



GUIDELINE No. 6

PENSION PLAN PRUDENT INVESTMENT PRACTICES GUIDELINE

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CONTEXT FOR THE GUIDELINE

This guideline is intended to help plan administrators demonstrate the application of prudence to the investment of pension plan assets.

Prudent Investment Practices

Prudent investment practices require appropriate processes that include due diligence in selecting, reporting and monitoring investments.

The goal of the investment function in the pension context is to generate returns taking into account the plan's liabilities and cash flow needs to meet short term and long term obligations, as well as the risk tolerances of the affected parties.

The plan administrator is responsible for the investment function. The manner in which assets are invested, and the way the investments are managed and supervised by the plan administrator are crucial to the success of the pension fund and delivery of the pension promise. The investment management function should be undertaken in accordance with the prudential principles of security and cash flow management, using appropriate risk management concepts. The plan administrator needs to achieve a balance between risk and reward considerations.

Each jurisdiction has its own legislation that governs registered pension plans. The legislation sets out the role of the plan administrator and the statutory standard of care that applies to the pension plan and pension fund. The legislation also sets out the role of the plan sponsor regarding the pension plan and pension fund. The legislation includes general and specific requirements for investing the pension plan's assets prudently, and in accordance with specific limits and restrictions.

The demonstration of the application of prudence in the investment of the pension plan's

assets is assessed principally by the process through which investment strategies are developed, adopted, implemented and monitored, in relation to the plan portfolio as a whole. Any specific investment should be considered in relation to the whole plan portfolio. For example, high-risk investments may not be imprudent if they are part of an overall investment strategy that is based on prudent risk management. Prudent investment practices take into account the nature of the pension plan's liabilities, the timing of pension payments, the pension plan's anticipated future experience, and the demographics of the pension plan beneficiaries (any person with an entitlement under the plan).

While different types of pension plans exist, all plans subject to pension legislation invest assets and should use prudent investment practices. Plan administrators are encouraged to review the guideline to determine how the guideline applies to their specific plan.

Although the emphasis in pension plan asset investment varies depending on the type of plan, the guideline is relevant to all plan types (defined benefit, defined contribution, combinations of defined benefit and defined contribution, jointly sponsored and multi-employer pension plans (MEPPs)). While the structure and design of the different pension plan types vary, the plan administrators have similar responsibilities regarding the investment function.

Defined contribution plans where the plan administrator provides a list of investment choices from which the plan beneficiaries select investments to construct their own individual investment portfolios will have different prudent investment practices criteria than a pension plan where this option is not available.

Plan administrators of defined contribution plans are encouraged to refer to *CAPSA Guideline No. 3 for Capital Accumulation Plans*, which provides guidance for plan sponsors and members about their duties and obligations for these types of plans, and to refer to any other

CAPSA publications which deal with defined contribution plans.

Prudent investment practices criteria for MEPPs that are collectively bargained with negotiated fixed contributions will take into account the target benefit levels specified in the plan documents.

Self-Assessment Questionnaire

A self-assessment questionnaire on prudent investment practices accompanies this guideline.

The questionnaire has been designed to help plan administrators review the investment practices of the pension funds for which they have responsibility, to assist the plan administrator in satisfying the requirements of the prudent person rule, and to identify areas of strength and areas for improvement.

Plan administrators may select from the questionnaire those question groupings which apply to the particular circumstances of their pension plans. It should be noted that completion of the questionnaire does not guarantee that the administrator has met all prudent standards and other legislative requirements.

Role of the Plan Administrator

The plan administrator is responsible for the overall administration of the pension plan, which includes managing the pension fund, establishing a written statement of investment policy/Statement of Investment Policies and Procedures (SIP&P), or a Statement of Investment Policy and Goals (SIP&G) and investing the pension fund's assets in accordance with the investment policy/SIP&P and SIP&G, other pension plan documents and applicable legislation. The plan administrator has a fiduciary responsibility to ensure the pension fund's assets are invested in a prudent manner and should establish, implement and adhere to policies and procedures that support its responsibilities.

For purposes of this guideline the reference to a SIP&P will include a SIP&G or any other similar document required by legislation.

