

Regulatory Update

IRS Issues Final Regulations on Diversification Requirements for Defined Contribution Plans Holding Employer Securities

Julie K. Stapel

WINSTON
& STRAWN
LLP

The Internal Revenue Service (IRS) recently issued final regulations governing the diversification requirements added to the Internal Revenue Code (Code) by the Pension Protection Act of 2006 (PPA). These regulations affect defined contribution plans that hold publicly traded employer securities. The IRS issued the regulations in proposed form in January 2008.

Prior to the 2008 proposed regulations, the IRS had issued transition guidance in Notice 2006-107, much of which is reflected in the proposed and final regulations. The IRS and Treasury have allowed continued reliance on Notice 2006-107 pending the effective date of the final regulations. Thus, plan sponsors with defined contribution plans holding publicly traded securities may be familiar with these rules in one form or another, but the finalization of the regulations provides a good opportunity to review. This column will provide an overview of Section 401(a)(35) and the regulations generally, while noting those items that were added by or clarified in the final regulations.

The PPA added Section 401(a)(35) of the Code. Section 401(a)(35) provides that, in order to be qualified under Section 401(a) of the Code, an “applicable defined contribution plan” (discussed below) must permit investments in publicly traded securities to be divested into other investment options under the plan. Many view Section 401(a)(35) as the PPA’s answer to the significant losses suffered by Enron employees whose defined contribution plan balances were heavily invested in company stock at the time of Enron’s collapse.

Diversification Rights

Employee Contributions, Elective Deferrals, and Rollover Contributions. All participants must have the right to direct the plan to divest employee contributions, elective deferrals and rollover contributions that are invested in employer securities and to reinvest an equivalent amount in other investment options on at least a quarterly basis.

Employer Nonelective Contributions. All participants who have completed at least three years of service must have the right to direct the plan to divest employer non-elective contributions that are invested in employer securities and to reinvest an equivalent amount in other investment options on at least quarterly basis.

The diversification rights apply not only to participants but also to certain alternate payees and beneficiaries of deceased participants. For ease of reference, however, participants, alternate payees and beneficiaries will be referred to as “participants” in this column.

Julie K. Stapel, an Employee Benefits and Executive Compensation partner in the Chicago office of Winston & Strawn LLP, is the “Regulatory Update” columnist for *Employee Benefit Plan Review*. Ms. Stapel can be reached at jstapel@winston.com.

Applicable Defined Contribution Plans

Section 401(a)(35) only applies to defined contribution plans which hold employer securities that are publicly traded. A “publicly traded security” is defined as an “employer security” as defined under Section 407 of ERISA which is “readily traded on an established securities market.” Section 407 defines employer security as “a security issued by an employer of employees covered by the plan, or by an affiliate of such employer.” The proposed regulations define “readily tradeable on an established securities market” to include trading on a national securities exchange registered under the Securities Exchange of 1934, such as the New York Stock Exchange, and trading on a foreign securities exchange that is officially recognized, sanctioned or supervised by a government authority that meets certain other securities law related requirements.

Notably, a plan that holds only employer securities that are *not* publicly traded will nevertheless be treated as holding employer securities that are publicly traded if any employer maintaining the plan, or any member of a controlled group of corporations that includes such employer, has issued publicly traded employer securities. Typically, in making controlled group determinations in the employee benefit plan context, a parent/subsidiary controlled group is one related by 80 percent or greater common ownership. For this purpose, however, the PPA specified that 50 percent common ownership must be used instead. The regulations also provide an exception from this general rule if no employer maintaining the plan (or such employer’s parent corporation) has issued stock that is publicly traded *and* no employer maintaining the plan (or such employer’s parent corporation) has issued any special class of stock with particular rights or particular risks with respect to any employer (or member of the employer’s controlled group) which has issued any stock that is publicly traded.

Exclusions from “Applicable Defined Contribution Plan” Definition

Section 401(a)(35) does not apply to employee stock ownership plans (ESOPs) that are stand-alone plans *and* that do not hold contributions subject to Section 401(k) of the Code (i.e., elective deferrals) or Section 401(m) of the Code (i.e., matching contributions). Thus, an ESOP that is part of another plan that holds publicly traded employer securities is an applicable defined contribution plan (regardless of whether it holds contributions subject to Section 401(k) or Section 401(m)) and a stand-alone ESOP that holds elective deferrals or matching contributions is also an applicable defined contribution plan.

Section 401(a)(35) does not apply to one-participant plans.

In determining whether a plan holds publicly traded employee securities for this purpose, it is not necessary to count employer securities held indirectly as part of a broader fund that is:

- A regulated investment company described in Section 851(a) of the Code (e.g., mutual funds and certain exchange traded funds).¹
- A common or collective trust fund or pooled investment fund maintained by a bank or trust company.
- A pooled investment fund of an insurance company.
- An investment fund managed by an ERISA Section 3(38) “investment manager” for a multiemployer plan.²
- Any other investment fund designated by the Commission in rulings, notices or other guidance.

