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To Our Clients and Friends *October 5, 2006*

Provisions of the Pension Protection Act of 2006 Affecting 401(k) and Other Defined Contribution Plans

On August 17, 2006, President Bush signed the "Pension Protection Act of 2006" (the "Act") into law. The Act may be best known for the sweeping changes that it made to the rules which affect the funding of pension plans. However, the Act also includes a number of significant changes that are discussed in this letter which affect 401(k) and other defined contribution plans. These changes include new rules relating to the automatic enrollment of employees in 401(k) plans and the related extension of ERISA relief for fiduciaries with respect to default investments which comply with Department of Labor ("DOL") regulations. These regulations were proposed by the DOL on September 27, 2006 and are summarized below.

Plan sponsors and fiduciaries should familiarize themselves with the changes discussed in this letter in order to understand how they may affect their qualified defined contribution plans.

401(k) Plan Automatic Enrollment

The Act includes the following provisions regarding the automatic enrollment of employees in 401(k) plans which are intended to encourage plan sponsors to automatically enroll eligible participants in their 401(k) plans at specific salary deferral contribution levels without requiring affirmative deferral elections to be made by the participants:

Preemption of State Laws. The Act confirms that employers may deduct 401(k) contributions from the paychecks of employees that are automatically enrolled in their 401(k) plans and that any state laws prohibiting wage withholding without an employee's consent are preempted by ERISA (effective as of the date of enactment).

90-Day Opt Out Period. It is not unusual for employees who are automatically enrolled in a 401(k) plan to elect to stop their automatic contributions after a minimal amount has been contributed to the plan. Prior to the Act, the automatic contributions that were already made to the plan could generally not be distributed until the employee terminated employment. This often resulted in the plan sponsor being required to incur extra administration costs in order to maintain a large number of small accounts. In an effort to eliminate this problem, effective for plan years beginning in 2008, the Act permits a plan sponsor to give automatic enrollees the ability to opt out of the plan within 90 days following their first automatic contribution by withdrawing all of their automatic contributions from the plan. These withdrawals are subject to income tax in the year distributed, but are not (i) subject to the 10 percent early distribution

penalty on plan distributions before age 59½ and (ii) taken into account for 401(k) (ADP) nondiscrimination testing purposes.

Corrective Distribution Rules are Relaxed. Currently, if a 401(k) plan does not satisfy the 401(k) nondiscrimination test requirements for a plan year, an employer must pay a 10 percent excise tax on any corrective distributions made to its highly compensated employees more than 2½ months after the end of the plan year. Under the Act, effective for plan years beginning in 2008, a plan sponsor of a 401(k) plan with an automatic enrollment feature that is subject to the 401(k) nondiscrimination requirements will be able to make corrective distributions of excess 401(k) and/or matching contributions within 6 months (rather than 2½ months) after the end of the applicable plan year without incurring the 10 percent excise tax.

Automatic Enrollment Nondiscrimination Safe-Harbor. Effective for plan years beginning in 2008, the Act provides special safe-harbor rules that a 401(k) plan with automatic enrollment may utilize so as to be considered to automatically pass the 401(k) nondiscrimination tests and be exempt from the top-heavy rules. Under these safe-harbor rules, the plan must apply a uniform salary deferral rate to all automatic enrollees. The minimum contribution rate is 3 percent of compensation in the first year in which the employee is automatically enrolled in the plan increased by 1 percent each year thereafter until it reaches 6 percent in the fourth year in which the employee is automatically enrolled in the plan. The maximum contribution rate that a plan sponsor may impose on automatic enrollees is 10 percent of compensation.

In order to satisfy the safe-harbor requirements, the plan sponsor must also contribute to the 401(k) plan either (i) a 3 percent nonelective contribution for all employees eligible to participate in the plan without regard to whether the employee makes 401(k) contributions to the plan (by automatic enrollment or otherwise) or (ii) a graduated matching contribution equal to 100 percent of the first 1 percent of compensation contributed by the employee, plus 50 percent of the next 5 percent of compensation, resulting in a maximum matching contribution of 3½ percent of compensation. These employer contributions (nonelective or matching) must be 100 percent vested after two years of service.

