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By Electronic Mail (e-ORI@dol.gov)
Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Definition of Fiduciary Proposed Rule
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Re: RIN 1210-AB32, Definition of Fiduciary Proposed Regulation

Dear Sir or Madam:

On behalf of a group of providers of valuations and fairness opinions identified below (hereinafter, the "Firms"),[1] we are pleased to provide the following comments and recommendations regarding the proposed regulation (the "Proposed Regulation") issued by the U.S. Department of Labor ("DOL" or "Agency") amending the definition of "fiduciary," as that term is defined under section 3(21)(A) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

The Firms that have joined together provide services related to Employee Stock Ownership Plans ("ESOPs"). Some have advised companies that are considering the establishment of an ESOP, some have advised sellers of stock to ESOPs, and all have advised trustees and fiduciaries of ESOPs. Viewed collectively, they have worked on hundreds of ESOP formation transactions[2] each year and perform annual valuations for a significant percentage, by number and value, of the roughly 11,500 ESOPs in the United States. The professionals in these Firms include the current chair and four former chairs of the ESOP Association's Advisory Committee on Valuation, a board member of The

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[1] The firms include: Chartwell Capital Solutions, Columbia Financial Advisors, Inc., ComStock Advisors, Duff & Phelps, LLC, Houlihan Lokey, Prairie Capital Advisors, Inc., and Stout Risius Ross.

[2] Unless noted differently, an annual valuation is not within the meaning of the term "transaction" as that term is used throughout this letter.

ESOP Association, a member of the board of directors of the National Center for Employee Ownership ("NCEO"), a member of the Business Valuation Committee of the American Society of Appraisers ("ASA"), a past President of the ASA, and a past chair of The Appraisal Foundation.

As set out below, the Firms have serious concerns about the impact of the Proposed Regulation on their own businesses, and on the over ten million active and retired employees who rely upon ESOPs for their retirement security. Because of these concerns, the Firms believe the Proposed Regulation should be withdrawn. If DOL does issue a final rule, then the Firms urge the Agency to take into account the recommendations outlined below.

COMMENTS

A. The Proposed Regulation Reverses A Longstanding And Widely Accepted Principle Of Law In The ESOP Context .

Under section 3(21)(A)(ii) of ERISA, a person is a fiduciary with respect to a plan to the extent that such person "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so." For persons who do not have discretion under the plan documents with respect to the purchase or sale of securities or other property of the plan, the current regulation, which went into effect in 1975 and is set forth at 29 C.F.R. § 2510.3.-21(c) (1975) (the "Current Regulation"), defines "investment advice" as advice as to the value of securities or other property, or recommendations as to the advisability of investing in, or purchasing, or selling securities or other property, and such advice is rendered (1) on a regular basis; (2) pursuant to a mutual agreement that the advice will serve as a primary basis for investment decisions; and (3) is individualized based on the particular needs of the plan. *Id.*

In 1976, DOL issued an advisory opinion that a person retained to conduct a valuation of privately held stock to be offered to an ESOP did not act as a fiduciary within the meaning of section 3(21)(A)(ii) of ERISA and the Current Regulation. DOL Adv. Op. 76-65A (June 7, 1976). In its opinion, DOL noted that the valuation services provided by the valuation firm were "limited to a valuation of the employer securities to assist in determining . . . the 'adequate consideration' for such securities." *Id.* Given that the "advice rendered by [the valuation firm] would *not involve an opinion as to the relative merits of purchasing the particular employer securities in question as opposed to other securities*," DOL opined that the valuation firm's services did not constitute

"investment advice," and, therefore, the firm was not a fiduciary under ERISA. *Id.* (emphasis added). This early delineation of an easily understood test for determining fiduciary status would be used in many other contexts by DOL and the courts, and is one of the building blocks of ERISA jurisprudence and a frequent basis of legal advice ERISA service providers receive from their counsel.

