



Investment Selection and Fiduciary Responsibility

How Much do Employers Really Understand

RETIREMENT - INSURANCE - INVESTMENTS



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Defining a Plan Fiduciary

In brief, under ERISA Section 3(21), a Plan Fiduciary is a person who:

- Exercises any discretionary authority over a plan or its assets; or
- Renders **investment advice** for a fee or other compensation; or
- Has discretionary authority over the administration of a plan.



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Who is a Fiduciary

Named Fiduciary

- Named in the plan documents
- Plan board of trustees or board of directors
- Usually the “Plan Administrator” at the company (not the TPA)

Other Fiduciaries

- Anyone exercising discretion for:
 - Plan management
 - Plan assets
 - Plan administration
- Rendering investment advice for a fee
- Can be:
 - Employer (when communicating about the plan)
 - Service provider (exercising discretion, giving investment advice)



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Service Providers

- Interpretive Bulletin 75-5: attorneys, accountants, actuaries, brokers and consultants generally are not fiduciaries
 - When “performing their usual professional functions”
 - Many cases show how they can take on duties for the plan that cause them to become fiduciaries.
- Interpretive Bulletin 75-8: purely ministerial functions with no discretion; no fiduciary status



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Six Basic ERISA Duties of a Fiduciary

- Act “solely in the interest of the participants and beneficiaries;”
- Act for the “exclusive purpose” of providing benefits and paying the “reasonable expenses” of the plan;
- Conduct the duties “with the care, skill, prudence, and diligence” of a **knowledgeable** plan Fiduciary;
- Diversify plan investments, unless clearly imprudent to do so;
- Avoid engaging in prohibited transactions; and
- Comply with the provisions of the plan, unless the plan conflicts with the law.



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Individuals/Entities who are Always Fiduciaries

- Plan Administrator at the company
- Trustee
- Investment Advisor
- Named Fiduciaries, often an Employer (or committee of the Employer) or Employee Organization



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Investment Advice

ERISA Section 3(21)(A)(ii) provides that a person is a Fiduciary for a plan if he or she provides investment advice for a fee.



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Common Misconceptions

Misconception #1

- “Arm’s length” transactions are sufficient

Fact:

- Plan and participant’s interests **must take precedence**

Misconception #2

- Good intentions are enough

Fact:

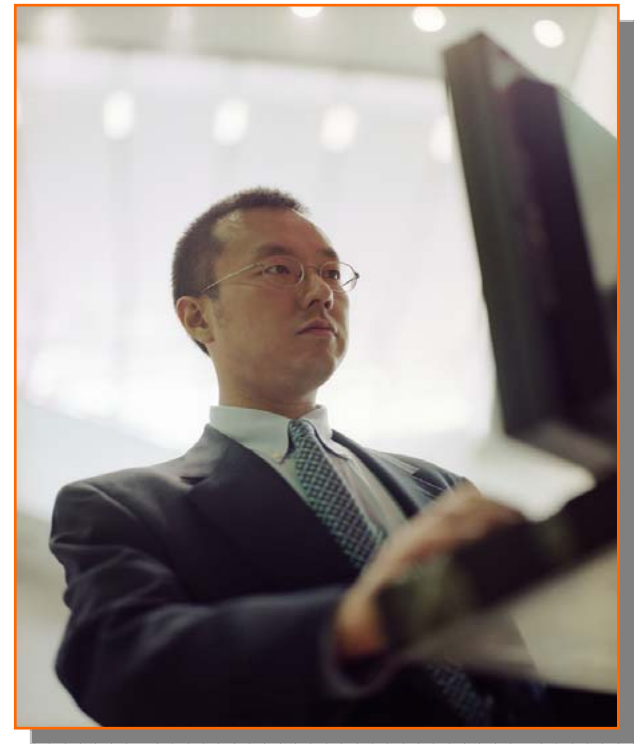
- ERISA requires a **knowledgeable** Fiduciary **familiar with the “enterprise”** of the plan



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Limiting Fiduciary Liability

- Comply with ERISA Section 404(c)
- Hire quality service providers to assist in monitoring plan activities
- Carefully monitor plan activities, particularly investment options and performance
- Purchase fiduciary insurance
- Contract with an objective third party



