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Employer Stock Diversification Requirements under the Pension Protection Act of 2006

In General

The Pension Protection Act of 2006 (the “Act”) added Section 401(a)(35) to the Internal Revenue Code (the “Code”) to require that a qualified defined contribution plan (other than certain employee stock ownership plans) must allow “applicable individuals” to sell the employer stock held in their plan accounts and reinvest any proceeds in certain diversified investments. The Act also adds a parallel provision as Section 204(j) to the Employee Retirement Income Security Act (ERISA) and a new requirement under Section 101(m) of ERISA that participants be notified of their diversification rights and informed of the importance of diversifying their retirement investments.

The new diversification and related notice requirements of the Act are generally effective for plan years that begin after December 31, 2006, and the Internal Revenue Service (IRS) has issued transitional guidance under Notice 2006-107 (the “Notice”).

Diversification Rights

Plans Subject to Requirements

The diversification requirements of Section 401(a)(35) are imposed on defined contribution plans that hold publicly traded employer stock. For this purpose, the stock of an employer that is not publicly traded will be considered to be publicly traded if any member of its controlled group of corporations (determined under a 50% test) has stock that is publicly traded. Section 401(a)(35) does not apply to plans with respect to investments made in certain pooled investment vehicles, such as regulated mutual funds or to plans covering only partners or one person.

Although certain employee stock ownership plans (ESOPs) are exempt from the diversification requirements, an ESOP becomes subject to Section 401(a)(35) if the ESOP either holds contributions that are elective deferrals, employee after-tax contributions or matching

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contributions (or earnings on same) subject to Section 401(k) or 401(m) of the Code or the ESOP is part of another plan maintained by the employer.

Definition of Applicable Individual

The diversification rights under Section 401(a)(35) are provided under Subsections (B) and (C). Subsection (B) provides that the diversification requirements apply with respect to elective deferrals, employee after-tax contributions and rollover contributions (and earnings on same). An “applicable individual” for this purpose is a participant in a covered plan, an alternate payee who has an account under the plan or any beneficiary of a deceased participant.

Subsection (C) provides that the diversification requirements apply with respect to other employer contributions (and earnings on same), and an “applicable individual” for this purpose is a participant who has completed at least three years of service, an alternate payee who has an account under the plan with respect to a participant who has completed at least three years of service or a beneficiary of a deceased participant.

Description of Diversification Rights

In General. When publicly traded employer stock is held in a participant’s covered account, an applicable individual must be allowed to divest the account of the employer stock and reinvest an equivalent amount in other investment options under the plan. The plan must offer at least three alternate investment options that are diversified and offer materially different risk and return characteristics. For this purpose, the Notice provides that investment options that satisfy the requirements under the ERISA Section 404(c) regulations will be treated as satisfying this requirement as well.

Prohibited Restrictions. In meeting these requirements, a plan may not impose restrictions or conditions with respect to the investment of employer securities that are not imposed on other investments under the plan. The Notice provides that restrictions on an applicable individual’s rights to divest an investment in employer securities that is not imposed on a non-employer securities investment or benefits that are conditioned on investment in employer securities are prohibited. The Notice provides the following as examples of restrictions or conditions prohibited under Section 401(a)(35):

- A plan allows applicable individuals to divest their accounts of employer securities on a periodic basis but allows divestiture of another investment more frequently. (A transition rule may apply to allow for such disparate treatment if such provision was in place as of December 18, 2006 and is removed by December 31, 2007.)

- A plan provides for more favorable treatment (such as a higher rate of matching contributions) for participants whose accounts remain invested in employer securities than for participants who divest their accounts of employer securities.
- A plan provides that if a participant divests his or her account of its investment in a class of employer securities, the participant is not allowed for a period of time thereafter to reinvest in that class of employer securities.

Permitted Restrictions. Under Section 401(a)(35), a plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly, provided, as noted above, that other investments are not allowed more frequent opportunities. Restrictions resulting from considerations under securities laws also are allowed. In addition, the following are permissible, provided they do not come into play because of an individual's previous divestment of employer securities (in which case, these restrictions would essentially act as a penalty for such prior sale):

- The plan limits the extent to which an individual's account balance can be invested in employer securities (*i.e.*, no more than 10%).
- The plan provides limits under which an employer securities investment fund is closed and unavailable for investment.

