

Diversification Requirements for Defined Contribution Plans – Action Required and Model Notice Included

This past summer Congress passed the Pension Protection Act of 2006 (“PPA”) that contained many new requirements for qualified retirement plans. Most of the rules primarily affected defined benefit plans (such as traditional pension plans). Many of the new rules will cause dismay for employers (such as the new funding requirements for defined benefit plans) while other changes are beneficial (such as the explicit sanction for cash balance plans). The rules add new compliance obligations, one of which deals with diversification requirements for certain defined contribution plans that have investments in publicly traded employer securities. The new rules require such plans to permit participants to diversify their accounts’ investments in publicly traded employer securities and require the plans to provide notice to the participants of that ability to diversify. The IRS released Notice 2006-107 on November 30, 2006, providing transitional guidance on the diversification rules and including a model notice. This Alert will summarize the transitional guidance, and the model notice also appears within this Alert. The notice should be sent to plan participants as soon as possible as the general requirement would be that it arrive thirty days prior to the general effective date of January 1, 2007. Although, there will be some relief for calendar year plans (because of the timing of the issuance of the guidance), the notice should be sent as soon as possible.

Background

New Internal Revenue Code §401(a)(35) provides that qualified defined contribution plans (other than certain employee stock ownership plans) must provide applicable individuals the right to divest employer securities in their accounts and reinvest those amounts in certain diversified investments.

In addition, ERISA §101(m) was added and requires a plan to provide applicable individuals with a notice describing their diversification rights and providing information on the importance of diversifying investments.

The diversification requirements will generally be effective for plan years beginning after December 31, 2006. The notice requirements are also effective with respect to plan years beginning after December 31, 2006.

Discussion

Publicly Traded Employer Securities - The new rules apply to “publicly traded employer securities” which generally means those employer securities which are readily tradable on an established securities market. However, even if employer securities are not publicly traded, they will still be treated as publicly traded employer securities if any employer corporation (or any member of the controlled group of corporations that includes an employer corporation) has issued a class of security that is a publicly traded employer security.

There is an exception to this general rule -- if the employer stock is held in an investment vehicle such as a mutual fund, insurance company vehicle, or other regulated security, the plan will not be deemed to hold employer securities to which these diversification requirements apply. That investment vehicle must be independent of the employer and be sufficiently diversified so as to minimize the risk of large losses.

ESOP Exception – The new rules generally do not apply to employee stock ownership plans (ESOPs) provided that: (1) there are no contributions held in the plan (or earnings thereunder) which are elective deferrals, employee after-tax contributions, or matching contributions; and (2) the plan is a separate plan from any other plan maintained by the employer.

Applicable Individuals Who Have Diversification Rights –With respect to employee contributions (including elective deferrals and the earnings thereon) the diversification rights are immediately available to (1) any participant; (2) any alternate payee who has an account under the plan; or (3) any beneficiary of a deceased participant.

With respect to other employer contributions (and earnings thereon), the diversification requirements will be available to each individual who has three years of service (based on vesting service) or is an alternate payee or beneficiary of an employee with at least three years of service.

Basic Divestiture Rules – The rules permit an applicable individual to direct the plan to divest any publicly traded employer securities in his or her account under the plan and to reinvest an equivalent amount in other investment options offered under the plan.

In addition, the investment options offered under the plans must include at least three investment options other than employer securities. Those investment option rules are based on the ERISA §404(c) rules and require each investment option to be diversified and have materially different risk and return characteristics. The model notice specifically refers to the Department of Labor regulations on §404(c) diversification for that purpose.

Restrictions or Conditions on Divestiture Rights – The rules do permit some restrictions on diversification rights. The plans can limit the time and opportunity to diversify as long as the participants have that right at least quarterly, but the restrictions must be applicable to all investments and not just employer securities. Any restriction that is imposed because of the application of other securities laws is not an impermissible restriction. Therefore, in order to ensure compliance with SEC rules, a plan may limit divestiture rights for participants who are subject to §16(b) of the Securities Exchange Act of 1934 (these would be officers, directors and 10% shareholders) to a set period (such as 3 to 12 days) following publication of the employer's quarterly earnings statements, and a plan may restrict the application of otherwise applicable diversification rights under the plan for up to 90 days following an initial public offering of the employer's stock.

Transition Rule through March 30, 2007 for Continuation of Existing Restrictions or Conditions. Any restriction that was in effect on December 18, 2006 may continue to be in effect through March 31, 2007 but must be removed after that date.

Transition Rule for 2007 for Grandfathered Investments. There is an additional transitional period through December 31, 2007 for any restriction that was in effect on December 18, 2006 if the restriction: (1) does not impose an otherwise applicable restriction on a stable value fund; or (2) restricts diversification rights for employer securities to periodic times while permitting divestiture of other investments more frequently. Those restrictions must be removed no later than December 31, 2007.

In addition, there is a special transition rule for any employer securities in an account prior to January 1,

2007. The plan can restrict diversification of those securities over time. The plan must permit 33% to be diversified in the first plan year, 66% in the second plan year, and 100% for all subsequent plan years. This transition rule does not apply to a participant who had attained age 55 and completed at least three years of service as of the first plan year starting after December 31, 2005.

Notice under ERISA §101(m)

Plan administrators must provide a notice to applicable individuals no later than 30 days before the first date on which the individuals are eligible to exercise their rights. The notice must set forth the diversification rights provided under §401(a) (35) and describe the importance of diversifying the investment of retirement account assets.

Although the diversification rules might require many plans to issue notices as early as January 1, 2007, the Department of Labor has indicated that it will not require plans to furnish notices before January 1, 2007. Therefore, calendar year plans will not be required to furnish the model (or other) notice earlier than January 1, 2007, although the DOL encourages plans to furnish the notice at the earliest possible date.

Model Notice

The Treasury Department did provide a model notice that appears below. The model may have to be adapted to reflect particular plan provisions.

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 rights under this new law, including how to make this election, contact *[enter name and contact information]*.

Conclusion

The guidance in the Notice and the model disclosure notice are very helpful to plans and plan sponsors. There are some timing issues, and plan sponsors should act as quickly as possible. If you have questions, please contact your Willis representative.

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