

Compliance Review

Ongoing Compliance Updates for Investment Advisors

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The Investment Policy Statement: Providing the Bridge Between Compliance and a Satisfied Client

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An investment policy statement helps an advisor communicate to relevant parties the procedures and investment philosophy of that advisor, and it documents the agreements between the advisor and the client about how that client's money will be managed. The statement should provide the guidelines for investment decisions and set forth the responsibilities of each party.

When our first article about investment policy statements was published in the *Journal of Financial Planning* in July 1992, very few advisors were using these statements in their practices. Today, the landscape has significantly changed: It is now considered a best practice to provide investment policy statements to all clients, whether or not it is legally directed. Although some compliance officers may disagree, we believe that a properly written investment policy statement can be critical in minimizing the legal liability of your fiduciary clients (i.e., qualified plan trustees and trustees of irrevocable trusts, endowments,

foundations and charitable trusts)—and for that matter, all your clients.

In our experience, providing an investment policy statement, or IPS, helps to increase client satisfaction—and, subsequently, client retention. An IPS gives clients a better understanding of what to expect from their advisor. That clarity can help build a higher level of trust and respect, which can lead to larger accounts and more referrals.

This article explores the rationale for an IPS, the components of an IPS, and the ways you can integrate the use of an IPS into your client relationships.

The Regulatory Environment

There are two levels of legal and regulatory oversight: the legal requirements for clients who are fiduciaries or trustees for an account and the regulations applicable to an advisor's practice. It is

important to understand the requirements for each. Let's start with the legal requirements for your clients.

ERISA: A Clear Policy and Prudent Procedures

An investment policy is required under virtually all investor circumstances, with the exception of individual investors. According to the Employee Retirement Income and Security Act of 1974, as amended (ERISA), for every qualified company retirement plan (e.g., 401[k], profit sharing, pension, 403[b]) there are certain fiduciary responsibilities to manage the plan assets with the care, skill and diligence of a prudent expert and to diversify the investments of the plan so as to minimize the risk of large losses. The IPS documents these fiduciary responsibilities and helps ensure they are being adhered to.

When auditing an ERISA plan, the U.S. Department of Labor regularly asks to review the associated IPS. The rationale for this request is in the Department of Labor Interpretive Bulletin 29 CFR 2509.94-2, which references ERISA Sections 404(a)(1)(A) and 404(a)(1)(B), specifically stating, "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)...For purposes of this document, the term 'statement of investment policy' means a written statement that provides fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories of investment management decisions...."¹

Under ERISA, all qualified plan trustees have a special responsibility to "prudently" manage their plan assets for the sole benefit of the plan

participants. ERISA and the Department of Labor have established the following prudent procedures for plan trustees:

- An investment policy must be established.²
- Plan assets must be diversified.³
- Investment decisions must be made with the skill and care of a prudent expert.⁴
- Prohibited transactions must be avoided.⁵

A properly written IPS can help ensure compliance with legal requirements as trustees of a qualified plan. The IPS sets forth the objectives, restrictions, funding requirements and general investment structure for the management of the plan's assets—and provides the basis for evaluating the plan's results. By establishing the criteria and procedures for selecting investments and investment managers, an IPS can minimize "Monday morning quarterbacking" if investment performance is disappointing.

An IPS also can help trustees communicate a plan's investment guidelines and procedures to those assisting in the investment process, such as investment advisors or money managers. Finally, and most importantly, an IPS provides a guide for making future investment decisions. Having and using the policy statement compels the trustees to be more disciplined and systematic, which in itself can help improve the odds of meeting the investment goals.

UPIA: A Focus on the Total Portfolio

The Uniform Prudent Investor Act (UPIA) is state-adopted legislation that governs the investment conduct of private family trusts. First enacted in 1994, it serves as the cornerstone of subsequent legislation (and drives how the courts now interpret such requirements relating to ERISA). UPIA requires

a written investment policy for every trust in which trustees manage assets for the benefit of others. UPIA formally requires a focus on the total portfolio, rather than following the act's earlier guidance that individual investments should be evaluated independent of whether or not they were appropriate for portfolio inclusion. The total portfolio is now the fiduciary's central consideration when judging the trade-off between risk and return. There are no more restrictions on the types of investments that can be included in the portfolio; the trustee can invest in anything that helps achieve the risk/return objectives of the trust and meets the other requirements of prudent investing.

