



# Pension Analyst

Important Information

Plan Administration and Operation

July 2010

## IRS issues final regulations on investment diversification requirement

### Who's affected

This guidance affects sponsors of and participants in qualified defined contribution plans, including 401(k) plans and multiemployer plans that offer publicly-traded employer securities ("employer stock") as an investment option.

### Background and summary

Effective for plan years beginning on or after January 1, 2007, the Pension Protection Act of 2006 (PPA) requires a defined contribution plan that offers employer stock as an investment option to provide diversification rights for amounts invested in employer stock. Plan sponsors must provide each individual with a notice explaining his right to diversify employer stock investments no less than 30 days before the first day the individual has this right. The notice requirement applies to plan years beginning on or after January 1, 2007.

On November 30, 2006, the IRS provided [transitional relief](#) on the new diversification requirements in IRS Notice 2007-107. The IRS also published a [model notice](#) for plan sponsors to use to meet the notice requirement. The guidance and relief provided in Notice 2006-107 applied for the period before January 1, 2008. However, in [Notice 2008-7](#), the IRS extended the transitional guidance and relief until final regulations were issued and became effective.

Recently, the IRS published final regulations regarding the diversification requirement. The final regulations:

- Confirm that a plan may not impose restrictions or conditions on the employer stock investments that are not imposed on the investment of other plan assets;
- Permit a plan to allow transfers into and out of the stable value or similar fund more frequently than other funds;
- Provide that a plan may allow for transfers out of a qualified default investment arrangement (QDIA) more frequently than a fund invested in employer stock; and
- Include a transitional rule for certain leveraged employee stock ownership plans (ESOPs).

### Action and next steps

These final regulations affect both plan administration and plan documents. They apply to plan years beginning on and after January 1, 2011. Plan sponsors should review the information contained in this publication and determine how the final regulations impact their plans. Until the start of the 2011 plan year, plan sponsors may follow the rules provided in Notice 2006-107, the proposed regulations or the final regulations to satisfy the diversification requirements. Sponsors of plans with investments in employer stock must adopt a plan amendment reflecting the diversification provisions on or before the last day of the first plan year beginning on or after January 1, 2010. For calendar year plans, this amendment must be adopted by December 31, 2010.

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## Applicable plans

The diversification requirement applies to any defined contribution plan that holds publicly-traded employer stock. Employer stock is publicly-traded if it is readily tradable on an established stock market. A stock is readily tradable on an established stock market if it is traded on a:

- Securities exchange registered under the Securities and Exchange Act (such as the New York Stock Exchange or Nasdaq); or
- Foreign national securities exchange that is officially recognized, sanctioned or supervised by a governmental authority and the Securities and Exchange Commission (SEC) deems the stock as having a ready market.

## Exceptions

The final rules carve out certain exceptions from the standard diversification requirement.

### Indirect investments

A plan or an investment option is not treated as holding employer stock with respect to any stock held by:

- A regulated investment company;
- A common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a State or Federal agency;
- A pooled investment fund of an insurance company qualified to do business in a State (such as an insurance company pooled separate account);
- An investment fund managed by an investment manager for a multiemployer plan; or
- Any other investment fund designated by the IRS.

In addition, the above described investment options must:

- Have stated investment objectives; and
- Be independent of the employer or any affiliate of the employer.

A fund is considered to be independent of the employer if the total value of the employer stock held in the fund does not exceed 10% of the total value of all the fund's investments. This determination is made as of the end of the preceding plan year. It can be based on the information in the latest disclosure of the fund's portfolio holding that is filed with the SEC in the preceding plan year. If the 10% limit is exceeded, the plan has a 90-day grace period before it must satisfy the diversification requirements.

### Employee stock ownership plans (ESOPs)

The final regulations also provide that the diversification rules do not apply to:

- An ESOP that is a separate plan and does not contain a 401(k) or a matching contribution provision; or
- A defined contribution plan that covers only one participant who fully owns the plan sponsors or partners who own the plan sponsor.

### Controlled group considerations

Under PPA investment diversification rules, a defined contribution plan that holds employer stock that is not publicly-traded is treated as holding publicly-traded stock, and therefore subject to the final regulations, if any member of its controlled group has issued publicly-traded stock. A plan will be treated as holding a publicly-traded employer stock if any employer maintaining the plan or any member of the plan sponsor's controlled group (determined by using a 50%

ownership) has issued a class of stock that is publicly-traded. *For example: A controlled group consists of three employers, X, Y and Z. Employer X maintains a defined contribution plan that holds employer stock that is not publicly-traded. However, Employer Y has issued publicly-traded stock. As a result, Employer X's defined contribution plan is subject to the final diversification rules.*

However, the diversification requirements do not apply if no employer or parent corporation has issued any publicly-traded stock or any special class of stock that grants particular rights to, or bears particular risks for the holder or issuer that issued the publicly-traded stock.

## Contributions

### Elective deferrals and employee contributions

An [applicable individual](#) must have the right to divest employer stock investments made using:

- Elective deferrals;
- Employee contributions (i.e., post-tax contributions); or
- Rollover contributions

and to reinvest them in other [investment options](#).

An “applicable individual” is any:

- Participant;
- Alternate payee designated in a Qualified Domestic Relations Order (QDRO) who has an account under the plan; or
- Beneficiary of a deceased participant.

### Employer matching and nonelective contributions

The diversification requirement also applies to an [applicable individual](#) who has employer stock investments made using employer contributions, such as matching or nonelective contributions.

For these purposes, an “applicable individual” is any:

- Participant who has completed at least three years of service;
- Alternate payee who has an account under the plan with respect to a participant who has completed at least three years of service; or
- Beneficiary of a deceased participant.

