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January 26, 2011

Employee Benefits Security Administration
Office of Regulation and Interpretations
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, D.C. 20210

Attn: Mr. Fred J. Wong

Re: Proposed Regulation, "Definition of the Term Fiduciary"

Ladies and Gentlemen:

Stern Brothers Valuation Advisors is an Employee Stock Ownership Plan (ESOP) appraisal firm. We perform approximately 120 ESOP valuations each year for private ESOP companies. We believe that the proposed rule defining the ESOP appraiser as a "Fiduciary" could have a significant negative impact on the number new of ESOP formations. The following are some of the issues that are of concern to the ESOP community:

(1) Fewer ESOP formations will occur (resulting in a lower level of retirement benefits) primarily because of the increased cost of fiduciary insurance (assuming it can be attained at any cost) for ESOP appraisers.

(2) It is likely that a number of ESOP appraisal firms that are the most qualified and experienced with the Department of Labor (DOL) requirements will no longer be willing to provide appraisal services due to the litigation risk. The cost of litigation defense is significant and if ESOP appraisers are fiduciaries, it is likely that they will be a defendant in a lawsuit along with the Trustee if the ESOP company has any type of financial difficulties. [The appraiser does not manage the ESOP company and cannot guarantee the financial performance of the ESOP company. The valuation of a business is not an exact science and reasonable people can disagree as to the value.]

(3) It will be very difficult to hire a new appraiser for an ESOP company that has significant financial leverage and may require a financial restructuring (due to the risk of litigation).

(4) There will be confusion concerning the legal responsibilities of the ESOP appraiser in a transaction.

We have attached the National Center for Employee Ownership ("NCEO") Executive Summary and the letter written by The ESOP Association concerning the Proposed Regulation. We believe that they are effective in communicating the issues faced by the ESOP community if the rule is passed. We will not repeat all of their points in this letter. We highly recommend their suggestion that ESOP appraisals be prepared by those appraisers that have significant appraisal credentials.

We believe that a requirement that an ESOP appraiser have two of the four following credentials [Certified Public Accountant, Accredited in Business Valuation (CPA/ABV), Accredited Senior Appraiser (ASA), Certified Business Appraiser (CBA), and Chartered Financial Analyst (CFA)] would be appropriate. The organizations that grant these designations [American Institute of Certified Public Accounts (AICPA), American Society of Appraisers (ASA), The Institute of Business Appraisers (IBA) and CFA Institute] provide thorough and rigorous training in business valuation. This requirement will result in higher quality ESOP appraisals and a less costly solution for poor quality appraisal work. Thank you for consideration of our analysis of the impact of the Proposed Regulation.

Sincerely,

STERN BROTHERS VALUATION ADVISORS

John C. Korschot

John C. Korschot, CFA, ASA, CBA, CPA/ABV
President

The ESOP Association

January 31, 2011

Employee Benefits Security Administration
Office of Regulation and Interpretations
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, D.C. 20210

Attn: Mr. Fred J. Wong

Re: Proposed Regulation, "Definition of the Term Fiduciary"

Ladies and Gentlemen:

The following comments are submitted by The ESOP Association (Association), a 501(c)(6) entity representing as its primary members corporations sponsoring employee stock ownership plans, or ESOPs. At this writing, the Association has approximately 1,400 primary, or corporate, members. The following information will give you an understanding of the Association and its membership. These statistics are intended to provide the Department of Labor (DOL) an understanding of the natural pride and passion ESOP companies, and ESOP beneficiaries, have in their ownership structure.

- Of our 1,400 corporate members, 91.2% have fewer than 500 employees and 53.9% have fewer than 100 employees. Membership in the Association is dominated by small privately--held businesses.

- In each year since 1975, between 80% and 95% of ESOPs were created when an exiting shareholder(s) of a private company sold his or her stock to an ESOP.

- The Association's 2010 survey of its members showed 22.1% are manufacturing companies, by far the dominant category, followed by construction companies at 13.2%.

- On average, the Association's corporate members have sponsored their ESOPs for 15 years

- ESOPs sponsored by Association corporate members owned an average of 77% of the stock of the sponsoring corporation.

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- The average individual ESOP account balance of corporate members, according to the Association's survey, is $192,223. Among Association corporate members, 78% also sponsor a 401(k) plan.

- When creating their ESOPs, 96.7% of the corporations did not reduce wages or other benefits, and 70.35% did not utilize another plan's assets, to fund their ESOPs.

Approximately 900 professionals are secondary members of the Association. Approximately 100 members provide valuation services to privately-held ESOP companies, which are required by law to obtain an independent valuation of ESOP shares annually. Other professional members include lawyers, plan administrators, lenders, trustees, and ownership culture management consultants.

Privately-held small businesses that sponsor ESOPs, businesses considering ESOPs, and professionals that provide services to ESOP trustees and companies would be directly impacted by the Proposed Regulation "Definition of the Term Fiduciary," (Federal Register, Volume 75, Number 204, Pages 65263-6578, October 22, 2010, Proposed Regulation).

On behalf of our membership, the Association appreciates the opportunity to express its views on the Proposed Regulation.