UPIA specifies that diversification is part of the definition of prudent investing. It also makes clear that if appropriate investment processes are in place and followed, the trustees will not be held responsible for the results. Under UPIA, the delegation of investment and management functions is permitted and encouraged.

Additional Legislation

The following two acts, which are largely consistent across the country but individually approved by each state, are substantially similar to UPIA; both require a written IPS.

- The 1997 Uniform Management of Public Employee Retirement Systems Act—addresses trustee responsibilities of government-sponsored qualified employee benefit plans
- The 2006 Uniform Prudent Management of Institutional Funds Act—addresses the responsibilities of trustees of nonprofit monies (primarily foundations and endowments)

The following table shows the legislation affecting different types of clients.

Relevant Legislation Requiring an Investment Policy	
Client Type	Legislation
Individual	None
Corporate qualified retirement plan	ERISA
Government qualified retirement plan	1997 Uniform Management of Public Employee Retirement Systems Act
Endowments and foundations	2006 Uniform Prudent Management of Institutional Funds Act
Private and family trusts	Uniform Prudent Investor Act

Now let's look at the legal requirements for advisors.

Suitability and Fair Dealing

The regulatory environment is constantly evolving, but trends are clearly moving toward greater consumer protection. Financial Industry Regulatory Authority (FINRA) member firms are subject to two primary obligations in terms of consumer protection: "suitability" and "fair dealing." RIA firms must satisfy additional fiduciary standards of care and client protection. Well-thought-out procedures are critical to satisfying these requirements. An IPS can help satisfy regulatory auditors by documenting the appropriate implementation of these procedures.

FINRA member firms are subject to a "suitability" requirement as described in Rule 2310. When a broker recommends that a client buy or sell a particular security, that broker must have a reasonable basis for believing that the recommendation is suitable for that client. In making this assessment, the broker must consider the client's risk tolerance, other security holdings, financial situation (income and net worth), financial

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needs and investment objectives, among other things. RIAs are subject to fiduciary standards for suitable recommendations.

In addition to the suitability requirement, FINRA member firms must comply with a “fair dealing” requirement, which is also described in Rule 2310. According to this rule, sales efforts will be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed. An “obligation of fair dealing” means that brokers must have a reasonable basis for believing that their securities recommendations are suitable for and appropriate to certain customers in light of the customers’ financial needs, objectives and circumstances.

Additional Requirements for RIAs

The fiduciary standards of care for RIA firms is even higher. RIAs must carry out their responsibilities with the utmost degree of good faith, honesty, integrity, loyalty and undivided service of the beneficiary’s interest. The good faith clause requires RIAs to act reasonably in order to avoid negligent handling of the beneficiary’s interests and mandates that they not favor anyone else’s interest, including the fiduciary’s, over that of the client. The other qualities speak for themselves. With that in mind, FINRA standards of “suitability” and “fair dealing” seem to be reasonable standards by which RIA firms would also be well-advised to comply.

Whether or not fiduciary responsibilities have been satisfied is not determined by investment performance, but by whether prudent investment practices and standards have been followed. In our opinion, the preparation of the IPS is one of the most important functions of the RIA. In some U.S. Securities and Exchange Commission (SEC) districts, auditors are asking to see the IPS for a particular client relationship. While the SEC isn’t consistently asking for this documentation yet, we

suspect that the IPS will increasingly become a factor in audits of client records.

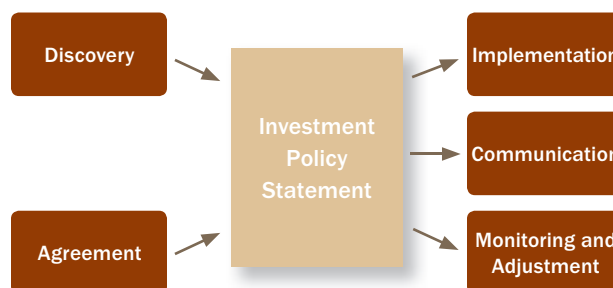
Well-thought-out procedures are critical to satisfying both FINRA and RIA requirements as well as creating a positive and open environment between the advisor and the client. In addition, a well-crafted IPS that addresses relevant information about the client goals and circumstances and about the investment procedures to be followed by the advisor can help satisfy regulatory requirements by documenting the appropriate implementation of these procedures.

