FRA PlanTools White Paper

HCM 401(k) Optimizer: Providing Participant Level Investment Advice While Reducing Fiduciary Exposure

Prepared for:
Vance Howard & John Marion
Howard Capital Management

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By: **David J Witz, AIF®, GFS™**
CEO/Managing Director
Fiduciary Risk Assessment LLC
PlanTools LLC

Thomas E Clark, Jr., J.D., LL.M
CCO/Director of Fiduciary Oversight
Fiduciary Risk Assessment LLC
PlanTools LLC

Disclaimer

This report is not intended to be nor should it be construed as legal advice. Instead, this report draws upon personal expertise and experience. No plan sponsor, employer, service provider, or other reader should act or refrain from acting on the basis of any matter contained in this report without obtaining specific professional legal advice on the particular facts and circumstances at issue.

Executive Summary

The U.S. Department of Labor ("DOL") has a long history of support for services that provide investment advice directly to participants of defined contribution plans. This support is in recognition that these participant funded plans, such as 401(k) and 403(b) plans, are the dominant retirement plan sponsored by the majority of employers. These types of plans place the burden on participants that lack interest and/or education on financial matters to develop an effective strategy for retirement. As a result, many participants fail to save enough or make prudent investment decisions that give them the best opportunity to achieve a successful retirement. Although the DOL does not require advice to be offered to plan participants, they have strongly encouraged it by issuing regulations and guidance that define approved methods of doing so. One such method is offering advice through an *eligible investment advice arrangement* under section 408(g) of the Employee Retirement Income Security Act ("ERISA").

Fiduciary Risk Assessment LLC ("FRA")[1] has been engaged by Vance Howard, President and CEO, of Howard Capital Management ("HCM") to create a white paper addressing fiduciary liability associated with a *plan sponsor's*[2] decision to offer the HCM 401(k) Optimizer, a computer model that provides investment advice directly to participants that exercise discretionary control over their individual account balance.[3] The HCM 401(k) Optimizer has been certified as an *eligible investment advice arrangement* under section 408(g) of ERISA, a valuable independent examination plan sponsors can rely upon to know that the HCM 401(k) Optimizer is a capable and unbiased source of advice.

Ultimately, we have concluded that a plan sponsor that properly authorizes the HCM 401(k) Optimizer incurs no additional liability under ERISA. In fact, participants that utilize the HCM 401(k) Optimizer computer model for asset allocation actually reduce the plan sponsor's fiduciary liability for the participant's investment results. This reduction in liability for participant investment performance is conditioned on the HCM 401(k) Optimizer computer model meeting the statutory exemption provided under section 408(g) and the prudent selection and monitoring of the computer model by the plan sponsor.[4] If done properly, a plan sponsor cannot be held liable for the investment decisions of both the plan participant and the investment advisor.[5] In addition, the plan sponsor has no duty to monitor the specific investment advice provided to any participant using the HCM 401(k) Optimizer.[6] This is a valuable reduction in fiduciary exposure to a plan sponsor. Additionally, a plan sponsor will be providing a beneficial service to its participants while establishing a strong defense to any claim the plan sponsor failed to provide sufficient assistance to participants in choosing appropriate investments, given their tolerance for risk, to achieve their retirement objectives.

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[1] The curriculum vitae of David J. Witz and Thomas E. Clark, Jr. are available at www.fraplantools.com.
[2] The term *plan sponsor* will be used throughout this white paper to mean any responsible plan fiduciary with authority to cause the plan to enter into, or extend or renew, a contract or arrangement for the provision of services to the plan. 29 C.F.R §2550.408b-2(c)(1)(viii)(E).
[3] ERISA §3(34).
[4] ERISA §408(g)(10).
[5] ERISA §408(g)(10)(B).
[6] ERISA §408(g)(10)(B).

