GROOM LAW GROUP

March 4, 2008

MEMORANDUM TO CLIENTS

RE: <u>Proposed IRS Regulations on PPA Diversification Requirements</u>

The Treasury Department and Internal Revenue Service ("Treasury") recently issued proposed regulations governing the ability of defined contribution plan participants to diversify the portion of their account balances that are invested in employer stock. 73 Fed. Reg. 421 (Jan. 3, 2008). As part of the Congressional response to a number of failed companies in which employees had held stock in 401(k) plans and ESOPs, the Pension Protection Act of 2006 ("PPA") created a new diversification right for participants in certain defined contribution plans.

Generally, Internal Revenue Code section 401(a)(35) provides as a qualification requirement that certain defined contribution plans allow participants who have accrued three years of service to divest their account balances of employer nonelective and matching contribution in publicly traded employer stock. Elective deferrals and other employee contributions which are made in the form of publicly traded employer securities are immediately subject to the divestiture right. A plan must offer participants at least three different investment options for their divested account balance. Permissible investment alternatives cannot be employer securities, must be diversified and must have materially different risk and return characteristics. Investments that satisfy the requirements for a "broad range of investment alternatives" under the DOL rules for "404(c) plans" are treated as satisfying these requirements.

A plan will be treated as holding a publicly traded employer security if any employer maintaining the plan, or any member of a plan sponsor's controlled group (determined by a 50 percent ownership interest), has issued a class of stock that is publicly traded. Even if a member of a plan sponsor's controlled group (as modified) has issued a publicly traded security, the plan will not be subject to the diversification requirement if none of the employers maintaining the plan or their parent companies have issued a publicly traded security. In addition, the diversification provision does not apply to (i) "stand-alone" ESOPs (which do not contain a 401(k) or matching feature) that are considered a separate plan under Code section 414(l), or (ii) defined contribution plans that only cover one participant who fully owns the plan sponsors or partners who own the plan sponsor.

In December 2006, the IRS issued its initial interpretation of this PPA diversification requirement in Notice 2006-107 (the "Notice"). The Notice also contains a model notice that can be used to satisfy the participant notice requirement contained in ERISA section 101(m), which requires that participants be provided notice of their right to diversify the employer stock held in their account at least 30 days before they can first exercise such right.

GROOM LAW GROUP, CHARTERED
1701 Pennsylvania Ave., N.W. • Washington, D.C. 20006-5811
202-857-0620 • Fax: 202-659-4503 • www.groom.com

The proposed regulations are generally consistent with the provisions contained in Notice 2006-107 with some modifications, described below. IRS has requested comments on the proposed rules by April 2.

- **Employer Stock Held in Pooled Investment Vehicles.** Following PPA's enactment, many practitioners were concerned that merely offering a mutual fund that held employer stock as an investment option would trigger the diversification requirement. The Notice provided that employer stock solely held in mutual funds and similar pooled investment vehicles that are (i) regulated by a federal or state agency, (ii) subject to stated investment objectives, and (iii) independent of the employer, will not trigger the participant diversification rights. These pooled investment vehicles have to be sufficiently diversified to minimize the risk of a large loss. The proposed regulations extend and clarify this exception to expressly include the following types of "investment funds:" (i) pooled investment vehicles maintained by an insurance company regulated by a state, (ii) a common or collective trust fund maintained by a bank or trust company that is supervised by a state or federal agency, and (iii) any other investment fund designated by the IRS. The proposed regulations also require that the investment fund must be sufficiently diversified so as to be considered independent of the employer. For this purpose, the proposed regulations provide that if the percentage of employer stock held by the investment fund does not exceed 10%, then the trust or fund will be considered to be sufficiently independent of the employer for this requirement.

- **Permissible Restrictions.** The requirements contained in Code section 401(a)(35) prevent a plan sponsor from placing additional restrictions on the investment in employer securities that do not apply to other plan investment options. This rule has raised many questions as plans have tried to work out how to apply it in practice, and the IRS has interpreted it very broadly. The statute provides that restrictions imposed on account of securities laws will not violate this rule. The Notice permits a plan to restrict the extent to which participant can invest in employer stock (the Notice uses a 10% limit as an example). In addition, a plan can close ("freeze") the plan to prohibit any further employer stock investment and can impose fees on other investment options that are not associated with employer stock. However, the Notice provides that a plan cannot restrict participants from reinvesting in employer stock for a specific period of time following a participant's divestiture of employer stock. The proposed regulations generally adopt these provisions with the following clarifications.

