

## Client Alert

# Deadline Extended for New Qualified Plan Employer Stock Diversification Requirements

The Pension Protection Act of 2006 (PPA 2006) made sweeping changes to the laws governing employee benefit plans, including adding new diversification requirements for most tax-qualified defined contribution plans holding publicly traded employer securities. The new diversification requirements take effect as early as January 1, 2007, and certain employers must provide plan participants with advanced notice of the new diversification requirements. As expected, late last week, the Treasury Department and Internal Revenue Service (1) extended the deadlines for complying with some aspects of the new diversification requirements, (2) extended the deadline for providing the required notice, and (3) issued a model notice to comply with the new notice requirement. The extensions and model notice were issued under IRS Notice 2006-107. For a link to the IRS notice, [click here](#) or go to [www.chadbourne.com/PPA.htm](http://www.chadbourne.com/PPA.htm).

### What Are the New Diversification Requirements?

The PPA 2006 gives participants (and certain other individuals, such as alternate payees) in tax-qualified defined contribution plans that hold publicly traded employer securities the right to diversify their plan accounts held in such securities. The holding of publicly traded employer securities via an investment company or similar pooled investment vehicle (such as a mutual fund) is generally not sufficient to trigger the diversification requirements. However, a plan will be considered to hold "publicly traded employer securities" if a plan holds employer securities that are not publicly traded, yet any participating employer or member of its controlled group has issued any class of stock that is traded on an established securities market. Certain ESOPs are exempted from the diversification requirements.

Covered plans will be required to permit participants to diversify immediately their employee deferral, after-tax, and rollover accounts held in publicly traded employer securities. A participant need not be given the right to diversify employer contribution accounts (both non-elective and matching) held in such employer securities until the participant accrues three years of service. Participants must be given the choice to diversify into at least three different investment options, each with materially different risk and return characteristics. Plans can limit diversification to reasonable time periods that occur at least quarterly, although participants generally must be given the opportunity to diversify as frequently as they may make changes to other investment elections.

The new diversification requirements also greatly limit a plan's ability to provide a benefit (such as an increased matching contribution) conditioned upon a participant's continued investment in employer securities and to limit a participant's ability to invest in employer securities if the participant transfers money out of that investment. For example, a plan limit that prevents participants from investing in employer securities for the six-month period after he or she transfers money out of the employer securities investment option will generally not be permissible. It is permissible to limit a participant's ability to re-invest in employer securities held in a closed fund (that is, a fund that does not accept any new contributions or transfers of existing contributions).

The new diversification requirements are generally effective for plan years beginning after December 31, 2006, although transition guidance has now been issued. Covered plans will need to comply with these diversification requirements in order to maintain their tax-qualified status.

## What Are Highlights of the New Transitional Guidance?

Here are some highlights of the transition rules contained in IRS Notice 2006-107:

- ***Plans Need Not Terminate Existing Restrictions or Conditions on Divestiture Rights Until March 30, 2007.*** Plan sponsors now have until March 30, 2007 to remove any conditions or restrictions prohibited by the new diversification requirements, as long as those conditions or restrictions are in effect on December 18, 2006. Those conditions or restrictions may not continue to be imposed on or after March 31, 2007 (except as noted in the next bullet).
- ***Certain Conditions on Grandfathered Investments Need Not be Removed Until December 31, 2007.*** Plan sponsors now have until December 31, 2007 to remove conditions or restrictions prohibited by the new diversification requirements, as long as those conditions or restrictions are in effect on December 18, 2006, but only to the extent they either (i) do not impose otherwise applicable restrictions on a stable value fund or (ii) allow divestiture of an investment that is not a generally available investment (that is, an investment only available to a fixed class of participants) on a more frequent basis than participants are allowed to divest employer securities. Those conditions or restrictions may not continue to be imposed on or after January 1, 2008.
- ***Diversification Rights for Existing Investments Can Be Phased In.*** In some cases, the new diversification requirements can be phased in over three years. This transition rule applies to employer securities held under a plan before the new diversification requirements become effective (“grandfathered securities”) as follows: (i) for the first plan year to which the new diversification requirements apply, a plan need only permit a participant to diversify 33% of his or her grandfathered securities; and (ii) for the second plan year, a plan need only permit a participant to diversify 66% of his or her grandfathered securities. Beginning with the third plan year, participants must be able to diversify 100% of their grandfather securities. ***Note that this transition rule does not apply to any participant who, before the beginning of the first plan year after December 31, 2005, is at least 55 years old with three completed years of service.***
- ***Notice Under ERISA is Not Required Until January 1, 2007.*** The Department of Labor has advised that Section 101(m) of ERISA (which requires that written notice of divestiture rights be provided to participants and certain other individuals) does not require plans to furnish a notice of rights before January 1, 2007. This means that plans with plan years beginning on or after January 1, 2007, but before February 1, 2007, are not required to furnish the notice to applicable individuals until January 1, 2007, even though that notice will not be furnished at least 30 days before the date that the individuals are eligible to exercise their rights. The Treasury Department nonetheless encourages plan sponsors to provide the notice as soon as possible and has therefore issued a model notice that plan sponsors can use. The model notice can be found in Notice 2006-17 (which can be reached via the earlier link to that Notice). We would also be happy to provide you with a copy of the model notice.

