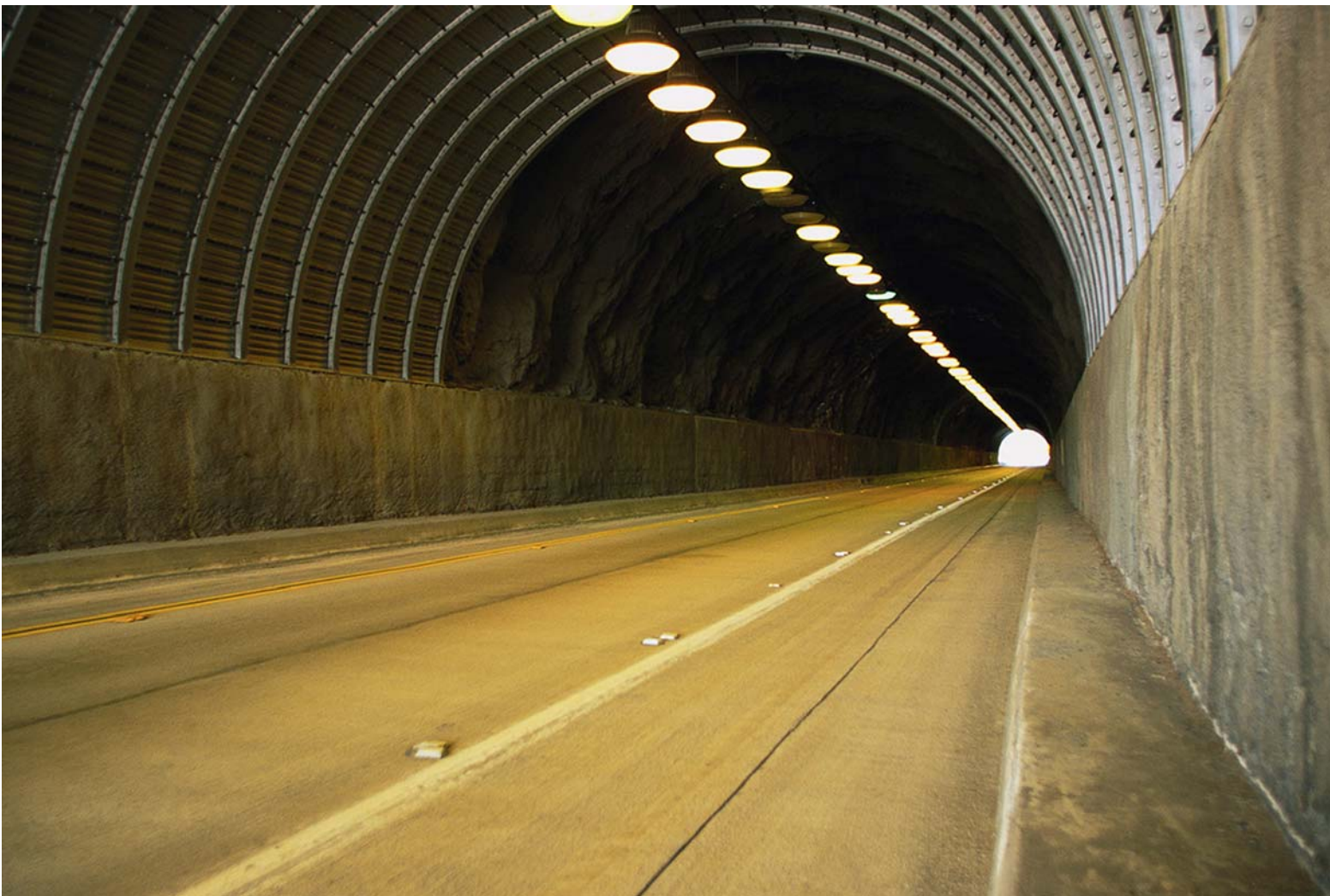


THE PENSION PROTECTION ACT OF 2006:

**New Rules for Retirement Plans: New
Plan Design Options, New Plan
Requirements, New Fiduciary Protection**

HayGroup®



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The Pension Protection Act of 2006 (PPA), which President Bush signed into law on August 17, 2006, contains significant changes to the rules governing retirement plan benefits, in addition to the sweeping changes to defined benefit pension plan funding requirements that were the major impetus to the legislation. The PPA includes many optional changes that will enhance retirement plan opportunities for employers and participants, as well as mandatory changes, some of which may be used immediately or beginning in the 2007 plan year.

Key among the changes unrelated to pension plan funding are extensive new rules governing the implementation of three retirement plans designs – automatic enrollment plans, cash balance and other “hybrid” plans, and combined defined benefit pension/401(k) plans for small employers. The PPA also includes a series of non-funding related changes affecting retirement plan contributions and distributions, including liberalization of plan rollover rules; new disclosure and reporting rules for ERISA-covered plans; and a series of changes to ERISA’s fiduciary rules, including fiduciary protection for providing certain investment advisory service to participants.

