



Understanding & Managing Fiduciary Responsibility

A Guide for Plan Sponsors

WE UNDERSTAND WHAT YOU'RE WORKING FOR®

Principal
*Financial
Group*

Preface by Fred Reish, nationally known ERISA attorney

This Guide has been written for the men and women who have the responsibility for managing tax-qualified retirement plans. That is an important job... because the retirement standard of living of your participants will depend partially on the decisions that you make. If your job is well done, employees can retire with more money and have a better opportunity for a good quality of life in retirement.

Unfortunately, most discussions of retirement plan responsibilities focus on the fiduciary requirements, and potential liabilities, under ERISA (the “Employee Retirement Income Security Act of 1974”), the federal law governing retirement plans. However, viewed properly, ERISA is a road map for successfully accomplishing the greater responsibility — the secure retirement of your employees. The vast majority of decision-makers, such as yourself, successfully navigate ERISA’s fiduciary waters without experiencing participant claims, Department of Labor investigations or lawsuits. This Guide will help you enjoy the successes of a qualified retirement plan and avoid the legal pitfalls.

As a decision-maker — a “fiduciary” — your first job is to do what’s right for the participants. In fact, the most important legal requirement under ERISA is that you act solely in the interest of the participants and for the exclusive purpose of providing retirement benefits (and paying only reasonable expenses). Once you understand that rule and accept that responsibility, most of the remaining requirements of ERISA are logical and intuitive. One commentator has made the analogy, “When you are managing your mother’s retirement money, you don’t need to call a lawyer... you intuitively know what to do.” If you bring that standard of care to supporting your employee’s retirement benefits, you will have gone a long way towards satisfying your fiduciary requirements.

Of course, some retirement plan decisions are difficult — and may require an expertise that you do not have. In those cases, under ERISA, you can turn to outside advisors for help. Those would include the investment provider, a financial advisor or broker, an investment advisor... and, yes, even an ERISA attorney. You need to make sure that the advisor is competent and qualified, and you need to evaluate and understand the advice and information they give you. Then, you need to make a reasoned and informed decision for the benefit of your participants. Having done that, you will have satisfied ERISA’s requirement that you engage in a “prudent process.” Stated simply, a prudent process requires that you look at the right information in the right way.

As an attorney, I would be remiss if I did not advise you of the need to document your decisions and to place that document (e.g., minutes of a meeting or just a memo) in a due diligence file. That file should also include the information you reviewed and advice you received. The records should be kept for at least six years.

Sponsoring a retirement plan can, and should be, a “win-win” situation. If you combine a good plan service provider with the necessary services (such as an advisor, investment education, and so on), your organization will provide an attractive benefit to retain your current employees and to attract new employees. In due course, those employees can accumulate meaningful retirement benefits. And, since the largest account balances are often held by the employees who are also fiduciaries (e.g., the officers and owners), the prudent management of a retirement plan pays double benefits — both in helping the officers fulfill their responsibilities and in helping them in building a meaningful retirement portfolio.

While this Guide primarily focuses on the legal responsibilities for participant-directed plans, like 401(k) plans, it also discusses responsibilities for operating other types of retirement plans, such as profit sharing, money purchase and defined benefit plans. In fact, many of the basic principles apply to all types of qualified retirement plans.

As you might imagine, as an ERISA attorney, I am particularly interested in the law and how it applies to the management of retirement plans. With that in mind, I have reviewed the Fiduciary Guide for accuracy in its presentation of the law. I am pleased to report that the Principal Financial Group® has done a good job of introducing and explaining ERISA's basic requirements for the management of retirement plans. Equipped with this information, you will be on your way to better understanding your responsibilities and, therefore, to helping your organization, your employees, and yourself.

I hope you enjoy these materials and profit from them.

*Fred Reish
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Table of contents



<i>Introduction</i>	4
<i>1. Defining a Fiduciary & Understanding ERISA</i>	6
<i>2. Investment Selection</i>	12
<i>3. Understanding the Difference Between Education vs. Advice</i>	16
<i>4. Plan Management</i>	18
<i>5. ERISA Compliance</i>	22
<i>6. Managing Fiduciary Responsibility</i>	26
<i>Closing</i>	30

Helping plan sponsors take control of fiduciary obligations



A retirement plan is among the most valuable employee benefit available. But for a plan sponsor, it involves important legal responsibilities. While the laws governing retirement plans and their fiduciaries may appear complex, complying with them doesn't have to be. However, it does take an awareness of the rules, an attention to the issues, and the use of quality advisors and providers. Almost all qualified plans are subject to the rules of the Employee Retirement Income Security Act of 1974 (ERISA). There are limited exceptions, for example, non-electing church and certain tax-exempt entity plans.

This guide was developed for plan sponsors of defined benefit and defined contribution plans, including employer-sponsored 403(b) plans that are subject to ERISA's rules. However, it focuses primarily on participant-directed plans, such as 401(k) and 403(b) plans, except where noted. At the Principal Financial Group® (The Principal®), we understand the unique needs of plan sponsors and their participants.* Our goal is to help plan sponsors navigate ERISA and successfully manage their fiduciary obligations.