Fiduciary Checklist Questions

- | | | | |
|----|---|------------------------------|-----------------------------|
| 1. | Access to proprietary (including subadvised) and third-party funds? | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 2. | An investment platform that doesn't require proprietary funds to get plan-level fiduciary protection? | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 3. | A signed contract assuming plan fiduciary responsibility as defined by §3(21)(A)(ii)? | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 4. | Access to fiduciary liability services without having to exhaust other forms of protection first? | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 5. | Active, ongoing reviews of funds selected by the plan? | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 6. | Unbiased, professional education about the plan that allows participants to make informed investment decisions? | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 7. | Professionally drafted Investment Policy Statements customized by plan demographics? | <input type="checkbox"/> Yes | <input type="checkbox"/> No |



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Complying with ERISA Section 404(c)

In brief, to comply with ERISA Section 404(c), participants must be:

- Able to choose from a broad range of investment alternatives consisting of at least three diversified investment categories, each of which is characterized by materially different risk and return factors,
- Able to give investment instruction as frequently as the market volatility of the particular investment alternative dictates (but in any event, not less frequently than quarterly), and
- Be provided with sufficient information to make informed investment decisions.



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Complying with ERISA Section 404(c)

EXAMPLE: ABC Profit Sharing Plan offers three investment alternatives to plan participants and beneficiaries.

- Option 1: Diversified Stock Fund
- Option 2: AAA Bond Fund
- Option 3: BAA Bond Fund

QUESTION: *Does this satisfy ERISA Section 404(c)?*

Answer: Probably not. If the two bond funds are expected to perform in a similar manner, this plan has not offered three sufficiently diverse investments. Providing an investment which simply varies in its rating rather than in material risk and return capabilities likely fails to meet the ERISA Sec. 404(c) standard.



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Complying with ERISA Section 404(c) (cont.)

ERISA Section 404(c) regulations only apply to self-directed defined contribution plans:

- Plans need not comply with 404(c)
- Often help from service providers is required to remain in compliance
- Compliance only insulates the fiduciaries from poor investment decisions made by participants and beneficiaries
- Fiduciaries are still liable for selecting funds, monitoring investments, and general fiduciary duties under ERISA



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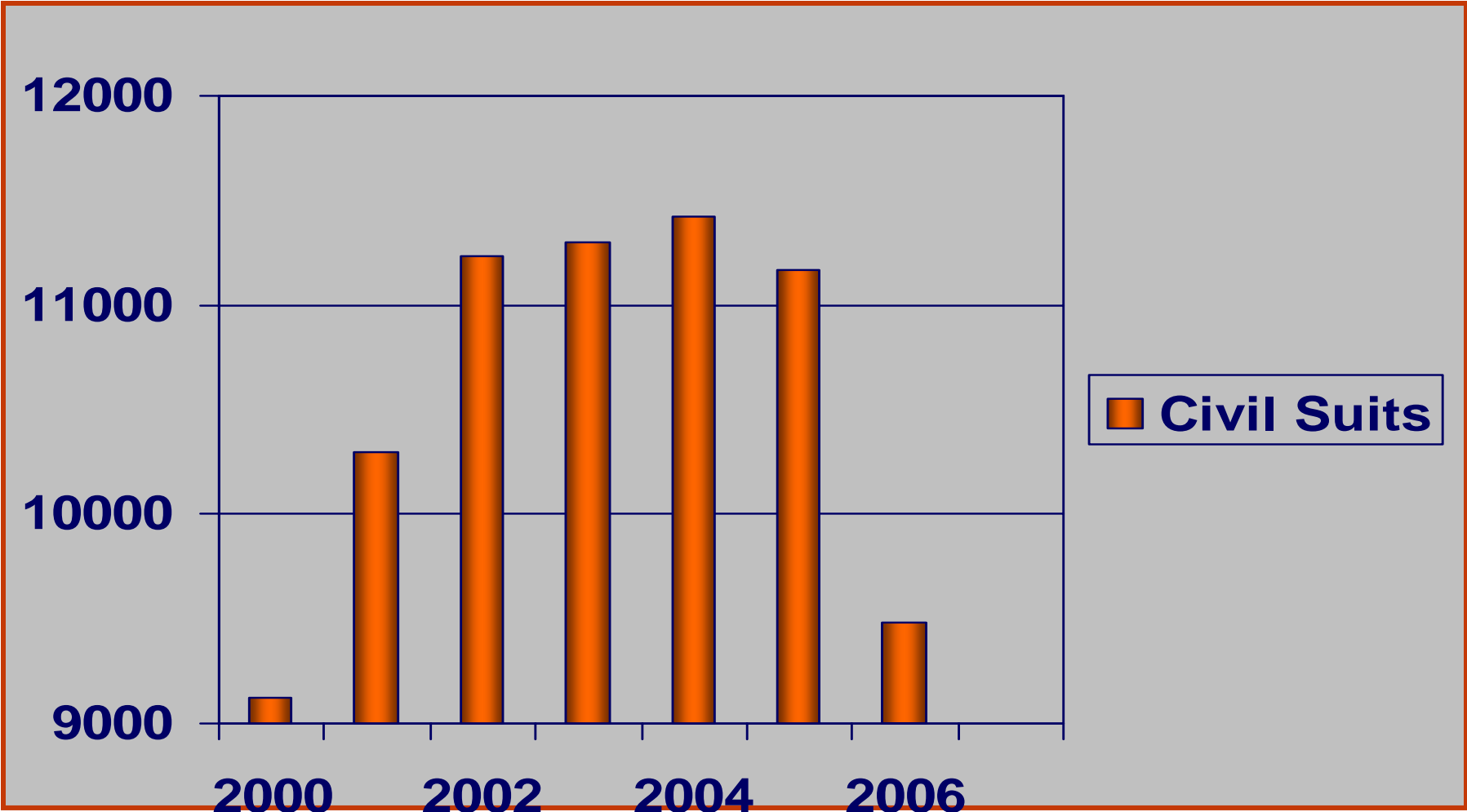
Complying with ERISA Section 404(c) (cont.)