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Background

The Pension Protection Act of 2006 ("PPA") amended ERISA to add a statutory exemption relating to the provision of investment advice. Specifically, section 601 of the PPA added a statutory exemption under section 408(b)(14) of ERISA. Section 408(b)(14) applies to the provision of investment advice under an *eligible investment advice arrangement*, as defined in paragraph (2) of section 408(g), to participants and beneficiaries of a defined contribution plan that permits them to direct the investment of their accounts in the plan. If the conditions of section 408(g) are met, section 408(b)(14) exempts from the prohibited transaction rules[7] the provision of investment advice, the investment transaction entered into pursuant to the advice, and the direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate in connection with the provision of advice or the transaction pursuant to the advice.[8]

Over the years, the DOL has supported various forms of participant level investment advice through the issuance of advisory opinions, field assistance bulletins and regulatory activism.[9] Their support for participant level advice has been positively received by plan sponsors that share the DOL's interest in providing participants the best possible chance to reach retirement age financially independent. In addition, studies have shown that participants that receive advice tend to save more and stay invested during volatile markets resulting in better outcomes.

In 2011, the DOL issued final regulations under ERISA section 408(g). These regulations provided guidance to both plan sponsors and investment advisors on how to reduce fiduciary liability under ERISA. One of the endorsed methods of offering advice is through the use of a computer model. The HCM 401(k) Optimizer is such a computer model as it has been certified by an independent *eligible investment expert* that it meets the detailed requirements of the ERISA section 408(g) regulations.[10]

The HCM 401(k) Optimizer

The HCM 401(k) Optimizer is a computerized advice solution designed to help plan participants implement an asset allocation strategy based on their tolerance for risk and the available investments[11] under their 401(k), 403(b) or other defined contribution plan that permits the participant to exercise discretionary control over their account balance.

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[7] The prohibited transaction provisions of ERISA prohibit an investment advice fiduciary from using the authority, control or responsibility, which makes it a fiduciary to cause itself, or a party in which it has an interest that may affect its best judgment as a fiduciary, to receive additional fees. As a result, in the absence of a statutory or administrative exemption, fiduciaries are prohibited from rendering investment advice to plan participants regarding investments that result in the payment of additional advisory and other fees to the fiduciaries or their affiliates. Field Assistance Bulletin 2007-01 (Feb. 2, 2007).

[8] Field Assistance Bulletin 2007-01 (Feb. 2, 2007).

[9] 29 CFR §2550.404c-1(f)(8) and (9) (use of investment advisors); 29 CFR §2509.96-1(e) (provision of investment advice in general); Advisory Opinion 97-15A (Frost National Bank); Advisory Opinion 2001-09A (SunAmerica), Advisory Opinion 2005-10A (Country Trust Bank); Field Assistant Bulletin 2007-01 (statutory exemption for investment advice); see also GAO-11-119 401(k), page 53.

[10] ERISA §408(g)(3)(C); FRA and its subsidiary PlanTools, LLC are not the eligible investment expert in this case.

[11] ERISA §408(g)(3)(B)(iii).

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The participant must fill out a detailed profile questionnaire, including, but not limited to their age, current 401(k) balance, outside savings balance, company or institution that they have their retirement plan with, and the date of their projected retirement.[12] Once this data is collected, the participant must fill out a detailed online risk tolerance questionnaire.

Upon completing the risk tolerance questionnaire, the HCM 401(k) Optimizer produces a detailed asset allocation model based on generally accepted investment theories and historic returns for different asset classes over defined periods of time.[13] The final report specifically tells the participant which funds to invest in and the recommended percentage. The HCM 401(k) Optimizer uses the Morningstar 'style boxes' to help determine the allocation. Once the allocation is determined, the HCM 401(k) Optimizer selects from the funds available those with a combination of superior performance and a low expense ratio to populate each prescribed asset class.[14]

The HCM 401(k) Optimizer creates asset allocation models designed for participants that are Conservative, Moderate or Aggressive investors as determined by their response to the risk tolerance questionnaire. These models have standard ratios between equities and fixed income as reflected in the following table. Specifically, Conservative is approximately 80% fixed income and 20% equities. Moderate is approximately 60% equities and 40% fixed income. Aggressive is approximately of 20% fixed income and 80% equities. Within the equity allocations, the 401(k) Optimizer includes an allocation to international equities of approximately 25% for the aggressive model, 15% for the moderate model and 10% for the conservative model.