DOL's opinion was followed by an important ERISA case that relied heavily on AO 76-65A. *See Foltz v. U.S. News & World Report*, 627 F. Supp. 1143, 1167 (D.D.C. 1986). The law now recognizes that, while valuation professionals play an important part in a transaction, they do not determine the consideration the parties ultimately negotiate because that is the product of many factors outside the control of the valuation professional. This makes a valuation or a fairness opinion important, but not determinative as to whether the fiduciary has made a good faith investigation of the fair market value of the security. *See Estate of Litchfield*, 97 T.C.M. 1079 (CCH), 2009 WL 211421, at *6 (2009). Put simply, valuation professionals and providers of fairness opinions ordinarily do not have decision-making control in a transaction and the law sensibly does not treat them in the same way it treats those with such decision-making authority. [3]

This same reasoning has been routinely used to determine the non-fiduciary status of virtually all professionals who act as service providers. DOL long has recognized that "attorneys, accountants, actuaries and *consultants* performing their usual professional functions . . . [are not to be] considered fiduciaries" absent a showing that the professional also "rendered investment advice" by evaluating the merits of a proposed transaction or by having been given authority over the plan's investments. DOL Interpretive Bulletin, 29 C.F.R. § 2509.75-5 (1975) (emphasis added); *see also Painters of Phila. Dist. Council No. 21 Welfare Fund v. Price Waterhouse*, 879 F.2d 1146, 1150-51 (3d Cir. 1989) (plan consultants are not fiduciaries unless they perform functions beyond their normal roles); *Gerosa v Savasta & Co.*, 329 F.3d 317, 321 n.3 (2d Cir. 2003) (agreeing with DOL that professional plan service providers "are not ordinarily

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[3] This is consistent with the treatment of providers of fairness opinions in other contexts. For example, in the case of a merger or acquisition, a corporate board of directors owes a fiduciary duty to the company's stockholders, and fairness opinion providers customarily represent in their engagement letters that they are independent contractors and, as such, are not acting in a fiduciary or agency capacity. Absent unusual facts or circumstances, these disclaimers of fiduciary or similar duties and obligations are not susceptible to challenge. *See, e.g., Kahn v. Tremont*, 694 A.2d 422, 429-32 (Del. 1997).

fiduciaries"). The Supreme Court has held that such a rule reflects Congressional intent, reasoning that ERISA reflects a balance between "allocat[ing] liability for plan-related misdeeds in reasonable proportion to respective actors' power to control and prevent the misdeeds." *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 262 (1993).

The Proposed Regulation would change DOL's historical position by creating a special rule for providers of valuations and fairness opinions by differentiating them from other professionals, in essence making them fiduciaries simply because they provide advice on one aspect of a transaction without regard to whether they also step outside their professional role to exercise "the power to control" decisions concerning plan assets or management. Respectfully, DOL has provided no justification for treating these professionals differently from other professionals performing similar functions. The attorney that advises an ESOP trustee on possible terms for a proposed employer security, or on provisions to include in an associated purchase and sale agreement, may have more influence on an ESOP's investment than the valuation professional or fairness opinion provider, yet the attorney would still not be deemed a fiduciary under the Proposed Regulation because his or her ESOP trustee client clearly has the decision-making authority. Preamble to the Proposed Regulation, 75 Fed. Reg. 65,266.

Judicial deference to agency rulemaking is tested when the agency reverses a longstanding interpretation that has become an important principle in the case law, and has repeatedly been held to arise from the plain terms of the statute. *See Chevron USA, Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 844 (1984) (agency regulation is subject to invalidation if the regulation is not a "reasonable interpretation" of the enacted text). At the least, the agency must produce evidence that supports such a reversal. As set forth below, DOL has failed to make a compelling case for the issuance of the Proposed Regulation.

B. Imposing Fiduciary Status On Providers Of Valuations And Fairness Opinions Would Have Far-Reaching, Adverse Consequences To The Over 10 Million Active And Retired Workers Participating In ESOPs.

DOL asserts that imposing fiduciary status on providers of ESOP valuations and fairness opinion providers would "discourage harmful conflicts of interest, improve service value, and enhance the Department's ability to redress abuses, and more effectively and efficiently allocate its enforcement resources." Preamble to Proposed Regulation, 75 Fed. Reg. 65,275. While no one argues with these goals, the question is whether there is sufficient evidence that the Proposed Regulation would accomplish them in the area of ESOP valuation.

1. There is no evidence that conflicts of interest are prevalent in the marketplace for ESOP valuations and fairness opinions.