I. Association's Education Mission Focuses on ERISA Compliance

The mission of the Association since 1993 is "To educate and advocate about employee ownership with emphasis on ESOPs." The leaders of the Association purposely listed "education" first, as a basic tenet of the Association is that well-managed, high performing ESOP companies, visible in local communities, are the best and most effective way to execute the advocacy mission.

Over 50% of the Association's annual resources are spent on education. In 2010, 8,089 individuals attended Association educational programs. Education of ESOP company fiduciaries, focusing on their obligations to retain competent valuation firms, understand the valuation report, and decide whether to accept a valuation report, is a major topic at Association national and chapter meetings. Other conference and meeting attendees had exposure to the topics related to ERISA compliant valuation of ESOP shares of private companies.

Nearly every chapter meeting had either breakout sessions or a general session, with a DOL official from a regional or district office going over the DOL audit process, including the documentation necessary for the auditor to review decisions about the annual valuation report made by the plan trustee. For over 20 years, representatives of the IRS and Department of Treasury have participated in the Association's annual conference, and have answered questions submitted by practitioners, in a continued effort to educate and inform Association professional members.

The members of the Association's Advisory Committee on Valuation (VAC) are key to the quality of fiduciary education on valuation matters. They lead discussions involving thousands of attendees and write articles for the Association's monthly newsletter on valuation "hot" issues, produce white papers on best practices, prepare booklets and handbooks on valuing ESOP shares, and contribute the chapter in the "ESOP Fiduciary Handbook" on reviewing, and rejecting or accepting a valuation report. VAC members educate companies, fiduciaries, and other professional members, and ensure that the latest information on valuation best practices is available.

Other Association committees also touch valuation topics. The Legal and Regulatory Committee, for example, often works with the VAC to update members on new case developments and other topics that may affect valuation, and the Financing and Administration Committees also contribute to discussions on valuation.

VAC members are volunteers. They agree with the basic premise that the best way to maintain current laws permitting and encouraging employee ownership via the ESOP model – the advocacy mission – is to have excellent ESOP practices, and ensure that ESOP trustees and fiduciaries, internal and institutional, understand and comply with ERISA. Compliance with ERISA law is the best path to a high performing company that will provide adequate retirement security to its ESOP participants.

II. Department of Labor Concerns

In proposing the expansion of the definition of investment advice for purposes of the definition of a fiduciary under Section 3(21) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), the DOL has identified three areas of concern: (i) a significant shift in the marketplace for employee benefit plan services since the DOL last provided fiduciary rules in 1975, (ii) avoidance of conflicts of interest that may exist with service providers, and (iii) incorrect valuations of employer securities. The proposal states that these concerns were identified in the DOL's Consultant/Advisor Project (CAP), recent testimony before the Government Accountability Office (GAO) and in the Employee Benefits Security Administration (EBSA) national enforcement project relating to ESOPs.

The Association believes that the marketplace for ESOP transaction services generally has not changed since 1975, with the overwhelming majority of ESOPs created when a shareholder(s) of a privately-held company sells her/his shares to an ESOP.

With regard to conflicts of interest, it is not apparent to the Association that ESOP appraisers regularly have conflicts of interest with respect to the plans for which they work. This would, of course, be contrary to Section 401(a)(28) of the Internal Revenue Code which requires that appraisers be independent. Moreover, the DOL proposed regulation setting forth the definition of adequate consideration (Prop. Reg. Sec. 2510.3-18, referred to herein as the 1988 Proposed Regulation) also requires the independence of an appraiser as a condition to a prohibited transaction exemption.

With regard to incorrect valuations of private company ESOP stock, the Association acknowledges and shares the DOL's concern but questions whether the problem is as widespread as the DOL implies. The Association has not heard significant numbers of complaints from its corporate or fiduciary members about incorrect ESOP valuations. The Association provides seminars and educational sessions on the valuation of employer securities at conferences, and publishes written material on valuation.

If the DOL is correct in its assessment, the Association also questions the effectiveness and appropriateness of converting ESOP appraisers into ERISA fiduciaries as means of reducing the number of incorrect ESOP appraisals. The Association believes there are other means of addressing the DOL's concern short of a wholesale change to over thirty five (35) years of statutory guidance, and respectfully requests the opportunity to engage in a dialogue with the DOL to assist in fashioning an appropriate and effective means for addressing such concerns.

To that end, it would be useful for purposes of this discussion if the DOL could provide statistics on the frequency of incorrect ESOP valuations and the nature of the errors the DOL auditors encounter.

III. Legal Precedent and ERISA Legal Regime Overlooked by Proposed Regulation

A. The Proposed Regulation Exceeds the DOL's Authority

Section 3(21)(ii) of ERISA creates fiduciary status for a person who "... renders investment advice for a fee ..." The preparation of an appraisal of an asset, whether employer securities, real estate or otherwise, was not intended by Congress to create an ERISA fiduciary status. Neither an appraisal, nor a fairness opinion rendered in a transaction, makes a recommendation to the trustee of a course of action. In either instance, it remains the trustee's ERISA fiduciary responsibility to make an investment decision, with the appraisal or fairness report a tool in that process.

Federal courts have correctly instructed ESOP trustees that an independent appraisal does not automatically establish a transaction price for employer securities. Rather, the trustee is responsible to prudently review and then utilize the report in making an investment decision. In order to add asset valuations and fairness opinions to the list of items that constitute "investment advice" we believe the DOL would need Congress to add a new subsection to Section 3(21) of ERISA to this effect.