The Investment Process

The most frequent questions we hear from advisors are “How do I start including an IPS in my practice?” and “What should I include in my IPS?”

Following is our suggested approach to investment management and client relationship management. This is the approach we have successfully taken in our own investment advisory practices for many years.

We see the investment process as a series of six steps, as shown in the following diagram. We believe that the creation of the IPS is the single most important step in this process. All the other steps either lead into the IPS or are directed by it.



1. Initial Discovery. Learn about the client’s circumstances, goals, income needs, restrictions, current holdings, risk tolerance, etc. We recommend developing a questionnaire to help ensure that all clients are asked the same

questions and that important issues are consistently addressed. During your client meeting, use the following best practices.

- Provide an agenda.
- Clarify to your client that there are no right or wrong answers.
- Hand out or introduce the questionnaire.
- Go through each question; have each client discuss or write down his or her answers.
- Make sure each client understands each question.
- Offer appropriate details on more technical questions.
- In closing, review how you will write the first IPS draft.

2. Discussion and Agreement. Talk with your clients about the issues that must be agreed to before you can appropriately manage their money. This gives you an opportunity to set appropriate expectations and come to agreement on issues such as the degree of client involvement, the asset allocation to be used, the kinds of instruments you'll be investing in (or not), your approach to taxes and investing, dollar-cost averaging and a host of other implementation concerns.

3. Creating the IPS. Once you and your client(s) have agreed on the full list of issues and policies to be followed, record these agreements. This document will become the IPS. The client(s) and the advisor sign the document, signifying each party's acknowledgment of the agreements.

4. Investment Implementation. We recommend that you do not conduct any trades in a client's accounts until an IPS is in place. Once the IPS has been signed by all parties, you are free to conduct all the initial and ongoing trades according to the road map provided by the IPS.

Remember: The IPS provides guidance for how decisions will be made; it is not a list of the specific securities to be used. This is one of the areas that cause frequent confusion among advisors. If you include a list of the specific securities to be used in the IPS, each time you change investments you will have to go back and update the IPS. This is neither necessary nor productive.

5. Ongoing Communication. Describe and reach agreement about the frequency of meetings and reports, as well as the respective responsibilities of the advisor and client.

6. Monitoring and Adjustment. Rarely does a portfolio stay as it was originally structured. Describe in the IPS how you will monitor the portfolio for poor performers, how you will go about choosing good performers, how you will approach rebalancing and tax-loss harvesting opportunities, and any other ways you will try to ensure that the portfolio stays in line with the objectives set forth in the IPS.

Clients and their needs change over time. That's why it's important to periodically go back to the first step—discovery—to make sure you are addressing the client's current needs and wishes. Every year or two, the IPS should be reviewed with the client to ensure continued agreement with its provisions. This review offers an opportunity to remind a client about all the things you do to make sure the client's portfolio continues to serve his or her needs, and it reminds the client of your philosophy and approach, all of which help to avoid surprises and disappointments.

You can also use the periodic review to modify the IPS to reflect any changes in the client's goals or circumstances, as well as any changes in your own procedures. If you do what your client expects you to do, then you are more likely to have a happy client.

What Should Be Included in an IPS?

Let's first address what *shouldn't* be included. You should never write something in an IPS that you, as the advisor, cannot commit to. For example, although we believe that a well-crafted IPS will describe the advisor's rebalancing methodology, if you don't regularly rebalance, leave out the issue of rebalancing—or describe what it is that you do.

Also, if you are using someone else's template or suggested wording as the basis of your IPS, make sure that you read through and edit the template until it reflects your own investment practices and procedures. Every advisor does things a little differently, so the odds are strong that you'll need to make a number of changes in wording.

An IPS usually has five major components that should be unique to each client:

1. All key factual data about the client, including where the client's assets are held, the amount of the client's assets under your management, and the identification of the trustees or interested parties to the account. This can be as detailed or as simple as you wish.
2. A discussion and review of the client's investment objectives, investment time horizon, anticipated withdrawals or deposits, need for reserves or liquidity, and attitudes regarding tolerance for risk and volatility.
3. Any constraints and restrictions on the assets, such as liquidity and marketability requirements, diversification concentrations, the advisor's investment strategy (including tax management), locations of assets by account type (taxable versus tax-deferred), how client accounts that are not being managed (if any) will be handled, and any transaction prohibitions.
4. The security types and asset classes to be included in or excluded from the portfolio, and the basic allocation among asset categories and the variance (rebalancing) limits for this allocation.
5. The monitoring and control procedures and responsibilities of each party.

