THE PENSION PROTECTION ACT OF 2006
NEW DISCLOSURE AND FIDUCIARY LIABILITY RULES

The Pension Protection Act of 2006 (the "Act"), one of the most sweeping pension reforms affecting qualified employee benefit plans, was signed into law by President Bush on August 17, 2006. Among the many provisions contained in the Act, plan administrators and fiduciaries should take note of several new rules affecting participant disclosure and fiduciary liability. These include changes in fiduciaries' obligations under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and certain amendments to the Internal Revenue Code of 1986, as amended (the "Code"), with respect to both qualified defined contribution plans and qualified defined benefit plans. Of particular importance are the following changes, some of which are first effective as early as 2007:

- **Periodic Pension Benefit Statements.** Plan administrators must begin providing periodic benefit statements to participants and beneficiaries in certain circumstances, whether or not such participants or beneficiaries make written requests for such statements.
- **Blackout Periods.** When a plan temporarily suspends or restricts the right of participants and beneficiaries to control the investment of plan assets in connection with a change in the plan's permitted investment options, the plan's fiduciaries will continue to be protected from liability under ERISA § 404(c) so long as participants and beneficiaries received proper notice of the change, and the investment of the participant's or beneficiary's account immediately prior to the change was the result of the participant's or beneficiary's exercise of control over the assets in the account.
- **Default Investment Rules.** Where a plan allows participants and beneficiaries to control the investment of plan assets and a plan participant or beneficiary does not submit investment instructions with respect to the assets in his or her individual account, the Act amends ERISA § 404(c) to relieve plan fiduciaries from fiduciary liability for any losses resulting from a plan's default investment fund, provided that participants and beneficiaries receive prior notice of the consequences of the failure to provide investment instructions and the account is invested in a qualifying default investment alternative in compliance with Department of Labor ("DOL") regulations.
- **Investment in Employer Securities.** In response to recent events relating to the investment of plan assets in employer securities, the Act creates new rules allowing participants and beneficiaries of certain defined contribution plans to invest in alternative investment options offered under the plan.

PERIODIC PENSION BENEFIT STATEMENTS

Background

Prior to the Act, plan administrators were required to provide a benefit statement only upon the written request of a plan participant or beneficiary. Such statements were only required to describe, based on the latest available information, both (i) the total benefits accrued by the participant or beneficiary and (ii) the nonforfeitable benefits accrued, or the earliest date on which benefits would become nonforfeitable (hereinafter referred to as the "Pre-Act Content"). For plan years beginning after December 31, 2006, the reporting obligations for plan administrators become somewhat more burdensome, although many plan sponsors will find that the content and frequency of their current benefit statements already satisfy many of the requirements of the Act. Under the Act, benefit statements will need to be provided, in certain circumstances, without solicitation and as frequently as quarterly, and the statements will need to contain information in addition to the Pre-Act Content. According to Field Assistance Bulletin 2006-03, until such time as regulations or other guidance has been issued concerning compliance with the new rules, the DOL will, as a compliance matter, treat a plan administrator as satisfying the requirements of the Act if the administrator has acted in good faith with a reasonable interpretation of such requirements. The DOL has also been directed to issue one or more model notices by August 17, 2007 that satisfy the requirements of the Act for use by plan administrators.

When Plan Administrators Must Furnish a Statement of Benefits

The frequency with which pension benefit statements must be provided depends upon whether the plan is a defined contribution plan or a defined benefit plan.

- **Defined Contribution Plans.** Administrators of defined contribution plans (such as profit sharing and 401(k) plans) must furnish benefit statements according to one of three frequency requirements: (i) at least quarterly to each participant and beneficiary who has the right under the plan to direct the investment of assets in his or her account, (ii) at least annually to each participant and beneficiary with an account under the plan who does not have the right to direct the investment of assets in that account, and (iii) upon written request to each plan beneficiary not described in (i) or (ii). The DOL has announced that the furnishing of a benefit statement not later than 45 days after the end of the applicable period (plan quarter or year end) will constitute good faith compliance with the new rules.