DOL asserts that if providers of valuations and fairness opinions are not considered to be fiduciaries under ERISA, "they may operate with conflicts of interest that they need not disclose to the plan fiduciaries who expect impartiality." Preamble to Proposed Regulation, 75 Fed. Reg. 65,265. The Firms agree that conflicts of interest are inimical to the rendering of a reliable, unbiased and accurate valuation or fairness opinion, but DOL offers no data or analysis showing that conflicts of interest leading to "biased appraisals" are a "common problem" in firm engagements.[4] To the contrary, our survey of the Firms shows a focus on avoiding conflicts of interest. Each Firm's policy is not to enter into ESOP valuation or fairness opinion engagements where its compensation depends on producing a valuation or fairness opinion that will result in the consummation of a transaction, and each Firm's engagement letters disclose their fees and fee arrangements.

In the absence of a definition of what DOL means by "conflict of interest" and any evidence to support its assertion that such conflicts are a problem affecting ESOP valuations, the Firms are unable to provide a more detailed response. However, the Firms do not believe that, in their broad experience, undisclosed conflicts are a "common problem."

2. DOL has not made the case that the Proposed Regulation would lead to improved service value.

The Firms agree with DOL that the most beneficial arrangements "are those in which a plan's service providers, in competition to provide the best value to the plan [and] deliver high quality services to the plan." Preamble to the Proposed Regulation, 75 Fed. Reg. 65,272. But DOL has offered no evidence demonstrating that the ESOP valuation market does not currently deliver a high level of service value, or that its decision to enact a broad interpretive regulation would improve the situation. In fact, as shown below, the Proposed Regulation would have unintended adverse effects on the current level of service value to the ultimate detriment of more than $900 billion of

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[4] The two "conflict" studies cited by DOL concern pension consultants and investment returns. Neither involves valuation professionals, much less ESOPs.

ESOP-supported retirement savings. *See* NCEO statistical worksheet, *available at* http//www.nceo.org/main/article/php/id/21.

a. Contrary to DOL's assumption, "incorrect" or "faulty" valuations are not a chronic problem.

We respectfully submit that DOL has failed to make the case that valuations under current law are routinely deficient. In support of its case, the Agency asserts that a recent "ESOP national enforcement project" has revealed that "incorrect valuation[s]" or "faulty valuations" are a "common problem." Preamble to the Proposed Regulation, 75 Fed. Reg. 65,265. But DOL has not provided the underlying empirical data or analysis supporting the determination by the "national enforcement project."

DOL's lack of empirical support and its reliance on findings known only to the Agency are at odds with what is required of a regulatory agency in issuing a proposed regulation. *See* Administrative Procedure Act ("APA") § 553(b); *Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 393 (D.C. Cir. 1973) ("It is not consonant with the purposes of a rule-making proceeding to promulgate rules on the basis of inadequate data that, [to a] critical degree, is known only to the agency"). *See also Chamber of Commerce v. SEC*, 443 F.3d 890, 899 (D.C. Cir. 2006) ("Under the APA notice and comment requirements . . . the information that must be revealed for public evaluation are the technical studies and data upon which the agency relies in its rule-making") (internal quotations omitted). Because the findings of the ESOP enforcement project have not been made available, we do not know (and have no opportunity to comment on) whether DOL simply is relying on the anecdotal views of its enforcement staff, who are dedicated professionals, but not providers of valuations or fairness opinions, or on a comprehensive empirical study.[5]

Whatever the basis, DOL's explanation runs counter to the information that is available to the public, which suggests that, based on reported cases collected by NCEO, "faulty valuations" would not appear to be a "common problem." In this regard, an NCEO study indicates that over the past twenty years, the amount of ESOP-related

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[5] The only public disclosure of the results of the ESOP national enforcement program that we have located is the testimony of a DOL official before the ERISA Advisory Council on September 11, 2008. In that testimony, the DOL official cited to two ESOP enforcement cases filed more than ten years ago and two unrelated cases involving embezzlement by fiduciaries.

litigation centering on valuation-type issues has been comparatively small. Corey Rosen, *BNA Pension & Benefits Daily*, (Dec. 8, 2010) (tracking 141 court cases from 1990 to 2010 involving privately-owned companies and, of those, only 17 concerned valuation – a de minimis number in light of the fact that there are estimated to be 11,500 ESOPs in the United States). This tension between the explanation provided in the Proposed Regulation and the evidence that runs to the contrary undercuts the notion that the rule is based on reasoned decision making. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Ins. Co.*, 463 U.S. 29, 43 (1983) ("[A]n agency rule [is] arbitrary and capricious if the agency [has] offered an explanation for its decision that runs counter to the evidence before the agency").

