



October 31, 2006

**TECHNICAL CORRECTIONS AND REGULATORY ISSUES
WITH RESPECT TO THE EMPLOYER STOCK DIVERSIFICATION PROVISIONS
OF THE PENSION PROTECTION ACT OF 2006**

This document sets forth possible technical corrections and administrative issues with respect to the employer stock diversification provisions of the Pension Protection Act of 2006. The page and line references below are to the version of H.R. 4 that passed the House.¹

OVERALL: Pending the issuance of administrative guidance on the employer stock diversification provisions of the Act, employers should be permitted to rely on a reasonable good faith interpretation of the statutory provision. [Administrative guidance.]

NOTICE ISSUES

Page 463, lines 8-18; ERISA section 101(m).

(a) There are several issues regarding who is required to received the diversification notice. First, the notice requirement should not apply with respect to any participant who does not have any employer securities in his or her account and who does not have any right to invest in employer securities. (This could arise, for example, where an employer securities fund in a plan has been closed to new participants; the new participants should not be required to receive a notice.) Second, do notices have to be given to participants who do not have any employer securities in their accounts, but have the right to invest in employer securities? Literally, under the statute, the answer appears to be yes. Third, assume that the new diversification rules do not require any changes to a plan, *i.e.*, a plan was previously structured in a way that complies with the new rules and this structure was described in the applicable SPD's. In that case, a notice should not be required with respect to any participant who, as of the effective date of the new notice rule, had received the SPD. Clarification of these points would be helpful. [Administrative guidance.]

¹ Substantively, the enacted version is the same, but it does not have line numbers, so the House-passed version is used for convenience of reference.

(b) There needs to be an exception to the 30-day rule for situations where 30-day advance notice is not possible. For example, 30-day notice is not possible where (i) employees are immediately eligible to participate, or (ii) the beneficiary “inherits” the diversification rights upon the death of the participant. In such cases, notices should be treated as in compliance with the law if they are provided required within an administratively reasonable period after the commencement of employment or death, as applicable. For this purpose, if there is a reasonable delay attributable to difficulty finding a beneficiary, this should be taken into account in determining what is an “administratively reasonable period.” [Technical correction or administrative guidance.]

(c) Many plans will provide diversification rights at an earlier date than is required by the new diversification rule. In those cases, the notice rule does not apply to such earlier date, but rather only requires notice 30 days before the legally required diversification date. Thus, penalties should not apply unless the plan administrator fails to provide a notice by the date 30 days before the legally required diversification date. [Administrative guidance.]

(d) On a different point with respect to the same fact pattern, it should be clarified that if a plan administrator does provide a notice in connection with the earlier date when diversification rights are first given, there is no requirement for an additional notice to be provided later when the statutory rules take effect. [Administrative guidance.]

(e) It should be clarified that the notice can be provided as part of the SPD. [Administrative guidance.]

Page 463, lines 19-23; ERISA section 101(m). Electronic delivery of the notice should be permitted under the rules of Treasury Regulation section 1.401(a)-21. [Administrative guidance.]

Page 464, lines 8-18; bill section 507(d).

(a) The effective date should be coordinated with the issuance of the model notice, so that a notice is not required at least until 60 days after issuance of the model notice. The substantive diversification provisions should be similarly delayed. At a minimum, it should be clarified that no notice is required prior to the first day of the 2007 plan year, since that is the statutory effective date. [Technical correction or administrative guidance.]

(b) If the effective date is not coordinated with issuance of the model notice as described above, it would be helpful for the Department of Labor to announce that it will not use its authority under ERISA section 502(c)(7) to assess any penalties with

respect to a notice failure that occurs on or before the 60th day after the issuance of the model notice. [Administrative guidance.]

DIVERSIFICATION RULES

Page 667, line 21 through page 678, line 23, and page 687, line 24 through page 678, line 23; Code section 401(a)(35)(B)-(C) and ERISA section 204(j)(2)-(3). It needs to be clarified that this provision does not apply to diversified investment vehicles, such as collective trusts, where the underlying investments are treated as plan assets and include investments in employer securities. [Technical correction or administrative guidance.]

Page 678, lines 15-16, and page 688, lines 15-16; Code section 401(a)(35)(C)(i) and ERISA section 204(j)(3)(A).

(a) It needs to be clarified that a participant cannot have “completed at least three years of service” until the end of the third 12-month computation period. In other words, in the context of a plan that uses hours of service for measuring years of service, a participant who has completed two years of service and has 1,000 hours in the third year is not treated as eligible for diversification until the end of the third year. If employers were required to offer diversification rights as soon as an employee attained 1,000 hours in the third year, it would impose huge administrative burdens on employers. (If our suggested rule is adopted, an employee with three years of service who terminates employment before the end of the third year would become eligible for diversification rights at the end of the third year.) [Technical correction or administrative guidance.]

