PRUDENTIAL RETIREMENT. INTELLIGENT SOLUTIONS, WORKING FOR YOU.

Pension ANALYST

Compliance Bulletin

December 2006

IRS Provides Transitional Relief From PPA's Investment Diversification Requirement And Related Participant Notification Requirement

Effective for plan years beginning on or after January 1, 2007 (later, for certain collectively-bargained plans), the Pension Protection Act of 2006 (PPA) requires a defined contribution plan that holds publicly-traded securities to provide diversification rights with respect to amounts invested in these securities. In addition, plan sponsors must provide each individual with a notice explaining his right to diversify employer security investments no less than 30 days before the first day the individual has this right. This notice requirement generally applies to plan years beginning on or after January 1, 2007.

Relief from Notification Requirement

The notice of an individual's right to diversify employer security investments must be provided by:

- Plans that are being revised to comply with the new PPA diversification rules, as well as
- Plans that already provide participants with the freedom to divest their employer security investments in accordance with the PPA rules.

Plan sponsors must only provide this notice when an individual (i.e., a participant, an alternate payee under a qualified domestic relations order, or the beneficiary of a deceased participant) is first eligible to diversify investments or for the 2007 plan year, if the individual is already able to diversify. For plan years beginning on January 1, 2007, notices would have to have been provided no later than December 2, 2006.

On November 30, 2006, the IRS provided transitional relief for this notice requirement for plans with plan years beginning before February 1, 2007. For these plans, the participant notices do not have to be provided before January 1, 2007. In addition, the IRS has published a model notice that plan sponsors may use to meet the notice requirement.

Transitional Guidance Regarding Investment Diversification

Under the PPA investment diversification rules, a defined contribution plan that holds securities that are not publicly traded is treated as holding publicly traded securities, and therefore subject to the new rules, if any member of its controlled group has issued publicly traded securities. In response to concerns raised by some plan sponsors whose non-publicly-traded securities are held by the plan solely as part of an insurance company pooled separate account or similar arrangement, the IRS guidance provides that such an arrangement will not be treated as holding employer securities, as long as the holdings of the investment vehicle are sufficiently diversified. As a result, the diversification rules will not apply, even if other members of the employer's controlled group issue publicly-traded securities.

In general, plans must allow certain individuals (participants and alternate payees) to redirect employer securities investments of employer contributions once they have completed three years of vesting service. The transition guidance clarifies that if a plan uses the 1000 hours or an equivalencies method of crediting vesting service, this three-year requirement is met immediately after the end of the third vesting computation period. *For example, if a plan measures the 1000-hour requirement over plan years and has a calendar plan year, an employee who is hired on January 1, 2007, and meets the 1000-hour requirement in consecutive plan years, will first be eligible to diversify his employer contribution investments on January 1, 2010.* For a plan that uses the elapsed time method of crediting vesting service, the three-year requirement will generally be satisfied on the third anniversary of the employee's date of hire.

To satisfy the new diversification requirements, a plan must provide a choice of at least three investment options other than employer securities. These other investment options must be diversified and have materially different risk and return characteristics. The IRS guidance confirms that investment options that satisfy the ERISA section 404(c) requirements will also satisfy these diversification rules.

The PPA diversification rules prohibit plans from imposing restrictions or conditions on the investment of employer securities that are not imposed on other plan investment vehicles. The IRS guidance provides three general examples of *prohibited restrictions or conditions*:

- A plan that permits quarterly divestiture of employer securities but daily divestiture of another investment.
- A plan that provides a lower rate of matching contributions for a participant who divests his account of his employer securities than for a participant who remains invested in employer securities.
- A plan limitation on reinvesting account balances in employer securities following a divestiture of employer securities investments.

However, the guidance does provide that it is *acceptable* to limit employer securities investments (for example, to 10% of a participant's account balance) or to close employer securities investments to new investments. In addition, it is permissible to limit divestiture rights for Section 16(b) participants to a specified period following publication of the employer's quarterly earnings statements. It is also permissible to restrict diversification rights for up to 90 days following an initial public offering. Finally, a plan may impose fees on other plan investment options even if no fees are imposed on employer securities investments.

Recognizing that plan sponsors may need additional time to bring plans into compliance with these new rules, the IRS is providing the following additional transitional relief:

- A plan provision imposing a restriction on employer security diversification rights that is not permitted under PPA may continue to be imposed through March 30, 2007, if the provision was in effect on December 18, 2006. If it is imposed on or after March 31, 2007, it will violate the PPA diversification rules.
- A plan provision that imposes a restriction on employer securities investments that is not also imposed on a stable value fund, or that permits the more frequent divestiture of another investment that is only available to a fixed class of participants, may continue to be imposed through December 31, 2007, if the provision was in effect on December 18, 2006.
- The special transition rule for employer contributions invested in employer securities before January 1, 2007, applies separately to each class of employer securities held by the plan. Under this rule, 33% of

these employer securities must be eligible for diversification in 2007, 66% must be eligible in 2008, and the entire amount must be eligible for diversification in 2009.

Comments and Future Regulations

The IRS has requested comments on these new employer security diversification rules, including the model notice. Final regulations, when issued, are expected to be consistent with these transitional rules. If you have questions about the application of these transition rules to your plan, please contact your Prudential Retirement representative for assistance.

Prudential Financial