- **Defined Benefit Plans.** Administrators of defined benefit plans must furnish statements according to one of two frequency requirements: (i) at least once every three years to each plan participant who has a nonforfeitable accrued benefit and who is employed by the plan sponsor at the time the statement is furnished, and (ii) to each other plan participant or beneficiary upon written request. The requirement with respect to plan participants described in (i) may be met by providing notice to participants, at least annually, of the availability of the pension benefit statement and the manner in which the statement may be obtained upon request. If a plan elects to

take advantage of the alternative annual notice provision in lieu of providing statements once every three years, the first required notification of the right to obtain a benefit statement must be furnished no later than December 31, 2007.

With respect to plan participants and beneficiaries who remain entitled to statements only upon written request, the Act does not change the current rule that the plan administrator need not provide a statement to any such participant or beneficiary more than once in any 12-month period.

What Information Must Be Provided in a Statement of Benefits

Three general requirements apply to *all* benefit statements to be provided to plan participants and beneficiaries as a result of the Act: (i) each statement must contain the Pre-Act Content as described above, (ii) each statement must contain an explanation of the extent to which social security benefits are taken into account in determining the benefits that are accrued under the plan, and (iii) each statement must be written in a manner that is understandable by the average plan participant. Any required benefit statement may be delivered in written, electronic or other appropriate form to the extent such form is reasonably accessible to the recipient.

With respect to individual account plans, in addition to the above-mentioned required content, those statements that must be furnished at least quarterly or annually must include the value of each investment to which assets in the individual account have been allocated, determined as of the most recent valuation date under the plan, including the value of any assets held in the form of employer securities. With respect to individual account plans that provide for investment direction by participants and beneficiaries, those statements must also contain three additional elements: (i) an explanation of any limitations or restrictions on any right of the participant or beneficiary under the plan to direct investments, (ii) an explanation of the importance of a well-balanced and diversified investment portfolio for long-term retirement security, including a statement of the risk that holding more than 20 percent of a portfolio in a single entity may not constitute adequate diversification, and (iii) a notice directing the participant or beneficiary to the website of the DOL for sources of information on individual investing and diversification.

FIDUCIARY LIABILITY DURING BLACKOUT PERIODS

In general, § 404(c) of ERISA relieves plan fiduciaries of fiduciary liability for investment losses in situations where participants and beneficiaries exercise control over the investment of plan assets credited to their individual plan accounts. However, prior to the changes made by the Act, when a plan fiduciary unilaterally changed the available investment options that were offered by a plan, plan participants and beneficiaries were not viewed by the DOL as having exercised control over plan assets for purposes of § 404(c) of ERISA, even when the new investment options were similar in character to the options previously selected by participants and beneficiaries.

The Act amends § 404(c) of ERISA by extending relief from fiduciary liability in connection with a "qualified change in investment options" offered by a plan. For this purpose, a "qualified change in investment options" is defined by the Act as a change in the investment options offered under the plan where (i) the account of a participant or beneficiary is reallocated among

one or more remaining or new investment options in lieu of one or more investment options offered immediately prior to the change, and (ii) the characteristics of the remaining or new investment options (including characteristics relating to risk and rate of return) are, immediately after the change, reasonably similar to those of the investment options offered immediately before the change.

The extension of fiduciary relief described above in connection with a qualified change in investment options is conditioned on satisfying the following requirements: (i) at least 30, but not more than 60, days prior to the change, the plan administrator must have provided notice of the change to participants and beneficiaries, including information comparing the existing and new investment options and an explanation that, in the absence of an affirmative investment election to the contrary, the account of the participant or beneficiary will be invested in the new investment options, (ii) prior to the change in the investment options, the participant or beneficiary must not have provided the plan administrator with investment instructions, as permitted by the plan, that are contrary to the proposed change, and (iii) prior to the change in the investment options, the plan's participants and beneficiaries must have exercised control over the investment of the assets credited to their individual plan accounts.

