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Comments on the Diversification Requirements for Qualified Defined Contribution Plans Holding Publicly Traded Employer Securities

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Department of Treasury
Internal Revenue Service

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates this opportunity to comment on the transitional guidance issued in IRS Notice 2006-107 (Notice) on the diversification requirements for qualified defined contribution plans holding publicly traded employer securities under Internal Revenue Code (IRC) §401(a)(35) as added by Pension Protection Act of 2006 (PPA) §901.

ASPPA is a national society of retirement plan professionals. ASPPA's mission is to educate pension professionals and to preserve and enhance the employer-sponsored pension system. Its membership consists of more than 6,100 actuaries, plan administrators, investment professionals, attorneys, CPAs and other retirement plan experts who design, implement and maintain qualified retirement plans covering tens of millions of American workers.

The transitional guidance in the Notice is a welcome step for practitioners who must implement and administer the new diversification requirements. ASPPA requests, however, that the Treasury or IRS provide clarification on several issues addressed in the Notice, as well as provide guidance for issues not covered in the Notice. Clarification and additional guidance will allow plan sponsors to implement and administer the diversification requirements and help them to achieve compliance in plan operation.

Summary of Recommendations

The following is a summary of ASPPA's recommendations. These are described in greater detail in the Discussion of Issues section.

A. The final regulations should clarify that the definition of an "established securities market" in the context of "readily tradable on an established securities market" does not include those securities listed on the National Association of Securities Dealers' Over-the-Counter Bulletin Board (OTCBB), or "pink sheets."

B. The final regulations should clarify that the definition of "readily tradable" in the context of "readily tradable on an established securities market" takes into consideration that not all publicly traded securities are "readily tradable." In fact,

there should be a standard under which securities that are very thinly traded are not considered to be "readily tradable," such as a volume of share trading threshold of at least ten percent (10%) of the shares held by the plan as of the last day of the prior plan year.

C. The final regulations should clarify the deadline for providing the required divestment notice to those participants making their initial investment in publicly traded employer securities after completing their requisite years of service. Specifically, the final regulations should allow plan administrators to provide the required diversification notice to participants by the later of 30 days prior to initial eligibility or 30 days following an initial investment in publicly traded employer securities.[1]

D. The final regulations should clarify that restrictions "reasonably designed to ensure compliance" with securities laws may include restrictions on participants who have been subject to Section 16(b) of the Securities Exchange Act of 1934 during a specified timeframe (*i.e.,* at any time during the current or previous plan year).

E. The final regulations should provide transition relief in certain dispositions and acquisitions similar to the relief afforded under IRC §410(b)(6)(c) for satisfaction of the minimum coverage requirements.

F. The final regulations should clarify that charging normal trading fees to the accounts of participants electing to divest employer securities does not constitute a prohibited restriction.

G. The final regulations should clarify that Employee Stock Ownership Plans (ESOPs) holding contributions to which IRC §§401(k) or (m) applies can spin off such contributions to a separate plan and restrict the diversification rights in the resulting "stand-alone" ESOP without violating the anti-cutback rules of IRC §411(d)(6).

Discussion of Issues

A. Definition of an "Established Securities Market"

When determining plans subject to PPA's expanded rights allowing participant diversification of employer securities, IRC §401(a)(35)(G)(v) defines the term publicly traded securities as employer securities that are readily tradable on an established securities market. The income tax regulations, however, do not include any guidance on what constitutes "readily tradable on an established securities market."