More generally, the Firms are concerned with the premise of DOL's argument – that it is easy to identify "incorrect" valuations. Valuations, by definition, involve some degree of subjectivity. Qualified valuation professionals with the experience and skill to make a professional judgment may reach different conclusions based on a review of the same information. Such a difference in professional opinion does not make one opinion "correct" and another "incorrect." *See Henry v. Champlain Enters., Inc.,* 445 F.3d 610, 619 (2d Cir. 2006) (internal quotations omitted) ("There may be a range of prices with reasonable claims to being fair market value"). In fact, the differing opinions of financial professionals are a necessary key to setting transaction prices in the public markets or on stock exchanges. In many instances, what many characterize as "errors" are future developments not reasonably foreseen by the subject company or the person providing the valuation. These are often the product of industry, market or lending conditions that, evaluated objectively, pose no actual or reasonably foreseeable material risk at the time a valuation is prepared but that, in perfect hindsight, ultimately would have had a material impact on a valuation had the factors been reasonably foreseeable. No "modification of business practices" would enable professionals to exercise 20/20 hindsight so as to avoid these so-called "errors." *See Keach v. U.S. Trust Co.*, 419 F.3d 626, 634 (7th Cir. 2005).[6]

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[6] Like all professional services firms, a provider of valuations and fairness opinions would not stay in business for long if it consistently produced "faulty" or "incorrect" valuations or opinions, as the Firms understand those terms to mean or to be applied. For that reason, each of the Firms has implemented internal review processes that are followed in connection with the preparation and delivery of valuations and fairness opinions. These valuations and fairness opinions generally are peer-reviewed for technical accuracy, often by individuals not directly involved in the project. Each of the Firms views its internal review process as a critical tool of quality control.

The Firms reject DOL's suggestion that valuation and fairness opinion provider firms perform substandard ESOP-related work because they have no fear of being sued under ERISA. As discussed below, the current market for valuation and fairness opinion services related to ESOPs is highly competitive, and while the Firms and other firms compete on price, the Firms' principal approach to obtaining new clients is based on the demonstrated quality of their work. The Firms are cognizant of the level of scrutiny their valuations and opinions are subject to from ESOP trustees, the ESOP companies' independent auditors, as well as both DOL and the Internal Revenue Service ("IRS"). The Firms do not believe that making them fiduciaries under ERISA would affect the quality of their analysis. Nor would it likely affect the conduct of less-qualified firms. If there is a problem with substandard quality of work in preparing ESOP valuations and fairness opinions, it likely derives from inexperienced and unqualified providers, and making those parties fiduciaries is not going to transform them into experienced and skilled professionals.

b. The Proposed Regulation would increase costs and reduce the competitiveness of the current valuation market.

All of the Firms disagree with DOL's implied conclusion that the current market for ESOP-related valuation and fairness opinion services is not competitive enough to generate fair pricing for those services.[7] It is commonplace for ESOP trustees to obtain at least two or three proposals from competing firms before selecting a provider, and where firms are judged to be comparable in expertise, price often is an important factor in who wins the assignment. As a result, valuation and fairness opinion services are priced reasonably as compared to fees other ESOP professionals charge, including ESOP attorneys, and certainly low when compared to fees charged by other financial professionals involved in major corporate transactions. Indeed, while all companies strive to maximize returns for their owners, ESOP-owned companies are particularly

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[7] DOL asserts that there would be an "improvement in service value" of $399 million over ten years if plans realize an additional one basis point return because of the Proposed Regulation. Preamble to the Proposed Regulation, 75 Fed. Reg. at 65273. However, there is no analysis supporting the assumption of a one basis point return other than a citation to a U.S. Government Accountability Office study focusing on pension consultants, not on providers of valuations or fairness opinions to ESOPs. In fact, DOL nowhere discusses how making providers of valuation services fiduciaries would increase ESOP returns.

attuned to charges by their ESOP service providers in their attempts to generate value for their employees.

