

COMMENT LETTER

March 19, 2007

Institute Comment Letter to IRS on Employer Stock Diversification Requirements (pdf)

March 19, 2007 VIA ELECTRONIC MAIL Internal Revenue Service CC:PA:LPD:DRU (Notice 2006-107) Room 5203 POB 7604 Ben Franklin Station Washington, DC 20044 Re: Comments on Transition Guidance Under Notice 2006-107 Regarding Employer Stock Diversification Requirements Ladies and Gentlemen: The Investment Company Institute,¹ on behalf of its investment company members, submits these comments concerning Notice 2006-107, which provides transition guidance on employer stock diversification requirements under new Code section 401(a)(35) (as added by the Pension Protection Act of 2006, or “PPA”). Under the PPA, individual account plans that invest in publicly traded employer securities must allow participants and beneficiaries to divest employer securities in their accounts and reinvest those amounts in certain other diversified investments. Plans must provide a notice to participants describing the diversification right and the importance of diversification of retirement assets at least 30 days before the first date on which the diversification right is exercisable. The Service has stated that it will issue regulations under Code section 401(a)(35) consistent with the guidance provided in the Notice and has asked for comments on the Notice. Summary of Comments The Institute applauds the Service for issuing prompt interim guidance on the employer stock diversification requirements, which are effective for plan years beginning after December 31, 2006. We generally agree with the guidance provided in Notice 2006-107, but believe that regulations should allow reasonable restrictions on trading employer stock, such as those designed to prevent market 1 Institute members include 8,839 open-end investment companies (mutual funds), 658 closed-end investment companies, 363 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the Institute have total assets of approximately \$10.445 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households. Internal Revenue Service CC:PA:LPD:DRU (Notice 2006-107) Page 2 of 5 March 19, 2007 timing in employer stock funds. We also recommend that the Service act as soon as possible to extend the transition relief provided for restrictions in effect on December 18, 2006. Because the Service is likely to receive many comments on the Notice, an immediate extension of the transition relief beyond March 30, 2007 is crucial so that this relief does not expire before the effective date of final regulations. Our letter also provides additional technical comments on issues addressed by the Notice. The mutual fund industry’s interest in guidance under section 401(a)(35) is substantial. In addition to offering mutual fund shares as investment options under 401(k) and other defined contribution plans, Institute members provide a broad range of services to these plans, some of which have employer

stock funds. Institute members, for example, may provide plan recordkeeping, tax compliance and reporting, and participant education services, as well as management of employer stock funds. Restrictions on Diversification Rights Under section 401(a)(35), a plan generally may not 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. The Notice explains that prohibited restrictions or conditions include (1) restrictions on the right to divest employer securities that are not imposed on other investments and (2) benefits that are conditioned on investment in employer securities. Limitations on Reinvestment In the Notice, the Service takes the position that a plan may not impose a limitation on reinvesting account balances in a class of employer securities (e.g., for a specified period of time) following divestiture of an investment in that class of employer securities. (This rule would not preclude closing an employer stock fund to new investments.) We urge the Service to issue guidance that allows plans to impose reasonable restrictions on reinvestment in employer securities. It is common for plans to restrict a participant from reinvesting in the employer stock fund for a period of time (e.g., 60 days) after the participant divests of employer securities. Alternatively, some plans may limit the total number of exchanges within the employer stock fund during a specified time period. These types of restrictions are meant to protect against market timing, which can be extremely harmful to other investors in an employer stock fund, especially in a unitized stock fund.² We believe that a reinvestment restriction that applies for a limited time period or a limitation on the number of exchanges in an employer stock fund in a given period would not be an impediment to divestment of employer securities. These restrictions should not be treated as

² In a unitized stock fund, participants do not own actual shares, but rather each employee owns a unit of the entire fund. Internal Revenue Service CC:PA:LPD:DRU (Notice 2006-107) Page 3 of 5 March 19, 2007 prohibited restrictions on diversification rights. Accordingly, we strongly urge the Service to change its position and allow restrictions or conditions that are meant to protect the remaining investors in a fund.