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***New York***

David Gallai	+1 (212) 408-1033	dgallai@chadbourne.com
Marjorie M. Glover	+1 (212) 408-1016	mglover@chadbourne.com
Jennifer Roselius	+1 (212) 408-5426	jroselius@chadbourne.com
Edward P. Smith	+1 (212) 408-5371	esmith@chadbourne.com

**Chadbourne & Parke LLP**

***New York***

30 Rockefeller Plaza  
New York, New York 10112  
Telephone: +1 (212) 408-5100  
Facsimile: +1 (212) 541-5369

***Washington, D.C.***

1200 New Hampshire Avenue, N.W.  
Washington, D.C. 20036  
Telephone: +1 (202) 974-5600  
Facsimile: +1 (202) 974-5602

***Los Angeles***

350 South Grand Avenue, Suite 3300  
Los Angeles, CA 90071  
Telephone: +1 (213) 892-1000  
Facsimile: +1 (213) 622-9865

***Houston***

1100 Louisiana, Suite 3500  
Houston, TX 77002  
Telephone: +1 (713) 571-5900  
Facsimile: +1 (713) 571-5970

***London***

Chadbourne & Parke  
(a multinational partnership)  
Regis House, 45 King William Street  
London EC4R 9AN  
Telephone: +44 (20) 7337-8000  
Facsimile: +44 (20) 7337-8001

***Moscow***

52/5 Kosmodamianskaya Naberezhnaya  
Moscow 115054 Russian Federation  
Telephone: +7 (495) 974-2424  
Facsimile: +7 (495) 974-2425

***St. Petersburg***

5 Italianskaya Str., office 56/57  
St. Petersburg 191186 Russian Federation  
Telephone: +7 (812) 326-9300  
Facsimile: +7 (812) 326-9341

***Warsaw***

(through a Polish partnership)  
ul. Emilii Plater 53  
00-113 Warsaw, Poland  
Telephone: +48 (22) 520-5000  
Facsimile: +48 (22) 520-5001

***Kyiv***

11 Mykhailivska Street, 4th Floor  
Kyiv 01001, Ukraine  
Telephone: +380 (44) 230-2534  
Facsimile: +380 (44) 230-2535

***Almaty***

Dostyk Business Center  
43 Dostyk Ave, 4th Floor  
Almaty 050010, Kazakhstan  
Telephone: +7 (3272) 585-088  
Facsimile: +7 (3272) 588-084

***Tashkent***

3rd Floor  
1 Turab Tula Street  
Tashkent 700003, Uzbekistan  
Telephone: +998 (71) 1206-627  
Facsimile: +998 (71) 1206-329

***Beijing***

Room 902, Tower A, Beijing Fortune Centre  
7 Dongsanhuan Zhonglu, Chaoyang District  
Beijing 100020, China  
Telephone: +86 (10) 6530-8846  
Facsimile: +86 (10) 6530-8849

If you would like additional copies of this client alert, please contact Phillipa Yule, Director of Marketing and Creative Services, at +1 (212) 408-5240 or e-mail: [pyule@chadbourne.com](mailto:pyule@chadbourne.com).