B. The Proposed Regulation Interferes with the Trustee's Traditional Oversight Role over the Appraiser

We assume the DOL believes that making the ESOP appraiser a fiduciary will create a system of oversight over the ESOP appraiser which has somehow been absent. This belief would be an incorrect understanding of the role that has developed between the ESOP appraiser and the ESOP trustee under current law and regulatory guidance. It is important to understand that an oversight system already exists. As the plan fiduciary, the ESOP trustee is responsible for determining the fair market value of the employer securities to be acquired by or held under the ESOP. The ESOP trustee retains and works closely with the ESOP appraiser as its financial advisor, to assist the ESOP trustee with undertaking the financial review and ultimate valuation determination. If the ESOP appraiser's skill, or analysis, is lacking under applicable professional standards, then it is the ESOP trustee's responsibility to investigate the relevant issues and make a determination regarding whether the ESOP appraiser can continue to provide the ESOP trustee with the necessary financial assistance on behalf of the plan. This relationship allows the ESOP appraiser to focus on the specific task of providing advice to the ESOP trustee who is the party responsible for decisions regarding transactions and the related fair market value of the employer securities. *(See Chapter 6.C, "Review of Valuation Report", ESOP Fiduciary Handbook, The ESOP Association, 2010, pages 36-42.)* Further, the current structure already provides the DOL with adequate redress for an incorrect valuation, but such redress rests with the ESOP trustee the plan fiduciary charged with making the fair market value determination and ensuring a correct valuation.

IV. Negative Impacts on Pension Benefits

The DOL's stated goal in expanding the definition of investment advice is to create a bright line identifying who is a fiduciary. The DOL states that its limited resources are stretched by the task of assessing who is a plan fiduciary, impacting its ability to assess whether a breach occurred. This reasoning is not justified, and is short sighted, because this sweeping shift in the fiduciary rules will have significant negative consequences for ESOP companies and the ESOP participants that the DOL seeks to protect. Further, because the ESOP trustee is always a plan fiduciary and acts in a fiduciary capacity in determining fair market value and adequate consideration, in each and every instance where the perceived ill is the incorrect valuation, the DOL's argument that it is unable to establish the ESOP trustee as the fiduciary is unfounded.

In the Regulatory Impact analysis section of the proposal, the DOL submits a list of three benefits the proposed regulation will provide, but states that ". . . the Department is unable to quantify these benefits, [but] the Department tentatively concludes they would justify their cost." The DOL then estimates the service provider community would incur a cost of $10.1 million to assess its fiduciary status under ERISA. Setting aside any disagreement over this initial cost, the Association's view is that the larger costs of the proposal will be felt by plan participants through: (i) a shrinking of the marketplace for competent appraisers (ii) higher costs to ESOP sponsors to retain competent appraisers and (iii) greater costs of protecting against litigation (i.e. additional involvement of counsel and greater documentation). The overarching cost however, is not so easily quantified and will be seen when business owners, instead of pursuing a transaction with burdensome regulation as well as cost, business owners choose to pursue other means of ownership transition, such as sales to third parties, which may result in less wealth in qualified plans.

Many of the best appraisers currently work for large or mid-sized multi-disciplinary financial service organizations. Such firms have resources, depth of expertise, breadth of experience, and work on a variety of types of non ESOP assignments and bring this experience to their ESOP appraisals. Generally, none of the professionals in these organizations are ERISA fiduciaries, or fiduciaries under any set of Federal or state laws. The Association believes these firms will not have a financial incentive to accept fiduciary status related to ERISA appraisals and may cease providing services to ESOP sponsors and trustees. ESOP companies and trustees will lose the expertise that these firms bring to their clients when performing an ESOP valuation engagement. The ESOP community, including peer firms, will also lose the benefit of these firms' knowledge.

For those firms that choose to continue to perform ESOP appraisals, significant costs will be incurred beyond the initial compliance assessment cost detailed by the DOL. First, firms will need to obtain fiduciary liability insurance, a more complex and expensive product than the current errors and omissions insurance most hold; second, valuation firms will need ERISA legal counsel for each engagement to advise on their fiduciary duties and responsibilities in a particular transaction or valuation; third, valuation firms will likely change their interactions and business relationships with ESOP trustees in order to manage their own ERISA fiduciary risks; fourth, ongoing compliance costs may increase; and fifth, instances of litigation will increase.

For ESOP sponsors, this means: (i) higher costs of valuation services, (ii) fewer qualified appraisers, and the need to replace appraisers who leave the market; (iii) confusion as to who is responsible for certain fiduciary functions; and (iv) loss in the industry of the benefits of working with multi-disciplinary organizations.

The DOL has identified "incorrect valuations" as the principal concern in the Proposed Regulation. The Association disagrees that the Proposed Regulation will, in and of itself, result in more accurate appraisals when fewer qualified appraisers will perform ESOP valuations, and the remaining firms may be less well capitalized entities that may not have the resources to defend their opinions. Further the Association fails to see how making more parties fiduciaries solves the problem when a clearly identified plan fiduciary, the ESOP trustee, is already responsible for the ESOP valuation and its accuracy.

