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DEFINED CONTRIBUTION PLAN ISSUES IN PENSION REFORM LEGISLATION: DIVERSIFICATION

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The pending pension reform legislation contains critical reforms of the rules relating to defined benefit plan funding, hybrid plans, and defined contribution plans. In response to suggestions from the Hill, the business groups listed above have assembled the following list of issues with respect to the provisions of the bills regarding diversification of employer stock investments and increase in the maximum bond amount. The list does not address fundamental policy issues. Instead, the list is intended to serve as a checklist of technical issues and other issues where input may be helpful.

Similar lists addressing other defined contribution plan issues have been or will be sent shortly.

Diversification. (section 104 of H.R. 1000 as it passed the House in 2003 and section 701 of the Senate bill):

a. There needs to be a broader securities law exception from the diversification rules. In order to be conservative and avoid potential violations, many companies impose restrictions on the sale of employer securities that are slightly broader than those technically required by the securities law. This should be permitted.
b. As under both bills, the U.S. Treasury (Treasury) should be given authority to exempt private companies with public affiliates. However, Treasury should be given a deadline for issuance of such exemptions. Also, Treasury should be required to consult with the Department of Labor (DOL), but the regulatory authority should not be given jointly to Treasury and DOL (which is how H.R. 1000 is structured). Joint regulatory authority can result in extensive delays.
c. Under both bills, if a non-public company goes public, the diversification rules would suddenly apply in full, which could cause problems. A natural solution would be to apply the same phase-in (five years under H.R. 1000; three years under the Senate bill) that applies when a plan first becomes subject to these rules.

d. The House bill provides a five-year transition rule with respect to all existing amounts held in employer securities, which is needed. The Senate bill provides only a three-year transition rule, and that transition rule does not apply to certain employees or to amounts attributable to employee contributions or elective deferrals. The Senate's more limited transitional rule would be problematic.
e. The Senate bill would amend ERISA section 204, dealing with benefit accrual requirements, rather than ERISA section 407, dealing with limitations on the acquisition and holding of employer securities. It is not clear how changes to section 204 would interact with current section 407. In general, ERISA section 407(b)(2) provides that the 10 percent limitation on the acquisition of employer securities applies separately to the portion of a defined contribution plan consisting of a participant's elective deferrals (and earnings thereon) if any portion of the participant's elective deferrals are required to be invested in employer securities. ERISA Sections 407(b)(2)(B)(ii)-(iv), however, provides for a series of exceptions to this general limitation, including where the amount of elective deferrals required to be invested in employer securities is not more than 1 percent of an employee's compensation. Since the Senate bill requires that employees be immediately eligible to diversify any investments of elective deferrals in employer securities, the restrictions in ERISA section 407(b) applicable to defined contribution plans are no longer necessary. Moreover, language in the Senate bill could be interpreted to conflict with the exceptions in ERISA section 407(b)(2)(B). Therefore, the limitation applicable to defined contribution plans in ERISA section 407(b)(2) should be eliminated.
f. The Senate bill prohibits "restrictions or conditions with respect to the investment of employer securities or real property which are not imposed on the investment of other assets of the plan." Currently, many plans are drafted to include a provision that the employer securities fund of the plan is designed to invest "primarily in employer securities" so that this portion of the plan can meet the requirements for an Employee Stock Ownership Plan (ESOP) for purposes of Code section 4975(e)(7) and the dividend deduction rules under Code section 404(k). Changes to the language should be made to ensure that mere restriction with respect to the design of a plan's stock fund is not subject to the bill's prohibitions. A possible approach would be to change "with respect to the investment of" to "on the investment decisions of applicable individuals with respect to" and "not imposed on the investment of other assets of the plan" to "not imposed on such investment decisions relating to other assets of the plan."
g. Both bills would apply to individual account plans without regard to whether they provide for participant investment direction.
    - These provisions could be particularly problematic for multiemployer plans. Many multiemployer defined contribution plans do not permit participant investment direction, but provide instead for a trustee to manage the assets and each participant to benefit from a proportionate share of the trust assets. The investments of the trust often include shares of publicly traded stock - - which could include securities of one or more participating employers - - and it makes little sense to give participants the right to diversify in this context. An exception from the diversification rules is needed for multiemployer plans that do not provide for participant investment direction.

- Regardless of whether the plans provide for participant investment direction, an exception is needed for indirect investment in employer securities that are held in diversified funds. "Diversified fund" in this context refers to diversified investment alternatives in the general sense such as broadly invested bank collective funds, managed accounts, and investment companies registered under the Investment Company Act of 1940. For example, if a company in the S&P 500 holds an S&P 500 index fund in its plan, diversification rights should not be triggered.

Increase in Maximum Bond Amount. (section 707 of the Senate bill):

This section of the bill requires an increase in the maximum fiduciary bond amount when the plan holds employer securities. Again, an exception is needed for indirect investment in employer securities that are held in diversified funds as described above. Even at the current law maximum amount of $500,000, service providers who are fiduciaries have found it very difficult to obtain the required bonds.