Role of the Plan Sponsor

The plan sponsor is responsible for determining the design of the pension plan, setting the benefit structure for various classes of members, and establishing, amending or terminating the pension plan. The plan sponsor is also responsible for determining the level and nature of pension benefits. During these activities, the plan sponsor is not held to a fiduciary standard of care in relation to the pension plan and the pension plan beneficiaries.

The type of pension plan impacts on the specific role and responsibilities of the plan sponsor, for example in multi-employer pension plans the plan sponsor obligations may be limited solely to the contributions as set out in the collective agreement and providing information to the administrator as required by the legislation. Benefit levels rather than contribution levels may need to be adjusted when there are funding deficiencies.

While not a requirement under any current pension legislation, it is a good practice in establishing the plan's governance structure for plan sponsors to consider developing and adopting a funding policy that takes into account the applicable minimum funding requirements. Plan sponsors may find the *CAPSA Guideline No. 7 Pension Plan Funding Policy Guideline* helpful in developing the funding policy.

When the plan administrator is a different entity from the plan sponsor there needs to be communication and interaction between the plan administrator and plan sponsor regarding their respective risk tolerances, volatility concerns and return expectations because they may impact on both the investment and funding requirements of the pension plan.

Both the plan administrator and the plan sponsor must stay current with developments that may impact on their roles and responsibilities, and

should seek advice if there is any uncertainty about their respective roles and responsibilities.

Dual Role of the Employer as Plan Administrator and Plan Sponsor

For many pension plans the plan administrator is the employer who is sponsoring the plan. In these situations, the employer is held to a fiduciary standard of care when the employer acts as the plan administrator. The employer also retains certain rights and powers with respect to the pension plan when the employer acts as plan sponsor.

The roles and responsibilities of the plan sponsor are very different from those of the plan administrator. In the plan sponsor role, the employer is entitled to act in its own best interests, but may be subject to an implied duty of good faith.

In the plan administrator role, the employer is responsible for ensuring the pension fund is administered and invested prudently in accordance with the investment policy/Statement of Investment Policies and Procedures (SIP&P), other pension plan documents and applicable legislation. When the employer acts as the plan administrator, the employer is a fiduciary whose actions and decisions must take into account the best interests of the pension plan beneficiaries.

When the employer is both the plan administrator and plan sponsor, it is very important for all individuals involved to have a clear understanding of when they are fulfilling plan administrator responsibilities and when they are carrying out plan sponsor functions.

Communication between Plan Administrator and Plan Sponsor

When the plan administrator and plan sponsor are different entities, or if the functions of the plan administrator and plan sponsor are

delegated to different individuals, committees or service providers, the parties should ensure they communicate with each other in the development of prudent investment practices and, where applicable, in the development of a funding policy.

Communication between the plan administrator and plan sponsor is essential to achieve consistency in investment and funding processes. If changes are made to the investment and funding documents and/or practices, these changes should be communicated to the other party. When there are conflicts or inconsistencies, the plan administrator and plan sponsor are responsible for disclosing and resolving them.

Communication with Plan Beneficiaries

It is a legislative requirement that plan administrators communicate specific prescribed information to pension plan beneficiaries in specific circumstances. Communication is of particular importance when the pension plan beneficiaries have responsibility for making investment decisions, as is the case with some defined contribution pension plans. Ongoing communication with pension plan beneficiaries ensures the beneficiaries are provided with the information and assistance they need to make their investment decisions. Plan beneficiaries should be provided with sufficient details about the pension plan investment options to be able to make informed investment decisions.

CAPSA Guideline No. 3 for Capital Accumulation Plans provides detailed guidance on the type of investment information and decision-making tools plan sponsors should provide to beneficiaries of plans providing defined contribution benefits. The guideline also discusses what information the plan sponsor should provide when an individual becomes eligible to enroll in the plan, and ongoing communication to beneficiaries.

Plan beneficiaries need to understand their plan benefit, need to be assured the benefit is adequately funded, and need to understand what the risks are related to receiving their entitlements.