To the relief of many, the PPA makes permanent more than 30 statutory provisions affecting retirement plans and IRAs that were adopted in 2001 under the Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA), which had been scheduled to expire after 2010. Some of the EGTRRA provisions made permanent are: higher limits for employee pre-tax contributions and annual additions; increased deduction limits for 401(k) plans; age-50 catch up contributions; Roth 401(k) accounts; expanded rollover options; automatic IRA rollovers for unclaimed cash-outs; faster vesting for employer matching contributions; higher compensation limits for qualified plans; higher benefit limits under defined benefit plans; and a tax credit to encourage low-income earners to save for retirement.

This paper highlights the key PPA provisions that do not relate specifically to defined benefit plan funding, multiemployer plans, or governmental plans. On page 18 we have included a chart summarizing, in chronological order, the effective dates of the provisions discussed below.

Hay Group has also issued papers on the PPA funding provisions, PPA changes that impact governmental plan sponsors, and new rules for multiemployer pension plans. For a copy of one or more of these papers, ask your Hay Group consultant.

New Rules for Automatic Enrollment Plans

The PPA encourages employers that sponsor 401(k) or 403(b) plans to adopt automatic enrollment features, pursuant to which elective deferrals are made at a specified percentage of pay, unless an employee elects out of participation.

First, the PPA provides a new safe harbor from nondiscrimination testing for automatic enrollment plans that meet specified requirements. Second, distribution rules are liberalized so employees who opt out may withdraw contributions and employers have more time to distribute excess contributions. Third, employers will be relieved of fiduciary liability for the investment performance of qualified default investments for elective deferrals made under an automatic enrollment feature. These provisions are effective for plan years beginning after 2007.

The PPA also amends ERISA, effective August 17, 2006, to affirm that state laws barring automatic enrollment arrangements that meet specified conditions are preempted by ERISA.

New Safe Harbor for Automatic Enrollment Plans. Under current law an employer can avoid nondiscrimination and top-heavy testing by offering a safe harbor plan, which requires either: (1) a non-elective employer contribution of 3% of pay, or (2) an employer match of 100% on the first 3% of pay deferred by an employee, plus 50% on the next 2% of deferred pay. All employer contributions are immediately vested, and subject to the same distribution restrictions as elective deferrals (except that they may not be withdrawn on account of hardship). Current law also allows plans to require automatic enrollment, provided employees have a meaningful opportunity to opt out of participation. The new automatic enrollment safe harbor combines both these concepts.

The automatic enrollment safe harbor plan provision specifies the minimum level of elective deferrals that an employee must make each year of participation and the maximum level of deferrals that the employee may be required to make, if the employee does not opt out or affirmatively elect to contribute at a different percentage of pay. The new rules also require the employer to contribute either: (1) 3% of each employee's pay, regardless of participation, or (2) matching contributions that are slightly less expensive than those required under the current safe harbor plan design. Under the automatic enrollment matching contribution safe harbor, an employee must receive a 100% match for the first 1% of pay contributed and a 50% match for elective deferrals of more than 1% of pay and not more than 6% of pay. If the employer chooses to make matching contributions, its matching contributions under the new design will not exceed 3.5% of pay (instead of 4% of pay under a current safe harbor plan). The automatic enrollment safe harbor also allows employers to defer full vesting of employer contributions until the end of two years.

To take advantage of the automatic enrollment safe harbor an employer must notify participants, within a reasonable period before each plan year begins, of: (1) the employee's right to elect out of the arrangement or make an elective deferral of a different percentage of pay, and (2) how the employee's contributions will be invested, if the employee fails to make an investment

election. The notice must be sufficiently accurate to apprise the employee of his or her rights and be written in a manner that the average employee can understand. In addition, the employee must have a reasonable period of time after the notice is provided, and before the first elective deferral is made, to opt out or make an investment election.

The chart below shows the key automatic enrollment safe harbor requirements.

Automatic Enrollment 401(k) Safe Harbor Requirements	
Criteria for Employee Elective Deferrals	Employer Contribution Requirements
Automatic deferral between 3% - 10% of compensation, but <ul style="list-style-type: none"> – at least 3% in the first year of participation – at least 4% in the second year – at least 5% in the third year and – at least 6%, but not more than 10%, in any subsequent year 	100% vesting after no more than two years under either option Option 1: Matching Contributions for nonhighly compensated employees* – 100% of elective deferrals up to 1% of compensation + 50% of elective deferrals of more than 1% up to 6% of compensation Option 2: Automatic Employer Contribution – 3% of compensation
*The matching contribution rate for highly compensated employees cannot exceed the matching contribution rate for automatically enrolled nonhighly compensated employees	
Employer must provide annual notice, which also explains, for self-directed investment plans, how the contributions will be invested in the absence of employee investment instructions.	

Employees who “opt out” will not negate the safe harbor testing advantages, and employees who have previously enrolled or opted out may be ignored for safe harbor eligibility purposes.

Special Distribution Rules. The PPA also encourages automatic enrollment plans by allowing plan sponsors to allow employees who have been automatically enrolled to withdraw their automatic elective deferrals. The withdrawal election must be made within 90 days of the date the elective deferral was made, and the employee must withdraw all elective deferrals made under the automatic enrollment arrangement. Related matching contributions must be forfeited. Withdrawals are treated as taxable compensation in the year distributed to the employee and are not subject to the early withdrawal tax.