Except in the case of collectively bargained plans, the above changes to § 404(c) of ERISA are effective for plan years beginning after December 31, 2007. Even though such changes will not be effective until 2008, plans that intend to comply with the requirements of § 404(c) of ERISA should consider implementing any changes in plan investment options as if the new rules were currently in effect.

DEFAULT INVESTMENT BY PLAN FIDUCIARIES

Act Provisions

The Act also amends § 404(c) of ERISA to provide further relief to plan fiduciaries with respect to a plan's default investments. Under preamendment law, if a plan allowed participants and beneficiaries to control the investment of their individual accounts and a participant or beneficiary did not actually exercise control over the investment of the assets in his or her account, the plan's fiduciaries would typically invest the account in a default investment (such as a stable value fund) and thereby remain liable for any breach of fiduciary duty arising out of the default investment. Under ERISA § 404(c) as amended by the Act, if a participant or beneficiary does not submit investment instructions with respect to his or her individual account and the account is invested in a plan's "qualified default investment alternative" (as defined below), the plan's fiduciaries will not be subject to fiduciary liability for any losses resulting from such investment so long as the default investment is compliant with DOL regulations.

In order for a plan fiduciary to avoid fiduciary liability under amended § 404(c) of ERISA with respect to a plan's default investments, certain notice requirements must be met. In particular, participants and beneficiaries must (i) receive, within a reasonable period of time before each plan year, a notice explaining their rights under the plan to designate how contributions and earnings will be invested and explaining how, in the absence of any investment election, such contributions and earnings will be invested, and (ii) have a reasonable period of time after receipt

of such notice and before the beginning of the plan year to make investment selections. The changes to § 404(c) of ERISA relating to default investments will not relieve a plan fiduciary from liability for failing to prudently select and monitor plan investments in the first instance.

The amendments to § 404(c) of ERISA apply for plan years beginning after December 31, 2006.

DOL Proposed Regulations

In response to the amendments made to § 404(c) of ERISA with respect to default investments, the DOL issued proposed regulations (29 CFR 2550.404c-5; September 27, 2006) outlining the extent to which plan fiduciaries will be relieved from liability in situations where participants and beneficiaries have the ability to exercise control over the investment of their individual accounts but have not exercised such control.

In order to be eligible for relief provided under the Act, the plan's investment fiduciary must designate a "qualified default investment alternative" ("QDIA") for the investment of plan assets when participants and beneficiaries fail to exercise control over the investment of their individual accounts. In general, a QDIA must satisfy the following five criteria: (i) it may not hold employer securities (except in limited circumstances), (ii) it may not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer out of the QDIA, (iii) it must be a registered investment company or managed by an investment manager that meets certain ERISA requirements, (iv) it must be diversified so as to minimize the risk of large losses, and (v) it must qualify as a life-cycle fund, a targeted retirement date fund, a balanced fund appropriate for plan participants as a whole, or a professionally managed account. As currently proposed, QDIAs do not include money market and stable value funds, which are currently in use by many plan sponsors as a plan's default investment fund.

The proposed DOL regulations also include a number of notice and disclosure requirements for obtaining relief from fiduciary liability with respect to a QDIA. A plan fiduciary may implement a QDIA only with respect to participants and beneficiaries who have the opportunity to control the investment of their plan accounts but fail to do so, and only if they have been provided notice (describing the QDIA, the circumstances under which accounts will be invested in the QDIA, and rights with respect to directing account assets to other investment options) at least 30 days before the first plan investment and before the beginning of each subsequent plan year. In addition, the plan's terms must provide that any materials provided to the plan relating to a QDIA (*e.g.*, proxy materials, account statements, etc.) must be provided to participants and beneficiaries. Finally, participants and beneficiaries must be able to transfer out of the QDIA with the same frequency as applies to other plan investments (but not less than once per calendar quarter) without financial penalty, and such other plan investments must represent a "broad range" of investment options consistent with DOL regulations under § 404(c) of ERISA (generally including at least three diversified investment alternatives with materially different risk and return characteristics).

