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Client Advisory

IRS Issues Guidance and Model Notice for Diversification Requirements Applicable to Defined Contribution Plans That Hold Publicly Traded Employer Securities

December, 2006

Section 401(a)(35) of the Internal Revenue Code of 1986, as amended (the "Code"), which was added by the Pension Protection Act of 2006 ("PPA '06"), requires diversification rights for participants and beneficiaries with respect to publicly traded employer securities held in certain defined contribution plans. Section 204(j) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), also added by PPA '06, contains requirements that are parallel to those under Code Section 401(a)(35). ERISA Section 101(m), also added by PPA '06, requires plans to provide participants and beneficiaries with a notice that sets forth these diversification rights and that describes the importance of diversifying the investment of retirement assets. These provisions are generally effective for plan years beginning after December 31, 2006.[1]

The Internal Revenue Service has issued transitional guidance[2] (the "Guidance") on these diversification requirements, as well as a model notice under ERISA Section 101(m). The following points summarize some of the key points of the Guidance:

- Under Code Section 401(a)(35), defined contribution plans (other than certain employee stock ownership plans and certain one-participant retirement plans) must provide participants, alternate payees and beneficiaries the right to divest employer securities held in their plan accounts and to direct the reinvestment of these amounts among at least three alternative investment options.
- The Guidance clarifies the scope of defined contribution plans to which the diversification requirements apply, the requirements applicable to alternative investment options, and permissible and impermissible restrictions on diversification rights.
- The Guidance also provides certain transition rules including that, until March 30, 2007, a plan is not deemed to impermissibly restrict divestiture from employer securities if the plan continues to apply a provision imposing restrictions on the divestiture of employer securities that was in effect on December 18, 2006.
- The Guidance contains a model notice that employers may use to satisfy ERISA Section 101(m). The notice must be provided not later than 30 days prior to the date that participants, alternate payees and beneficiaries are first eligible to exercise the diversification rights under Code Section 401(a)(35) or ERISA Section 204(j). Plans must satisfy this notice requirement with respect to plan years beginning after December 31, 2006. The Guidance notes, however, that the Department of Labor has advised that plans with plan years beginning on or after January 1, 2007 and before February 1, 2007 are not required to furnish the notice *earlier than* January 1, 2007. Because the Guidance appears to require that the notice must be furnished as early as January 1, 2007, it would be advisable for calendar year plans subject to the diversification requirements to provide the notice by January 1, 2007. A copy of the IRS's model notice is attached to this Client Advisory.

Plan administrators are subject to a penalty of up to $100 per day per participant or beneficiary for failure to timely provide this notice.[3]

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1 Later effective dates apply with respect to plans maintained pursuant to collectively bargained agreements and to certain employee stock ownership plans.

2 The guidance is contained in IRS Notice 2006-107 (11/30/2006), 2006-51 IRB.

3 ERISA Section 502(c)(7), as amended by PPA '06.

IRS Model Notice

This model notice may have to be adapted to reflect particular plan provisions. For example, changes would generally be necessary if either the plan has more than one class of employer securities, the plan provides the same diversification rights for participants without regard to whether they have three years of service, some of the plan's investment options are closed, the plan receives participant elections electronically, or the transition rule at Section 401(a)(35)(H) of the Code (i.e., phased in applicability of diversification rights with respect to employer contributions invested in employer securities) is being applied.

NOTICE OF DIVERSIFICATION RIGHTS CONCERNING PUBLICLY TRADED EMPLOYER SECURITIES HELD UNDER [INSERT NAME OF PLAN]

Notice of Your Rights Concerning Employer Securities

This notice informs you of an important change in Federal law that provides specific rights concerning investments in employer securities (company stock). Because you may now or in the future have investments in company stock under the [insert name of plan], you should take the time to read this notice carefully.

Your Rights Concerning Employer Securities

For plan years beginning after December 31, 2006, the Plan must allow you to elect to move any portion of your account that is invested in company stock from that investment into other investment alternatives under the Plan. This right extends to all of the company stock held under the Plan, except that it does not apply to your account balance attributable to [identify any accounts to which the rights apply only after three years of service] until you have three years of service. [Insert description of any advance notice requirement before a diversification election becomes effective.] You may contact the person identified below for specific information regarding this new right, including how to make this election. In deciding whether to exercise this right, you will want to give careful consideration to the information below that describes the importance of diversification. All of the investment options under the Plan are available to you if you decide to diversify out of company stock.

The Importance of Diversifying Your Retirement Savings

To help achieve long-term retirement security, you should give careful consideration to the benefits of a well-balanced and diversified investment portfolio. Spreading your assets among different types of investments can help you achieve a favorable rate of return, while minimizing your overall risk of losing money. This is because market or other economic conditions that cause one category of assets, or one particular security, to perform very well often cause another asset category, or another particular security, to perform poorly. If you invest more than 20% of your retirement savings in any one company or industry, your savings may not be properly diversified. Although diversification is not a guarantee against loss, it is an effective strategy to help you manage investment risk.

In deciding how to invest your retirement savings, you should take into account all of your assets, including any retirement savings outside of the Plan. No single approach is right for everyone because, among other factors, individuals have different financial goals, different time horizons for meeting their goals, and different tolerances for risk. Therefore, you should carefully consider the rights described in this notice and how these rights affect the amount of money that you invest in company stock through the Plan.

It is also important to periodically review your investment portfolio, your investment objectives, and the investment options under the Plan to help ensure that your retirement savings will meet your retirement goals.

For More Information

If you have any questions about your obligations under these new diversification requirements, contact:

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