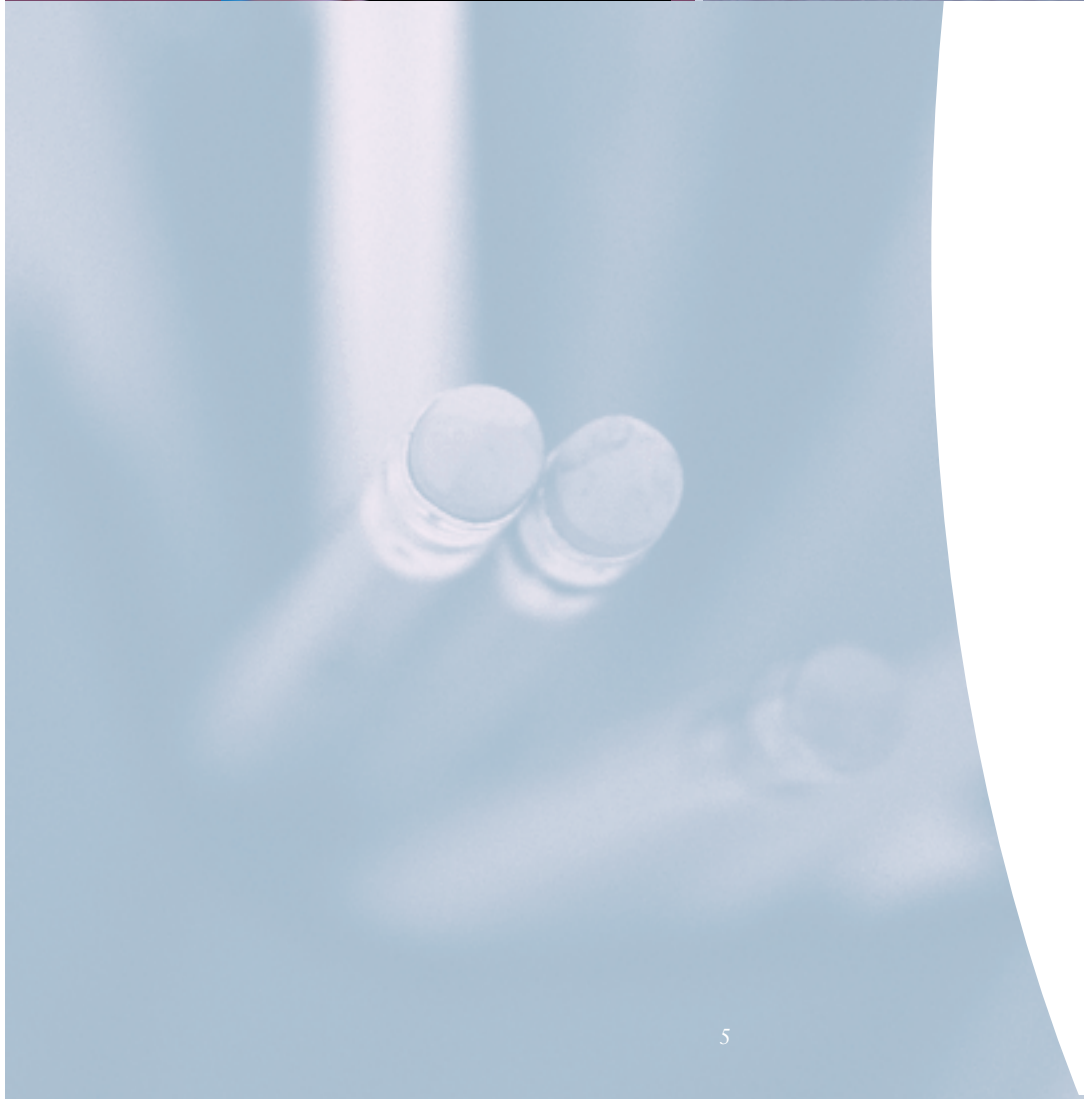
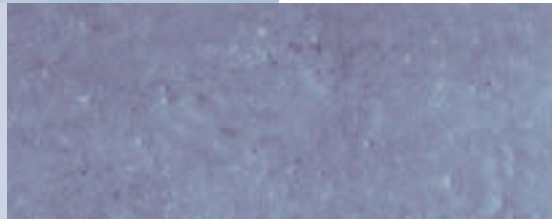
It's a commitment that's backed by an industry leader with more than 60 years of retirement plan experience and over 51,000 plan sponsors. This guide offers important background and guidance on:

- The role of an ERISA fiduciary
- Making investment selections
- The difference between participant education vs. advice
- ERISA compliance requirements
- Managing fiduciary responsibility

In order to get the most out of a retirement plan, careful consideration must be given to the decisions that relate to a plan's design, day-to-day operations, and investments. By managing a plan in accordance with ERISA's standards, plan sponsors can protect themselves from potential liability and help participants maximize their benefits in the plan.

We encourage plan sponsors to work closely with their financial advisors and consult with their attorneys, accountants, and other parties as needed.

* In order to make this Guide easier to read, the term "participant" has been used to refer to both participants and beneficiaries.



ERISA— protection for retirement plan participants



The Employee Retirement Income Security Act of 1974, more commonly referred to as ERISA, was enacted to protect participants' retirement savings. In order to accomplish this objective, ERISA governs the operation and investment of most private sector retirement plans. Persons known as “fiduciaries” are given the primary responsibility for managing the plans and their investments. Fiduciaries are held to a high standard and are required to act in the best interests of their plan and its participants.

Failure to comply with ERISA can result in significant personal liabilities and penalties being imposed on a fiduciary, as well as on the company that sponsors the plan.

WHO ENFORCES ERISA?

The Department of Labor's Employee Benefits Security Administration (EBSA) is responsible for enforcing ERISA's fiduciary requirements. The EBSA focuses on whether fiduciaries have complied with their duties under ERISA. For example,

during the investigation of a plan, the EBSA will look closely at the timing of the deposit of employee deferrals, the reasonableness of plan expenses, the prudence of investments, and any transactions with closely-related parties (like the plan sponsor or its owners).

The Internal Revenue Service (IRS)

oversees the application of the Internal Revenue Code (IRC), which establishes the rules for operating a tax-qualified retirement plan. It assists plan sponsors by providing guidance and education on the IRC and by approving the plan documents. However, the IRS also audits plans for compliance with these rules. The discovery of a serious violation of those rules can result in penalties and taxes.

Defined benefit pension plans are also regulated by another federal agency — the Pension Benefit Guaranty Corporation, or PBGC. The PBGC oversees the adequacy of the funding of promised pension benefits and insures a minimum level of pension benefits.