V. Alternative Approaches

A. Provide Guidance

We are not aware, and do not acknowledge, that there is a widespread problem with ESOP valuations among our membership.

However, to the extent the DOL perceives a problem, the Association believes it is more effective to focus regulatory efforts on prevention rather than punishment. Valuation standards already exist in a variety of professional organizations such as the American Society of Appraisers (ASA), American Institute of Certified Public Accountants (AICPA), as well as guidance used by the IRS, and could be easily adopted by the DOL. Hard-to-value securities held on companies' and ERISA plans balance sheets have been a significant focus of accounting standards. It would be very reasonable for the DOL to adopt general operating principles of valuation that are already generally accepted and well understood in the valuation profession.

DOL's 1988 Proposed Regulation defining "adequate consideration" provides guidance on valuing employer securities. Though not issued as final, and therefore not binding. many appraisers choose to rely on the 1988 Proposed Regulation as if it were final. With better guidance, the ESOP trustee's task of reviewing and approving valuations before accepting them would be improved because it would know the standard against which to measure the appraisal

We respectfully suggest the DOL finalize the 1988 Proposed Regulation, and amend it to include a more detailed description of the trustee's role in assessing a valuation or the valuation report.

B. Appraiser Credentials

The Association's Valuation Advisory Committee, whose members consist of the most prominent ESOP valuation advisors in the United States, was formed to bring professionals together to discuss ESOP valuation issues. The Association also provides forums for the interaction among various ESOP professionals to address ESOP issues, including a recently formed Interdisciplinary Committee. ESOP valuations have, for the most part, been self regulated by those professionals who have endeavored to build solid ESOP valuation practices based on generally accepted valuation methods and procedures. These experienced ESOP professionals have worked together to develop consensus on many ESOP valuation issues.

Most ESOP appraisers are well educated, informed, and credentialed and continue their education by reading industry materials and scholarly journals, and attend conferences and seminars to keep abreast of financial theory, regulatory changes, and other factors affecting business appraisals. Many have advanced degrees in finance and maintain appraisal-related credentials such as the ASA, Chartered Financial Analyst, or AICPA designations. One of the duties of an ESOP trustee is to choose a qualified appraiser, and various credentials can help an ESOP trustee discern who is qualified.

In light of the fact that most ESOP appraisers are already credentialed, the Association believes that the DOL's resources would be best served by engaging in a dialogue with ESOP professionals, including the Association, to identify the DOL's specific concerns about appraiser competence so the ESOP community can self-regulate. For example, the DOL may find that those ESOP appraisals that it believes are "incorrect" are performed by appraisers without appropriate valuation credentials, or who are not part of the various professional organizations that provide training and education related to ESOP valuation. Further discussion and guidance may help the Association's members choose the most qualified appraisers.

VI. Conclusion and Final Words

Again, The ESOP Association appreciates your review of these comments.

The valuation of privately held stock is an imprecise science. This is the very nature of advanced finance theory. There is often no single "correct" answer to the question of valuation. Imposing fiduciary standards on ESOP appraisers would expose ESOP appraisers to increased liability, without addressing the DOL's perceived need for improved financial advice regarding valuation.

On behalf of our 1,400 corporate members, we believe the proposal to mandate appraisers of privately-held ESOP company stock be ERISA fiduciaries will increase the cost of the valuation substantially. We also believe there are more efficient, less economically burdensome ways to ensure valuations are done properly without reducing ESOP companies' profits (and the accounts of ESOP participants). The Proposed Regulation will confuse and blur responsibilities between the trustee and the valuation firm. The Proposed Regulation will confuse interpretation of the law about ESOP trustee decisions and will be very expensive for ESOP companies if more private parties sue ESOP companies and ESOP trustees in cases that Federal courts currently dismisses.

Finally, ESOP companies provide locally controlled jobs, many in the manufacturing sector, that provide average pay employees with significant retirement savings. In fact, DOL's Office of the American Workplace under former Secretary of Labor Robert Reich labeled ESOP companies as examples of high performing companies, and highlighted quotes from The ESOP Association's then leader, the late Charles Edmunson.

We respect and support the important and difficult job of DOL investigators in uncovering improper valuation work and agree that those responsible should be held accountable. We would welcome the opportunity to work with you to discover an approach that will help the DOL achieve that goal.

Sincerely yours,

J. Michael Keeling, CAE
President

Note: These comments were primarily prepared under the direction of Laurence A. Goldberg, Sheppard, Mullin Richter & Hampton, San Francisco. He had input from other members of The ESOP Association Advisory Committee on Legislative and Regulatory Issues, and member of the Advisory Committee on Valuation. The Executive Committee of The ESOP Association, consisting of four people who are senior executives of corporations sponsoring ESOPs, reviewed the comments as well.

NCEO Response to Department of Labor Proposal to Define ESOP Appraisers as Fiduciaries

Corey Rosen, NCEO Executive Director
Email: crosen@nceo.org :: Phone: 510-208-1314
November 30, 2010

Executive Summary

This is the first time the National Center for Employee Ownership (NCEO), a private, nonprofit membership, information, and research organization, has submitted formal comments on Department of Labor regulatory proposals. We have commented here because we believe these proposals could have a serious and detrimental impact on the number and quality of ESOPs, which in turn would very adversely affect retirement security in the U.S. On the other hand, we agree there are faulty ESOP appraisals (as do all of the ESOP appraisers who do this work regularly that we consulted on this), and we therefore suggest a number of alternatives the DOL could consider to address this issue more effectively.