(b) The diversification rules refer to the vesting rules for purposes of defining a year of service. Does a plan have to measure a year of service for purposes of the diversification rule in the same manner that it does for vesting purposes? Or would be any measurement approach be permitted as long as it is permitted under the vesting rules? [Administrative guidance.]

(c) Assume that a participant completes three years of service during the 2007 plan year. Is the participant immediately eligible to diversify 1/3 of the employer securities that were acquired before the 2007 plan year and that are attributable to employer contributions? Or could the plan provide the right as of the first day of the next quarter? This issue also exists outside the context of the transition rule. [Administrative guidance.]

Page 678, lines 15-19 and page 688, lines 15-19; Code section 401(a)(35)(C) and ERISA section 204(j)(3).

(a) This language seems internally inconsistent. The first part of the language suggests that diversification rights only apply to beneficiaries of participants with three years of service. The second part of the language seems to indicate any beneficiary of any deceased participant would have diversification rights. This needs to be clarified. [Technical correction or administrative guidance.]

(b) Clarification is needed with respect to the treatment of alternate payees. [Administrative guidance.]

Page 679, lines 1-9, and page 689, lines 1-9; Code section 401(a)(35)(D)(i) and ERISA section 204(j)(4)(A).

(a) If a plan does not allow participants to direct investments at all, the new diversification rule should not apply, since the new rule is premised on participant direction. Also, if a plan, for example, offers two diversified options, the new rules should be treated as satisfied if the plan makes those two options available. The three-option rule should be interpreted as limited to plans that have at least three such diversified options that are otherwise available to participants.

A contrary rule would have disruptive and unintended consequences. For example, multiemployer defined contribution plans often do not permit participants to direct investments. The plan, as directed by the plan fiduciary, may invest in a diversified group of securities, including securities that are employer securities with respect to one or more participating employers. It is hard to imagine that the diversification rules were intended to apply to such plans.

An exemption could be limited to multiemployer plans in the circumstances described above. However, there is a need for a more generic rule with respect to plans that do not permit participants to direct investments. The rule described at the outset of the discussion - - making the diversification rule inapplicable to plans that do not permit participants to direct investments - - would address that need. Such a generic rule would apply to profit-sharing and stock bonus plans that are invested in employer stock and do not permit participant investment direction. Without such an exemption, such plans will likely have great difficulty complying with the new rules, since they do not have any system in place to allow participant direction of investment. [Technical correction or administrative guidance.]

(b) If the diversification rules apply to plans that do not otherwise permit participants to direct investments, it should be clarified that the first diversification option may be provided at the end of the first quarter of 2007 (*i.e.*, it is not required that the option be provided as of January 1, 2007). The general rule permitting quarterly diversification rights supports this approach. [Administrative guidance.]

Page 679, line 20 through page 680, line 4, and page 689, line 19 through page 690, line 1; Code section 401(a)(35)(D)(ii)(II) and ERISA section 204(j)(4)(B)(ii).

(a) It should be clarified that restrictions on investing (or reinvesting) in employer securities are not treated as prohibited restrictions, even if such restrictions are not imposed on other plan assets. The purpose of the legislation was to permit diversification, not to facilitate investment in employer securities. [Administrative guidance.]

(b) It is common for various plan investment options to have different trading restrictions, such as different rules regarding trade frequency. In such cases, how do we compare the restrictions on employer securities with the restrictions on “other assets of the plan”? The law should permit any reasonable restriction on employer securities as long as that restriction is imposed with respect to any plan investment that is available to the participant. [Administrative guidance.]

(c) This provision would not require that a plan eliminate reasonable fees imposed on other investments solely because no fees are imposed with respect to investments in employer securities. See the Joint Tax explanation at 223. [Administrative guidance.]

Page 680, lines 4-7, and page 690, lines 1-4; Code section 401(a)(35)(D)(ii)(II) and ERISA section 204(j)(4)(B)(ii).

(a) A restriction should be treated as “imposed by reason of the application of the securities laws” if there is a reasonable relationship between the restriction and the securities laws. The quoted phrase should not be interpreted to mean that the restriction is required by the securities laws. For example, it is not uncommon of companies to broadly prohibit trading of company stock prior to (and immediately after) the release of earnings. This prudent, prophylactic measure should not be prohibited by the legislation. [Administrative guidance.]

(b) Other restrictions imposed solely on certain top employees should also be permitted. For example, in certain contexts (such as a private company going public), certain top employees are often required to retain their company stock for a certain period of time. [Technical correction or administrative guidance.]