	Conservative	Moderate	Aggressive
Equities – Domestic	10%	45%	55%
Equities - International	10%	15%	25%
Fixed Income	80%	40%	20%

The participant can update his or her profile at any time. Changes to the profile could affect their tolerance for risk which, in turn, would impact their asset allocation strategy. Changes to the asset allocation strategy resulting from changes in the participant's profile will require the participant to implement changes with their retirement provider. It is important to emphasize that the HCM 401(k) Optimizer is not a discretionary advice engine. Instead, it operates as a fiduciary advisor under ERISA section 3(21)(A)(ii) that provides recommendations that the participant must exercise discretion to implement.

The HCM 401(k) Optimizer's Compliance with ERISA §408(g)

In order to comply with ERISA section 408(g)[15] the HCM 401(k) Optimizer is required to:

- Apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time,
- Utilize relevant information about the participant, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments,

[12] ERISA §408(g)(3)(B).
[13] ERISA §408(g)(3)(B)(i).
[14] ERISA §408(g)(3)(B)(iv) and (v).
[15] The HCM 401(k) Optimizer must meet the requirements as specified in 29 C.F.R. §2550.408g–1(b)(4)(i) and (ii), (5), (6), (7), (8) and (9) and paragraph (d).

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- Utilize prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan,
- Operate in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the fiduciary adviser, and
- Take into account all investment options under the plan in specifying how a participant's account balance should be invested and is not inappropriately weighted with respect to any investment option.

These are examples of the many requirements. To be compliant with ERISA section 408(g), HCM obtained a written certification from an independent eligible investment expert that the HCM 401(k) Optimizer meets all the requirements found in ERISA section 408(g). HCM must also seek and receive an annual audit of the HCM 401(k) Optimizer from an independent auditor. The audit seeks to validate that the HCM 401(k) Optimizer considers all available investments and provides advice that is conflict free. Following completion of the annual audit, a copy of the written report by the auditor will be provided to HCM for distribution to a plan sponsor that adopts the HCM 401(k) Optimizer.[16]

HCM must also provide to a participant or a beneficiary, before the initial provision of investment advice, a written disclosure that complies with 29 C.F.R. §2550.408g–1(b)(7), including an explicit statement that they are a fiduciary. This disclosure can be and is provided in electronic form when a participant signs up for the HCM 401(k) Optimizer.

A Plan Sponsor's Compliance with ERISA §408(g)

In order to comply with ERISA section 408(g), a plan sponsor must expressly authorize the HCM 401(k) Optimizer to become available to a plan's participants and beneficiaries.[17] This can be done, for example, by documenting the decision in minutes or by passing a resolution. Additionally, a plan sponsor must prudently select and monitor HCM as a fiduciary service provider within the fiduciary provisions of ERISA.[18] To assist with this responsibility and compliance with ERISA section 408(g), HCM will provide the following documentation to a plan sponsor:

1. A written disclosure informing the plan sponsor that:
    a. HCM intends to comply with the conditions of the statutory exemption for investment advice;
    b. The HCM 401(k) Optimizer must be audited annually by an independent auditor for compliance with the requirements of the statutory exemption and related regulations; and
    c. The plan sponsor will be furnished a copy of that auditor's findings within 60 days of its completion of the audit;
2. A copy of the written certification from the independent eligible investment expert;

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[16] ERISA §408(g)(5)(B).
[17] ERISA §408(g)(4).
[18] "In monitoring investment advisers, we anticipate that fiduciaries will periodically review…the extent to which there have been any changes in the information that served as the basis for the initial selection of the investment adviser, including whether the adviser continues to meet the applicable federal and state securities law requirements, and whether the advice being furnished to participants…was based upon generally accepted investment theories." Field Assistance Bulletin 2007-01 (Feb. 2, 2007).