Restrictions Based on Securities Laws As an exception to the rule against conditions or restrictions, section 401(a)(35) and Notice 2006-107 provide that a restriction imposed by reason of the application of securities laws or a restriction reasonably designed to ensure compliance with securities laws is not an impermissible restriction or condition. The Service provided an example in the Notice that, to comply with SEC Rule 10b-5 (relating to anti-fraud and insider trading), plans may limit the divestiture rights of participants subject to Section 16(b) of the Securities Exchange Act of 1934 (generally, a company's directors, officers, and principal shareholders) for a period of time (such as three to twelve days) following publication of the employer's quarterly earnings statements. The Institute strongly agrees with the Service that a restriction reasonably designed to ensure compliance with securities laws should be permissible. Public companies typically place restrictions on the ability of certain employees to trade company stock (both buying and selling) to comply with rules against insider trading. ³ These restrictions may apply at various times, including for a period of time before publication of the earnings report. Therefore, we recommend expanding the example included in the Notice to cover trading restrictions imposed before or after publication of the earnings report or other material information. We note that public companies typically have in place policies and procedures to ensure compliance with SEC Rule 10b-5 and these policies and procedures are disclosed to the employees covered by such restrictions. The Service should clarify that it will defer to the SEC on questions of whether a restriction is reasonably designed to ensure compliance with securities laws.

Transition Relief The Notice provides a special transition rule for restrictions on diversification rights in effect on December 18, 2006 by allowing such restrictions to continue through March 30, 2007. We urge the Service to act immediately to extend this transition relief until the final guidance is effective. In many cases, employers

will not be able to make the necessary changes to their plans as soon as March 30, 2007. Furthermore, it is critical that, for restrictions meant to prevent harmful market timing practices, as described above, the transition relief not expire before final guidance is issued permitting such restrictions. 3 These restrictions typically apply to any investment in employer securities, regardless of whether the investment is made through the employer's plan. Internal Revenue Service CC:PA:LPD:DRU (Notice 2006-107) Page 4 of 5 March 19, 2007 The Notice provides a separate transition rule for restrictions that do not apply to a "stable value fund" or that allow divestiture of another investment more frequently than employer stock divestiture is permitted (provided the other investment is available only to a fixed class of participants). These restrictions, if in effect on December 18, 2006, may continue through December 31, 2007. The intent of the special rule for stable value funds is unclear. It may indicate recognition that reasonable restrictions placed on employer stock trading (or other plan investments) may not be practical or necessary in the context of capital preservation investments, such as a stable value fund. The same is true with respect to money market funds and other capital preservation vehicles in addition to stable value funds. We believe that it is important to have permanent relief for restrictions that are reasonable and beneficial to other plan participants. We urge the Service to consider both making this exception permanent and clarifying it to include other capital preservation investments such as money market funds. We would welcome the opportunity to discuss this matter further with the Service. Notice to Participants of Diversification Rights Notice 2006-107 contains a model notice for purposes of satisfying the participant notice requirement of ERISA section 101(m) (as added by the PPA). Under the PPA, plans must provide this notice to participants at least 30 days before the first date on which the diversification right is exercisable. The Service indicated that any comments it receives on the notice rules will be shared with the Department of Labor. The Department, in related guidance, has granted limited relief from the notice requirement for plans that, prior to January 1, 2007, provide diversification rights with respect to employer stock at least as equal to those required by the PPA. We urge the Department to provide additional relief for plans that permit employees to participate immediately upon being hired. For plans with immediate eligibility, it may be impossible to satisfy the 30-day rule without delaying participant entry into the plan. We suggest that for new hires who are immediately eligible, the plan should be permitted to satisfy the notice requirement by providing the notice within a reasonable period of time, such as including it with other plan enrollment materials. * * * Internal Revenue Service CC:PA:LPD:DRU (Notice 2006-107) Page 5 of 5 March 19, 2007 The Institute would welcome the opportunity to provide further assistance to the Service in developing the regulations and any additional guidance. Please feel free to contact the undersigned at (202) 326-5826 with any comments or questions. Sincerely, /s/ Mary S. Podesta Mary S. Podesta Senior Counsel - Pension Regulation cc: Robert Doyle, Department of Labor