The IPS and the Advisor-Client Relationship

What defines a successful advisor-client relationship? We suggest that both parties are more likely to be happy when the client gets what is expected, understands the various aspects of the engagement, and accepts and implements the advice—and when the relationship is profitable and beneficial for both client and advisor.

The IPS development process lays the foundation for a successful relationship. Advisors who use this process find that taking a little more time with clients up front helps to cement the relationship and brings opportunities for more and better business. Clients appreciate the extra effort and the greater clarity the IPS development process brings to them.

Another important benefit of using an IPS is that clients have a better understanding of what the advisor is going to do with their money, and of their advisor's approach. They understand there is a reason why each action is being taken. As a result, they are more confident in the advisor's abilities and, therefore, more willing to release control, thereby making it more likely that clients will feel comfortable with you taking full discretion.

Granting of full discretion can only happen if the client trusts your abilities and approach. Systematically ensuring a full discovery of the client's relevant facts and issues, reaching clear

agreements about how the investments will be managed, and documenting it all in an IPS will build the foundation for that trust.

If your clients have confidence in you, they won't be calling to ask you to move their accounts to safer investment vehicles when the markets go through a down period. The IPS establishes investment guidelines and a framework for long-term investment thinking. Simply reminding your clients of what they agreed to in the IPS is often enough to calm their nerves.

If clients continue to ask about moving their accounts, remind them that it may be necessary to update their IPS in order to implement their changed instructions. When, per the IPS agreement, the document itself must be changed as a precursor to modifying the portfolio, clients are more likely to realize the seriousness of their request. The IPS serves clients well by providing a framework for them to use as they think about investment decisions. The IPS can also help ease them through difficult market periods, which obviously makes the advisor's life easier as well.

As you think about how you manage your clients' investments, here are some questions to ponder for each of your clients:

- Were risk and return objectives defined and reasonably suited to the client?
- Were all conflicts of interest fully disclosed?
- Was an overall investment strategy established?
- Were the purposes, terms, distribution requirements and other circumstances of the client considered?
- Were reasonable care, skill and caution exercised?
- Were decisions respecting individual assets evaluated in the context of the portfolio as a whole?
- Is there a consistent approach to investment decision making?
- Is all of this information documented in an investment policy statement?

We suggest that if you can answer "yes" to all of these questions, you should be on your way to fulfilling your compliance responsibilities and building a foundation of strong communication and clear expectations between you and your client—an ideal combination!

About the Authors

Linda Lubitz Boone is founder and president of the Lubitz Financial Group in Miami, Florida, which provides fee-based personal financial planning and investment advisory services for individuals and company-sponsored retirement plans. She is also the managing director of the East Bay Region of Mosaic Financial Partners, Inc. Nationally, she served on the board of directors of the Financial Planning Association from 1999 to 2002 and was chair of the Conference for Advanced Planning in 1996. She is currently an emeritus member of the advisory board of the TIAA-CREF Institute.

Norman M. Boone is founder and president of Mosaic Financial Partners, Inc. in San Francisco. He has been recognized by *Worth* magazine as one of the top financial advisors in the U.S. every year since the list was first published in 1994, and has been regularly listed in *Barron's*, *Medical Economics* magazine and other publications. He is a regular industry columnist and has written a number of articles about investment policy statements and other financial topics.

Mr. Boone and Ms. Lubitz Boone are coauthors of *Creating an Investment Policy Statement: Guidelines and Templates*. Together they developed IPS AdvisorPro®, an online software tool to help advisors systematize and improve the process of writing investment policy statements.

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¹ Part 2509 of Title 29 of the Code of Federal Regulations. Department of Labor 29 CFR 2509.94-2—Interpretive bulletin relating to written statements of investment policy, including proxy voting policy or guidelines.

² Department of Labor 29 CFR 2509.94-2.

³ ERISA Section 404(a)(1)(C).

⁴ ERISA Section 404(a)(1)(B).

⁵ ERISA Section 406(a)-(b).

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