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3. A copy of the annual audit; and
4. A copy of the disclosure provided to plan participants.

The obligation to select and monitor a plan service provider is specifically tied to the prudent man rule that has existed in the statute since the inception of ERISA in 1974 and applies to all decisions to retain service providers, investments options or investment advisors. The DOL has provided additional clarification in the regulations on the prudent man rule as it applies to investment options or the investment course of action:

> With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of section 404(a)(1)(B) of the Act…are satisfied if the fiduciary (A) has given **appropriate consideration to** those **facts and circumstances** that…the fiduciary **knows or should know are relevant** to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (B) has acted accordingly.[19] [Emphasis added]

This regulation contains specific guidance as to the duties of a fiduciary. For example, a fiduciary must have the information or the "facts and circumstances" they need to make a decision about a particular investment or investment course of action i.e., computerized advice program. In addition, a fiduciary must "know" or "should know" what information is relevant to make a prudent decision including information about their plan, participants, the investments or investment course of action and the current state of affairs which, in this case, would include a recognition that industry studies support a conclusion that participants with advice tend to save more, stay invested when markets are volatile and ultimately accumulate more for retirement. In relation to the investment or investment course of action this, in large part, is covered by the statutory obligation to obtain a certification and audit of the computerized advice program i.e., HCM 401(k) Optimizer to rely on the statutory exemption. Finally, the fiduciary must evaluate and give consideration to "relevant" information applicable to their plan's circumstances to make an informed and reasoned decision. Relevant information would include the investment experience, knowledge and skills of their participants. Based on these factors, and others, a plan sponsor can document their selection process and monitor the continued use of the service by applying the same prudent selection standards to the monitoring process on, at least, an annual basis.

Payment of Fees

The provision of investment advice is a service rendered for a fee. Fees associated with this service may be paid by a plan sponsor or by a participant. Payment of fees for services rendered for investment advice may also be paid with plan assets assuming the fee is reasonable.[20]

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[19] 29 CFR §2550.404a-1(b)(1).

[20] "Nothing in this part shall be construed to preclude the use of plan assets to pay for reasonable expenses in providing investment advice referred to in section 3(21)(A)(ii)." ERISA §408(g)(10)(C). "The Department has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the provider's qualification, quality of services offered and reasonableness of fees charged for the service. The process also must avoid self dealing, conflicts of interest or other improper influence." Field Assistance Bulletin 2007-01 (Feb. 2, 2007).

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Conclusion

We conclude that if a plan sponsor properly authorizes the HCM 401(k) Optimizer as an eligible investment advice arrangement under ERISA section 408(g):

1. A plan sponsor has not increased their fiduciary liability,
2. A plan sponsor has no responsibility or liability to review the advice rendered by the HCM 401(k) Optimizer to a participant,[21]
3. A plan sponsor has no liability for the investment decisions of either the participant or the advisor i.e., HCM 401(k) Optimizer,
4. A plan sponsor has reduced its fiduciary liability for investment results or asset allocation decisions associated with participants that utilize the HCM 401(k) Optimizer,
5. A plan sponsor has provided a valuable benefit to assist the participants in making prudent investment decisions, and
6. A plan sponsor has implemented an effective risk mitigation strategy to combat any claims the plan sponsor failed to provide participants with an opportunity to achieve a successful outcome.

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Fiduciary Risk Assessment has developed this white paper for Howard Capital Management drawing upon its extensive experience in ERISA matters including the provision of technology tools to the retirement plan industry to evaluate, select and monitor investments, the creation of sound web-based fiduciary governance tools, the assessment of fee reasonableness through our proprietary benchmarking system and customizable request for proposal system and the evaluation of prudence in the selection of managed portfolios such as target date funds.

[21] ERISA §408(g)(10)(B).

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