Permissive withdrawals are permitted under a 401(k), 403(b) or governmental 457(b) plan with an automatic enrollment feature even if the plan does not qualify for the safe harbor. However, default investment elections must comply

with requirements prescribed by the U.S. Department of Labor, and the plan administrator must provide notice to employees that meet the notice requirements applicable to automatic enrollment safe harbor plans.

The PPA further liberalizes the rules governing corrective distributions from 401(k) and 403(b) plans with automatic enrollment features by extending to six months after the end of the plan year the 2½ month period generally applicable to distributions of contributions that fail the ADP and ACP nondiscrimination tests applicable to elective deferrals and matching contributions. In addition, all such excess contributions, when distributed within the applicable 2½ or six month time period will be taxed in the year distributed, rather than the year contributed.

Default Investments. As part of the PPA, Congress directed the U.S. Department of Labor (DOL) to issue regulations to protect plan fiduciaries who provide default investments, when employees fail to make investment elections. These rules apply to automatic enrollment plans and in other situations. They are discussed on page 14 under “Defined Contribution Plan Investments, Employer Protection for Making Default Investments.”

Automatic Enrollment Preempts State Law. Many employers that are subject to ERISA have been reluctant to adopt automatic enrollment features for their 401(k) or 403(b) plans because of concerns that non-consensual payroll deductions may violate state laws. The PPA amends ERISA to preempt (*i.e.*, supersede) any state law that would prevent an ERISA-covered employer from adopting an automatic enrollment feature for its plan. The ERISA amendment is effective August 17, 2006. Church plans and other plans exempt from ERISA cannot rely on the PPA’s ERISA preemption, and should not use automatic enrollment features without an analysis of applicable state law.

Cash Balance and Other Hybrid Plans

The PPA resolves many of the legal issues that brought a halt to the growth of cash balance and pension equity plans, although the resolution applies only for periods beginning on or after June 29, 2005. Cash balance plans and pension equity plans are defined benefit pension plans that look in many respects like defined contribution plans and often pay lump sum benefits, even though the automatic form of benefit is a qualified joint and survivor annuity for married participants, and a single life annuity for unmarried participants.

Unlike the traditional defined benefit plan, in which most of the benefit value accrues as the participant nears retirement, in cash balance and hybrid plans benefits accrue more evenly over the participant’s career, making them much more attractive to a mobile workforce. In addition, funding for these plans is more predictable. Under a cash balance plan, an employer credits each

participant's hypothetical account with a percentage of pay each year, and then credits the account balance with hypothetical earnings until the participant's normal retirement age. The interest credits are part of the participant's accrued benefit. A pension equity plan pays a participant a lump sum benefit equal to a percentage of his or her final average pay multiplied by the number of his or her years of service.

Legal Challenges. Many challenges to the hybrid plan designs arose based on perceived age discrimination when employers converted traditional defined benefit plans into cash balance plans. In many of these conversions, a participant's accrued benefit would equal the greater of (1) his accrued benefit frozen as of the date of the conversion, or (2) the benefit determined by applying the new formula to all of the participant's years of service. This approach (called the "wearaway" approach) resulted in lengthy periods during which many older workers would not accrue new benefits. Others challenged the basic cash balance contribution approach as age discriminatory, because the same dollar amount of contribution for a younger worker, compared to an older worker, produces a larger annuity for the younger worker, because he or she has more years of compounding interest until retirement.

Another legal issue arose because of the "whipsaw" effect that results when a plan used a different interest rate to credit a participant's hypothetical account balance than the statutorily mandated rate for determining the present value of an annuity form of benefit. When the credited interest rate is higher than the statutory discount rate, the present value of that account balance projected to normal retirement age, converted to an actuarially equivalent annuity, and then discounted to present value, is larger than the account balance. Many courts have ordered payment of the larger amount, based on the requirement that, if a defined benefit plan pays a lump sum benefit, the amount paid may be no less than the present value of the participant's accrued benefit.

PPA Resolution of the Age Discrimination Issue. The PPA provides that an "applicable defined benefit pension plan" does not violate the prohibition against age discrimination if a participant's entire accrued benefit as of any date is equal to or greater than that of any similarly situated, younger individual, as long as certain conditions are met. An applicable defined benefit pension plan is a plan, like a cash balance or pension equity plan, in which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for a participant or as an accumulated percentage of the participant's final average compensation. Individuals are similarly situated if they are identical in terms of service, compensation, position, date of hire and every other respect but age. In other words, the fact that the same dollar contribution results in a higher benefit for a younger employee, because of the time value of money, does not result in age discrimination.

To qualify as nondiscriminatory based on age, the plan must provide for vesting after not more than three years and must credit interest at a rate that is no greater than a market rate of return. Despite this requirement, the plan may provide for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return. In addition, an interest credit of less than zero may not result in an account balance less than the aggregate value of contributions made on a participant's behalf. Special rules apply in determining the interest rate at plan termination. The interest rate rules likely will inhibit plan designs that credit accounts based on actual rates of return.

Although these new provisions generally take effect for periods beginning on or after June 29, 2005, the vesting and interest crediting provisions apply to a plan in effect on that date in years beginning after 2007, unless the plan sponsor elects to have them apply for any period after June 29, 2005, and before the first year beginning after 2007.