We identify several key problems with the proposal:

1. The absence of final regulations on how ESOPs should be appraised would create considerable confusion for courts, ESOP trustees, and appraisers on how to judge whether appraisers were following their fiduciary duties, which necessarily would be a legally ambiguous question.
2. Fewer ESOPs would get started, especially in smaller companies, because costs would rise substantially as valuation firms now required fiduciary insurance (assuming it could be obtained). This is especially worrisome because the data definitively show that ESOPs add not just to total retirement security but also to diversified retirement assets.
3. There would be fewer qualified ESOP appraisers because some of the most qualified appraisers would drop out of the ESOP appraisal business.
4. There would be considerable legal confusion over just who is responsible for the errors and how responsibility is allocated.
5. Existing case law already provides that appraisers are fiduciaries when effectively exercising discretion over plan assets.

It is difficult to estimate just how common faulty appraisals are, and the discussion in the proposed regulations does not indicate how frequent the problem is in the DOL's view. We do know, however, that over the last 20 years, there have been only 17 lawsuits specifically concerning ESOP appraisals that have made it to court during that time. More tellingly, leveraged ESOPs have a default rate that is a small fraction of one percent per year, while LBOs in general have default rates several times that high. If appraisals were consistently faulty, ESOPs should

often be overpaying for stock and ending up unable to repay the loan. Of course, there are problematic appraisals that never rise to these levels, but the proposal does not attempt to weigh the consequences of the changes suggested against the magnitude of the problem.
We believe there are a number of alternative approaches that may address the problems more effectively, including:

1. *Issue final ESOP valuation regulations:* This would provide much clearer guidance to existing fiduciaries and appraisers, which should reduce the problem significantly.
2. *Provide regulatory guidance on what "independence" means:* Current law requires that appraisers be independent, but this term has never been specifically defined.
3. *Require that employer stock appraisers be credentialed by a professional appraisal organization:* Consideration should be given to whether this requirement should specify that employer stock appraisers have professional training related to employer stock appraisals.
4. *Set specific standards for fiduciaries with respect to valuation:* Rather than creating an additional fiduciary with all the problems that arise from that, standards for existing fiduciaries could be tightened.
5. *Establish an industry-DOL advisory committee to seek alternative approaches to the problem.*

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Complete Response

Introduction

The National Center for Employee Ownership, a private, nonprofit membership, information, and research organization, has never before submitted formal comments on Department of Labor regulatory proposals. We are not a lobbying or trade association. Our mission is to provide "the most objective, reliable information possible about broad-based employee ownership plans," including ESOPs. To draw a bright line on this, we have avoided commenting on legislative or regulatory matters unless specifically asked to do so. We are making an exception in this case, however, because we are concerned that this proposal could have serious and negative implications for the retirement security of millions of employees.

We agree there are some ESOP appraisals that are poorly done and/or being performed by people who are not truly independent and therefore may have a financial interest in the transaction. We also believe there are more effective and less blunt ways of dealing with these problems that will have fewer unintended and damaging consequences.

In this response, we first briefly outline what the data show on the contribution of ESOPs to retirement security (full details are available on request). Second, we look at how common faulty appraisals might be, admittedly a difficult question to answer very precisely. Third, we look at the likely impact of defining appraisers as fiduciaries in terms of ESOP adoptions and terminations. Fourth, we look at the issue of the existing law on fiduciary responsibilities of plan providers and how that might be affected by this. Finally, we suggest some alternative approaches that might help solve the problem without causing as much potential damage as the proposal likely will.

ESOPs and Retirement Security

It is important first to address the question of why we should even be concerned that the new rules are likely to lead to fewer ESOPs and to lead some existing plan sponsors to terminate them. It has been national policy, confirmed in a bipartisan fashion over many pieces of legislation over the last 36 years, to support these plans. President Obama recently told an audience in Virginia that ESOPs are "aligning the interests of workers with the interests of the company as a whole." While he noted that this means employees are subject to the ups and downs of companies, "theoretically, at least, it's something that can help grow companies, because the workers feel like they're working for themselves, and they're putting more of themselves into their job each and every day. I think that it's something that can be encouraged." But the real test is whether ESOPs are good for employee retirement security.

A common criticism of ESOPs is that they do not provide for adequate retirement security because they are too undiversified. While this argument has intuitive appeal, research on what actually happens in ESOP companies makes it largely irrelevant. First, ESOPs do tend to diversify somewhat over time because private companies often build up cash in the plan to handle the repurchase obligation (private company ESOPs are the only ones at issue here because public companies do not need an appraisal). ESOPs are also required by law to allow diversification to participants aged 55 with 10 years of plan participation. Most companies either pay people out or, more commonly, transfer diversified assets into a 401(k) plan. Second, diversification outside the ESOP is typical. More than half (56%) of ESOP companies offer a second defined contribution retirement plan in addition to the ESOP, making them more likely to have a second retirement plan than comparable companies are to have any retirement plan. Third, unlike 401(k) plans, which are primarily funded by employees and often end up with little or no participation among younger and less well-paid employees, ESOPs, by law, are funded primarily by the company and include all employees meeting the basic qualified plan rules.