DOL acknowledges that the Proposed Regulation will drive up the cost of doing business as firms providing valuation and fairness opinion services would attempt to pass along those costs to plans. While DOL acknowledges additional compliance costs,[8] the Agency has made no effort to quantify the costs associated with litigation risk. Although the Firms historically have seldom been the subject of lawsuits or investigations, the cost of defending their work in a single ERISA lawsuit or investigation could be devastating relative to the profits realized in this competitive market, and the relatively small number of transactions each of the Firms is retained to work on each year.[9] These same factors would drive the cost of fiduciary insurance for ESOP-related valuation and fairness opinion work. While such a product does not currently exist, we believe that DOL, having acknowledged this factor as significant, should make an effort to quantify this cost. As a starting point, the Agency could obtain information from the major fiduciary liability carriers on the cost of insurance for those who serve in capacities that are understood to make them fiduciaries. The Agency would then have to take into account

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[8] DOL's analysis of the estimated impact on service providers appears to understate the costs of complying with the Proposed Regulation, and its lack of specificity in the case of ESOP valuation firms makes it of questionable value for purposes of a *Chevron* analysis. DOL's estimate makes no attempt to distinguish between the effects of the proposed rule on an ESOP provider of valuations and fairness opinions opposed to the effect on other affected persons. Moreover, DOL acknowledges that it estimated the universe of service providers using only information provided by plans on their Schedule C's to their annual Form 5500 filings. And yet, as DOL concedes, small plans generally are exempt from completing a Schedule C and most ESOPs are plans sponsored by such companies. Thus, it is questionable whether DOL has developed a reasonable method to account for the compliance costs that would be imposed by the Proposed Regulation on service providers to small plans. Even without that defect, there is no evidentiary or methodological support for DOL's estimate that the legal costs to service providers to review any final rule would be, on average, 16 hours at $119 per hour. The latter figure is particularly suspect in light of the Firms' experience with legal fees, especially in the specialized area of ERISA compliance.

[9] We are aware of one valuation firm that once was swept into an ESOP lawsuit as one of over forty parties named as defendants. The firm ultimately was dismissed from the action in a three-sentence order, but over $500,000 was incurred in legal bills.

that insurance companies will have difficulty pricing the product due to the unfamiliarity with ESOP valuation practice, and as a result, rates would start higher than on existing product lines.

Unfortunately, there appear to be few avenues outside of insurance to cover against litigation risk. This is especially so given the uncertain legal landscape created by *Johnson v. Couturier*, 572 F.3d 1067 (9th Cir. 2009) and subsequent cases. Those cases raise serious questions with respect to advancement of fees to ESOP fiduciaries, either by the ESOP or the sponsoring company, whether partially or wholly-owned by the ESOP. Thus, the need to obtain insurance coverage becomes even more paramount. Even if significant insurance coverage were available, the Firms are concerned that plaintiffs' lawyers may attempt to use *Johnson* and its progeny to cut off their ability, as fiduciaries under the Proposed Regulation, to defend themselves once insurance coverage has run out.

If the Proposed Regulation becomes law, the Firms fear that they may have no other choice but to exit the ESOP market. This is particularly the case with Firms whose ESOP-related work represents a small percentage of the company's overall revenues. Even those Firms whose ESOP work represents a larger percentage of their overall revenue would be reluctant to expose their invested capital to this increased risk without some certainty that they would be able to offset the risk through insurance or by commanding higher fees.[10] This would lead to qualified, experienced firms exiting the business, while those firms that try to remain in the market by charging higher fees would find themselves at a competitive disadvantage. The result would be that a higher percentage of work would go to low cost providers who compensate for a lack of experience and training by offering their services at prices that more qualified firms with experienced professionals and rigorous quality control procedures cannot match. Moreover, these small, undercapitalized firms may not appreciate or be as concerned as more established firms about increased litigation risk since they are, in essence, judgment-proof, and thus less likely to be sued. Frivolous lawsuits are not uncommon, and the firms who have meaningful assets and can afford insurance would most likely be the firms targeted by plaintiffs' lawyers.

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[10] We are aware that large institutional trustees made similar business decisions after being exposed to expensive litigation in connection with ESOP-related work for which they were unable to charge fees commensurate with the risk. As DOL is aware, similar considerations led many large directed trustees to consider leaving the 401k employer stock arena until DOL issued Field Assistance Bulletin ("FAB") 2004-03.