Conversions. The PPA also prescribes rules that conversions of traditional defined benefit plans into cash balance or pension equity plans must follow to comply with age discrimination requirements. The wearaway approach is prohibited for any plan amendment adopted after June 29, 2005 (including adoption of a new plan after freezing a traditional defined benefit plan). If a defined benefit plan is converted to a cash balance or pension equity plan after June 29, 2005, the participant's accrued benefit after the conversion cannot be less than the sum of (1) the participant's accrued benefit for years of service before the conversion under the pre-conversion rules, plus (2) the participant's accrued benefit for years of service after the conversion effective date, determined under the post-conversion plan terms. In addition, the plan must credit the participant's accumulation account with the amount of any early retirement subsidy under the old formula if the participant retires at a time when he or she would have been eligible for the subsidy.

The Whipsaw. The PPA resolves the whipsaw problem for distributions after August 17, 2006 from a cash balance or pension equity plan that meets the requirements for "an applicable defined benefit plan." For those distributions, a participant's hypothetical cash balance account balance or accumulated percentage of final average compensation is treated as the present value of his or her accrued benefit. Therefore, the plan may distribute that amount in full satisfaction of the participant's accrued benefit.

Impact of PPA Rules Prior to PPA Effective Date. The PPA indicates that no inferences are to be drawn about (1) the legality of hybrid plan designs under the age discrimination rules before the effective date of the PPA; (2) the legality of conversions to hybrid plan designs, before the applicable PPA effective date;

or (3) application of the present value rules to cash balance plans or pension equity plans before the applicable effective date.

New Defined Benefit / 401(K) Plan

Beginning with the 2010 plan year, employers with at least two and no more than 500 employees will be able to create a new hybrid defined benefit/401(k) plan that is exempt from nondiscrimination and top-heavy testing.

In general, the DB/401(k) plan will combine a final average pay defined benefit plan with a safe harbor-type 401(k) plan. The 401(k) feature will require automatic enrollment with an employee deferral of 4% of compensation and an employer matching contribution of 50% of an employee's contributions up to 4% of compensation. The rate of matching contributions for highly compensated employees cannot exceed the matching contribution rate for nonhighly compensated employees. Employees must be immediately vested in their 401(k) accounts. The defined benefit plan must provide a benefit equal to 1% of final average pay times years of service, to a maximum of 20% of final average pay.

If a cash balance plan is used instead of a final average pay plan, the PPA requires the following pay credits (*i.e.*, contributions): at least 2% of compensation for participants age 30 and under, 4% of compensation for participants who have attained age 30 but not age 40, 6% of compensation for participants who have attained age 40 but not age 50, and 8% of compensation for participants who have attained at least age 50.

The lure for employers is that this DB/401(k) gets an automatic pass on nondiscrimination testing, including the 401(k) average deferral percentage (ADP) and average contribution percentage (ACP) discrimination tests as well as top-heavy testing. In addition, the plan uses one plan document and trust fund, and will be treated as a single plan for reporting purposes.

This new hybrid DB/401(k) plan will be particularly attractive to small professional corporations and partnerships (e.g., doctors, lawyers, accountants, architects), where owners want to defer more income for retirement than is possible under defined contribution rules and are willing to give their employees pension benefits.

New Contribution and Distribution Rules

Accelerated Vesting for Employer Contributions to Defined Contribution Plans. The PPA requires that all employer contributions to qualified defined contribution plans vest as rapidly as current employer matching contributions to 401(k) and 403(b) plans. Plans that use cliff vesting will be required to vest participants after three years of service, not five. Plans with graded vesting

schedules will be required to use a schedule with at least 20% vesting after two years (not three), and full vesting after six years (not seven). For this purpose qualified defined contribution plans include profit-sharing plans, 401(k) plans, money purchase plans, ESOPs, and 403(b) plans.

The new vesting standards generally apply beginning with the 2007 plan year to all employees who have at least one hour of service on or after the 2006 plan year. For collectively bargained plans, the new standards must apply to plan years beginning on or after the earlier of: (1) the later of (a) January 1, 2007 or (b) the expiration of the last collective bargaining agreement in effect on August 17, 2006 (ignoring any extensions after August 16, 2006) or (2) January 1, 2009. Leveraged ESOPs may delay application of the new requirements until the first plan year beginning on or after the earlier of: (1) the date on which the ESOP loan is fully repaid, or (2) the date on which the ESOP loan was (as of September 26, 2005) scheduled to be repaid.

According to our 2006 Hay Benefits Report, more than 85% of 401(k) plans provide vesting for non-elective employer contributions that is at least as favorable as the new PPA vesting requirements. The increased cost of the new vesting standards will depend on turnover rates in your employee population and the amount of employer contributions. Employers with plans that have vesting schedules slower than the PPA-mandated vesting schedules will want to budget for the increased costs for 2007.

New Qualified Joint And Survivor Annuity Option Required. If a defined benefit plan (including a cash balance plan) or a money purchase plan has an automatic married form of payment or QJSA with a survivor annuity of 75% or less (for example a joint and 50% survivor annuity), the plan sponsor must add a qualified joint and 75% survivor annuity option, if one does not exist. If the plan's QJSA provides a 75% or more survivor annuity, the plan must add a qualified joint and 50% survivor annuity if one does not already exist. The PPA specifies that the new QJSA must be actuarially equivalent to the single life annuity. The new QJSA option applies beginning with the 2008 plan year. However, for collectively bargained plans, the provision applies to either the 2008 or 2009 plan year, depending on whether a current collective bargaining agreement expires after January 1, 2008.