ERISA is also “enforced” by participants who file claims for benefits and who can sue fiduciaries for breaches of their ERISA duties.

While the law has these enforcement mechanisms, most plan sponsors operate their plans without penalties or lawsuits. The key to having a successful plan is an awareness of the rules and the use of quality providers.

WHO IS A FIDUCIARY?

A fiduciary is any individual who:

- Is named in the plan document as a fiduciary or is appointed as a fiduciary in accordance with a procedure in the plan document
- Exercises any discretionary authority or control regarding the management of a retirement plan or its assets, or exercises any control over the management or disposition of a plan's assets
- Provides (or has any responsibility to provide) investment advice with respect to plan assets for compensation, such as commissions
- Has any discretionary authority or responsibility for plan administration

WHAT IS A NAMED FIDUCIARY?

ERISA requires a retirement plan to have one or more "named" fiduciaries who have the authority to control and manage the operation and administration of the plan, including its investments. The named fiduciary can be an individual, group of individuals, or the employer/company. A named fiduciary must be designated in the plan document or in accordance with a procedure described in the plan documents. The sponsoring employer and the trustee are always named fiduciaries. If a committee is appointed to manage the plan under the terms of the plan document, it is also a named fiduciary.

WHAT IS A FUNCTIONAL FIDUCIARY?

Generally speaking, a functional fiduciary is a person who exercises control over the plan or its investments or gives investment advice, but who was not formally appointed to perform those roles. In order to be considered a functional fiduciary, a person must exercise discretionary control over the management of a plan or its assets or exercise any authority or control over the management or disposition of a plan's assets; exercise any discretionary authority for plan administration; or provide investment advice about plan assets for compensation.

WHO IS NOT A FIDUCIARY?

An individual is not considered a fiduciary if he or she (a) is not a named fiduciary or (b) is not appointed or does not function as a fiduciary. Accountants, attorneys, consultants, and other individuals who perform purely ministerial functions within a framework of policies, interpretations, rules, practices and procedures made by other persons are not ordinarily fiduciaries. However, they can become functional fiduciaries if they take on any of the fiduciary responsibilities under ERISA.

What are the responsibilities of the plan fiduciary?



Under ERISA, a plan fiduciary must operate a plan solely in the interests of its participants. This is called the duty of loyalty. A fiduciary must also comply with the following requirements:

Exclusive benefit rule: A fiduciary must act for the exclusive purpose of providing benefits and paying only reasonable expenses of the plan.

Prudent person rule: A plan fiduciary must perform his or her duties “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use [under similar circumstances].” This is sometimes called the “prudent expert” rule, because fiduciaries are measured by the standard of a knowledgeable investor. In other words, good faith effort — without investment knowledge — is not enough.

In order to satisfy this rule, fiduciaries must engage in a prudent process. That is, they must gather all of the important information and analyze it before making a decision. If fiduciaries lack expertise in retirement investment matters, they should seek the

advice of knowledgeable advisors. Fiduciaries should retain the information received and document their processes to protect themselves against claims that they breached their duties.

Diversification rule: ERISA requires that fiduciaries diversify their plan’s investments in order to minimize the risk of investment losses. When choosing investments, the fiduciaries should select investments with different objectives and risk/return characteristics. For participant-directed plans, a broad range of investments should be offered so that participants have the opportunity to build portfolios that are appropriate given their goals and risk tolerances.

There is an exception for certain types of plans that hold employer stock, such as Employee Stock Ownership Plans (ESOP).



Duty to follow terms of the plan:

Fiduciaries are required to act in accordance with the plan document to the extent they are consistent with ERISA. However, fiduciaries are required to override a plan's provisions if they would cause the plan to violate ERISA.

DELEGATING FIDUCIARY DUTIES

Named fiduciaries may delegate their responsibilities to other persons in accordance with their plan's provisions. Under ERISA, fiduciaries are required to prudently select and monitor these individuals. It is a good idea to document what duties are being delegated and to whom. Fiduciaries should also make sure that each party understands their specific responsibilities.

Fiduciaries may also obtain the assistance of other persons, such as attorneys, accountants, and recordkeepers to assist them with their fiduciary duties.

PLAN FIDUCIARY ROLES OR FUNCTIONS

Under ERISA, the fiduciaries are responsible for the operation of a plan and the management of its assets. Typically, the fiduciaries and their key responsibilities are:

Plan sponsor: Plan sponsors are typically employers, employee organizations, or associations that maintain retirement plans. The plan sponsor often serves as the plan administrator. (For its duties as administrator, read the information below about the plan committee.)

Duties may include:

- Designing and adopting the plan
- Amending the plan document for changes in the law
- Appointing key fiduciaries such as the trustee and the plan committee

Plan committee: Plan sponsors frequently appoint a plan committee to be responsible for administering the plan and for managing the plan's investments.



Duties may include:

- Communicating the plan to participants
- Interpreting the plan's provisions
- Providing retirement plan education to participants
- Developing an investment policy
- Selecting and monitoring appropriate investment options
- Ensuring that plan reporting and testing is performed accurately and on time
- Authorizing distributions, loans and withdrawals

Investment advisor: The fiduciaries responsible for the plan's investment options may use an advisor to assist them in the selection and monitoring of the plan's investments.

Duties may include:

- Selecting the plan's investment options
- Developing proposals for a menu of investment options to meet participants' diverse needs
- Monitoring performance of investment options on an ongoing basis and communicating changes in investment strategy or management
- Assisting with the development and updating of the plan's investment policy statement (IPS)

Plan trustee: One or more individuals or an entity (such as a bank or trust company) can be appointed as a trustee. A trustee may either have discretionary powers or be subject to the instructions of another person or entity who does have discretionary powers, in which case the trustee's role is that of a "directed trustee". For example, a directed trustee may be subject to the instructions of the plan sponsor, the plan committee, or another designated fiduciary with respect to the investment options to be offered to plan participants. In a participant-directed plan, such as a 401(k) plan which grants participants to direct the investment of plan assets held for their benefit, the directed trustee would be subject to their investment instructions or transactions.

