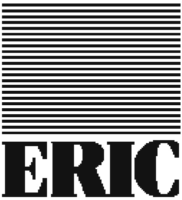

The ERISA Industry Committee

February 2, 2007

By Hand

Internal Revenue Service
CC:PA:LPD:DRU (Notice 2006-107)
Room 5203
1111 Constitution Avenue, N.W.
Washington, D.C. 20044

Re: Diversification Requirements for Defined Contribution Plans

Ladies and Gentlemen:

We are pleased to submit the enclosed comments of The ERISA Industry Committee ("ERIC")[1] on the diversification requirements for publicly-traded employer securities held by defined contribution plans.

If the Service has any questions about our comments, or if we can otherwise be of assistance, please let us know.

Respectfully submitted,

Mark J. Ugoretz
President

cc: W. Thomas Reeder
Joseph H. Grant
Robert Gertner

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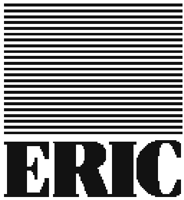
[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and compensation plans of America's largest employers. ERIC's members provide comprehensive benefits to tens of millions of active and retired workers and their families and beneficiaries. ERIC's members' plans are the benchmarks against which industry, third-party providers, consultants, and policy makers measure the design and effectiveness of employee benefit, incentive, and compensation plans. ERIC's members are engaged daily with meeting the demands of both their enterprise and the needs of employees while dealing with an increasingly complex web of benefit and compensation laws. ERIC, therefore, is vitally concerned with proposals affecting its members' ability to provide employee benefits, incentive, and compensation plans, their costs and effectiveness, and the role of those plans in the American economy.

1400 L Street, N.W.
Suite 350
Washington, DC 20005
TEL: (202) 789-1400
FAX: (202) 789-1120
www.eric.org



The ERISA Industry Committee

SUBMISSION OF THE ERISA INDUSTRY COMMITTEE TO THE INTERNAL REVENUE SERVICE AND THE TREASURY DEPARTMENT

DIVERSIFICATION REQUIREMENTS FOR DEFINED CONTRIBUTION PLANS HOLDING PUBLICLY TRADED EMPLOYER SECURITIES

February 2, 2007

The ERISA Industry Committee ("ERIC")[1] is pleased to submit these comments regarding the diversification requirements imposed by IRC § 401(a)(35) on qualified defined contribution plans ("DC plans") holding publicly traded employer securities. **As our comments explain (at pp. 7-8, below), there is a compelling and urgent need for an extension of the transition relief that the Notice now provides. ERIC respectfully requests the Treasury and the Service to grant the extension immediately.**

Section 401(a)(35) was added to the Internal Revenue Code by § 901 of the Pension Protection Act of 2006 (the "PPA"). Section 901 of the PPA also

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added a parallel provision to the Employee Retirement Income Security Act ("ERISA"), which is set forth in § 204(j) of ERISA.

In Notice 2006-107 (the "Notice"), the Treasury and the Service provided transitional guidance on the diversification requirements imposed by § 401(a)(35). The Notice states that the Treasury and the Service intend to issue regulations under § 401(a)(35) that will incorporate the transitional guidance set forth in the Notice. The Notice also solicits comments on both the transitional guidance set forth in the Notice and the topics that the regulations should address.

ERIC applauds the Treasury and the Service for requesting public comment before they issue proposed regulations. ERIC looks forward to working with the Treasury and the Service to address the concerns identified in this submission.

ERIC's Interest in the Diversification Requirements

All of ERIC's members sponsor DC plans, including both relatively small plans, usually sponsored by members' subsidiaries, and some of the largest DC plans in the country, covering tens of thousands of employees and beneficiaries. Because the great majority of these plans make each participant responsible for directing how all or part of the participant's account balance will be allocated among the plan's investment options, and because many of these plans offer employer securities as one of the plan's investment options, the diversification requirements imposed by § 401(a)(35) will directly affect a great many of the DC plans sponsored by ERIC's members and their subsidiaries.