Page 680, line 14 through page 681, line 2, and page 690, lines 11-23; Code section 401(a)(35)(E)(ii) and ERISA section 204(j)(5)(B). Assume that a plan contains assets attributable to contributions subject to section 401(k) or (m) (which may or may not be part of an ESOP); assume further the plan also contains an ESOP attributable to nonelective employer contributions. It should be clarified that the latter part of the plan can be spun off and subsequently covered by this ESOP exemption. It should not matter whether the spinoff occurs before or after the effective date of the provision. In

the case of post-effective date spinoffs, the exemption would apply prospectively as of the date of the spinoff. [Administrative guidance.]

Page 682, line 19, through page 683, line 4, and page 691, lines 6-16; Code section 401(a)(35)(F)(i) and ERISA section 204(j)(5)(D)(i). In light of the very fast effective date, it is important that Treasury use its regulatory authority to provide that, pending the issuance of further guidance, the new diversification rule will not apply to employer securities that are not “publicly traded employer securities”. For example, a plan holding non-tradable stock could be subject to the diversification rule (if, for example, certain controlled group members have publicly traded stock). It is not at all clear how such a plan could come into compliance within the time provided. [Administrative guidance.]

Page 684, line 24 through page 685, line 3, and page 693, line 12-14; Code section 401(a)(35)(G)(iii) and ERISA section 204(j)(6)(C). Assume that a plan contains employer securities. In the context of a corporate transaction, a portion of the plan containing the employer securities is spun off to an unrelated company. Under ERISA section 407(d)(1), it appears that the securities do not retain their character as employer securities in the context of the new plan sponsor. [Administrative guidance.]

Page 685, line 21 through page 686, line 14, and page 694, lines 7-22; Code section 401(a)(35)(H)(i) and ERISA section 204(j)(7)(A).

(a) A similar phase-in is needed in the case of a private company that goes public or in other situations where the diversification rules suddenly apply to a plan that was previously exempt. [Technical correction.]

(b) Assume that as of 12/31/06 (in the case of calendar year plan), employer securities are held in a suspense account. Assume further that such securities are released during 2007 and/or 2008. Such securities should be treated as acquired before the effective date, so that the transition phase-in rule applies. [Administrative guidance.]

(c) Also, the transition phase-in rule should apply to employer securities contributed during the 2007 plan year but attributable to the 2006 plan year. [Administrative guidance.]

(d) Clarification is needed with respect to how the phase-in applies to beneficiaries and alternate payees. It should be made clear, for example, that such an individual’s qualification for the phase-in exception turns on the participant’s age and service as of 12/31/05. [Administrative guidance.]

Page 686, line 19 through page 687, line 4; bill section 901(a)(2)(A). Some plans complied with Code section 401(a)(28) by offering distribution options. Any such plans

that will now be subject to the new diversification rules appear to be permitted to eliminate such distribution options under bill section 1107 (absent Treasury guidance to the contrary). Confirmation of this would be helpful. Alternatively, elimination of the distribution options could be permitted under Code section 411(d)(6)(C) and ERISA section 204(g)(3). [Administrative guidance.]

Page 695, lines 8-11; bill section 901(c)(1). The statute does not specify a date during the 2007 plan year by which diversification rights must be provided. A plan should be treated as in compliance if, by the end of the 2007 plan year, participants have been given the required diversification rights. This reasonable interpretation of the statute would help address some of the difficult compliance issues raised by this very fast effective date. [Technical correction or administrative guidance.]

Page 695, line 12 through page 696, line 6; bill section 901(c)(2).

(a) Historically, “collective bargaining effective dates” have consistently applied to plans where participants covered by a collectively bargained agreement constitute at least 25% of the total number of plan participants. In addition, plans can be aggregated for purposes of this test if they have “essentially the same” benefits and contributions. See, e.g., House Conference Report for ERISA at 267 (referring to Ways and Means Report at 51-52); General Explanation of TEFRA at 290-91; IRS Notice 88-98; PLRs 9610025, 8618042. This 25% rule should apply for purposes of the effective dates of the provisions of the Act including this provision. [Administrative guidance.]

(b) The collective bargaining delay applies (1) if the plan is treated as collectively bargained (under the rule described above), and (2) with respect to “benefits pursuant to, and individuals covered by, any [collectively bargained] agreement”. Thus, if a union employee becomes a salaried employee, any of his or her benefits left in the collectively bargained plan would be “benefits pursuant to ... [a collective bargaining] agreement” and thus subject to the delay. In the reverse situation where a salaried employee becomes a union employee, any benefit left in the salaried plan would not be subject to the delay unless the salaried plan is treated as a collectively bargained plan under the rule described above. But if the benefit in the salaried plan is transferred to the collectively bargained plan, the delay would apply since the plan would be a collectively bargained plan (and the employee is an “individual covered by ... [a collectively bargained] agreement”. Confirmation of these points would be helpful. [Administrative guidance.]

(c) Consideration should be given to extending the collective bargaining delay for plans maintained pursuant to agreements that expire after 2008. [Technical correction.]