Duties of the trustee are specified in the trust document and may include:

- Administering the trust in the interests of participants
- Protecting trust property against theft or loss
- Maintaining records on investments, contributions, disbursements, and other transactions
- Sending plan contributions to funding agent(s) (for example, the mutual funds)
- Ensuring retirement assets aren't used in a manner considered to be a prohibited transaction under ERISA or the IRC

WHEN IS A TRUST NEEDED?

Generally, ERISA requires retirement plan assets to be held in a trust. However, assets may also be held in a custodial account or an annuity contract issued by an insurance company qualified to do business in a state.



Choosing appropriate investment options



When it comes to selecting investments for a defined contribution or defined benefit plan, it's important to develop an investment program that offers broad diversification across asset classes. Plans may want to select investment funds that have managers with: complementary investment styles, employ risk controls to help achieve consistent investment performance, and diversify the plan's assets.

Today, there is an almost unlimited number of investment choices. To build a sound investment program, fiduciaries must understand the many types of investment vehicles and asset classes available. Unless a plan is designed to hold one type of asset, such as company stock in an ESOP, the fiduciaries need to develop an investment line up that provides participants with a broad range of suitable and well-selected investment options.

REVIEWING ASSET CLASSES

The first step in developing a plan's investment program is to decide on the investment categories to be offered by the plan. Each category should have distinct risk and return features that enable plan sponsors to construct a diversified portfolio

and, for participant-directed plans, allows the participants to combine investments in a way that accomplishes their objectives—based on their need for investment return and their willingness to accept investment risk.

Common investment categories include:

- Stable value
- Fixed income
- Domestic stock
- International or foreign stock
- Real estate

When making decisions about the number and types of investment categories, a variety of factors should be considered:

- Depth of investment knowledge of participants
- Risk tolerance of participants
- Size of plan
- Plan design features
- Cost considerations
- Liquidity needs

While the law does not specifically require that the process for selecting the investment categories (and the specific investments) be in writing, it is a good practice to include these steps, and other investment guidelines, in an investment policy statement. An investment policy statement provides plan sponsors and fiduciaries with a framework to guide their decision-making process for selecting and monitoring plan investments and for managing their fiduciary responsibilities.

INVESTMENT VEHICLES COMMONLY USED IN RETIREMENT PLANS

Once plan sponsors have selected the investment categories, the next step is to choose the investments for each of those categories. There is a variety of available investment products and options.

Pooled investment options

Pooled investment options include mutual funds and separately managed accounts that invest in stocks and/or bonds. The diversification of the pooled options helps manage portfolio risk by minimizing the negative impact of any one security on the entire investment portfolio. These investment vehicles also offer professional management and relatively low transaction fees compared with individual stocks and bonds. Most pooled investment options are considered “diversified” under ERISA, and provide fiduciary support because of the professional management and the regulation of the investments and their managers.

Company stock

Some plans make employer contributions or allow participants to invest in the stock of the plan sponsor. As with any investment, the value of the stock may rise and fall depending

upon a company’s performance, the industry’s growth, and the stock market as a whole. Investing in a non-diversified, unmanaged single stock inherently involves more risk than investing in a diversified pool of stocks. As a result, fiduciaries have oversight responsibility for the company stock. They must take into account the knowledge they have about the company’s operations and may be required, under some circumstances, to sell the company stock or take other steps to protect the participants.

Individual stocks and bonds

Some plans may permit participants to direct investments to individual stocks and bonds through a brokerage account. Brokerage accounts permit participants to direct investments in most listed stocks, bonds, and other mutual funds, as allowed by the plan. Given the risks associated with providing more investment choices, plan sponsors should consider their participants’ investment experience and the depth of the plan’s investment education programs before offering this feature.

IMPORTANCE OF OFFERING A RANGE OF DIVERSE INVESTMENT OPTIONS

By offering a broad range of diversified and well-selected investment options, fiduciaries of participant-directed plans meet their duty to provide investments that are suitable for participant direction. While there is no required number of investment options, both the number and types of investments should be appropriate for the plan’s circumstances, including the investment abilities of the participants.

Evaluating investment options

*I*n general, an investment policy statement should:

- Document the plan's investment goals
- Identify the selected investment categories
- Outline the plan's process for selecting and monitoring investment options and investment managers
- Discuss the criteria for selecting investments and evaluating fees
- Describe any special provisions and restrictions
- Determine participant needs and the services to help participants, such as investment education

CONDUCTING INVESTMENT DUE DILIGENCE

By documenting a plan's decision-making process, the fiduciaries are more likely to maintain consistency with the plan's objectives. An investment policy statement should describe that process and the criteria for making decisions. Of course, it's important to monitor the investment policy statement and investment alternatives regularly, to ensure that they continue to be appropriate for the plan and are consistent with ERISA.

An investment policy statement should identify the plan's decision on the investment categories and provide guidelines for selecting the investments for each category. There are a number of factors to consider when selecting a plan's investment options. The following are some of the criteria:

- How long has the investment manager been in business?
- What is the investment manager's track record and reputation versus its peers?
- How much money do they currently manage?
- Does the investment manager have a sound capital structure, clear business



objectives, capable leadership, and a strong regulatory record?

- How does the investment manager pursue its objective? Do they have a clear investment philosophy?
- How long has the particular investment product (e.g., mutual fund) been in existence?
- Has the investment manager consistently adhered to its stated investment style?
- Are the investment expenses reasonable when compared to similar options and to performance?

Additional considerations for defined benefit plans:

- How will the funding obligation of the plan be satisfied?
- How frequently will the plan's liabilities be determined?
- What measures will be taken to handle the plan's liabilities?
- How will investments be managed in order to have sufficient liquidity for potential benefit distributions?