ERIC's members have a vital interest in assuring that the diversification requirements imposed by § 401(a)(35) are implemented in a manner that is consistent with two important goals: (1) permitting eligible participants to elect to diversify the investments in employer securities that are allocable to their accounts and (2) effective and efficient plan administration. ERIC looks forward to working constructively with the Treasury and the Service to achieve both of these goals.

In this submission, we focus on § 401(a)(35)(D)(ii)(II). In general terms, this provision states that, except as provided in regulations, a plan does not meet the diversification requirements of § 401(a)(35) if the plan subjects investments in employer securities to restrictions or conditions that are not imposed on other plan investments. For convenience, we refer to this provision as the "restrictions or conditions provision" or the "ROC provision."

We begin by making a number of general comments about § 401(a)(35) and the ROC provision. We then make specific recommendations about the implementation of the ROC provision.

General Comments

Section 401(a)(35) requires a DC plan to allow an eligible participant to direct the plan to *divest* any employer securities that are allocated to the participant's account. Section 401(a)(35) does not require a DC plan to allow a participant to direct the plan to *invest* in employer securities. Section 401(a)(35) requires a DC plan to allow an eligible participant to diversify the investments allocated to the participant's account to the extent that the investments are made in employer securities. The statute does this by requiring the plan to allow a participant to direct the plan to *divest* the employer securities that are allocated to the participant's account and to reinvest the proceeds in a diversified investment option. The text of § 401(a)(35) makes this evident: § 401(a)(35) states that, in general, in order to meet the Code's qualification requirements, a DC plan must provide eligible participants with *the right to divest employer securities* in their accounts and to reinvest the proceeds in diversified investment options.

Section 401(a)(35)(D)(ii)(I) provides that a plan does not fail to meet these requirements merely because the plan limits the time for divesting employer securities and reinvesting the proceeds in a diversified investment option to periodic, reasonable opportunities occurring no less frequently than quarterly.

Section 401(a)(35)(D)(ii)(II) -- the ROC provision -- states, however, that:

> "Except as provided in regulations, the plan shall not meet the requirements of this subparagraph if the plan imposes restrictions or conditions with respect to the investment of employer securities which are not imposed on the investment of other assets of the plan. This subclause shall not apply to any restrictions or conditions imposed by reason of the application of securities laws."

The ROC provision forbids a DC plan from subjecting investments in the plan's employer securities investment option to restrictions or conditions that the plan does not impose on other investment options. The ROC provision does not require a DC plan to apply identical terms and conditions to *all* of the plan's investment options. The text of the ROC provision does *not* require each restriction or condition that applies to investments in employer securities to be applied to *every one* of the plan's investment options. The PPA's legislative history confirms that this is so:

> "Except as provided in regulations, a plan may not impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other plan assets (other than restrictions or conditions imposed by reason of the application of securities laws). **For example, such a restriction or condition includes a provision under which a participant who divests his or her account of employer securities receives less favorable treatment (such as a lower rate of employer contributions) than a participant whose account remains invested in employer securities.**

> **On the other hand, such a restriction does not include the imposition of fees with respect to the investment options under the plan, merely because fees are not imposed with respect to investments in employer securities.** " Staff, Joint Comm. on Taxation, Technical Explanation of H.R. 4 at 223 (Aug. 3, 2006) (JCX-38-06) (emphasis added).

The foregoing passage make it clear that the ROC provision does not require a plan to apply the same terms and conditions to every one of the plan's investment options. The plan in the first example violates the ROC provision because the plan provides that employer contributions are made at a lower rate for a participant who liquidates an investment in employer securities than for a participant who liquidates an investment in any other investment option: the plan thus penalizes a participant for directing the plan to divest employer securities, but not for directing the plan to divest *any other investment*.

The PPA authorizes the Treasury to create exceptions to the ROC provision. Both the text and the legislative history of the PPA make it clear that the ROC provision does not apply to the extent provided in regulations. Thus, even if the ROC provision bars a plan from imposing a particular restriction or condition on investments in an employer securities investment option, the Treasury is authorized to issue regulations that permit the plan to impose the restriction or condition in question.