In other words, ESOPs are less diversified than 401(k) plans or profit sharing plans, but ESOP companies tend to provide more retirement assets in more plans, and require less of a employee contribution. For most employees (especially the estimated 60% or so who do not actively participate in any retirement plan), being 100% undiversified in an ESOP with assets is better than being 100% diversified in nothing.

In 2010, the NCEO conducted the definitive research on this question by using all of the Form 5500 returns for ESOPs nationally and other defined contribution plans. ESOP companies, by definition, have at least one defined contribution plan: the ESOP. More than half of them (56%) have a second defined contribution plan, likely a 401(k). In comparison, the Bureau of Labor Statistics reports that 47% of companies overall have a defined contribution plan. In other words, an ESOP company is more likely to have two defined contribution plans than the average company is to have any.

The average ESOP company contributed $4,443 per active participant to its ESOP in the most recently available year. In comparison, the average non-ESOP company with a defined contribution plan contributed $2,533 per active participant to its primary plan that year. Controlling for plan age, number of employees, and type of business increases the ESOP advantage to 90%-110% above the non-ESOP companies in our sample.

The value of the assets contributed by the company to all defined contribution plans in ESOP companies is substantially higher than the value in non-ESOP companies. Controlling for company size, industry, and plan age, the average ESOP participant in the average ESOP company has company-sourced defined contribution assets worth 2.22 to 2.29 times as much as the assets held by the average participant in the average company with a non-ESOP defined contribution plan. This ESOP difference is an estimate. The data do not allow us to calculate the actual value of the assets per participant in combined defined contribution plans or the source of the accumulated assets. The data do show how much of each year's contribution is from the company, and this number is stable over the years. We believe it provides a reasonable basis to estimate how much of the accumulated assets in the average employee's account was originally a company contribution.

The results confirmed a 1998 study by Peter Kardas and Jim Keogh of the Washington Department of Community, Trade, and Economic Development and Adria Scharf of the University of Washington. This study used 1995 employment and wage data from the Washington State Employment Security Department, 1995 data on retirement benefits from a survey of companies, and federal Form 5500 data for 1995. The study matched up 102 ESOP companies with 499 comparison companies in terms of industrial classification and employment size. The study found the average value of all retirement benefits in ESOP companies was equal to $32,213, with an average value in the comparison companies of about $12,735. Looking only at retirement plan assets other than ESOPs, the ESOP companies had an average value of $7,952, compared to $12,735 for non-ESOP companies. Given that based on the most recently available Form 5500 data, the typical ESOP is actually about 17% invested in diversified assets other than company stock (with participant-directed diversifications typically not part of this because they are transferred or paid out), employees in ESOP companies would have had about as much in diversified assets as employees would have in all assets in non-ESOP companies. In ESOP companies, the average corporate contribution per employee per year was between 9.6% and 10.8% of pay per year, depending on how it is measured. In non-ESOP companies, it was between 2.8% and 3.0%.

Private companies fund ESOPs at these high levels because they are usually used to buy the shares of existing owners in a tax-favored way, and the high levels are needed to make the purchase. It is highly unlikely that these same companies, if they did not have an ESOP, would fund their retirement plans at anything close to these levels. So discouraging ESOPs would lead to a significant reduction in company-funded contributions to retirement plans.

How Common Are Poor or Conflicted Appraisals?

We agree with the DOL that there are faulty ESOP appraisals. We believe most of these faulty appraisals come from two sources:

1. Appraisers who only occasionally do ESOP valuations and do not become sufficiently educated in the special issues ESOPs raise. In our experience talking with hundreds of ESOP companies every year, we find that a large majority of appraisals are done by a relatively small number of firms that specialize in this work. However, a significant minority does not use these firms.
2. Appraisers who have a financial interest or other conflict with the company.

We believe these problems have become less frequent as ESOPs have matured. Early on, valuation models sometimes used "investment banker" approaches that were too aggressive. The ESOP valuation community was in its early stages, and there had not yet been time to develop the kind of intense and frequent dialogue among members of the community that now regularly goes on in conferences and meetings as well as in various publications. This does not mean that problems have disappeared, but they do seem to be much less common.

Assessing the frequency of these problems is difficult. Naturally, the DOL sees mostly the problem cases, and with over 10,000 private companies with ESOPs and ESOP-like plans, it would only take a very small percentage to produce a fairly large number. The best we can do to make an indirect assessment is look at the number of legal cases involving valuation and how often ESOPs default. It would be valuable to know how many faulty appraisals the DOL finds on audit to add to this.

The NCEO conducted a comprehensive review of litigation over employer stock in defined contribution plans between 1990 and 2010. We believe we located virtually every case. There were 175 court cases filed on these issues, 141 of which involved private companies. Of these 141 cases, only 17 concerned valuation, or fewer than one per year. Of course, just because a case is never filed does not mean all the other appraisals were acceptable, but this is a remarkably low figure given the litigation that occurs in all qualified plans and the amounts per participant that are often at stake in ESOPs. Valuation cases were also less common than claims over distributions.