Additional considerations for an Employee Stock Ownership Plan (ESOP):

- Does the investment policy address the plan's investments other than employer stock (if applicable)?
- Has repurchase liability for privately held companies been contemplated?

Conducting investment reviews

Investment options should reflect a plan's investment policy statement.

Fiduciaries are responsible for regularly monitoring the plan investments. The plan sponsor and other fiduciaries should meet at least annually to review the investment line-up. An investment policy statement provides a framework for evaluating investment options on an ongoing basis. The monitoring process helps to ensure that any adverse changes to the investment manager's organization, investment process, or performance results are identified and responded to in a timely manner.

Many full-service retirement plan providers will assist fiduciaries in meeting these requirements, but in general, an annual review of the plan's investments should include at least the following:

- **Review the plan's investment options**

Evaluate each investment option against the original selection criteria to ensure that it continues to meet the objectives of the plan. Is the investment option still consistent with the investment style or asset class that it was intended to fill?

- **Evaluate performance**

Compare each option's historical performance, excess returns, and risks relative to its peer universe and passive index over the long-term. How does performance compare with overall market conditions and the investment's peer group during specific time periods?

- **Investment strategy**

It's important to continually evaluate qualitative elements of an investment manager's process, for example: A clearly identified strategy, disciplined buy/sell decisions, systematic portfolio construction, and adequate risk controls.

These factors can help determine an investment manager's ability to add value in the future.

- **Review investment expenses**

Evaluate fees relative to a defined peer group and other alternatives, such as proprietary and non-proprietary products. Do the fee levels continue to comply with the fee criteria in the investment policy statement? Have expenses increased recently? Was the increase justified?

- **Evaluate the investment manager's qualifications**

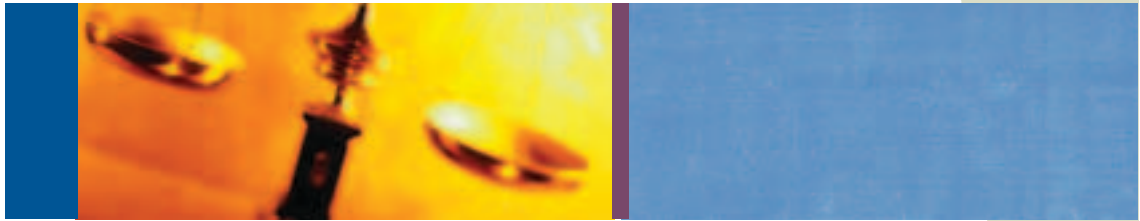
Has there been a loss of key investment personnel or a change in the investment manager's ownership structure? Have there been any changes to the investment management organization? Does the management firm still offer sound capital structure, capable leadership, a strong industry reputation, a good regulatory record, and experienced and talented staff?

If any of the investment options fail to meet the standards in a plan's investment policy statement, it may be necessary to conduct an in-depth review.

DOCUMENT, DOCUMENT, DOCUMENT

Documenting the investment review—including any changes or actions to be taken—in a due diligence file demonstrates compliance with ERISA rules. The file should include the materials and data reviewed by the fiduciaries, including any reports from the plan's service providers. It should also include minutes or a memo of the conclusions reached at the meeting, including any needed follow up.

Education versus Advice



Effective participant communication is integral to the success of any retirement plan, no matter what the type of plan or the size of the employer. For participant-directed plans (like a 401(k) or 403(b) plan), helping participants understand the importance of planning for retirement, the benefits of the plan, and the different investment options usually leads to increased plan participation, higher contribution amounts and better invested accounts.

If a participant-directed plan complies with ERISA Section 404(c), the fiduciaries can reduce their exposure to liability. In general, Section 404(c) states that if participants are provided with sufficient information to make informed investment decisions, and if they actually control their investments, the fiduciaries will not be legally responsible for the participants' investment decisions. See page 28 for additional information on 404(c).

Providing specific investment recommendations to plan participants constitutes investment advice.

WHAT IS INVESTMENT EDUCATION?

Discussions related to the benefit of plan participation, basic financial planning strategies, retirement income calculators, and the impact of asset allocation on retirement investing is considered education — as opposed to advice — by the Department of Labor. While a provider of investment education must be prudently selected and monitored by the plan fiduciaries, the provider is not an ERISA fiduciary.

WHY CONSIDER PROVIDING INVESTMENT ADVICE?

In recent years, participants have asked for more help with their investment decisions. While investment education points the way, it does not give answers to participant questions about investing specific amounts in options. Providing investment advice through a third-party registered investment advisor may help participants make more informed and productive investment decisions. And, if participants are better informed, the fiduciaries have taken a big step towards fulfilling their responsibilities and thereby managing their risks. Of course, the fiduciaries must prudently select the advisor and monitor its performance on an ongoing basis.



Manage a plan prudently

Prudently managing a retirement program is an important fiduciary duty. As mentioned earlier, fiduciaries must act in the best interest of the plan and its participants, make decisions for the exclusive purpose of providing retirement benefits, and avoid using plan assets for their own benefit.



CONTRIBUTING TIMELY

CONTRIBUTIONS AND LOAN PAYMENTS

ERISA and Department of Labor guidelines require that elective deferrals, voluntary contributions, and participant loan payments be promptly paid to the plan (that is, deposited into the annuity contract or trust). Specifically, these amounts must be deposited on the earliest date on which the money can be reasonably segregated from the plan sponsor's accounts. At a maximum, this cannot be later than the 15th business day of the month following the month in which the amounts were withheld from the participants' paychecks. However, in almost all cases the plan sponsor is required to deposit the money much earlier. That is because it usually requires only a few days to calculate the amounts and to deposit them into the plan. As a rough rule of thumb (in order to avoid trouble) some commentators suggest plan sponsors should put the money in the plan no later than a week after withholding.

CHANGING INVESTMENT OPTIONS

If an investment consistently underperforms its peer group over a period of three to five years, the fiduciaries should consider removing and replacing the option.