If the plan's joint and survivor annuity forms of payment are subsidized (*i.e.*, the benefit is worth more than the pure actuarial equivalent of the normal form of payment), plan sponsors will want to evaluate with their actuaries how the new QJSA option will fit with the other payment options. Clarification from the IRS may allow plan sponsors to provide a subsidy (*i.e.*, make it more valuable) so it is comparable to the subsidy provided for the plan's other joint and survivor options. The burden of adding another form of payment may be mitigated, in some cases, by the elimination of redundant, or burdensome and insignificant, forms of payment, in accordance with IRS rules.

New Rules for Calculating Lump Sums. Beginning with the 2008 plan year, the PPA changes the rules for valuing cash-outs by requiring the use of new interest rates and a new mortality table to determine the minimum cash-out amount that must be paid. Under current law, lump sums are based on the interest rate for 30-year Treasuries. The PPA requires use of interest rates based on the yield curves for high quality corporate bonds of varying maturities, which depend on when the benefit would have been payable had the participant delayed receipt until normal retirement age. The new interest rates are phased in over five years. The net effect of the interest rate and mortality changes is likely to be a slight decrease in lump sum amounts.

Liberalized Hardship and Unforeseeable Emergency Distribution Rules. The PPA directs the Treasury Department to expand the current rules governing hardship withdrawals from 401(k) plans and 403(b) plans, and unforeseeable emergency distributions from 457(b) plans and nonqualified deferred compensation plans subject to Section 409A, by mid-February 2007. The current rules limit such withdrawals to hardships or unforeseeable emergencies incurred by the participant, or his or her spouse or dependent. Under the revised rules, plans may permit withdrawals for hardships incurred by any beneficiary of the participant under the plan, even if the beneficiary is not the participant's spouse or dependent.

Rollovers by Nonspouse Beneficiaries. For rollovers made after 2006, a nonspouse beneficiary who is entitled to a distribution from a qualified retirement plan (including a governmental plan), a 403(b) plan, or a governmental 457(b) plan, may transfer the distribution directly to an IRA. Distributions from the IRA will be subject to the distribution rules applicable to beneficiaries, allowing the distributions to be taken out over the beneficiary's lifetime. Plan administrators will need to quickly update distribution forms and notices, although actual plan amendments can wait until 2009.

Rollovers from Retirement Plans to Roth IRAs. Beginning in 2008, distributions from tax-qualified retirement plans (including governmental plans), 403(b) plans, and governmental 457(b) plans may be rolled over directly into Roth IRAs, in addition to employer plans and traditional IRAs. This opportunity for Roth IRA rollovers is only available to a taxpayer whose adjusted gross income is \$100,000 or less. The rollover will not be tax-free, except to the extent attributable to after-tax contributions, but it also will not be subject to the 10% early withdrawal penalty tax. Plan sponsors will need to modify plan rollover provisions, distribution forms and notices.

Distributions at Age 62 for Phased Retirement. Under current law a participant cannot receive a pension while working for a plan sponsor unless the

participant has attained normal retirement age (typically defined in the plan as age 65). The PPA allows plan sponsors to amend their plans to permit plan distributions as part of a phased retirement beginning no earlier than age 62. The eligible employee must reduce his or her work schedule by at least 20 percent and receive a pro rata share of his or her pension. The PPA rule is effective beginning with the 2007 plan year.

Last year the Treasury Department proposed more liberal rules for phased retirements that would allow pensions to begin at age 59½ in connection with a phased retirement. Although it seems likely that this PPA provision will replace Treasury's initiative, we expect further Treasury guidance on this new provision. Phased retirement can be a powerful human resources tool when properly designed and implemented. Employers have used phased retirements for many years, but the PPA rule adds pension benefits as part of the economic incentives to help with talent management and staff transitions. Phased retirement benefits have been used successfully by governments exempt from the current pension distribution restrictions.

Relief from 10% Early Withdrawal Penalty for Reservists. A member of the reserves who is called up for active duty for at least 180 days, or for an indefinite period, after September 11, 2001 and before 2008, may withdraw amounts held in a 401(k) or 403(b) plan attributable to elective deferrals, or in an IRA, without incurring the 10% premature distribution penalty tax. The reservist may repay the distribution within the two-year period following the end of active duty (or by August 17, 2008, if later). No tax deduction is allowed for repayments. Since the relief applies to withdrawals made after September 11, 2001, eligible reservists may have already paid the extra 10% tax. The PPA specifically allows reservists to file for a tax refund or credit for prior tax years, provided the reservist files for the refund or credit by August 17, 2007.