A more indirect way to look at this issue is how often ESOP companies default on their ESOP loans. There can be many reasons why an ESOP company defaults, including unanticipated changes in the economy or a company's market. But an excessively high initial valuation (presumably generally the DOL's concern, as opposed to excessively low one that would favor employees) should put a company at substantially more risk. Based on data from plan providers we obtained in 2010, as well as Form 5500 data, we estimate the default rate on ESOP loans at about 0.2% per year, compared to estimates of 3% to 6% for leveraged buyouts in general. Most ESOPs are leveraged, at least to start, so this suggests that, at least, valuations are rarely excessively overstated.

What Would Happen If Appraisers Are Defined as Fiduciaries?

If appraisers now are deemed fiduciaries, appraisal costs would increase dramatically. Just how much they would increase is impossible to predict, although appraisers we asked about this expect it could double or triple the costs, meaning an added $20,000 to $60,000 for initial appraisals and about half that or somewhat more for ongoing appraisals. This assumes that insurance companies will write these kinds of liability policies. Given that this is a new and uncertain market, it is difficult to say just how quickly and efficiently this might or might not develop.

The effects of this are predictable:

- Fewer ESOPs would get started, especially in smaller companies. This is especially worrisome because these smaller companies are the least likely to provide any kind of funded retirement plan for employees, or, indeed, any plan at all.
- There would be fewer appraisers available to do ESOP work. That could drive up costs further.
- Some of the most qualified appraisers told us in an informal survey of experienced ESOP appraisers we conducted that they would stop doing ESOP appraisals. Ironically, the firms most aware of the fiduciary risks are precisely those with a lot of ESOP experience, so more appraisals might get done by less qualified appraisers more willing to take the fiduciary risk or not understanding its potential cost.
- There would be considerable legal confusion over just who is responsible for the errors. If the valuation firm is a fiduciary, then do the ESOP trustees who are supposed to have vetted the transaction now have a legitimate defense that they can and should have relied on the greater expertise of their co-fiduciaries? Even if cases do not go to trial or audit, it seems reasonable to expect that trustees, especially inside trustees, might now believe that their role is just to sign off on an appraisal and let the fiduciary responsibility rest with the party most responsible for it and the most knowledgeable about how to perform the appraisal.

While the proposed regulations might exclude some poorly qualified and/or conflicted appraisers, a desirable end, it would do so at a tremendous cost to retirement security that is hard to justify.

Issues Under Existing Law

In *Mertens v. Hewitt Assocs.*, 508 U.S. 248 (1993), the Supreme Court defined fiduciaries not in formal terms but:

> in functional terms of control and authority over the plan (see 29 U.S.C. § 1002(21)(A), thus expanding the universe of persons subject to fiduciary duties--and to damages--under § 409(a). Professional service providers such as actuaries become liable for damages when they cross the line from advisor to fiduciary; must disgorge assets and profits obtained through participation as parties in interest in transactions prohibited by § 406, and pay related civil penalties, see § 502(i), 29 U.S.C. § 1132(i); and (assuming nonfiduciaries can be sued under § 502 (a)(3)) may be enjoined from participating in a fiduciary's breaches, compelled to make restitution, and subjected to other equitable decrees. All that ERISA has eliminated, on these assumptions, is the common law's joint and several liability, for all direct and consequential damages suffered by the plan, on the part of persons who had no real power to control what the plan did. Exposure to that sort of liability would impose high insurance costs upon persons who regularly deal with and offer advice to ERISA plans, and hence upon ERISA plans themselves. There is, in other words, a "tension between the primary [ERISA] goal of benefitting employees and the subsidiary goal of containing pension costs." Alessi v. Raybestos Manhattan, Inc., 451 U.S. 504, 515 (1981); see also Russell, 473 U. S., at 148, n. 17. We will not attempt to adjust the balance between those competing goals that the text adopted by Congress has struck.

The court here is thus supporting the argument that a balance must be struck between the costs fiduciary status would impose on providers and the benefits it would provide, coming down on the side of non-fiduciary status for providers unless they exercised some functional control. With ESOPs, the law already specifically locates that functional control with the plan fiduciary or fiduciaries, who can be, and are, sued for failing to assure proper valuations.

On the other hand, the *Mertens* case does not simply preclude action against plan providers. ERISA Section 406(a) specifically refers to transactions in which parties-in-interest may not participate. Federal courts of appeals have unanimously held that ERISA Section 502(a)(3) can be used to take action against parties-in-interest in prohibited transactions, at least for equitable relief. In those cases where appraisers actually are exercising discretion or control with respect to the structuring of an ESOP transaction, they already are fiduciaries and are subject to liability for breach of fiduciary duty under existing law.

Under this theory, appraisers could be sued if they have conflicts of interest, addressing one of the principal concerns at issue in the proposed regulations. Of course, appraisers can also be sued (and have been) by plan trustees, most commonly the successor trustee in an ESOP, for simply making faulty appraisals.

If appraisers are deemed to be fiduciaries, would it not make sense, using this same line of argument, to name plan administrators, attorneys, and other advisors fiduciaries as well, even if they do not have specific discretionary authority? For instance, there have been more ESOP legal cases filed for improper distributions or allocations than for appraisals. As with valuations, ESOP trustees often rely on the advice of the plan administrators on these issues. If it seems wrong to declare that all administrators are fiduciaries, consider that the logic for naming them fiduciaries is the same as for naming appraisers as fiduciaries, namely that the ESOP trustee is, in effect, ceding authority to them. The same could be said for trustees who follow an attorney's advice on plan design and a financial advisor who provides a feasibility study.