If a plan sponsor elects to replace an existing investment with a new option, the process

should be documented. The documentation should explain the reasons for the removal and the rationale for the replacement. Those records should be kept for at least six years. It is important that the plan sponsor communicate the changes to the participants on a timely basis.

MAPPING FROM ONE INVESTMENT OPTION TO ANOTHER

A common method used to move plan assets from one service provider to another is referred to as mapping. Mapping matches the previous provider's investments with similar options offered by the new provider. This process allows the money in the plan to be continuously invested while moving directly from one provider to another. A plan sponsor can also use mapping to replace an investment with a new option. In mapping, it is important to properly evaluate the new investments to ensure they are similar to the previous options. The plan sponsor should communicate material information about the mapping of the investments, and the new options, to participants as soon as possible. In fact, in certain circumstances you are required to provide notices to participants when the investments are changed (blackout periods).



SELECTING INVESTMENT DEFAULT OPTIONS

Participant-directed plans, such as 401(k) and 403(b) plans, may provide for a default investment option. That is, the fiduciaries may want to choose an investment for participants who do not direct the investment of the money in their accounts. This is common for plans that use “automatic enrollment.” In those plans, all employees are automatically included in the plan and defer from their paychecks at a pre-determined rate — unless they elect a different rate or elect not to defer. Some plans use automatic enrollment as a way to help their employees save, improve participation rates, and increase the deferral percentage of non-highly compensated employees.

Since 404(c) protection only applies where a participant has given an investment direction, fiduciaries remain responsible for the default investments. Plans often utilize a conservative option such as a stable value or money market investment. However, as part of a

fiduciary’s responsibility to act “prudently,” there is a trend to default retirement plan contributions into a well-diversified balanced vehicle or to a lifestyle option based on a participant’s age.

ALLOCATING PLAN EXPENSES

A plan may, as a general rule, pay the expenses for operating and investing the plan. These expenses include administration fees, reporting costs, fees for maintaining tax qualification, and investment expenses. Of course, the plan documents must allow for the payment of these expenses. Costs associated with designing or deciding to terminate a plan cannot be paid from plan assets. On the other hand, fees related to participant transactions, such as loans or withdrawals, or expenses associated with self-directed brokerage accounts, may be charged to participant’s accounts, provided they are reasonable.

It's recommended that fiduciaries evaluate plan expenses annually, at a minimum.



MONITORING AND EVALUATING PLAN EXPENSES

Fiduciaries are responsible for ensuring that the costs of operating the plan are reasonable compared to the value being received. Excessive fees can significantly reduce the value of participants' balances over time. The expenses must be evaluated periodically. It is recommended that fiduciaries evaluate plan costs annually, at a minimum, to ensure that they remain appropriate and reasonable compared to the needs of the plan and to the costs in the marketplace. Plan sponsors should document the review process in their due diligence file.

PLAN ADMINISTRATOR DUTIES

Plan administrators should be familiar with the plan's provisions and operations. As a result, a plan administrator should review the plan's operation at least annually. This list offers suggestions on important items to review:

- Employee eligibility and enrollment
- Recordkeeping, including allocations and investment instructions
- Participant and employer contributions, including their timely deposit
- Vesting of employer contributions
- Withdrawals and distributions
- Participant loans and hardship withdrawals
- Annual reporting and compliance testing
- Participant communications and investment education



Compliance considerations



ERISA's exclusive benefit rule requires that fiduciaries act in the interest of the plan and its participants. As a result, persons with certain relationships to a plan are prohibited from engaging in transactions with the plan, unless they can satisfy an exception to the general rule. These persons are known as "parties in interest" and include (but are not limited to) the company and its owners, officers and directors, as well as the plan's fiduciaries and service providers.

The transactions prohibited between these parties in interest and the plan include, but are not limited to:

- Selling, exchanging or leasing property
- Extending credit (i.e., making loans)
- Providing goods, services or facilities
- Transferring or using plan assets for the benefit of the party in interest

Additionally, fiduciaries cannot:

- Use the plan's assets for their own benefit
- Act on behalf of someone whose interests are adverse to the plan or its participants
- Receive money from anyone dealing with the plan's assets

Fiduciaries may be personally liable for losses to the plan that result from prohibited transactions.

The prohibited transaction rules are complicated and the consequences are severe.

For information as to whether a particular transaction is prohibited by ERISA, plan sponsors and fiduciaries should consult an ERISA attorney.

PLAN TESTING

In order to have the tax advantages offered by the IRC, a plan must maintain its qualified status. To do so, certain tests must be performed and satisfied. These tests may include:

- Average Deferral Percentage (ADP) Test (for 401(k) plans)
- Average Contribution Percentage (ACP) Test (for plans with employee or matching contributions)
- Discrimination Testing Under IRC Section 401(a)(4)
- IRC Section 410(b) Coverage Test
- Top-heavy Determination
- IRC Section 415(c) Annual Additions Limitation (for defined contribution plans)
- IRC Section 409(p) requires special testing for ESOPs with S Corporation status

COMMON CONTROL GROUPS

Employers that are under common control are treated as a single entity for qualified plan purposes. Organizations are considered to be under common control if there is sufficient overlapping ownership. This rule applies to trades and businesses, including corporations, partnerships, sole proprietorships, joint ventures, associations and limited liability companies.

There are three basic types of controlled groups:

Parent-subsidiary group – an organization owns 80% or more of its subsidiary

Brother-sister group – five or fewer individuals, estates or trusts own 80% or

more of two organizations and own over 50% of those organizations, to the extent the ownership interests are identical

Combined group – this is a combination of parent-subsidiary and brother-sister relationships

In addition, the IRC treats certain affiliated employers in the service business as if they were a single plan sponsor for purposes of satisfying the tax qualification rules.

The IRC has complex rules to determine common control. For further guidance on these issues, plan sponsors should seek the advice of counsel.