Other Common 404(c) Compliance Pitfalls Include failing to:

- provide prospectus information to plan participants each year
- provide information on fees that are part of the investment products
- appoint an independent Fiduciary and creating a proxy voting procedure when company stock is in the plan
- notify participants that the plan is designed to comply with 404(c)



ERISA Civil Suits



Source: Administrative Office of the U.S. Courts Table C-2A (September 30, 2006 and 2002 Annual Report)



Department of Labor Investigations

	2003	2004	2005	2006	2007
Civil Cases Closed	4,253	4,399	3,782	3,411	3,236
Civil Cases with Results	2,939	3,056	2,862	2,534	2,402
Criminal Cases Closed	175	152	196	221	188
Indictments	137	121	106	106	115
Funds Restored to Plans (in millions)	\$275	\$323	\$709	\$829	\$642

Source: Employee Benefit Security Administration, U.S. Department of Labor, 2008



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Fiduciary Protection for Default Investment Alternatives

- Historically, 404(c) protection only available *following* participant direction of investment
- PPA created new ERISA Sec. 404(c)(5) for certain “Qualified Default Investment Alternatives” or QDIAs



Six Conditions for QDIA Fiduciary Relief

1. Investment in QDIA
2. Participant failure to direct
3. Notice requirements (initial and annual)
4. Pass-through disclosure requirements
5. Transfers out must be permitted with no restrictions or fees
6. Access to broad range of investment alternatives



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Definition of QDIA

- No employer securities (limited exceptions)
- Satisfies the six conditions for fiduciary relief
- Must be managed by one of three parties
 - *Must be managed by either an Investment manager or Trustee as defined under ERISA section 3(38), a Plan Sponsor who is a Named fiduciary of the plan, or a registered investment company.*
- Three basic categories
- Special carve outs for stable value/capital preservation



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Three Basic QDIA Alternatives

1. Life-Cycle/ Target-Retirement-Date

(i) An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. For purposes of this paragraph (e)(4)(i), asset allocation decisions for such products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a "life-cycle" or "targeted-retirement-date" fund or account.

2. Balanced

(ii) An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. For purposes of this paragraph (e)(4)(ii), asset allocation decisions for such products and portfolios are not required to take into account the age, risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a "balanced" fund.

3. Managed Account

(iii) An investment management service with respect to which a fiduciary, within the meaning of paragraph (e)(3)(i) of this section, applying generally accepted investment theories, allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios are diversified so as to minimize the risk of large losses and change their asset allocations and associated risk levels for an individual account over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. For purposes of this paragraph (e)(4)(iii), asset allocation decisions are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a service may be a "managed account."