Newly eligible employees must be notified in advance of their rights and obligations under the 401(k) plan's safe-harbor automatic enrollment program and given a reasonable amount of time before the first automatic contribution is deducted to decline participation in the plan or to enroll at different contribution level. The notice must also explain what the plan's default investment will be in the absence of any investment election by the employee.

Extension of ERISA Fiduciary Relief to Default Investments

Under current law, Section 404(c) of ERISA grants plan fiduciaries relief from liability for the investment choices that are affirmatively elected by plan participants, provided that certain notice and other procedural requirements are satisfied. Plan fiduciaries, however, receive no such protection with respect to default investments that are used by a plan (e.g., a plan which provides for automatic 401(k) contributions) when a plan participant fails to make an investment election.

In order to facilitate the use of automatic 401(k) plan enrollment, effective for plan years beginning in 2007, the Act extends protection under Section 404(c) of ERISA to plan fiduciaries in connection with default investments made on behalf of participants failing to make affirmative elections, as long as the plan complies with regulations to be issued by the DOL.

Proposed DOL Regulations. On September 27, 2006, the DOL issued proposed regulations regarding default investments. The proposed regulations create a safe-harbor rule which permits plan fiduciaries to designate a qualified default investment alternative ("QDIA") for plan participants who do not affirmatively select an investment option under their plan. If the safe-harbor requirements under the proposed regulations are satisfied, a plan participant will not be able to claim that the plan's fiduciaries should be responsible for earnings that the participant would have received, or losses the participant would have avoided, had the participant's account been invested in one of the plan's other investment options.

There are several conditions that must be satisfied in order to qualify for the safe-harbor fiduciary protection. The core condition of the proposed regulations relates to three permitted investment alternatives, which generally target long-term appreciation and capital preservation as their investment objectives, from which a plan fiduciary may choose the plan's QDIA. The first alternative is a group of "life cycle" or "target-retirement-date" funds which manage mixed equity and debt portfolios that are geared to the participant's age, target retirement date or life expectancy. The funds' asset allocations and associated risk levels generally change over time with the objective of becoming more conservative with increasing age. The second alternative is a single "balanced" fund which manages a mixed equity and debt portfolio consistent with a target level of risk appropriate for participants in the plan as a whole. The third alternative is an individually managed account which is managed by an investment manager based upon the participant's age, target retirement date or life expectancy. Any investment alternative that is used as a QDIA must either be a registered mutual fund or a fund which is managed by an ERISA investment manager.

In addition to designating a QDIA, plan fiduciaries must offer participants a broad range of investment options which are consistent with the current ERISA Section 404(c) rules. A fiduciary may invest a participant's assets in a QDIA only after the participant receives notice of the opportunity to direct the investment of his or her account and fails to do so. Participants must be informed of their ability under the Plan to transfer all or a portion of their account balance out of the QDIA into any other investment option without financial penalty. Finally, at least 30 days before the first default investment is made and before the beginning of each subsequent plan year, the plan must provide notice to participants of the plan's default investment option and the circumstances under which it applies.

The proposed regulations do not relieve a plan fiduciary from prudently selecting and monitoring the QDIA. It is also important to note that an investment fund whose primary investment objective is the preservation of capital, such as money market, fixed income and stable value funds, will generally not be acceptable as a QDIA, although one or more of such funds may be part of a QDIA when appropriate. Plan fiduciaries that currently use a capital

preservation fund as a default investment will have to switch to a QDIA to be able to qualify for fiduciary relief under ERISA.

Other Fiduciary Relief Provisions

Blackout Periods. Currently, plan fiduciaries are not protected from liability under ERISA Section 404(c) for losses which occur during a "blackout period"; i.e., a period of three or more consecutive business days during which a participant's right to direct the investment of his or her plan accounts is temporarily suspended. Effective for plan years beginning in 2008, plan fiduciaries will be able to continue to maintain their Section 404(c) fiduciary protection during a blackout period if participants have previously made investment elections that comply with ERISA Section 404(c) and if ERISA's requirements for authorizing and implementing blackout periods, including the furnishing of the blackout notice, are satisfied.