Transition Rules

Existing Restrictions or Conditions. From January 1, 2007 through March 30, 2007, a plan that restricts employer stock diversification rights pursuant to a plan provision in effect on December 18, 2006 will not be deemed to impose a prohibited restriction or condition, provided that the restriction does not continue to be imposed on or after March 31, 2007.

Grandfathered Investments. Under Section 401(a)(35)(H), the diversification rights are phased-in with respect to employer securities that are acquired in a plan year beginning prior to January 1, 2007. Accordingly, for the first plan year in which Section 401(a)(35) applies, only 33% of those securities are subject to the diversification requirements, and the applicable percentage rises to 66% in the second year and 100% in the third and all subsequent plan years. This transition rule does not apply with respect to participants who have attained age 55 and completed at least three years of service prior to the first plan year beginning after December 31, 2005.

Notice Requirements

The Act also added Section 101(m) to ERISA, which is effective for plan years beginning after December 31, 2006 and requires plans to notify applicable individuals of their divesture rights discussed above. Plan administrators must provide a notice to applicable individuals no later than 30 days before the first date on which the individuals are eligible to exercise their rights. The notice must describe the applicable diversification rights under Section 401(a)(35) and describe the importance of diversifying the investment of retirement assets.

The Notice provides a Model Notice with respect to this requirement under Section 101(m) of ERISA, which appears below and may have to be adapted to reflect the specific plan provisions. The notice to applicable individuals must be written in a manner calculated to be understood by the average plan participant and may be delivered in written, electronic or other appropriate form reasonably accessible to the participant. Provision of the notice is not a requirement for tax qualification but failure may result in penalties under ERISA for failure to fulfill reporting obligations.

Conclusion

The IRS and the Department of Labor are expected to issue proposed regulations with respect to the diversification requirements under Section 401(a)(35) in the future, which may differ from the transitional guidance. We also note that, under its Notice 2007-2, the IRS states that it will not consider the Act in issuing opinion, advisory or determination letters with respect to remedial amendment Cycle B, and, therefore, such letters cannot be relied upon with respect to any plan provisions reflecting Section 401(a)(35), regardless of whether the plan has been amended to reflect such provisions at the time it is submitted for an opinion, advisory or determination letter in Cycle B.

Model Notice

Notice of Your Rights Concerning Employer Securities

This notice informs you of an important change in federal law that provides specific rights concerning investments in employer securities (company stock). Because you may now or in the future have investments in company stock under the *[insert name of plan]*, you should take the time to read this notice carefully.

Your Rights Concerning Employer Securities

For plan years beginning after December 31, 2006, the Plan must allow you to elect to move any portion of your account that is invested in company stock from that investment into other investment alternatives under the Plan. This right extends to all of the company stock held under the Plan, except that it does not apply to your account balance attributable to *[identify any accounts*

to which the rights apply only after three years of service] until you have three years of service. [Insert description of any advance notice requirement before a diversification election becomes effective.] You may contact the person identified below for specific information regarding this new right, including how to make this election. In deciding whether to exercise this right, you will want to give careful consideration to the information below that describes the importance of diversification. All of the investment options under the Plan are available to you if you decide to diversify out of company stock.

The Importance of Diversifying Your Retirement Savings

To help achieve long-term retirement security, you should give careful consideration to the benefits of a well-balanced and diversified investment portfolio. Spreading your assets among different types of investments can help you achieve a favorable rate of return, while minimizing your overall risk of losing money. This is because market or other economic conditions that cause one category of assets, or one particular security, to perform very well often cause another asset category, or another particular security, to perform poorly. If you invest more than 20% of your retirement savings in any one company or industry, your savings may not be properly diversified. Although diversification is not a guarantee against loss, it is an effective strategy to help you manage investment risk.

In deciding how to invest your retirement savings, you should take into account all of your assets, including any retirement savings outside of the Plan. No single approach is right for everyone because, among other factors, individuals have different financial goals, different time horizons for meeting their goals, and different tolerances for risk. Therefore, you should carefully consider the rights described in this notice and how these rights affect the amount of money that you invest in company stock through the Plan.

It is also important to periodically review your investment portfolio, your investment objectives, and the investment options under the Plan to help ensure that your retirement savings will meet your retirement goals.

For More Information

If you have any questions about your rights under this new law, including how to make this election, contact [*enter name and contact information*].

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If you have any questions concerning the information discussed in this Alert or any other employee benefits topic, please contact one of the attorneys listed below or your primary contact with the firm who can direct you to the right person. We would be delighted to work with you.

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