Several IRS Private Letter Rulings (PLRs), including PLR 9036039 and PLR 200052014, have provided guidance on this issue in the context of the applicants' request to defer

[1] Alternatively, ASPPA suggests that regulations allow the required participant disclosure language be contained within the quarterly benefit statements and thus satisfy the notice requirement for those employees who have already met the diversification eligibility requirements at the time they invested in employer securities.

recognition of long-term capital gains on the sale of employer securities to an ESOP pursuant to IRC §§1042(a) and 1042(c)(1). Both PLRs held the term "readily tradable on an established securities market" to follow the definition of "publicly traded" under the Excise Tax Regulations, §54.4975-7(b)(1)(iv). These regulations provide that publicly traded securities are those listed on a national securities exchange or quoted on a system sponsored by a national securities association, either of which is registered under the Securities Exchange Act of 1934. Further, both PLRs ruled that employer securities listed on the OTCBB, also referred to as the "pink sheets," do not satisfy the registration requirements to be classified as publicly traded.

ASPPA recommends that the final regulations clarify that the definition of "readily tradable on an established securities market" does not include those securities listed on the National Association of Securities Dealers' OTCBB, or "pink sheets."

B. Definition of "Readily Tradable" on an Established Securities Market

When determining plans subject to PPA's expanded rights for allowing participant diversification of employer securities, IRC §401(a)(35)(G)(v) defines the term publicly traded securities as employer securities that are readily tradable on an established securities market. The income tax regulations, however, do not include any guidance on what constitutes "readily tradable." An issue arises when allowing a participant to exercise his or her right to diversify inherently drives down the price of that employer security because of its thinly traded nature. Furthermore, when a security is thinly traded, a buyer may not be readily available when the participant wants to sell his or her shares out of the plan account, thus delaying the timing of the trade. Awaiting a market transaction could be viewed as a violation or restriction of the participant's right to diversify (particularly if other investment options are available that are traded readily upon demand).

ASPPA recommends that the final regulations clarify the definition of "readily tradable" in the context of "readily tradable on an established securities market" to include only those employer securities that have an average daily share trading volume of at least 10% of the number of shares of employer stock held by the plan (or plans) sponsored by the employer, as measured on the last day of the preceding plan year.

C. Timing of Divestment Notice

The Notice provides that diversification rights must be extended to eligible participants within the applicable timeframes for employee and employer contributions. It also notes the rights only apply when publicly traded employer securities are held by the plan and allocated to a participant's or beneficiary's account. The Notice also requires plan administrators to notify participants of their diversification rights 30 days prior to their eligibility to exercise such rights. To the extent a participant with the requisite years of service initially elects to invest in publicly traded employer securities, the plan administrator would immediately be in violation of the 30-day notification requirements.

For example, assume participant X has completed five years of service as of December 31, 2006, but never invested any portion of his plan account in the publicly traded employer securities. On June 1, 2007, X elects to transfer 50% of his plan account into publicly traded employer securities using the plan's participant Web site. Since X would have satisfied all

the requirements to be eligible to diversify his accounts as of the date of the June 1 transfer, the Notice imposes a deadline of May 1, 2007, to provide X with the diversification notice. The plan administrator, however, would have no way to anticipate such a transfer and be able to provide the notice on a timely basis.

ASPPA recommends that the final regulations allow plan administrators to provide the required diversification notice to participants by the later of 30 days prior to initial eligibility or 30 days following an initial investment in publicly traded employer securities. ***Alternatively,*** ASPPA suggests that regulations allow the required participant disclosure language be contained within the quarterly benefit statements and thus satisfy the notice requirement for those employees who have already met the diversification eligibility requirements at the time of investment in the employer securities.

D. Reasonable Restrictions to Comply with Securities Laws

The Notice allows for restrictions that are "reasonably designed to ensure compliance with [securities] laws" and lists the establishment of trading windows for corporate "insiders" as a reasonable restriction. Because of the significant ramifications of violating insider-trading prohibitions, public companies frequently impose employer stock trading restrictions on employees not just by title but also during the time period for which a participant was subject to the Securities and Exchange Act of 1934, Section 16(d). Thus, a larger class of employees than those currently subject to the Securities Exchange Act of 1934, Section 16(b), could be restricted from trading corporate stock in the qualified plan. For example, a plan sponsor may choose to establish trading windows for all participants who were subject to Section 16(b) at any time during the current or preceding plan year or at any time within the six calendar quarters immediately preceding the trading window.