Mapping of Investments. The Act also clarifies that Section 404(c) fiduciary protection may similarly extend to new plan investments, where a plan "maps" the proceeds of a removed investment fund to a new investment fund with similar risk and rate of return characteristics, even though plan fiduciaries, rather than plan participants, make the mapping decision. In order for the fiduciary protection to apply, participants must have previously made investment elections that comply with ERISA Section 404(c) and notices required by the Act must be provided to participants 30 to 60 days before the change in investment funds.

Investment Advice. The Act contains a prohibited transaction exemption for investment advice provided to plan participants by a fiduciary advisor, such as a bank, insurance company, broker-dealer or registered investment adviser, under an eligible investment advice arrangement. To qualify for the exemption, in addition to satisfying numerous safeguards against potential self-dealing, the advisor's fees must not vary depending on the investment selected or the advice given by the investment advisor must be based upon a computer model that meets certain requirements. From the plan sponsor's perspective, the provision is significant because it provides relief to the plan sponsor and other plan fiduciaries from liability for advice given by the fiduciary advisor to plan participants. Plan fiduciaries are not relieved, however, of their duty to prudently select and monitor the fiduciary advisor.

Accelerated Vesting

Under current law, employer contributions made to a defined contribution plan (other than matching contributions) are required to vest either under a five-year cliff vesting schedule or a seven-year graded vesting schedule. Matching contributions must vest either under a three-year cliff schedule or six-year graded schedule. The Act extends the application of the faster matching contribution vesting schedules to all employer contributions that are made to a defined contribution plan (but not defined benefit plans). Therefore, a participant must be 100 percent vested after three years of service on all employer contributions made to a defined contribution plan or become 20 percent vested after two years of service, increasing by 20 percent over each of the next four years.

The new accelerated vesting schedules generally go into effect for contributions made by employers to defined contribution plans in plan years beginning in 2007, and apply to

all participants who are credited with an hour of service after the effective date. Plan sponsors may continue to apply the longer pre-Act vesting schedules to contributions made to participant's accounts for plan years beginning prior to 2007. However, when considering any cost savings that may be achieved by applying a plan's old vesting schedule to these contributions, plan sponsors should take into account that the use of the same vesting schedule for all employer contributions made to the plan (i.e., matching contributions and pre-2007 and post-2006 employer contributions) should simplify and likely reduce the costs of plan administration.

Corrective 401(k) Distributions Made to Participants

Under current law, excess 401(k) contributions greater than $100 that are distributed to highly compensated employees within 2½ months after the end of a plan year in order for a plan to satisfy 401(k) nondiscrimination testing requirements are treated for tax purposes as received by the employee in the year in which the contributions were made. Thus, such excess contributions are considered to be taxable compensation for that previous year rather than the year in which the actual corrective distribution is made. The same rule applies for the distribution of excess matching contributions in order to satisfy the nondiscrimination testing requirements applicable to matching and after-tax contributions. As a result of this rule, employees who file their tax returns early may be required to file amended tax returns. Under the Act, effective for plan years beginning in 2008, all corrective distributions (even those made within 2½ months after the end of the plan year) will be taxable in the year of distribution.

Current law also requires that the corrective distributions must include earnings for the plan year in which the contribution was made and earnings for the period from the end of that plan year to the date of distribution (commonly referred to as "gap period earnings"). Under the Act, effective for corrective distributions made with respect to plan years beginning in 2008, gap period earnings will no longer be required to be distributed to participants.

Hardship Rules

Prior to the Act, a participant in a 401(k) plan could request an in-service distribution based only upon the financial hardship of the participant, the participant's spouse or dependent. Effective upon enactment, the Act has expanded the financial hardship distribution criteria to include the hardship of a participant's designated beneficiary under the plan. Thus, for example, the financial hardship of a grandchild, parent or domestic partner can satisfy a 401(k) plan's hardship criteria, provided that such individual has been designated as the participant's beneficiary under the plan.

Increase in Bonding Amount for Plans which Hold Employer Securities

ERISA generally requires that a plan fiduciary and any other person who handles plan funds be bonded up to a maximum amount of $500,000. Effective for plan years beginning in 2008, the maximum bond that is required for a plan that holds employer securities is increased to $1 million.

If you have any questions or would like further information about the matters discussed above, please call Norman J. Misher at (212) 903-8733; Allen J. Erreich at (212) 903-8769; Howard W. Hans at (212) 903-8767 or Gary J. Chase at (212) 903-8737.

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