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THE PROFIT SHARING AND 401(k) ADVOCATE ◆ SHARING THE COMMITMENT SINCE 1947
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January 22, 2007
via e-mail

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RE: Notice 2006-107

Tom,

Thank you for the transitional relief provided in Notice 2006-107, particularly regarding the due dates for the notice and for ensuring that certain plan provisions designed to encourage diversification by limiting investment in employer securities will continue to be permitted. Following are several issues that have been raised by our Legal and Legislative Committee regarding the Notice. Most of them are merely requests for clarification that could be addressed in the pending proposed regulation relating to section 401(a)(35).

Applicable employer securities - The Notice provides that a plan is not treated as holding employer securities to which section 401(a)(35) applies with respect to securities held in a registered mutual fund or similar regulated pooled investment if the investment in employer securities is in accordance with the investment vehicle's objectives and is independent of the employer *"but only if the holdings of the investment company or similar investment vehicle are diversified so as to minimize the risk of large losses."* The notice does not further elaborate on the requirement that the investment be diversified. One interpretation is that the total investment must be diversified among asset classes, such as a balanced fund. Another interpretation is that the investment vehicle must be diversified by combining the employer securities with other investments in a manner such that a significant change solely in the value of the employer securities will not result in a large loss by the entire investment vehicle. PSCA strongly recommends that the latter interpretation be incorporated in the proposed regulation. If the former interpretation is applied, many equity funds commonly offered in plans, such as a S&P 500 fund, a Russell 2000 fund, or a an equity growth or income fund could trigger the application of section 401(a)(35) to the extent such funds include employer securities.

There is another situation in which employer securities should not be treated as subject to section 401(a)(35). Some plans contain separately managed accounts that include the delegation of some investment decisions to ERISA section 3(38) investment managers to manage plan assets in accordance with parameters set by the plan sponsor. In some cases the professional manager will independently invest some plan assets in employer securities. Since the decision is made independent of the employer, and the investment manager is regulated pursuant to section 3(38), employer securities held in a plan in this manner should not be treated as subject to section 401(a)(35).

Basic divestiture rules – The Notice requires that the other investment options required by section 401(a)(35) must be offered under the same plan that holds the employer securities. PSCA recommends that the proposed regulation provide that the other investment options may be available under a separate plan. Such an arrangement would not negatively impact participants. It would also permit plans designed to invest primarily in employer securities, such as an ESOP or a stock bonus plan with a 401(k) feature that is treated as a separate plan, to adhere to their investment policy.

Additionally, plans that previously met the diversification requirements of section 401(a)(28) by offering a distribution option rather than diversification within the ESOP should be provided anti-cutback relief.

Restrictions on conditions on divesture rights – Several questions have arisen concerning the examples of restrictions or conditions that are not prohibited. The Notice states "Thus a provision that does not allow more than 10% of an individual's account balance to be invested in employer securities is permitted." The proposed rule should clarify that the use of "10%" is merely an example and that a plan may restrict any percentage of an account balance to be invested in employer securities.

The second example is one in which the employer securities fund is closed to asset transfers *and* no contributions are permitted to be invested in employer securities. Are both conditions required, or can only one apply? PSCA recommends that either, or both, restrictions be permitted.

The Notice then states that a provision that bars, for a period of time, the ability to reinvest in employer securities after divesting employer securities is not a permitted restriction. This impermissible restriction has created confusion in light of the second example of permitted restrictions. The statutory language provides that a time period ban is permitted as long as the time period is not longer than that applied to any other plan investment. The proposed regulation should not usurp this provision. Additionally, the proposed regulation should not restrict plans that close new investments and/or transfers of assets to an employer securities fund from applying the restrictions to participants or beneficiaries who previously diversified their investment in employer securities pursuant to section 401(a)(35).

Permitted restrictions – The example in the Notice regarding the application of securities laws has raised concern because the example is so narrowly drawn – it is a 3 to 12 day restriction of only the highest company officials following the publication of a quarterly earnings statement. Trading restrictions applied as the result of the application of securities laws are usually applied to larger groups of participants; sometimes to all participants. The proposed rule should clarify that any restriction made by an employer's good faith compliance with securities laws is a permitted restriction. Additionally, the applicable securities laws should include any securities law of any nation or state that applies to the employer.

As always, do not hesitate to call me if you have any questions or if I can be of assistance.

Sincerely,

Ed Ferrigno