**Prudent Investment Practices
Guideline**

The plan administrator has a duty to invest the pension fund's assets in a prudent manner, while taking into account the particular needs of the pension plan and pension fund. An assessment and analysis of the pension plan's liabilities should be conducted, and appropriate investment strategies should be developed for the pension fund's assets. Plan administrators should be guided by the principles of prudence when designing and implementing an investment strategy for the pension fund, recognizing that returns on the portfolio of investments along with plan contributions should be sufficient to provide the pension plan benefits over time.

CAPSA encourages all plan administrators to assess their current pension plan investment practices, to ensure prudent practices are in place. Plan administrators should ensure they have established a robust, process-oriented decision-making framework, within which investment management activities can be conducted. Plan administrators are also encouraged to consider the guideline and its application to their specific plans, as well as the legislative requirements in their particular jurisdiction.

PRUDENT INVESTMENT PRINCIPLES

Prudent Person Rule

The Prudent Person Rule is a substantive rule of law that is intended to lead to balanced decision making, rather than dictate particular outcomes. It is an objective standard of conduct which references the actions of a prudent person. One statement of the rule is:

A fiduciary is expected to discharge its duties with the care, skill, prudence and diligence a prudent person acting in a like capacity would use.

For registered pension plans, the Prudent Person Rule is modified by legislation that may introduce a higher, more subjective standard. One example is that the administrator shall use the skill and knowledge the administrator possesses or ought to possess by reason of their profession, business or calling.

The Prudent Person Rule focuses on behaviours and processes rather than solely on outcomes. Its application requires individuals with responsibility for managing the assets of the pension fund to do so in a reasonable and professional manner having regard to the best interests of the pension fund and the pension plan beneficiaries.

In the pension investment context, a key element of the Prudent Person Rule is that fiduciaries should exercise due diligence. This includes making decisions based on proper consideration of adequate information, documenting the final decision, documenting the reasons for the decision and documenting the circumstances that were considered.

Since this rule emphasizes processes, it stresses the importance of having a good governance structure, deliberate decision making, appropriate documentation and record keeping.

An important part of this rule is the ability of the plan administrator, regulator, plan beneficiaries and others who may have an interest, to monitor and assess investment management practices. In order for effective monitoring to occur, there must be adequate information available.

Policies must be established and processes must be documented to support the decisions that are made and actions that are taken.

Prudent Delegation

Investment decisions about the pension fund should be made by those individuals or organizations that have the authority, skills, knowledge, expertise, information and resources to effectively make the decisions. The plan administrator should assess the extent to which the administrator has the right internal structures, processes, resources, skills, knowledge and expertise to effectively perform its duties with respect to investing and administering the pension fund.

If the plan administrator determines it does not have the structures, processes, resources, skills, knowledge and expertise in place, it would be prudent for the plan administrator to delegate these tasks. It is important that investment related tasks be properly delegated to parties with sufficient skills, knowledge and expertise, because the required activities for investing and administering the pension fund must be performed according to the standards of the Prudent Person Rule.

If a plan administrator decides to delegate certain tasks to external third party service providers, internal committees or staff, then the written governance documents of the plan should clearly set out the authority to delegate, the requirement of the delegate to report back to the plan administrator and the obligation of the plan administrator to monitor the delegate. Similarly, the delegation itself should clearly set out the terms of delegation, including what functions are being delegated, the delegate's obligation to report back to the plan administrator and

whether or not the delegate has authority to subdelegate.

The plan administrator must be prudent when delegating functions, as the plan administrator remains responsible for the delegated activities and should monitor and review the delegated activities to ensure they have been appropriately and prudently carried out. This includes monitoring and reviewing service provider activities based on established policies and performance procedures.

Investment Objectives

The investment objectives need to be well defined so that the risks associated with the objectives are understood, are consistent with the pension plan's risk tolerances, and steps can be taken to actively manage the risks. The investment objectives should be consistent with the pension plan's retirement income objective, the liabilities of the plan, the plan's demographics and the ability of the plan to deal with volatility in investment returns.

The investment objectives should take into consideration relevant legal provisions and investment principles, such as asset allocation, diversification and liquidity, to ensure the investment of the pension plan assets is consistent with the pension plan's obligations.