Plan reporting requirements

Plan sponsors are responsible for providing the information described below. Included in this chart are documents that are required upon the occurrence of certain events. (This list is not exhaustive. See your service provider or advisor for more details.)

To Participants	To the Internal Revenue Service (IRS)	To the Department of Labor (DOL)	To the Pension Benefit Guaranty Corporation (PBGC)*
Summary plan description (SPD)	Determination letter requests (if applicable)	Annual reports (Form 5500)	Annual reports (Form 5500)
Summary of material plan changes (updates to SPD)	Annual reports (Form 5500)	Summary plan description, if requested	PBGC premiums
Summary of most recent annual report (Form 5500)	Merger, consolidation or transfer of assets or liabilities (Form 5310)*	Summary of material plan changes (updates to SPD)	Notice of a reportable event that impacts the plan or participant benefits
Benefits statements to certain separated employees		Copies of any plan documents and trust agreements, if requested	Notice of Intent to Terminate
Explanation of distribution options and notice of tax treatment and rollover distributions			
Notice of failure to meet minimum funding requirements			
Written explanation of a denial of claim for plan benefits			
Notice regarding black-out period (for participant-directed plans)			

*For defined benefit pension plans



The following information must be provided to participants or their beneficiaries if requested:

- A complete copy of the plan's most recent annual report (Form 5500)
- A copy of plan documents
- An updated summary plan description
- Statement of participants' benefits (once during a 12-month period)
- Any bargaining agreement, trust agreement, contract, or other instrument under which the plan is established or operated.

The plan sponsor may charge a reasonable amount for copying costs.

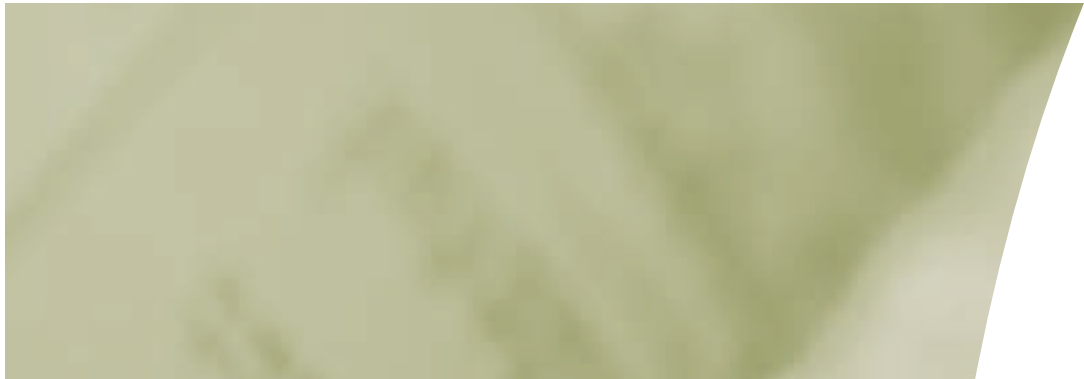
FIDUCIARY BONDING REQUIREMENTS

ERISA requires that all fiduciaries and every person that handles plan money be bonded. There are exceptions for governmental plans and for church plans not electing to be subject to certain provisions of ERISA. Fiduciary bonds are intended to cover losses due to fraud, theft, or embezzlement. The bond must cover 10% of the total assets during the

preceding plan year. The minimum required bond is \$1,000, and the maximum is \$500,000, except in certain limited circumstances. To determine the amount, refer to the Annual Report, Form 5500, from the previous year. For new plans, the amount can be estimated, and the bond should be secured when the plan is established.

FIDUCIARY LIABILITY INSURANCE

Fiduciary liability insurance protects a plan and its fiduciaries from losses due to fiduciary breaches of duties for plan investment or operation. This insurance typically covers the plan, trustees, and the fiduciaries. Fiduciary liability insurance is optional and not required by ERISA. While plan assets can be used to pay the premium for covering the plan, the additional premium cost of protecting the fiduciaries must be paid by them or by the plan sponsor.



Managing Fiduciary Responsibility



ERISA was enacted to promote secure retirement benefits for participants and to help protect their interests in retirement plans. Acting in the best interest of participants, making careful and prudent decisions, following the terms of the plan documents, and diversifying plan assets are critical to satisfying ERISA's standards — and managing fiduciary responsibilities.

COMMON FIDUCIARY BREACHES

Examples of situations where a fiduciary may breach ERISA's duties include:

- Failure to offer a diverse choice of well-selected investment options
- Failure to prudently monitor the plan's investment options and to eliminate any investments that do not satisfy the plan's investment policy
- Failure to deposit participant deferrals and loan payments into the plan on time
- Failure to provide proper notification for blackout periods
- Failure to avoid conflicts of interest or potential conflicts of interest
- Distributing misleading information about benefits or investments
- Use of plan assets by a fiduciary for personal or company benefit
- Failure to follow the terms of the plan document

PENALTIES FOR NON-COMPLIANCE

Fiduciaries are personally liable for not following ERISA's fiduciary requirements or for engaging in prohibited transactions. Consequences include:

- Payment of any losses to the plan
- Surrender of any profits made by the fiduciary
- Department of Labor (DOL) penalties on amounts recovered for the plan
- Penalties for failure to accurately disclose information to participants
- Penalties for failure to properly report to the government
- Payment of legal fees and excise taxes
- Lawsuit by participants and others
- Criminal penalties of up to \$100,000 for individual fiduciaries and (\$500,000 for corporations) and up to 10 years in prison

If a plan meets the 404(c) requirements, a fiduciary will not be liable for investment losses attributable to a participant's investment decisions.



THE VOLUNTARY FIDUCIARY CORRECTION PROGRAM

The Voluntary Fiduciary Correction Program allows fiduciaries to voluntarily correct breaches and prohibited transactions and thereby avoid civil actions and penalties. It is only available if the plan is not under investigation by the DOL. The IRS also has a self-correction program for defects in the operation or documentation of plans.