Rollover Rules for After-Tax Contributions to Defined Benefit Plans. Beginning January 1, 2007, defined benefit plans and 403(b) plans may accept rollovers of after-tax contributions from a qualified plan if they separately account for the contributions and earnings thereon. After-tax rollovers may only be made by a trustee-to-trustee transfer. The new rule, which is intended to expand portability options, builds on the EGTRRA rule that currently permits after-tax contributions to a Roth 401(k) account and rollovers of after-tax contributions between defined contribution plans. Implementing separate after-tax rollover accounts under a defined benefit plan will raise new administrative issues, including: what are appropriate account investments (which could include self-directed investments) for the accounts; whether interest should be based on actual portfolio performance; and who will bear any separate account charges.

ODRO Rules to be Clarified. The PPA directs the Department of Labor to clarify by August 17, 2007 how revisions to a domestic relations order or a second domestic relations order are to be evaluated. Once new regulations have been issued plan administrators will need to determine whether any changes are needed to current plan provisions or procedures.

New Notice and Disclosure Requirements

Expanded Window for Required Distribution Notices. Under current law, administrators of defined benefit plans (including money purchase plans) subject to the qualified joint and survivor annuity rules, must give participants written notice of their distribution rights (including benefit election and related forms) at least 30 days, and not more than 90 days, before the distribution commences. The PPA gives plan administrators the latitude to give the distribution notice up to 180 days before, but at least 30 days before, benefits commence. The expanded window applies for plan years beginning after 2006. This provision will allow administrators to issue benefit election materials to participants much earlier, reducing the need to reissue forms that are returned after 90 days.

Benefit Statement Requirements for Defined Contribution Plans. The PPA amends ERISA to require that benefit statements must be provided quarterly for participant-directed individual account plans, and annually for all other individual account plans. For most plans, quarterly (or annual) statements will be required beginning with the 2007 plan year. However, for collectively bargained plans, the new statement requirements apply to the plan year following the expiration of the last collective bargaining agreement in effect on August 17, 2006, but not later than the 2009 plan year.

The Department of Labor must issue rules and a model statement by August 17, 2007. Regulations could permit current benefit statements to be provided on a continuous basis through a secure plan website. (For information about Hay Group's online statement capabilities go to: <http://www.haybenefits.com>.) This PPA provision generally codifies the best practice among employer defined contribution plans and should create little if any additional burden for most employers.

Benefit Statement Requirements for Defined Benefit Plans. All defined benefit pension plans subject to ERISA will be required to issue benefit statements to active participants every three years. Terminated vested participants and beneficiaries will be entitled to statements upon request. The statement must indicate accrued benefits and, if not vested, the earliest date the participant could be vested. As an alternative to sending benefit statements to all active participants, the administrator may notify them that statements are available upon request. Statements may be sent electronically. Statements generally are required beginning in the 2007 plan year. For collectively

bargained plans these requirements are effective beginning for plan years 2008 or 2009 (depending on whether the last current collective bargaining agreement expires after December 31, 2007). The Department of Labor will issue a model statement by August 17, 2007.

Annual Funding Notices for Defined Benefit Plans. The PPA repeals the requirement of distributing summary annual reports (SARs) beginning with the 2008 plan year. Instead, single employer defined benefit plan sponsors will be required to issue an annual funding notice to each participant, affected union, and the PBGC. The notice must include, among other things: the plan's funding target percentage; the market value of assets versus liabilities for the current and preceding two years; the plan's funding policy and investment allocation; and a summary of the rules relating to plan terminations and PBGC benefit guarantees.

Multiemployer plans, which currently have an annual funding notice requirement, will also be required to use a new funding notice beginning with the 2008 plan year. The PPA provides transition requirements for multiemployer plan notices issued for the 2006 and 2007 plan years.

The new annual funding notices must be provided no later than 120 days after the end of the plan year. For small plans (with 100 or fewer participants) the annual funding notice should be provided with the annual Form 5500. The Department of Labor will issue rules describing the notice and the method of distribution.

Electronic Posting of 5500s. Subject to Department of Labor rules, an ERISA-plan sponsor will be required to post its Form 5500s on its intranet website, if it has such a site maintained for communicating with its employees, and not the public. The Form 5500 posting requirement also applies to a TPA that maintains a plan website for a plan sponsor. Posting is required 60 days after the Form 5500 filing. The Department of Labor will issue further guidance before 2008. In addition, the Department of Labor is required to post Form 5500 information on its website. The Department of Labor has been working toward online filing of 5500s, and the PPA effectively establishes a 2008 deadline for the transition, although the 2008 Form 5500 will not be posted online until late in 2009.

Additional Form 5500 Reporting Requirements. Beginning with the 2008 plan year return, additional Form 5500 disclosure will be required pertaining to the funded status of the plan and the employers that contribute to the plan. These disclosure requirements will apply to ERISA-covered single and multiemployer pension plans.

Defined Contribution Plan Investments

Plan Sponsors May Pay for Third-Party Investment Advice. The PPA exempts from the prohibited transactions provisions of ERISA certain arrangements to provide for investment advice to defined contribution plan participants who direct their own investments on or after January 1, 2007. The advice must be provided by a “fiduciary adviser” that is a registered investment adviser, the trust department of a bank or similarly regulated financial institution, an insurance company, a registered broker-dealer, an affiliate of any of these entities, or an employee, agent or representative of any of these entities who is legally qualified to give investment advice.