A more serious concern may be that the courts routinely reject the proposed valuation regulations as law or guidance. Naming appraisers as fiduciaries could make it even harder to sue than suing untrained fiduciaries relying on their experts' reports and advice. An appraiser's own judgment will be the heart of the case, and the "range of value" will be a pure judgment call. Competing experts will go head to head. DOL experts could have a hard time testifying based upon "their experience as fiduciaries" (which is the standard for an expert to testify) as to what they would have done in such a transaction. The pool of ESOP appraisers will also be shallower, so the DOL will have even fewer qualified experts (appraisers who have acted as fiduciaries) to draw from.

Alternative Remedies

While deeming appraisers to be fiduciaries seems then an excessively blunt tool to solve the problem, we acknowledge that there is a problem in some cases, and it does make sense to address it.

In our own work, we have tried to do this by helping ESOP trustees and other fiduciaries understand just what their legal responsibilities are by providing substantial educational material and meetings at which we outline these responsibilities in detail. We also advise people at every opportunity that their appraisal firms should have substantial ESOP experience and have no other financial relationship of any kind with the firm.

The DOL could take several steps that would prove very helpful:

1. *Issue final ESOP valuation regulations:* The DOL here is proposing to ask appraisal firms to become fiduciaries, but then, in effect, telling them there are no clearly articulated standards for determining fair market value. This seems unreasonable. If there were regulations, ESOP trustees and other fiduciaries would have a much clearer sense of what to look for in a valuation, and ESOP appraisers would have clear standards to follow.
2. *Provide regulatory guidance on what "independence" means:* Current law requires that appraisers be independent, but this term has never been specifically defined. There is some question of whether this means the appraisal firm can do other work for the company, such as financial modeling, that may make it easier to do an appraisal. There are good arguments on either side of this, but we have not seen this be a significant problem. More troublesome is a situation where the appraisal firm or a firm associated with the appraisal firm would gain from a higher-than-justified price when the ESOP buys stock from a seller because a lower price could mean the company chooses not to do an ESOP. Setting a clear demarcation of independence for initial transactions, then could be a useful step. The ESOP Association asked for such guidance some years ago, but there has been no response.
3. *Require that employer stock appraisers be credentialed by a professional appraisal organization:* Consideration should be given to whether this requirement should specify that employer stock appraisers have professional training related to employer stock appraisals. For instance, the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), the National Association of Certified Valuation Analysts (NACVA), and the American Institute of Certified Public Accountants (AICPA) all provide rigorous coursework, demonstration report submission review procedures, and proctored testing for business valuation credentials.

   Each of the above-mentioned organizations has adopted professional business valuation standards. Among these professional valuation standards, the American Institute of Certified Public Accountants (the largest of these organizations) has adopted and issued a Statement of Standards on Valuation Standard No. 1: Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset (SSVS). As SSVS is adopted by state accountancy laws, SSVS is already the "law of the land" for approximately 500,000 CPAs. However, these SSVS valuation standards are as applicable to non-CPAs as they are to CPAs. And SSVS could be adopted for all employer stock appraisers. Similarly, the American Society of Appraisers (ASA) has developed the ASA Principles of Appraisal Practice and Code of Ethics the ASA Business Valuation Standards, and the Uniform Standards of Professional Appraisal

Practice. The ASA also has an ESOP-specific appraisal track, with a recertification program.

It may be worth considering requiring an "ESOP valuation certification" from an appraisal organization. In the presence of such a requirement, organizations would undoubtedly develop programs that DOL could then certify and monitor.

4. *Set specific standards for fiduciaries with respect to valuation:* Rather than creating an additional fiduciary with all the problems that arise from that, standards for existing fiduciaries could be tightened to require that (1) at least one fiduciary certify in writing that he or she has the requisite financial skills to read and understand a valuation report; (2) sign an acknowledgement that the fiduciary is responsible for judging the appropriateness of the appraisal, not just accepting it because it was performed by an appraiser, and (3) sign a statement acknowledging financial liability as a fiduciary. It would also be very helpful if the DOL could develop a checklist of issues fiduciaries should look for and ask about in responding the appraisal reports.
5. *Establish an industry-DOL advisory committee to address the problem:* The ESOP appraisers we spoke or corresponded with universally agree that there are poor appraisals, and that this is a problem that needs effective resolution. While this response outlines some of the key ideas, an alternative would be to create a council of people in the industry and the DOL to evaluate which steps could be taken most effectively.

Conclusion

We understand and appreciate the DOL's concern to protect plan participants from practices that can be harmful to their retirement security. Our organization was formed not to promote employee ownership per se, or try to make sure there are simply more employee ownership plans no matter how effective they are, but to do all that we could to research and disseminate facts about employee ownership. We believe that the unbiased truth will encourage the kind of employee ownership that benefits employees and society. It has been our privilege to work with various people at EBSA over the years to provide what we believe is objective feedback on plan practices.

We believe, however, that the remedy proposed here will, in the end, result in less retirement security for employees, not more. We believe there are more appropriate steps to take.

We appreciate your consideration of these comments.

A PDF version of this document is available at this link.