

## **Pension Protection Act of 2006—Employer Stock Diversification Notice: But What If Our 401(k) Plan Already Permits Diversification?**

**December 8, 2006**

On Thursday, November 30, 2006, the IRS issued Notice 2006-107 to provide interim guidance, pending the issuance of regulations, on the operation of the new employer stock diversification requirements under Code Section 401(a)(35), as added by the **Pension Protection Act (PPA) of 2006**. Among other things, Notice 2006-107 affirmed that participants need not be provided a written notice describing their diversification rights in advance of the original January 1, 2007 effective date of Code Section 401(a)(35). However, as explained below, Notice 2006-107 would appear to require that such a notice be provided to participants **on or before January 1, 2007** for a calendar-year defined contribution plan that includes employer securities as an investment option—even if the plan already permits free diversification out of the company stock fund. In addition, Notice 2006-107 included a model form of a participant diversification notice, but that model is designed to inform participants of a “new” diversification right; as worded, that notice would be confusing to participants in a plan that already permits diversification. Therefore, plan sponsors and administrators of such plans should gear up to provide a notice before year end and should consider tailoring the IRS model notice to avoid participant confusion.

### **Diversification and Notice Requirements—Code Section 401(a)(35); ERISA Section 101(m)**

Briefly, Code Section 401(a)(35), as added by the PPA, requires that qualified defined contribution plans provide “applicable individuals” (certain participants, beneficiaries, and alternate payees) the right to diversify the portions of their plan accounts that are invested in publicly traded employer securities. The right must be provided immediately with respect to any portion of the account balance attributable to participant contributions (pre- or post-tax), and the right must be provided for the portion of the account balance attributable to employer matching or other contributions following the participant’s completion of three years of service (or to a beneficiary following a participant’s death, whether or not the participant had three years of service). These rights are generally effective as of January 1, 2007 for calendar-year plans, subject to a three-year phase-in for employer securities acquired before January 1, 2007. (An exception applies to a stand-alone ESOP but not to the employer securities included in an ESOP portion of a 401(k) plan.)

The PPA also added a new Section 101(m) to ERISA, under which applicable individuals are required to be provided a written notice describing their Code Section 401(a)(35) diversification rights no later than 30 days before they first become eligible to diversify. The notice must describe the right as well

as the benefits of diversification. The PPA authorized the Secretary of the Treasury to issue a model notice that could be used for this purpose.

### **Notice 2006-107**

Notice 2006-107 clarified several aspects of the operation of Code Section 401(a)(35). For example, it clarified that the three years of service requirement in an “hours” plan is treated as applying immediately after the end of the third vesting computation period (typically, plan year) in which the participant satisfies the relevant year of service requirement (typically, completion of 1,000 hours of service). In an elapsed-time plan, the requirement is generally treated as applying on the third anniversary of the participant’s date of hire.

Notice 2006-107 also makes clear that the diversification requirement is not violated if the plan maintains a “frozen” stock fund under which participants can only sell employer securities, not make additional investments; if the plan limits a participant’s ability to make additional employer stock investments after a specified limit is reached (e.g., 10% of the value of the participant’s total account balance); or if the plan imposes restrictions on selling employer securities necessary to comply with applicable securities law requirements or selling employer securities during the 90-day period following the initial public offering of those securities.

The Notice clarifies that plans need not operationally comply with the diversification requirement until, at the earliest, March 31, 2007, as long as the applicable restriction on diversification was part of the plan on December 18, 2006. It also provides additional transition relief through the end of 2007 for plans that permit divestiture of a nonemployer securities investment more frequently than an employer securities investment (which is otherwise prohibited under Code Section 401(a)(35)), so long as the nonemployer investment is not a “generally available” investment (i.e., applies to a limited class of participants).

### **Notice Requirement**

As noted earlier, Notice 2006-107 clarifies that notice to applicable individuals of their diversification rights under the new law need not be made before January 1, 2007. However, it also indicates that plans with plan years that begin on January 1, 2007 or on February 1, 2007 must give the notice before January 1, 2007, and it encourages earlier notice if possible. It also makes clear that the notice requirement applies to plans that provide “the same diversification rights to participants without regard to whether they have three years of service.” Notice 2006-107 includes the text of a model notice, which can ostensibly be used to satisfy the notice requirement. ([Please click here to see text for the model notice.](#)) However, the Notice recognizes that “the model may have to be adapted to reflect particular plan provisions,” including for a plan that provides for greater diversification rights than required under Code Section 401(a)(35).

The fact that the Notice contains a transition rule delaying the first compliance date for the new requirements until March 31, 2007 clouds the issue of when a participant notice will be required—would this delay permit the notice to be given on March 1, 2007, as that would be 30 days before the March 31, 2007 compliance date? Notice 2006-107 does not appear to contemplate this further delay. Since the notice requirement itself is contained in ERISA, and is ostensibly under the jurisdiction of the Department of Labor, it is possible that DOL may permit an additional delay. However, pending any

indication from DOL that a further delay may be permitted, plan sponsors and administrators should gear up for a January 1, 2007 notice deadline and may want to include the diversification notice with other notices or materials being distributed to participants at or before year end.

Use of the unmodified model notice would likely be confusing to participants in a plan that already permits diversification of investments in company stock. For example, the model notice provides that “[f]or 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,” and it refers to that right as a “new right.” In a technical sense, this is true; plans that permitted diversification prior to the PPA did so voluntarily, and, prior to the PPA, participants with three years of service did not have a protected statutory “right” to diversification. Nevertheless, participants who can already diversify will undoubtedly be puzzled as to why they are being told that they now have the “new right” to do so. At the least, plan administrators and recordkeepers in a plan that already permits diversification should anticipate a flood of phone and email inquiries if they send out the model form of notice.

For this reason, we recommend that the model be adapted significantly before being used in such a plan. The adapted notice should explain that the notice is required by law and that while the plan already complies with the new legal requirement, the plan administrator is required to explain the requirement and explain the importance and value of diversification. The notice can remind participants of the systems already in place to permit them to diversify out of the stock fund, in addition to any existing restrictions on the exercise of those rights that would be permitted under Code Section 401(a)(35) (e.g., the need for certain corporate officers to pre-clear discretionary transactions in the company stock fund in accordance with the company’s insider trading policy). It can also be tailored as needed for other plan-specific circumstances (e.g., for a plan with a frozen stock fund).

If you would like any assistance in preparing a tailored notice for plan participants, or if you have any questions concerning the new diversification and notice requirements, please contact one of the Morgan Lewis lawyers listed below, or any Morgan Lewis employee benefits lawyer that you work with.

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