In sum, the Firms strongly disagree with the assumption that the Proposed Regulation would raise the quality and value of ESOP valuations. As long-time competitors in this market, the Firms uniformly believe that the likely result of the Proposed Regulation would be to increase the cost and lower the quality of the valuations and fairness opinions being provided as the most qualified and experienced firms are forced out of the market.

c. Conferring fiduciary status on a valuation provider is inconsistent with the requirement under the Internal Revenue Code and professional standards of practice that the service provider remain impartial.

Given its regulatory responsibility under Title I of ERISA, we appreciate DOL's broad goal to ensure that service providers to ERISA plans will be careful and appreciative of the interests of the plans' participants and beneficiaries. Where we have a disagreement is in DOL's attempt to have that goal override the professional obligation of a provider of valuation services to provide an impartial opinion of value. Impartiality is the critical concept for valuation providers under the Internal Revenue Code ("IRC") and the standards that many of the professionals in the Firms are bound to uphold as members of relevant professional organizations.

IRS regulations provide that an ESOP can only be considered a qualified trust under the IRC if "all valuations of employer securities which are not readily tradable on an established securities market with respect to activities carried on by the plan are by an *independent appraiser*," *see* IRC § 401(a)(28)(C), as defined in Treasury regulations promulgated under IRC § 170(a)(1) (emphasis added). A "qualified independent appraiser" under these regulations is a person who, among other things: (1) *is not a party to the transaction, and is not related to any party to the transaction*, (2) holds him or herself out to the public as an appraiser or performs appraisals on a regular basis; and (3) is qualified to make appraisals of the type of property being valued. 26 C.F.R. § 1.170A-13(c)(5)(i)(emphasis added). Further, the regulations disqualify a valuation provider if the seller had "knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value" of the property. *Id.* These requirements are strictly enforced. *See Hollen v. Commissioner*, T.C. Memo 2011-2 (2011) (disqualifying ESOP for failure to use an independent appraiser as required under § 1.170A-13(c)(5)(i)).

Importantly, the IRS has advised that a "qualified appraisal" has been conducted by a "qualified appraiser" within the meaning of § 1.170A-13 only if it is done "in

accordance with generally accepted appraisal standards." I.R.B. 2006-46. The IRS further has clarified that this would include appraisals "consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice" ("USPAP")." *See* Proposed Reg. 26 C.F.R. § 1.170A-17(a) (1)-(2) (proposing to codify guidance under I.R.B. 2006-46).

USPAP provides industry standards for conducting valuations. USPAP ethics rules impose specific conduct requirements on valuation providers, including an impartiality requirement. *See* USPAP Ethics Rule, http://www.uspap.org/2010USPAP/USPAP/frwrd/uspap_toc.htm. (appraiser "must not perform with bias" and "must not advocate the cause or interest of any party or issue . . . . "). While not specifically mentioned in IRS's guidance, the ASA's Principles of Appraisal Practice and Code of Ethics also underscore the professional obligation to remain impartial and independent in performing valuation services. For example:

> 2.2 Objective Character of the Results of an Appraisal Undertaking
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> The primary objective of a monetary appraisal, is determination of a numerical result, either as a range or most probable point magnitude—the dollar amount of a value, the dollar amount of an estimated cost, the dollar amount of an estimated earning power. *This numerical result is objective and unrelated to the desires, wishes, or needs of the client who engages the appraiser to perform the work.* The amount of this *figure is as independent of what someone desires it to be as a physicist's measurement of the melting point of lead* or an accountant's statement of the amount of net profits of a corporation. *All the principles of appraisal ethics stem from this central fact.*
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> 4: Appraiser's Obligation to His Client
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> The appraiser's primary obligation to his client is to reach *complete, accurate, and pertinent conclusions and numerical results regardless of the client's wishes or instructions in this regard. The relationship between client and appraiser is not one of principal and agent...*

See http://www.appraisers.org/ProfessionalStandards/CodeOfEthics.aspx. (emphasis added).

The American Institute of Certified Public Accountants ("AICPA") also has promulgated a code of conduct for its members, including certified public accountants ("CPAs") performing appraisal work. A fundamental precept of that code of conduct is that the CPA must be "independent in the performance of professional services." AICPA Code of Professional Conduct, ET Section 101.01, available at http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx. The code of conduct further defines independence as "the state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism." ET Section 100-1.06.