The Treasury should issue regulations that, consistent with SEC and DOL guidance, allow a DC plan to subject investments in employer securities to reasonable restrictions that prevent plan participants from using short-term trading strategies, such as market timing. The ROC provision states that it does not apply to restrictions or conditions imposed "by reason of the application of securities laws." The text of the ROC provision thus indicates that the Treasury's regulations should exempt plan provisions that advance the objectives of the securities laws, such as plan provisions that prevent participants from using market timing and other short-term trading strategies.

The Securities and Exchange Commission (the "SEC") has concluded that a small group of investors in a mutual fund can harm the majority of investors in that fund by using short-term trading strategies, such as market timing,[2] that call for frequent purchases and redemptions or sales:

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[2] "Market timing includes (a) frequent buying and selling of shares of the same fund or (b) buying or selling fund shares in order to exploit inefficiencies in fund pricing. Market timing, while not illegal per se, can harm other fund shareholders because (a) it can dilute the value of their shares, if the market timer is exploiting pricing inefficiencies, (b) it can disrupt the management of the fund's investment portfolio, and (c) it can cause the targeted fund to incur costs borne by other shareholders to accommodate the market timer's frequent buying and selling of shares." 70 Fed. Reg. 13,328 at n. 4.

> "Excessive trading in mutual funds occurs at the expense of long-term investors, diluting the value of their shares.[7] It may disrupt the management of a fund's portfolio and raise the fund's transaction costs because the fund manager must either hold extra cash or sell investments at inopportune times to meet redemptions.[8] Frequent trading also may result in unwanted taxable capital gains for the remaining fund shareholders. Funds have taken steps to deter excessive trading or have sought reimbursement from traders for the costs of their excessive transactions.[9]
>
> "These steps frequently include establishing market timing policies that prevent shareholders from making frequent exchanges among funds, and imposing a redemption fee -- a small fee at the time a shareholder redeems shares, typically a short time after purchasing them.[10]" 70 Fed. Reg. 13,328-29 (March 18, 2005)(footnotes omitted).

The SEC has adopted a rule that is designed to allow mutual funds to recoup costs incurred as a result of market timing and other short-term trading strategies. The rule also requires most mutual funds to enter into agreements with retirement plan administrators and other financial intermediaries in which the intermediary agrees to provide the fund with certain information upon request and to carry out instructions that it receives from the fund in order to enable the fund to monitor the frequency of short-term trading and to enforce their short-term trading policies:

> "(2) *Shareholder information.* The fund or its principal underwriter must enter into a written agreement with each financial intermediary of the fund, under which the intermediary agrees to:
>
> "(i) Provide, promptly upon request by the fund, the Taxpayer Identification Number of all shareholders that purchased, redeemed, transferred, or exchanged shares held through an account with the financial intermediary, and the amount and dates of such shareholder purchases, redemptions, transfers, and exchanges; and
>
> "(ii) Execute any instructions from the fund to restrict or prohibit further purchases or exchanges of fund shares by a shareholder who has been identified by the fund as having engaged in transactions of fund shares (directly or indirectly through the intermediary's account) that violate policies established by the fund for the purpose of eliminating or reducing any dilution of the value of the outstanding securities issued by the fund." 17 C.F.R. § 270.22c-2(a)(2).

The Department of Labor (the "DOL") also has issued guidance pointing out that market-timing can affect many pooled investment funds in addition to mutual funds, and that plan fiduciaries could seek to curtail market timing by imposing reasonable limits on the number of a times a participant can move in and out of a particular fund without preventing the plan from failing to qualify for the protection that § 404(c) of ERISA [3] provides to the plan's fiduciaries:

> "In considering appropriate courses of action, plan sponsors and fiduciaries have raised questions as to the steps that can be taken at the plan level to address identified market-timing problems. In particular, questions have been raised as to whether a plan's offering of mutual fund or similar investments that impose reasonable redemption fees on sales of their shares would, in and of itself, affect the availability of relief under section 404(c) of ERISA[1]. Similarly, questions have been raised as to whether reasonable plan or investment fund limits on the number of times a participant can move in and out of a particular investment within a particular period would, in and of itself, affect the availability of relief under section 404(c).
>
> "Without expressing a view as to any particular plan or particular investment options, we believe that these two examples represent approaches to limiting market-timing that do not, in and of themselves, run afoul of the "volatility" and other requirements set forth in the Department's regulation under section 404(c), provided that any such restrictions are allowed under the terms of the plan and clearly disclosed to the plan's participants and beneficiaries."
>
> "[1] In general, ERISA section 404(c) relieves fiduciaries of individual account plans, such as 401(k) plans, from liability for the results of investment decisions made by plan participants and beneficiaries. See regulations at 29 CFR § 2550.404c-1."
>
> Statement of Ann L. Combs, Assistant Secretary Employee Benefits Security Administration, "Duties of Fiduciaries in Light of Recent Mutual Fund Investigations" (Feb. 17, 2004).

[3] In general, if a participant in a § 404(c) plan exercises independent control over assets in the participant's account, no fiduciary under the plan will be liable for any loss, or with respect to any violation of ERISA's fiduciary standards, that is the direct and necessary result of the participant's exercise of control. *See* 29 C.F.R. § 2550.404c-1(d).

According to the DOL guidance, reasonable plan provisions that are designed to prevent participants from engaging in market timing should not prevent the plan from qualifying for the protection that ERISA § 404(c) offers to plan fiduciaries. Since that is so, such provisions should not cause a plan to violate the ROC provision either. Both § 404(c) and the ROC provision seek to identify plans that allow participants to control how their account balances are invested. A provision that does not prevent a plan from meeting the requirements of § 404(c) should not cause the plan to violate the ROC provision.

Specific Recommendations

Based on the general comments we made in the preceding section, we make the following specific recommendations regarding the application of the ROC provision (§ 401(a)(35)(D)(ii)(II)):

1. **The regulations should state that the ROC provision does not bar a plan from providing that if a participant directs the plan to divest some or all of the participant's interest in the plan's employer securities investment option, the participant may not reinvest in the employer securities investment option for a specified period of time. Part III.D.3 of the Notice permits a plan to continue to impose any such restrictions that were in effect on December 18, 2006, but only for a temporary period that is scheduled to expire on March 30, 2007. The temporary rule in Part III.D.3 should be extended until the effective date of regulations that adopt the rule that we recommend.**

Restrictions on reinvestment are consistent with the purpose of the ROC provision: to allow participants to *divest* their interests in employer securities, not to encourage additional investments in employer securities. Such restrictions are also consistent with SEC and DOL policies encouraging plans (and other pooled investment funds) to curb the use of short-term trading strategies, such as market timing, that harm the vast majority of plan participants.

The drafters of the Notice might have been concerned that if a plan can forbid a participant from reinvesting in the plan's employer securities investment option shortly after he or she has liquidated an interest in that investment option, the plan's restriction on reinvestment might discourage some participants from liquidating their interests in the employer securities investment option. We are not aware of any evidence that this is likely to occur. In any event, any such concern suggests, at most, the need for a reasonable time limit on reinvestment restrictions, rather than what amounts to a bar against such restrictions.

Although our recommendation is contrary to the position taken by Part III.D.1 of the Notice, our recommendation is consistent with the provision in Part III.D.1 that allows a plan to provide that participants may transfer funds out of the plan's employer securities investment option, but may not transfer funds (or make contributions) to the employer securities investment option. Since the Notice allows a plan to impose a permanent or indefinite bar against transfers to its employer securities investment option, a plan should also be allowed to bar transfers temporarily as well.

2. The regulations should provide that the ROC provision does not require a plan to apply the same terms and conditions to both investments in its employer securities investment option and investments in its other investment options (such as stable value funds and certain bond funds) that do not present opportunities for market timing and other short-term trading strategies. Part III.D.4(1)of the Notice provides temporary relief for plans with such provisions, but only with respect to stable value funds, only for plan provisions in effect on December 18, 2006, and only until December 31, 2007. Broader, non-temporary relief is needed.

