information ratio rank" as one of criteria that will be monitored to evaluate the performance of each investment option. The IPS explains that the "information ratio rank" measures a fund's annualized five-year information ratio and it notes that the fund must rank in the top half of its peer group. This statement is intended to provide a specific and actionable guideline for the committee, but it is only useful if committee members know what an information ratio is and why it may be important in evaluating the performance of a fund.

### **What should you do if your IPS seems hard to understand?**

Employee benefits lawyers are not investment professionals. We are not qualified to judge the effectiveness of the methodologies used by investment advisors when they counsel retirement plan fiduciaries. But we deal with complex concepts all the time and face the daily challenges of preparing and explaining complex documents in a way that our clients can understand. We recommend that fiduciary committees expect their investment advisors to do the same when it comes to the form and content of an IPS. If an intelligent and engaged committee member finds statements in the IPS hard to understand, the wording should be improved so that it can be understood. If technical jargon used in portions of the IPS is necessary (and it often is), that jargon should be explained in the IPS or elsewhere. In our experience, most investment advisors are happy to explain the jargon, rework an IPS, and accept comments from committee members and legal counsel that will make the document understandable and useable.

One final recommendation, specifically for committee chairs. Chairs of retirement plan investment committees (or administrative committees with investment duties) are often quite familiar with technical investment concepts and conversant in the language of

investment professionals. Just remember that some of your fellow committee members may not be – this may especially be the case where the committee’s authority and duties are not limited to the investment of plan assets. Encourage questions and feedback regarding the IPS. Often committee members are reluctant to ask questions because they do not want to admit their ignorance or lack of understanding. In our experience, those committee members can provide the most valuable comments on an IPS. Educate committee members and use language they can understand in the IPS, and your committee will be well-positioned to fulfill their duties as investment fiduciaries.



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