The Proposed Regulation erodes the ability and professional responsibility of the valuation provider to provide impartial advice as to the range of value of privately held securities. As a fiduciary, the valuation provider's fiduciary duty to act "solely in the interest of the participants and beneficiaries" would contradict the provider's ability to act impartially. For example, the valuation provider would have a fiduciary duty to advocate the advisability of making a particular investment. However, the standards under the IRC and well-established professional standards provide that the role of such a person is not to advocate for a value, or an investment, on behalf of anyone, but instead to provide an impartial opinion as to the value of a particular security, no matter who asks the question.[11]

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[11] Making a provider of valuation services a fiduciary would not only be inconsistent with existing law and the standards of the profession, it also would fundamentally change the dynamic of the negotiation process. It is conceivable that the other side to an ESOP transaction would assume that the ESOP's valuation was slanted in favor of the ESOP. This could make transactions more difficult to consummate and thereby affect the ability of companies to form ESOPs, threatening long-standing Congressional policy designed to encourage employee stock ownership. But it would not only be ESOP formations that would be affected: making the provider of a valuation or fairness opinion a fiduciary advocate also could hinder the sale of stock by existing ESOPs, thereby jeopardizing the ability of an ESOP to execute an exit strategy and generate cash for an ESOP's participants and beneficiaries.

d. The relationship between ESOP Trustee and a valuation or fairness opinion provider would be thrown into confusion by making the provider a co-fiduciary.

The Proposed Regulation fundamentally would alter the relationship between the ESOP trustee and the provider of valuations and fairness opinions in a way that would undercut the Congressional policy to make fiduciaries responsible for their decisions. Current law places the sole responsibility for making prudent investment decisions on the ESOP trustee. He or she must investigate the terms of the proposed transaction with "the care, skill, prudence, and diligence" of a prudent person acting under the circumstances then prevailing. ERISA § 404(a)(1)(B); 29 U.S.C. § 1104(a)(1)(B). The reviewing court's task "is to inquire whether the [trustee] . . . employed the appropriate methods to investigate the merits of the investment and to structure the investment." *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir. 1984). ERISA § 406 prohibits certain transactions involving fiduciaries and "parties in interest" to a benefit plan. ERISA Section 3(14)(H); 29 U.S.C. § 1002(14)(H) (defining parties in interest). Among these transactions is the "sale or exchange . . . of any property between the plan and a party in interest," including the "acquisition, on behalf of the plan, of any employer security." *Id.* (quoting 29 U.S.C. § 1106(a)(1)(A), (E)). However, ERISA § 408(e) 1108(e) expressly exempts the sale of employer stock by a party in interest to an ESOP if the purchase is made for "adequate consideration." *Id.* (quoting 29 U.S.C. § 1108(e)). ERISA, in turn, defines "adequate consideration" in pertinent part as:

> [I]n the case of an asset other than a security for which there is a generally recognized market *the fair market value of the asset as determined in good faith by the trustee* pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

Id. (quoting 29 U.S. C. § 1002(18)(B) (emphasis added).

If the merits of a particular valuation result are challenged, an ESOP trustee will need to demonstrate that it has satisfied its obligations as an ERISA fiduciary by having arrived at a determination of fair market value by way of a *prudent investigation*. As part of that process, an ESOP trustee is expected to retain an independent financial advisor to assist the trustee in evaluating the financial terms of the proposed transaction, including obtaining an opinion as to the range of value of the employer securities proposed to be purchased or sold, and thereafter thoroughly to review, analyze, and question the valuation provider's work. Thus, as in other ERISA contexts, the focus of the law is on

the ESOP trustee as the fiduciary and decision maker, and not the valuation or fairness opinion provider unless such provider has stepped over the fiduciary line to assume some measure of decision-making control.

The merit of having a bright-line test is self-evident. Among other things, all parties involved in ESOP transactions have a clear understanding of their roles: the trustee-fiduciary understands that he or she is responsible for evaluating the merits of a particular investment decision, and the valuation professional understands that his or her role is to provide an impartial valuation or fairness opinion to assist the fiduciary in making that decision.