A stable value fund does not provide opportunities for market timing and other short-tem trading strategies. It makes no sense to require a plan to subject a stable value fund to the same restrictions that the plan applies to other investment options (such as an employer securities investment option) that offer opportunities for market timing strategies.

Moreover, in order to qualify for the protection that ERISA § 404(c) provides to a plan's fiduciaries, many plans maintain an investment fund (such as a money market or other stable value fund) to hold the assets that participants elect to transfer out of the plan's employer securities investment option.[4] The ROC provision was not intended to make it more difficult for plans to qualify for § 404(c) protection, and Part III.C of the Notice explicitly recognizes that plans affected by Code § 401(a)(35) are typically designed to qualify under § 404(c).

It also would be inconsistent with the objectives of the securities laws and ERISA's fiduciary standards to require a plan to treat its employer securities investment option as if it were a money market fund and to bar the plan from imposing any restrictions on transfers into or out of that fund -- thereby subjecting the plan and the vast majority of plan participants to the adverse effects of market timing and other short-term trading strategies that have concerned the SEC and the DOL.

3. The regulations should make clear that a plan does not violate the ROC provision merely because the administrative practices that apply to its employer securities investment option differ from those that apply to its other investment options. The following administrative practices are illustrative:

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[4] According to the DOL regulation, in order for the plan to qualify as a participant-directed plan for purposes of § 404(c), the plan must provide that when a participant directs the plan to transfer funds out of an employer securities investment option, the plan must either (1) permit the transfer to be made into any of at least 3 diversified investment options meeting the requirements of §404(c) or (2) permit the transfer to be made into an income-producing, low risk, liquid fund. *See* 29 C.F.R. § 2550.404c-1(b)(3). Many plans are designed to use the second of these alternatives.

- **a trading cut-off time (*e.g.,* 1:00 PM or 2:00 PM) for the employer securities investment option that is earlier than the trading cut-off time for other investment options -- adopted so that the plan administrator has enough time to go to the market to execute a trade at that day's price; and**

- **fair pricing or forward pricing policies that do not apply to other investment options -- adopted so that employer securities are credited to participants' accounts on the basis of the average trading price over a period of days.**

The Treasury and the Service recognize that administrative features like these are not protected by the anticutback rule in Code § 411(d)(6). *See* Treas. Reg. § 1.411(d)-4, A-1(d)(8), (9) & (10). The regulations under the ROC provision should likewise exempt such administrative provisions from the general rule in § 401(a)(35)(D)(ii)(II),

4. The regulations should make clear that a plan does not violate the ROC provision merely because restrictions imposed on investments in the plan's employer securities investment option are *less* stringent than the restrictions imposed on investments in any other investment option that the plan offers.

Section 401(a)(35)(D)(ii)(II) might be misconstrued to provide that the restrictions that apply to a plan's employer securities investment option may not be *less* stringent than those that apply to any investment option that the plan offers. The regulations should make it clear that this is not so.

The purpose of § 401(a)(35) is to make it possible for participants to diversify their investments in employer securities. A rule preventing a plan from subjecting transfers out of the plan's employer securities investment option to restrictions that are *less* stringent than the restrictions that the plan imposes on transfers out of the plan's other investment options would subvert the purpose of the statute.

In any event, if the statute required the restrictions on investments in an employer securities investment option to be neither more nor less stringent than the restrictions that apply to any of the plan's other investment options, the ROC provision would have been worded quite differently. We are not aware of any evidence that Congress intended to impose such a straight-jacket on employer securities investment options. Surely, if Congress had this intent, it would have said so and said so directly.

We very much appreciate the opportunity to submit these comments. We look forward to working with the Treasury and the Service on the development of proposed and final regulations under § 401(a)(35).

THE ERISA INDUSTRY COMMITTEE