Risk Tolerances

The pension plan's primary risk is not being able to pay pensions. Risk should be managed by taking into consideration the plan's investment and funding objectives when setting and implementing the investment policy, and evaluating ongoing performance of the fund and effectiveness of the investment policy.

The risks associated with the investments need to be clearly identified to actively manage the risks. Some of the risk factors to be managed include but are not limited to investment risk, interest rate risk, foreign exchange rate risk, credit risk, liquidity risk, market risk, funding

risk, demographic risk, longevity risk and legislative/regulatory risk.

Investment Policy/Statement of Investment Policies & Procedures

The investment policy reflects the investment objectives of the pension plan. The investment policy also sets out investment principles, strategic asset allocation, performance objectives and risk tolerances. It sets out the processes for the regular monitoring and review of the objectives and tolerances, the persons delegated responsibilities for the administration and investment of the assets and the established processes. It should also include a process for selecting and replacing asset managers, as well as ways to monitor and review performance and change asset allocation.

It is a statutory requirement for the plan administrator to establish a written Statement of Investment Policies and Procedures (SIP&P). The SIP&P must include the key elements identified by the applicable legislation. While the SIP&P by itself may be used as the plan's investment policy document, pension plans may decide to have a broader investment policy including or referencing other documents. The plan administrator is to consider whether a comprehensive investment policy in several documents or the SIP&P on its own best suits the plan's specific circumstance.

The investment policy, which may include the SIP&P, guides investment decision making and sets out how the plan administrator is to comply with investment principles that:

- identify the kinds of investments that could be held;
- indicate the allocation between different kinds of investments;
- address the nature and extent of risk that is anticipated in the investment portfolio; and
- identify expected return on investments.

Asset Allocation

Asset allocation refers to the process of apportioning the plan's total assets among major asset classes or other types of investments.

Asset allocation is a key element in determining long run investment performance and outcomes, and is a significant component of the pension plan's investment strategy. Asset allocation should reflect the characteristics of the pension plan's liabilities, demographics and risk tolerances. Decision makers should consider a full range of possible investment opportunities.

For each asset class or type of investment in which the pension fund is invested, decision makers should consider whether active or passive management is more appropriate, given the efficiency, return expectations, liquidity and level of transaction costs in the given market. For active management, consideration should be given to what expertise is required and whether the decision makers possess the necessary expertise.

Investment Selection and Due Diligence

When considering particular investments the plan administrator or its delegate should use appropriate methods to research the investments and to review the investment decisions once they have been implemented. Due diligence includes carrying out an independent and thorough investigation to determine the advantages and disadvantages of a particular investment before making an investment decision.

Monitoring

The plan administrator needs to have adequate information to perform its duties, to monitor the risks facing the plan and to map out strategies for managing those risks. To monitor the pension plan and fund for compliance with statutory requirements and policies that have been adopted by the plan administrator, sufficient information

should be provided to appropriate individuals, and an effective reporting and disclosure regime is needed. Appropriate mechanisms should be in place to monitor an activity, transaction or investment. Investment activities should also be monitored to ensure policies are being followed. The plan administrator should:

- review investment objectives and risk tolerances
- ensure that adequate investment procedures are in place
- review key decisions regarding pension investments
- ensure that service providers are monitored, measured, and evaluated
- review the investment performance of the pension fund.

Documenting Processes, Policies and Procedures

The governance documents of the pension plan and pension fund need clear information on the roles and responsibilities of the plan administrator and plan sponsor, delegated authority, decision making and approval processes, and the rights of pension plan beneficiaries and their obligations.

The plan administrator should set up a process for documenting decisions and activities, and have documented processes, policies and procedures to help demonstrate that the Prudent Person Rule has been applied and plan administrator obligations have been fulfilled. Any time a key decision is made, it should be well documented, and include the reasons and circumstances that were considered.

This guideline identifies prudent investment practices and prudent investment principles. The *Self-Assessment Questionnaire on Prudent Investment Practices* provides more detail regarding topics the plan administrator should consider when establishing and reviewing the investment practices in place for its pension plan.