A participant completes three years of service on the last day of the vesting computation period as determined under the plan's vesting provisions. If the plan uses the elapsed time method for vesting purposes or provides for immediate vesting, a participant completes three years of service on the third anniversary of his date of hire.

## Restrictions and conditions

### Investment options

A plan may limit the period for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

A plan satisfies the diversification requirement if it offers at least three investment options, in addition to employer stock, to which an applicable individual may direct the proceeds from the divestment of employer stock. Each of the three investment options must be diversified and have materially different risk and return characteristics. Investments that satisfy the [broad range of investment alternatives](#) under the Department of Labor's section 404(c) requirements satisfy the diversification requirement.

### Impermissible restrictions

A plan may not impose any direct or indirect restrictions or conditions with respect to the investment of employer stock that are not imposed on the investment of other assets of the plan. However, this rule does not apply to restrictions or conditions imposed to comply with securities laws.

A restriction or condition with respect to employer stock includes a:

- Restriction on an individual's rights to divest an investment in employer stock that is not imposed on an investment that is not employer stock; or
- Benefit that is conditioned on investment in employer stock.

The final regulations provide that a plan imposes an indirect restriction on an individual's right to divest an employer stock investment if the plan provides that a participant who divests his account balance with respect to this investment is prohibited from reinvesting in employer stock for a period of time following the divestment.

However, any applicable tax consequences are disregarded in determining whether a plan imposes an indirect restriction or condition on an individual's right to diversify an investment in employer stock. Therefore, a plan may provide that an individual may not reinvest dividend amounts in the same employer stock account but may invest the divested amounts in another employer stock account where the only relevant difference between the accounts is the cost or basis of the shares held in each account.

### Permitted restrictions and conditions

The final regulations also provide a number of permitted restrictions and conditions.

- **Securities laws.** A plan may impose a restriction that is either required in order to comply with securities laws or is reasonably designed to ensure compliance. *For example, a plan may limit divestiture rights for participants who are subject to Section 16(b) of the Securities and Exchange Act of 1934 to a reasonable period such as three to 12 days following publication of the employer's quarterly earnings statements to ensure compliance with Rule 10b-5 ("insider trading rule").*
- **Application of diversification rules.** A plan may restrict the application of the diversification rights for up to 90 days after the plan becomes subject to the diversification requirements; e.g., following an initial public offering of the employer's stock.
- **Limit on employer stock.** A plan may limit the extent to which an individual's account balance can be invested in employer stock. *For example, a plan may prohibit a participant from investing additional amounts in employer stock if more than 10 percent of that participant's account balance is invested in employer stock.*
- **Trading frequency.** A plan may impose reasonable restrictions on the timing and number of investment elections that an individual can make to invest in employer stock, if the restrictions are designed to limit short-term trading. *For example, a plan may provide that a participant may not elect to invest in employer stock if he has elected to divest employer securities within a short period of time, such as seven days.*
- **Fees.** A plan may charge reasonable fees for divesting employer stock.
- **Stable value or similar fund.** A plan may permit transfers to be made into or out of a stable value fund option (or similar fund option) more frequently than other funds, including funds invested in employer stock. For this purpose, a "stable value" fund or similar fund means 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 alternatives.
- **Transfers out of a qualified default investment account (QDIA).** The final regulations expand the list of permitted restrictions to provide that a plan may provide for transfers out of a QDIA more frequently than a fund invested in employer stock.
- **Frozen funds.** The regulations clarify that a plan may allow reinvestment of dividends paid on employer stock in a frozen fund provided the plan does not have another employer stock fund.

## ESOPs

### Transitional rule for certain leveraged ESOPs

The final regulations provide a transitional rule for certain leveraged ESOPs. An employer stock fund continues to be a frozen fund despite the allocation of employer stock released as matching contributions from the plan's suspense account that holds employer stock acquired with an exempt loan. The transitional rule was added because leveraged ESOPs cannot cease allocations of employer stock acquired with an exempt loan that are held in a suspense account without significant effect on the company's debt.

This transitional rule only applies to employer stock that was acquired in a plan year beginning before January 1, 2007, with the proceeds of an exempt loan.

### Anti-cutback relief

Before the enactment of PPA, ESOPs were required to provide employees who have reached age 55 and have 10 years of plan participation, the right to diversify up to 25 percent of the employer stock in their accounts. This election option continues for up to five years (with a maximum of 25 percent of their account being diversified at any one time), and increases to 50 percent when the employees reach age 60 and have ten years of participation.

The IRS has now clarified that an ESOP that has been satisfying the rule described above does not satisfy the PPA diversification requirement. However, an amendment to an ESOP that eliminates the distribution option will not violate the anti-cutback rules.

The IRS expects to issue guidance in the near future that will permit the elimination of such distribution option with respect to an ESOP that is subject to the PPA diversification requirement. The guidance will permit the elimination of this distribution option during the remedial amendment period that ends on the last day of the first plan year beginning on or after January 1, 2010.

### Plan amendments

PPA required sponsors of defined contribution plans with investments in employer stock to adopt a plan amendment reflecting the diversification provisions on or before the last day of the first plan year beginning on or after January 1, 2009. However, this amendment deadline was then extended to the last day of the first plan year beginning on or after January 1, 2010. For calendar year plans, the amendment must be adopted by December 31, 2010.

If Prudential provides document services for your plan, we will prepare the appropriate plan amendment for your adoption by the deadline described above. Prudential's volume submitter document will be amended to add clarifying language reflected in the final regulations. We anticipate that this language will be combined with the [HEART](#) amendment and intend to mail this amendment this fall.

Prudential's prototype document will also be amended to incorporate the additional language reflecting the final diversification rules. This amendment will be mailed to you later this year with the HEART amendment.

If you have questions about the application of the final regulations to your plan, please contact your Prudential Retirement representative for assistance.

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