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QDIA Provisions Regarding Stable Value/Capital Preservation

- Generally not a QDIA
- Special provisions
 - Grandfather-type rule for existing stable value default investments
 - Short-term use option (120 days) after a participant's first elective deferral is defaulted



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Anticipated Market Impact of New QDIA Regulations

- Accelerated adoption of automatic enrollment programs
- Significant shift in asset flows
- Window of business development opportunity as sponsors investigate/transition



Fiduciaries are Personally Liable

Fiduciaries are personally liable for losses and plan violations, even if they did not cause the violation, but knew that one exists or occurred.



Adding Value by Helping Employers Stay on the Straight and Narrow

You can significantly enhance your relationship with an employer by providing guidance and structure for fulfilling Plan Fiduciary duties. Specifically, you can:

- Understand duties of Plan Fiduciary and ramifications of non-compliance
- Identify vendors that can help the plan meet its fiduciary responsibilities
- Provide guidance on, or if you are the Investment Advisor, draft the Investment Policy Statement
- Provide plan with information necessary to carefully monitor and select investments
- Help plan create structured and documented process for explaining plan decisions



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What Employers Must Do as Plan Fiduciaries in a 401(k) Plan

- Monitor administrative services
- Comply with disclosure requirements (SPDs, plan documents, statements, Form 5500, etc.)
- Make timely plan contributions
- Monitor claims and appeals
- Oversee the investment of plan assets



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Common Misconceptions of Plan Fiduciaries

- Recordkeeper is responsible for monitoring whether I make timely contributions
- The recordkeeper provides all the documentation necessary
- My financial consultant is responsible for monitoring my investments
- We have well-known investments, so we have fulfilled our fiduciary duties



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The Role of the Investment Policy Statement (IPS)

- Sets goals and objectives
- Creates a process for monitoring investments
- Sets criteria for replacing investments
- The review process must tie to receiving reports necessary to conduct the review



KEY:

Must follow the IPS and do what it requires, or change it.
If you change it, document the reason why
in the minutes of the meeting.



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Contents of an IPS

The Profit Sharing/401(k) Council of America sample IPS contains the following sections:

- Part I. Plan Information and 404(c) Intention
- Part II. The Purpose of the Investment Policy Statement
- Part III. Investment Objectives
- Part IV. Roles and Responsibilities of Plan Providers
- Part V. Selection of Investments and Managers



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Contents of an IPS

- Part VI. Investment Monitoring and Reporting
- Part VII. Manager Termination
- Part VIII. Coordination with the Plan Document
- Part IX. Additional Provisions (such as company stock, participant education and communication)



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Selecting Initial Plan Investments

The IPS sets criteria for selecting initial plan investments. You should consider:

- The overall objectives of the plan for benefiting participants
- Selecting at least 3 core funds that satisfy the diversification rules of ERISA Section 404(c) (if applicable)
- Risk and return characteristics of funds offered in each asset class
- The ability to trade the funds as often as the plan (and, if applicable, ERISA Section 404(c)) requires
- The ability to obtain information necessary on each asset necessary to undertake a periodic review in accordance with the IPS
- The ability to report the expenses associated with plan investments



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Ongoing Monitoring of the IPS with Clients

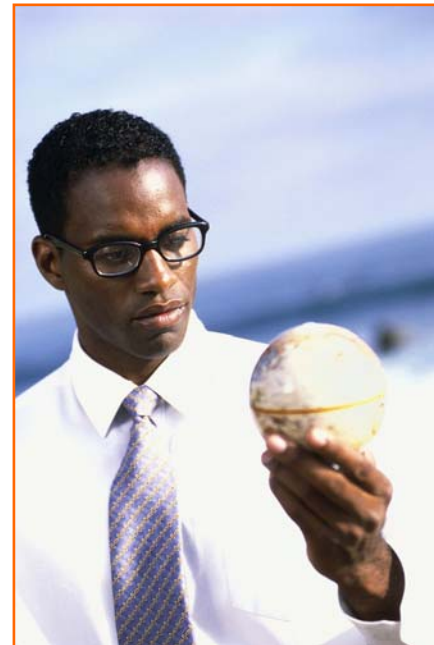
- Have a plan meeting at least annually to review the investments in accordance with the investment policy statement
- Provide an analytical report that provides the information required by the IPS to monitor plan investments
- Ensure that there are minutes and notes that emphasize the process
- Keep your eye on the ball – Plan Participants and Beneficiaries



The Investment Professional Perspective

Benefits include the following:

- Solidifying relationships with current clients and prospects
- Enhancing image as an expert



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