Final DOL regulations are currently expected to be issued in early 2007 and will be effective 60 days after the date of publication in the Federal Register.

DIVERSIFICATION OF INVESTMENT IN EMPLOYER SECURITIES

Diversification Requirements

The Act amends § 401(a) of the Code by creating new diversification rules that pertain to qualified defined contribution plans (other than certain employee stock ownership plans (ESOPs)) that invest directly in publicly traded employer securities (*i.e.*, employer securities traded on an established securities market). With certain exceptions, a plan holding employer securities that are not publicly traded will be treated as holding publicly traded employer securities for purposes of the new rules if the employer maintaining the plan (or certain affiliates of the employer based on a 50% ownership test) has issued a class of stock that is a publicly traded employer security, even if it is not held by the plan. The new diversification requirements are generally effective for plan years beginning after December 31, 2006.

Under the Act, the right to divest employer securities applies to any portion of a participant's plan account that is attributable to employee contributions (including earnings and rollover amounts). With respect to amounts that are attributable to employer contributions (and related earnings), the right to divest employer securities applies to participants with three years of vesting service, alternate payees of participants with three years of vesting service and beneficiaries of deceased participants without regard to years of service.

A special three-year phase-in period applies with respect to employer contributions and earnings used to acquire employer securities in plan years beginning prior to 2007. Under the phase-in rule, the diversification right applies to (i) 33% of such securities for the first plan year beginning after 2006, (ii) 66% of such securities for the second plan year beginning after 2006, and (iii) 100% of such securities for plan years thereafter. The phase-in rule does not apply to participants who have attained age 55 and completed at least three years of vesting service before the first plan year beginning after 2005.

To the extent any individual is entitled to direct a plan to divest any publicly traded employer securities held in his or her account, the plan must offer not less than three investment options other than employer securities. Each alternative investment option must be diversified, and must have materially different risk and return characteristics. For this purpose, investment options that satisfy the requirements of DOL regulations under § 404(c) of ERISA will be deemed to satisfy this requirement.

A plan will not be treated as failing the diversification requirements merely because it limits the time for divestment and reinvestment to periodic, reasonable opportunities occurring at least quarterly. However, a plan cannot impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan, unless such restrictions or conditions are required by applicable securities laws.[1] Examples of prohibited restrictions include the following:

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[1] For the period from January 1, 2007 through March 30, 2007, a plan will not be treated as imposing a prohibited restriction or condition pursuant to a plan provision that was in effect on December 18, 2006.

- A plan that allows participants the right to trade alternative investment options on a daily basis may not limit the investment in or divestment of employer securities to once each calendar quarter.
- A plan may not provide a lower matching contribution rate for a participant who divests his or her account of employer securities.
- A plan may not limit the right of an individual to reinvest in employer securities for a period of time following the exercise of the individual's divestment rights.

Notice of Right to Divest Employer Securities

Plan administrators must provide affected individuals with notice of the right to divest employer securities credited to their accounts. In general, the notice must be provided no later than 30 days before the first date on which an individual becomes eligible to divest employer securities, must be understandable by the average plan participant, and must describe the importance of diversifying the investment of retirement account assets.[2] The notice can be delivered in any form that is reasonably accessible to the recipient (*e.g.*, written, electronic or other appropriate form). According to a recent announcement by the DOL (FAB 2006-03), to the extent the Act confers additional diversification rights not already provided by the plan, the notice should be provided as soon as possible following January 1, 2007. With respect to plans that, prior to January 1, 2007, provided affected individuals with diversification rights at least equal to those conferred under the Act, providing the quarterly benefit statement as discussed previously will be treated as satisfying the diversification notice requirements of the Act.

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[2] The Internal Revenue Service has published a model notice for this purpose (IRS Notice 2006-107).