DELEGATING RESPONSIBILITIES

A fiduciary should always:

1. Use reasonable and informed judgment when selecting a co-fiduciary or appointing other fiduciaries.
2. Evaluate and monitor the ongoing performance of all fiduciaries and other providers.
3. Maintain a due diligence file documenting the information reviewed and the decisions made.

It is permissible to delegate both fiduciary and administrative duties to others. Doing so does not relieve the fiduciary of ultimate responsibility, but it can help plan sponsors and their officers better manage their fiduciary risks.

Plan sponsors must prudently select and monitor the fiduciaries and others (e.g., advisors, consultants, attorneys) who they appoint.

MEETING FIDUCIARY OBLIGATIONS – ERISA SECTION 404(C)

Under ERISA, plans can allow participants to take control of their investments. ERISA Section 404(c) permits plan sponsors and fiduciaries to transfer legal responsibility for those decisions to the participants—if the detailed requirements of 404(c) and its regulation are satisfied. However, complying with 404(c) is optional. Unfortunately, many plans fail to satisfy those requirements and unnecessarily expose their officers to fiduciary liability. If a plan meets the 404(c) requirements, a fiduciary will not be liable for investment losses attributable to a participant's investment decisions. In the following pages, we'll explore in detail what this means and offer guidance about how to take advantage of the protection offered by 404(c).

Taking Advantage of ERISA Section 404(c) Protection

Section 404(c) protection is only available for plans that permit participants to direct the investments. If a participant actually directs the investments, and if the plan provides the participant with appropriate investment options, the plan document provides participants with a reasonable opportunity to give investment instructions (and to obtain written confirmation of those instructions) and certain information. The participant will be legally responsible for his or her investment decisions. However, if those requirements are not met, the fiduciaries remain responsible. To qualify for 404(c) relief, there are a number of requirements that must be met, including:

1. Offer a broad range of diversified investment options

A plan will meet 404(c) guidelines if participants can choose from at least three diversified investment alternatives, each of which offers significantly different risk and return characteristics. In the aggregate, the investments offered should enable the participant to achieve a portfolio with appropriate risk-and-return characteristics. The investment options should tend to

minimize through diversification the overall risk of the participant's portfolio. These investment options are commonly referred to as "core" investments.

2. Allow participants to transfer among investment options

Participants must be able to transfer between investments at least quarterly, or within a timeframe deemed appropriate based on the market volatility of the investments that are offered. The more volatile an investment option, the greater the need for more frequent transfers to enable participants to maintain appropriate control over their account. With today's investment products, like mutual funds, these requirements are usually easily satisfied, with trading permitted on any day in which the major securities markets are open.



3. Provide participants with adequate information about their investment options

404(c) requires that each participant receive the following information:

- An explanation that the plan intends to comply with the 404(c) requirements and that, as a result, the plan fiduciary may be relieved of liability for losses resulting from investment directions of the participants
- A description of the plan's investment options, including a general description of the investment objectives and risk and return characteristics of each investment option
- Identification of any investment managers for the plan
- An explanation of how participants can give investment instructions, including an explanation of any limits or restrictions on making purchases or sales in their account
- A description of any transaction or other expenses charged to participants' accounts
- A description of additional information that must be provided to participants upon request and the contact information of the individual responsible for providing that information
- For registered investments (like mutual funds) a copy of the most recent prospectus provided to the plan. The

prospectus must be given to a participant immediately preceding or following the participant's initial investment in an option

Additional information that must be provided to participants upon request (or can be provided automatically by the plan sponsor):

- A description of the annual operating expenses of each investment option
- Copies of any prospectuses, financial statements, reports, and other information relating to an investment alternative received by the plan
- A list of the securities and value of each asset held by each investment option that constitutes plan assets
- Past and current investment performance of the various investment options offered and information about the value of shares in the investment options
- Information about the value of shares in the investment options in the participant's account

Note that there are additional requirements for plans offering employer stock or fixed rate investment contracts and plans that pass through voting rights.

Putting it all together



Managing fiduciary responsibility is no easy task. But, remember there are many resources available, including financial advisors, attorneys, accountants, and others who can help. We encourage the use of these individuals or firms for help meeting ERISA's fiduciary obligations.

FIDUCIARY STEPS

Follow these steps for complying with the fiduciary responsibility requirements:

- Maintain an updated plan
- Appoint and monitor capable plan fiduciaries
- Conduct an annual retirement plan meeting to review plan investments, expenses and operations
- Collect and review the information; document decisions
- Maintain an investment policy statement that outlines the criteria for investment decisions
- Offer participants a well-diversified menu of prudently selected investment options
- Comply with ERISA Section 404(c) if your plan is participant-directed
- Ensure that participant deferrals and loan payments are deposited in a timely manner
- Conduct annual plan testing
- File annual reports with the government agencies

- Follow the provisions of the plan
- Act in the best interest of the plan and its participants

DEDICATED TO HELPING FIDUCIARY PLAN SPONSORS MANAGE THEIR DUTIES

At The Principal, we are committed to helping plan sponsors take control of their fiduciary obligations. For more than 60 years, we have provided industry-leading, bundled investment and recordkeeping services — experience that makes us uniquely qualified to help individuals navigate ERISA and manage the many details that come with fiduciary responsibility. We offer comprehensive ERISA guidance, a broad range of quality investment options, and the support needed to design and construct a winning retirement plan program. To learn more about the benefits of working with The Principal, please refer to the supplement, *How The Principal Can Help*.

“Equipped with this information, you will be on your way to better understanding your responsibilities and, therefore, to helping your organization, your employees, and yourself.”

— Fred Reish

*Our goal is to help plan sponsors successfully
manage their fiduciary obligations.*

WE UNDERSTAND WHAT YOU'RE WORKING FOR®



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This document is intended solely for information and education. Consult your financial advisor for advice about your situation.