In addition, the investment in employer securities by such a fund must be independent of the employer and any affiliate of the employer and must be consistent with the stated investment objectives of the fund. Further, the value of the employer securities may not exceed 10 percent of the total value of the fund's investment for the plan year.³

Investment Options

A plan must offer not less than three investment options other than employer securities for the investment of proceeds of the divested employer securities. Each of the three investment options must be diversified and have "materially different risk and return characteristics." The regulations provide that if investment options constitute a "broad range of investment alternatives," within the meaning of the ERISA Section 404(c) regulations (which provide limited fiduciary relief with respect to participant-directed investments), the investment options will be treated as being diversified and having materially different risk and return characteristics for purposes of the Section 401(a)(35) regulations.

Investment Restrictions

A plan is not permitted to impose restrictions or conditions with respect to the investment in employer securities that are not imposed on the investment of other assets of the plan. The regulations define "restrictions or conditions with respect to employer securities" to mean (a) restrictions on a participant's right to divest an investment in employer securities that are not imposed on investments other than employer securities or (b) a benefit that is conditioned on investment in employer securities.

Notwithstanding the general prohibition, the regulations set forth certain restrictions and conditions that are permissible, including:

- Tax consequences that result from the divestment (e.g., loss of special treatment for net unrealized appreciation).⁴
- Restrictions or conditions required to ensure compliance with applicable securities laws (e.g., limiting divestitures to comply with Section 16(b) of the Securities Exchange Act of 1934).
- 90-day "grace period" if a plan becomes an applicable defined contribution plan (if, for example, employer securities not previously publicly traded become publicly traded); in such cases, the plan may restrict the diversification requirements for up to 90 days.
- 90 day "grace period" if an investment fund holding publicly traded employer securities no longer meets the requirements of the exclusion for employer securities held by a broader fund (discussed above) (if, for example, the value of the employer securities exceeds 10 percent of the investment fund); in such cases, the plan may restrict the diversification requirements with respect to that investment fund for up to 90 days.⁵
- Limits on the extent to which an individual's account balance can be invested in employer securities (e.g., limiting employer securities to 10 percent of the participant's account balance).
- Reasonable restrictions on the timing and number of investment elections to invest in employer securities (e.g., a restriction that a participant may not elect to invest in employer securities if the participant has elected to divest an investment in employer securities within a short period of time, such as seven days).
- Fees on other investment options that are not applicable to employer securities and reasonable fees for the divestment of employer securities.

-
- More frequent transfers out of or into a stable value or similar fund.⁶
 - More frequent transfers out of a “qualified default investment alternative” (QDIA).⁷
 - Prohibitions on further investment in employer securities due to a “frozen” employer stock fund but only if the plan does not permit additional contributions or other investment in employer securities.⁸

Effective Date

The final regulations are effective and applicable for plan years beginning on or after January 1, 2011. The statutory provisions are already effective, however, and plans are permitted to rely on Notice 2006-107, the proposed regulations or the final regulations until the first day of the first plan year beginning on or after January 1, 2011.

Conclusion

Although the diversification requirements have been around in various forms since late 2006, plan sponsors may wish to take this opportunity to consult with their advisors and confirm plan documents are in compliance with the requirements. Particular attention should be paid to those provisions that are new to be final regulations (noted herein).

Endnotes

- 1 The proposed regulations instead used the term “investment company registered under the Investment Company Act of 1940.” By changing the reference to instead be “a regulated investment company described in Section 851(a) of the Code,” the category of permissible funds was broadened to include certain exchange traded funds.
- 2 The final regulations added this provision. Commenters urged that this exception be extended to *all* plans, not just multiemployer plans. The IRS and Treasury declined this suggestion “because such a fund would not necessarily be holding employer securities only as an indirect result of its investment policy.”
- 3 In response to commenters’ suggestions that the 10 percent limit be eliminated because it would be costly and difficult to monitor, the final regulations provide that the 10 percent determination can be made as of the end of the preceding plan year using, if applicable, information in the latest disclosure of the fund’s portfolio holdings that was filed with the SEC.
- 4 This provision regarding tax consequences was added in the final regulations.
- 5 This provision was added in the final regulations in response to commenter concerns about the ability to monitor the 10 percent limit.
- 6 The final regulations provided that more frequent transfers both *into* and *out of* stable value funds are permissible (the proposed regulations had addressed only transfers *into* stable value funds) and the final regulations also defined “stable value or similar fund” to mean “an investment product or fund designed to preserve or guarantee principal and provide a reasonable rate of return while providing liquidity for benefit distributions or transfers to other investment alternative. . . .”
- 7 The final regulations added this provision regarding QDIAs in response to comments regarding the rule that QDIAs must be restriction free for 90 days.
- 8 The final regulations provide two clarifications on what constitutes a “frozen fund.” First, an employer stock fund may still be considered “frozen” for this purpose even if dividends on employer securities under the plan continue to be reinvested in employer securities. Second, the regulations provide limited transitional relief to leveraged ESOPs that acquired employer securities in a plan year beginning before January 1, 2007, and that have not been refinanced after the end of the last plan year beginning before January 1, 2007. Such leveraged ESOPs may continue to allocate employer securities that are released from the suspense account without jeopardizing treatment as a frozen fund.

Another commenter requested that a frozen fund include a plan that makes matching contributions in employer securities, allows participants to divest employer securities attributable to such matching contribution but does not permit participants to later elect to reinvest any portion of their account balance in employer securities. The IRS and the Treasury Department declined this suggestion because “the inability to reinvest in employer securities generally acts as a material deterrent to an individual who might otherwise have elected to diversify his or her account balance of employer securities.”