

LEGAL ALERT: IRS PROVIDES TRANSITIONAL GUIDANCE ON EMPLOYEE DIVERSIFICATION RIGHTS WITH RESPECT TO PUBLICLY TRADED EMPLOYER SECURITIES

December 8, 2006

On December 1, 2006, the IRS issued Notice [2006-107](#) providing guidance on the investment diversification requirements applicable to publicly traded employer securities held by defined contribution plans. The Pension Protection Act of 2006 (the Act) requires that defined contribution plans other than certain ESOPs provide applicable participants the right to divest publicly traded employer securities in their accounts and to reinvest those amounts in certain diversified investments. The Act also adds a provision to ERISA requiring notice describing the diversification rights and providing information on the importance of investment diversification.

The Notice addresses several interpretive questions raised by the statute and provides a model diversification notice and several types of transitional relief from some of the short-term notice timing requirements. The Notice establishes that no diversification notice must be sent before January 1, 2007. Although it is not entirely clear how the diversification notice rules apply to applicable individuals who currently have diversification rights, we recommend that employers provide diversification notice to those individuals by January 1, 2007. The IRS anticipates that regulations promulgated pursuant to the statute will be consistent with the transitional guidance in the Notice. Click [here](#) for a more detailed description of the diversification requirements added by the Act.

Basic Divestiture Rules

A plan subject to the new diversification requirements must provide at least three investment options other than employer securities. These options must be diversified and have materially different risk and return characteristics. The Notice provides that investment options satisfying DOL Reg. § 2550.404c-1(b)(3), which describes what constitutes a broad range of investment alternatives for purposes of ERISA section 404(c), are treated as meeting these diversification requirements.

Publicly Traded Employer Securities

The Act describes what investment vehicles constitute the category of publicly traded employer securities. In addition to these statutorily created rules, the Notice provides that a plan is *not* treated as holding employer securities for purposes of the diversification requirements with respect to any securities held by either (1) an investment company registered under the Investment Company Act of 1940, or (2) a similar pooled investment vehicle that is regulated and subject to periodic examination by a State or Federal agency and with respect to which the investment is made in accordance with the stated investment objectives of the vehicle and independent of the employer, but only if such holdings are diversified so as to minimize the risk of large losses.

Applicable Individuals Who Have Diversification Rights

With respect to elective deferrals and employee contributions (including after-tax contributions and rollovers), diversification rights must be available to any participant, alternate payee who has a plan account, and beneficiary of a deceased participant. With respect to employer contributions, these rights are required for a participant who has completed at least three years of service, an alternate payee whose account relates to a participant with at least three years of service, and a beneficiary of a deceased participant. The three-years-of-service requirement is satisfied upon the completion of the third vesting computation period provided for under the plan. For plans using the elapsed time method, the service requirement is satisfied on the third anniversary of the participant's date of hire.

Restrictions or Conditions on Diversification Rights

The Act prohibits plans from imposing certain restrictions and conditions on the investment and divestiture of employer securities that are not imposed on other plan investments. Moreover, plans cannot condition a benefit on investment in employer securities. There are, however, some permitted restrictions, including those imposed by the securities laws or restrictions designed to ensure compliance with such laws.

The Notice gives examples of both prohibited and permitted restrictions and conditions. For instance, a plan cannot permit individuals to divest themselves of employer securities less frequently than they can divest themselves of any other plan investment. Also, the plan cannot provide for a lower level of matching contributions for individuals who divest themselves of investments in employer securities. The plan may, however, limit the percentage of an individual's account that can be invested in employer securities.

Transition Rules for Existing Investment Restrictions and Conditions

From January 1, 2007 through March 30, 2007, it will not be considered a violation of the prohibited restriction rules for a plan to impose investment restrictions or conditions in effect on December 18, 2006. Moreover, for the period before January 1, 2008, it will not be considered a violation of the statutory prohibitions if a plan in effect December 18, 2006 (1) does not impose an otherwise applicable restriction on a stable value fund or (2) allows applicable individuals the right to divest employer securities on a periodic basis but permits divestiture of another investment that is not generally available under the plan on a more frequent basis.

Transition Rule For Phase-In of Diversification Rights

For employer securities acquired before 2007 using employer contributions, the Act phases in the diversification rights ratably over three years beginning in 2007. The Notice clarifies that, if a plan holds more than one class of securities, the transition rule percentages apply separately with respect to each class.

No Notice Required Before January 1, 2007

The Act amends ERISA to require plan administrators to provide notice to applicable individuals of their diversification rights and of the importance of diversifying the investment of retirement account assets. The Notice indicates that it is the Department of Labor's (the DOL) position that the Act does not require any such notices be issued before January 1, 2007. Therefore, plans with plan years beginning on or after January 1, 2007 but before February 1, 2007 are not required to provide notice earlier than January 1, 2007. Even with this guidance, a number of questions remain as to when and to whom the diversification notice requirements apply. For instance, the guidance does not address whether the notice requirements apply to existing participants as the statute requires notice when a participant is first eligible. We will continue to provide updates as the IRS provides additional guidance.

Model Notice

The IRS has provided a "Model Notice" that plans may issue for purposes of the ERISA notice requirements. The Model Notice should be reviewed carefully and tailored to the specific terms of the plan before it is distributed. Click [here](#) for a copy of the Model Notice. Comments are requested on the diversification requirements, including on the issues raised in the Notice, and should be submitted by March 18, 2007. Comments received on the Notice rules will be provided to the DOL.



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