The investment advice may only be provided under an “eligible investment advice arrangement.” An eligible arrangement must be authorized by disinterested plan fiduciaries who are not affiliated with the fiduciary adviser giving the advice. In addition, the investment advice must be provided: (1) by a fiduciary adviser whose fees do not vary based on the investment option selected, or (2) through a computer model that meets the statutory requirements for objectivity and comprehensiveness, and is certified by an eligible investment expert. In addition, the plan must obtain an annual independent audit of the investment advice arrangement.

Before rendering any investment advice the fiduciary adviser must give a notice, annually and upon the participant’s request, to the participant disclosing information related to: (1) the role of any affiliate of the fiduciary adviser in developing the advice and selecting the investments; (2) the past performance of each available investment option; (3) the fees received by the adviser or its affiliates with respect to the advice or in connection with the investment transactions; (4) any relationship between the adviser and the security or other property involved in the investment transaction; (5) how participant or beneficiary information will be used or disclosed; (6) the kinds of services provided by the adviser with respect to the advice given; (7) the adviser’s fiduciary status; and (8) the ability of the recipient to enter a separate arrangement with an unaffiliated adviser.

The employer or other plan fiduciary who arranges for a fiduciary adviser to provide investment advice under an “eligible investment advice arrangement” is exempt from fiduciary liability, provided the fiduciary adviser acknowledges being a fiduciary and agrees to comply with the applicable requirements. However, the PPA does not exempt an employer or a plan fiduciary from its obligations under ERISA for the prudent selection and monitoring of a fiduciary adviser who provides investment advice. But neither are they required to monitor specific investment advice given by the fiduciary adviser.

The PPA has removed a significant legal roadblock for getting investment advice to unsophisticated (and even some sophisticated) participants. Over the

next year plan sponsors will begin to see new investment advice features being marketed by investment companies. We expect that most companies will offer computer models that develop investment strategies based on a participant's answers to a series of questions about his or her retirement horizon and risk tolerance. Plan sponsors should "test drive" the models and determine whether the model's direct or indirect cost and the model itself are suitable for their particular employee population.

The Department of Labor, in consultation with the Treasury Department, is to determine, by December 31, 2007, whether computer models are appropriate for IRAs and other investment accounts such as MSAs and health savings accounts.

Employer Protection for Making Default Investments. Under current law plan sponsors risk fiduciary liability when they invest participant contributions in default investments in the absence of participant investment instructions. Default investments are most likely to occur when a plan with a self-directed investment feature includes an automatic enrollment provision or otherwise allows employee deferrals before the employee has selected an investment allocation. Employers may also choose default investments when investment alternatives or service providers are changed and participants fail to give instructions. Because plan administrators are not protected against adverse default investment results, most employers use low-yield, money market funds as the default investment.

Beginning with the 2007 plan year, plan sponsors will be eligible for protection against fiduciary liability when they make default investments in the absence of participant investment directions. To qualify for this protection the plan sponsors must distribute a timely participant notice explaining the default investment process, the default investment(s), and the participant's rights to select investments.

The DOL proposed rules on September 29, 2006 to implement the PPA's default investment rules that will provide a safe harbor from liability when investing participant accounts in the absence of participant investment instructions. These rules cannot be relied on until finalized. The final rules must be issued by August 17, 2007.

Under the proposed rules, the plan fiduciary must give participants and beneficiaries for whom default investments may be made a notice at least 30 days before the first default investment is made and again at least 30 days before the beginning of each subsequent plan year that explains the default investment program. Under the safe harbor a permitted "qualified default investment alternative" is an investment in (1) a "life-cycle" or "targeted-retirement-date" fund, or (2) a "balanced fund" or similar investment fund product or model portfolio that is designed for long-term appreciation through a mix of investments consistent with a target level of risk appropriate for plan participants

as a whole (which does not need to take into account the age, risk tolerances, or investment preferences of any particular participant). Alternatively, a professional investment adviser may tailor the investment portfolio to achieve varying degrees of long-term appreciation and capital preservation through a mix of investments, based on the participant's age, target retirement date, or life expectancy that becomes more conservative over time.

This provision will help employers provide more diversified default investment allocations and increase investment returns for default accounts. The DOL estimates a \$45-90 billion increase in long-term aggregate account balances as a result of these new PPA rules. Many plans now provide lifestyle and target retirement funds, which provide an appropriately diversified asset allocation for participants in a given age range. For these plans, the DOL rules will be easy to implement. Plan sponsors who want to implement the DOL rules as soon as possible should begin to evaluate whether their current investment lineup meets the DOL criteria for default investments.

Clarification of Fiduciary Liability and Black Out Rules for Mapping to New Investment Lineup. When a plan sponsor replaces certain investments in a self-directed investment plan's lineup with reasonably similar investments, participants must be given a notice 30-60 days before the effective date of the investment option changes. The notice must compare the existing and new investment options and explain that, in the absence of the participant's affirmative investment instructions for moving the investment from a closed investment to another investment, the participant's account balance will be transferred to the corresponding new investments.