    - **Stable Value Exception.** The Notice provided that an employer could place restrictions on employer stock investments that do not apply to stable value investments. The proposed regulations extend this exception to apply to any fund that is similar to a stable value investment. However, a plan could not place restrictions on employer stock that do not apply to the other non-stable value investments and still take advantage of this exception. The regulations provide that it is permissible for the plan to permit transfers to be made more frequently to stable value investments than the other plan investments.

- **Restrictions Related to Securities Laws.** A restriction reasonably designed to comply with securities laws can be broader than necessary to comply with the securities laws. The preamble to the proposed regulations makes clear that the example contained in the Notice regarding a 3-12 day blackout period for participants subject to Section 16(b) of the Securities Exchange Act of 1934 (the "'34 Act") is merely one example of a restriction that would comply with the securities law exception. The preamble provides that a restriction permitting divestiture only once a quarter may be permissible under the securities law exception for some smaller entities.

- **Frequency of Investing in Employer Stock.** The proposed regulations would permit a plan to restrict the frequency of investments in employer stock. A plan is permitted to place reasonable restrictions on the timing and number of elections to invest in employer stock so long as such restrictions are designed to limit short-term trading of employer securities. As an example, the proposed regulations provide that a plan could restrict purchases of employer stock within 7 days following the participant's sale of employer stock. A plan cannot place any restrictions which limit the ability of participants to exercise their divestiture rights.

- **Reasonable Fees.** The proposed regulations make clear that a plan can charge reasonable fees for divesting employer securities without being considered to place an impermissible restriction on the divestiture right.

• **Definition of "Publicly Traded".** Code section 401(a)(35) only applies to "publicly traded" employer securities. The statute provides an employer security is considered publicly traded when the security is "readily tradable on an established securities market." The Notice did not provide any additional guidance regarding the definition of "readily tradable." The proposed regulations provide that a security is deemed readily tradable when it is traded on a securities exchange registered under Section 6 of the '34 Act. NYSE and NASDAQ are examples of national exchanges that are registered under Section 6 of the '34 Act. In addition, a security will be "readily tradable" if it is traded on a foreign national securities exchange that is officially recognized, sanctioned or supervised by a governmental authority and the SEC deems the security as having a "ready market" under SEC Rule 15c3-1 (which provides a net capitalization requirement for brokers and dealers).

- **Delayed Application of Diversification Rights.** As drafted, the statute would immediately apply the diversification rights to participants once the plan meets the publicly traded employer security requirement. The Notice provided a plan could restrict the application of otherwise applicable diversification rights for a period up to 90 days following an initial public offering of employer stock. The proposed regulations adopt this provision and also permit a restriction for up to 90 days following the plan becoming an applicable defined contribution plan (*e.g.*, when a separate entity within the controlled group issues publicly traded stock or a stand-alone ESOP first offers contributions subject to Code section 401(k) or 401(m)).

- **Beneficiaries' Rights.** While the diversification right generally applies to participants who have accrued three years of service and their beneficiaries, the Notice extended the diversification right to alternate payees of participants who are eligible for the diversification right. The preamble to the proposed regulations makes clear the diversification rights apply all beneficiaries of deceased participants – even if the participant was not eligible to exercise the diversification right prior to death.

- **Service Crediting.** The divestiture right applies to participants who have accrued three years of service as determined under the plan's vesting provisions. The Notice provided that if a plan provides immediate vesting or uses the elapsed time method, then a participant would be eligible for the diversification right following the third anniversary of the participant's date of hire. The proposed regulations adopt this provision without modification.

- **Effective Date and Other Transition Rules.** These regulations are proposed to be effective beginning with the 2009 plan year. The diversification rights contained in Code section 401(a)(35) generally apply beginning in 2007, subject to a ratable, three-year phase-in for employer nonelective and matching contributions that were made in the form of publicly traded employer stock prior to January 1, 2007. However, participants who have attained age 55 and accrued three years of service prior to the 2006 plan year can immediately exercise their diversification rights. In Notice 2008-7, the IRS provided that plan sponsors can either apply the rules contained in the Notice or the proposed regulations until final regulations are issued and effective. This means plans can continue to subject employer stock to restrictions (which were in effect on December 18, 2006) that do not apply to stable value funds or permit specific investments that are not generally available for investment to be divested more frequently than the period during which employer stock can be diversified.