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Final Regulations Regarding Diversification Requirements for Defined Contribution Plans Holding Employer Securities

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The Internal Revenue Service recently issued final regulations under Section 401(a)(35) of the Internal Revenue Code of 1986, as amended (the Code), regarding the diversification of investment opportunities required for defined contribution plans holding publicly traded employer securities (other than stand-alone ESOPS or one participant retirement plans). With the finalization of these regulations, employers need to review their plan provisions and procedures carefully to ensure compliance.

Code Section 401(a)(35) was added by the Pension Protection Act of 2006. In 2006, the IRS issued Notice 2006-107 (the Notice), which provided transitional guidance and relief regarding the diversification requirements. In 2008, the IRS issued proposed regulations on the diversification requirements and has now issued final regulations with various modifications.

The final regulations are effective for plan years beginning on or after January 1, 2011. For plan years beginning prior to January 1, 2011 a plan may rely on the Notice, the proposed regulations or the final regulations to satisfy Code Section 401(a)(35).

Diversification Rights

To satisfy the diversification requirements, a plan must permit participants, alternate payees and beneficiaries of participants (collectively, Participants) to direct that the portion of their defined contribution plan account holding employer securities be invested in alternative investments. With regard to the portion of an account holding employer securities that was acquired with employee contributions, the right to reinvest such funds in alternative investments must be provided immediately. With regard to employer contributions, a precondition of up to three years of service may be imposed for the right to reinvest such funds in alternative investments, except with regard to a beneficiary of a deceased participant.

The opportunity to divest the employer securities and reinvest the equivalent amount in another investment must be provided at reasonable, periodic times occurring at least quarterly. The plan may not impose restrictions or conditions on the divestment of employer securities that are not imposed on other plan assets. A Participant must be permitted to select from at least three investment options, each of which is diversified and has materially different risk and return characteristics.

Publicly Traded Employer Securities

The final regulations, like the proposed regulations, treat an employer security as “publicly traded” if it is readily tradable on an established securities market.

A plan that holds employer securities that are not publicly traded will be subject to the diversification requirements only if an employer sponsoring the plan or any member of its controlled group (defined for this purpose as ownership of at least 50% of the total voting power or total value of the shares) has issued a class of stock which is publicly traded (*i.e.,* utilizing the definition in Section 407(d)(1) of the Employee Retirement Income Security Act of 1974, as amended).

Certain Investment Funds Not Treated as Holding Employer Securities.

The final regulations, liked the proposed, provide that certain investment funds that include employer securities as part of a broader fund are not treated as holding employer securities. This exception was generally limited under the proposed regulations to the extent the employer securities were held indirectly through an investment company registered under the Investment Company Act of 1940; a common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a state or a federal agency; a pooled investment fund of an insurance company that is qualified to do business in a state; or any other investment fund designated by the IRS. The proposed exception was limited to funds where the investment is independent of the employer and where employer securities do not exceed 10 percent of the fund.

The final regulations expanded this exception in several ways:

- An investment option in a multiemployer plan will not be treated as holding employer securities to the extent the employer securities are held indirectly through an investment fund managed by an investment manager if the investment is independent of the employer and the employer securities do not exceed 10 percent of the plan.
- The requirement that a fund that is an investment company be registered under the Investment Company Act of 1940 has been expanded to cover regulated investment companies as described in Code Section 851(a), so as to include exchange traded funds such as unit investment trusts that satisfy Code Section 851(a).

If a fund that indirectly holds employer securities fails to meet the requirement that the investment be independent of the employer or the percentage limitation rule, the plan will not fail to satisfy the diversification requirements under Code Section 401(a)(35) even if it does not offer diversification rights for up to 90 days after the investment fund is treated as holding employer securities.

The determination of whether the percentage limitation rules are satisfied is made for a plan year as of the end of the preceding plan year and can be based on the information in the latest disclosure of the fund's portfolio holdings (for example, Form N-CSR, Certified Shareholder Report of Registered Management Investment Companies) that was filed with the Securities and Exchange Commission for the preceding plan year.

Prohibition on Restrictions or Conditions

Except to the extent required or reasonably designed to comply with securities laws, the final regulations prohibit a plan from imposing restrictions or conditions on investing employer securities where such restrictions or conditions are not imposed on the investment of other assets. Such prohibitions apply to direct or indirect:

- Restrictions on an individual's right to divest an investment in employer securities that are not imposed on non-employer securities, or
- Benefits that are conditioned on investment in employer securities.

The final regulations, however, permit certain indirect restrictions and indirect benefits that are conditioned on investment in employer securities, such as a plan may:

- limit the extent to which an account can be invested in employer securities (*e.g.*, prohibit the investment of additional amounts in employer securities where more than 10 percent of the individual's account is already invested in employer securities).
- impose fees on other investment options that are not imposed on the investment in employer securities.
- impose a reasonable fee for the divestment of employer securities.

The final regulations clarify the exception for reinvestment in employer securities for frozen funds. A plan may prohibit reinvestment in employer securities only if the plan precludes all contributions and other investments from being invested or reinvested in employer securities. Additionally, according to a clarification in the final regulations, a plan will not be considered to provide for further investment in employer securities because dividends paid on employer securities under the plan are reinvested in employer securities.

An employer can restrict access to an employer securities account if it allows an individual to invest in another employer securities account, where the only relevant difference between the two accounts is the tax cost, without violating the diversification rules.

A plan may also impose reasonable restrictions on the timing and number of investment elections that an individual can make to invest in employer securities if the restrictions are designed to limit short-term trading of the employer securities without violating the diversification rules. For example, a fund can limit the purchase of employer securities if there has been a sale within a short period of time, such as 7 days.

Under the final regulations, a plan is permitted to provide for transfers out of a qualified default investment alternative (a QDIA) and into or out of stable value funds or similar funds more frequently than a fund invested in employer securities.

A limited transitional rule is provided for the release of employer securities as matching contributions from a plan's suspense account for certain leveraged ESOPs for employer securities that were acquired in a plan year beginning before January 1, 2007 with the proceeds of an exempt loan, which was not refinanced after the end of the last plan year beginning before January 1, 2007.

Additionally, an amendment to an ESOP that is subject to the Code Section 401(a)(35) diversification requirements that eliminates the distribution options available to participants to satisfy Code Section 401(a)(28) will not violate the anti-cutback rules. The final regulations indicate that further guidance will be issued soon with respect to this issue.

Implications for Employers, Plan Sponsors and Administrators

Employers and other sponsors, fiduciaries and administrators of 401(k) and other defined contribution pension plans that hold publically traded employer securities should review their plan documentation, communications and practices to ensure compliance with the final regulations. In particular, employers that "froze" their employer stock funds or placed other limits on participant investments should review those restrictions to be sure that the standards set forth in the final regulations are followed.

Finally, public companies should be aware that they may be required to register their stock offered through plans covered by Code Section 401(a)(35). Public companies are generally required to register their stock offered under defined contribution plans on a Form S-8 and to provide a prospectus to Participants because such offerings are considered a sale of stock for purposes of the Securities Exchange Act of 1934 (the Exchange Act). However, if contributions are solely non-contributory and involuntary on the part of Participants, such as employer matching contributions, that are invested in employer stock, the stock offerings generally will not be considered a sale of stock for purposes of the Exchange Act and would not require the filing of a Form S-8 or distribution of a prospectus. As the diversification rights in Code Section 401(a)(35) require providing Participants with the right to reinvest employer contributions in employer stock, companies must reexamine the need to register the securities as well as the ability of their record keepers to track and demarcate the source of the funds available for reinvestment.

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