The PPA also clarifies that, for ERISA purposes, if a plan sponsor complies with the blackout notice and related requirements, the sponsor will not be liable for blackout period losses. These increased notice requirements are a trade-off for the explicit immunity from ERISA fiduciary liability during blackout periods that some employers thought they already enjoyed before this PPA clarification. Generally these rules apply beginning with the 2008 plan year. However, for collectively bargained plans, the notice requirement applies to either the 2009 or 2010 plan year, depending on whether the last current collective bargaining agreement expires after December 31, 2008.

Freedom to Divest Employer Securities from Defined Contribution Plans. An ERISA-covered individual account plan that requires investment in publicly traded employer securities must allow participants and beneficiaries to divest their accounts of employer securities in accordance with PPA rules. The divestiture requirements also apply to plans holding employer securities that are not publicly traded, if the employer or any member of its controlled group has issued publicly traded securities. Individual account plans include 401(k), profit

sharing, and money purchase plans, but exclude certain employee stock ownership plans (ESOPs).

To comply with the divestiture rules, participants and beneficiaries must be offered a choice of at least three investment options other than employer securities. Each such option must be diversified and have materially different risk and return characteristics. The opportunity to invest in these other options must be made available at least quarterly. Restrictions imposed on investments in employer securities may be no different than restrictions applicable to other investment options, unless required by the securities laws.

The following chart summarizes the rights provided by the PPA to participants and beneficiaries, with respect to when they must be permitted to divest the employer securities in their plan accounts.

Divestiture Requirements for Employer Securities	
Category of Employer Securities Subject to Account Holder Divestiture Rights	Applicable divestiture rules (see special rules below for collectively bargained plans and ESOPs)
Employer securities attributable to employee deferrals and contributions	Participants and beneficiaries must be permitted to divest all employer securities in the 2007 plan year
Employer securities attributable to employer contributions (including matching contributions):	
1. Participants who have attained age 55 and have three years of service prior to the 2006 plan year	Participants and beneficiaries must be permitted to divest in the 2007 plan year for employer securities acquired before the 2007 plan year
2. Participants with three years of service, and surviving beneficiaries	For employer securities acquired before 2007, participants and beneficiaries must be allowed to divest the following percentages of employer securities: 33% in plan year 2007 66% in plan year 2008 100% in plan year 2009
3. Participants with less than three years of service	Plan may only require participants to hold employer securities until the end of the participant's third year of service

These divestiture rules generally do not apply to ESOPs that do not permit elective deferrals, after-tax employee contributions, or matching contributions.

The divestiture rights and notice obligations generally apply beginning with the 2007 plan year. However, for plans maintained pursuant to one or more collective bargaining agreements, the requirements apply for plan years beginning after the earlier of: (1) the later of December 31, 2007 or the expiration date of the last bargaining agreement in effect on August 17, 2006 (ignoring any extension), or (2) December 31, 2008.

Increased Maximum Bond for Plans Holding Employer Securities. Because of the increased risk for a participant when a plan holds employer securities, the maximum bond amount required for fiduciaries of such plans is increased from \$500,000 to \$1,000,000, effective for plan years beginning after 2007. The bonding requirement protects plan participants from loss or dishonesty on the part of plan officials handling plan assets.

Plan Amendments

Plans must be amended to comply with applicable provisions of the PPA by the end of the 2009 plan year. For example, for a calendar year plan, the deadline is December 31, 2009; for a July 1 – June 30 plan year, the deadline is June 30, 2010. Where the PPA requires earlier compliance, the plan must be operated in compliance with the PPA provision, even if the amendment's adoption date is later.

Summary of Effective Dates

Page #	PPA Provision	Effective Date
2	ERISA preemption for auto-enrollment	August 17, 2006
10	Reservist relief from 10% early withdrawal penalty	August 17, 2006, retroactive to September 12, 2001
9	Rollovers by nonspouse beneficiaries	January 1, 2007
10	After-tax rollovers to defined benefit plans	January 1, 2007
13	Independent investment advice	January 1, 2007
9	Liberalized hardship and emergency distribution rules	Rules expected Feb. 2007
7	Accelerated vesting for employer DC plan contributions	2007 plan year; delayed effective date for bargained plans
9	Phased retirement	2007 plan year
11	Longer period for distribution notices	2007 plan year
11	Benefit statements	2007 plan year; delayed effective date for bargained plans
14	Fiduciary protection for default investments	2007 plan year
15	Diversification rights for employer securities	2007 plan year; delayed effective date for bargained plans
9	Rollovers to Roth IRAs	January 1, 2008
1	Automatic enrollment safe harbor plan	2008 plan year
4	Cash balance rules	2008 plan year; conversion relief effective after June 29, 2005; whipsaw relief effective after August 17, 2006
9	New lump-sum calculation rules	2008 plan year
8	New qualified joint and survivor option	2008 plan year; delayed effective date for bargained plans
15	Expanded black out and investment mapping notice requirement	2008 plan year; delayed effective date for collectively bargained plans
12	Annual Funding Notices for Defined Benefit Plans	2008 plan year
12	Additional 5500 requirements	2008 plan year
7	Defined benefit/401(k) hybrid plan	2010 plan year

About Hay Group

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For more information on the impact of the Pension Protection Act of 2006, please contact your Hay Group Consultant, Robert Landau, (Robert_Landau@haygroup.com or 703.841.3123), or Melissa Rasman (Melissa_Rasman@haygroup.com or 215.861.2350).

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