ASPPA recommends that final regulations interpret "reasonably designed" as broadly as possible so that plan sponsors' existing conservative administrative policies that restrict anyone who was subject to the Securities Exchange Act of 1934, Section 16(b), for any time period up to the current year or preceding year are permissible.

E. Transition Relief in Mergers and Acquisitions

The Notice specifies that a plan holding private employer securities will be deemed to hold publicly traded employer securities if any member of such plan sponsor's controlled group has issued a class of stock that is publicly traded. As such, a private company holding employer securities in its plan would be immediately subject to the expanded diversification rights upon acquisition by a public company. Such immediate application of those rights would result in a failure to provide the required 30-day advance notice of eligibility to diversify for all of the acquired company's participants.

ASPPA recommends that in the context of a corporate transaction, such as a merger or acquisition, the final regulations include transition relief for the application of diversification of employer securities similar to that provided in IRC §410(b)(6)(c) for satisfaction of the minimum coverage requirements following a corporate acquisition or divestiture.

F. Allocation of Normal Trading Fees and Expenses

The increased trading volume likely to result from the expanded rights to diversify employer securities will generate additional trading fees. IRS Revenue Ruling 2004-10 discusses the allocation of expenses to participant accounts as a significant detriment when he or she consents to a distribution pursuant to IRC §411(a)(11). The ruling specifies that allocating such expenses is not a significant detriment "if that allocation is reasonable and otherwise satisfies the requirements of Title I of ERISA." DOL Field Assistance Bulletin 2003-3 provides that reasonable and proper plan expenses in a defined contribution plan may be charged to individual participants.

The Notice permits fees on other plan investment options in situations where no fees are assessed to investments in employer securities; however, the reverse situation is not specifically addressed for situations where transactions involving employer securities generate reasonable trading fees and expenses but other plan investment options do not generate reasonable trading fees and expenses.

ASPPA recommends that final regulations specify that the allocation of normal trading fees to execute participants' diversification rights is not a prohibited restriction under §401(a)(35).

G. Spin-off ESOPs

IRC §4975(e)(7) defines an employee stock ownership plan in relevant part as a qualified defined contribution plan designed to be primarily invested in employer securities. To reduce administrative expenses (*e.g.,* recordkeeping, plan document, annual audit, etc.) related to maintaining multiple qualified defined contribution plans, many plan sponsors who maintain ESOPs have either merged those ESOPs with their 401(k) plans or simply added §401(k) and/or §401(m) components to their existing ESOPs (combined plans).

The Notice provides that ESOPs holding publicly traded employer securities are generally exempt from the diversification requirements of IRC §401(a)(35) unless such ESOPs hold any contributions subject to IRC §§401(k) or (m). Since application of the expanded diversification rights to the non-401(k)/(m) portions of the plan would frustrate the purpose of an ESOP under IRC §4975(e)(7), it is anticipated that sponsors of such plans will elect to spin off the non-ESOP components so the ESOP component will qualify for the exemption described above.

A participant's right to direct investments in a defined contribution plan is not a protected benefit under IRC §411(d)(6); however, unlike participant direction of investments, the diversification rights of IRC §401(a)(35) are statutory and not voluntary on the part of the plan sponsor.

ASPPA recommends that final regulations clarify that if a plan sponsor elects to spin off the 401(k)/(m) components of combined plans, the resulting ESOP is no longer subject to IRC §401(a)(35) and the elimination of the divestment provisions with respect to the ESOP would not violate IRC §411(d)(6).

These comments were prepared by the 401(k) Subcommittee of ASPPA's Government Affairs Committee, Virginia Krieger Sutton, QKA, Chair, and were primarily authored by Adam C. Pozek, QKA, QPFC. Please contact us if you have any comments or questions

regarding the matters discussed above. Thank you for your consideration.

Sincerely,

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