Making a provider of ESOP valuations or fairness opinions an ERISA fiduciary upsets this orderly chain of command in ESOP-related transactions. As a co-fiduciary, a provider may not legally be able to cede final decision-making authority to the ESOP trustee on areas or issues of disagreement since the provider might be exposing itself to co-fiduciary liability under section 405 of ERISA if it does so. This is likely to create additional confusion, expense, and inefficiency in the ESOP space. Indeed, many ESOPs may decide that the cost of retaining two ERISA fiduciaries – the ESOP trustee and its valuation provider – is simply too high, thus eliminating a critical part of the good faith investigation process; since an independent valuation is required, the independent fiduciary may be eliminated and a company officer may be appointed a fiduciary instead. At the least, the ESOP trustee simply may cede financial issues to the valuation provider, thereby eliminating the benefit of a rigorous review of the valuation.

For thirty-five years, DOL has told courts that the best way to assure good decision-making is to hold the person with that authority accountable. Whatever advantages DOL perceives by expanding the category of fiduciaries, the Agency must also recognize that the contemplated expansion will have a corresponding negative effect on the way the decision-making ESOP trustee comprehends its role, and consequently on the fiduciary process itself.

RECOMMENDATIONS

After DOL issued the Proposed Regulation, President Obama issued an Executive Order directing agencies to use "the least burdensome tools for achieving regulatory ends," and to "select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits." We have serious concerns that DOL's proposed rule-making can be squared with the letter and spirit of the Executive Order. By choosing an interpretive rule, as opposed to dealing directly with the specific concerns it

has in the area of ESOP valuations, DOL would leave the development of valuation-specific rules to the judicial process. The Firms do not see that as "the least burdensome tool[] for achieving [DOL's] regulatory ends." In fact, a litigation-based approach is highly inefficient and likely to result in an inconsistent application of the law. Besides often exhausting the assets of both plaintiffs and defendants, developing valuation-specific rules through litigation is an evolutionary process requiring multiple decisions before a rule of law emerges. Sometimes no rule of law ever emerges as the holdings in cases are highly dependent on unique facts, the quality of counsel, the effectiveness of each side's experts, and the judicial approach of the presiding judge.

For this, and the reasons outlined above, the Firms urge the Agency to withdraw the Proposed Regulation.

Nevertheless, the Firms would support a well-reasoned approach toward further strengthening the standards governing the provision of ESOP-related valuation services. For that reason, we have suggested below targeted and more effective solutions to the concerns stated by DOL – an approach we believe is more consistent with the President's directive than the Proposed Regulation. DOL has many tools available to do such tailoring, from more specific interpretive rules, to class exemptions, to Field Assistance Bulletins. The Firms are ready to assist the DOL in developing such regulatory guidance.

A. DOL Can Issue Regulations or Guidance on Specific Issues Affecting ESOP-Related Valuation And Fairness Opinion Services Under Current Law.

1. DOL should restructure its Proposed Regulation and draw an appropriate line that carves out a safe harbor for professionals providing valuation and fairness opinion services allowing them to perform traditional ESOP-related services without becoming an "investment advice" fiduciary under ERISA.

If DOL is determined to make changes affecting the provision of valuation services and fairness opinions, it should do so by dealing specifically with its concerns. To the extent the Agency believes that there is ambiguity in the Current Regulation, DOL could promulgate a broader rule with a specific carve out from the regulatory definition of "investment advice" the provision of financial data or a valuation analysis or fairness opinion to an ESOP fiduciary as long as the provider does not render advice concerning the relative merits of a proposed transaction or any available alternative transaction. DOL could further make clear that a valuation professional would "cross the line" and act as an investment advice fiduciary if it provides advice as to the comparative merits of

purchasing or selling employer securities, as opposed to some other securities, acts as the person responsible for making the investment decision, where it acted as the person recommending the investment decision, or provides individualized investment advice to the ESOP or to ESOP participants on investment policies or strategies, portfolio composition, or diversification of plan investments.

There already is strong precedent for clarifying that certain activity by a plan service provider is exempt from the statutory definition of investment advice. Under the Current Regulation, a broker dealer is not considered an investment advice fiduciary if, among other things, the broker dealer is given a limited range of discretion with respect to the execution of a particular trade, such as the time frame for executing the particular transaction, the number of shares to be bought or sold, and the price range for the transaction, and the fiduciary providing the instructions is independent of the broker dealer.

DOL could address its concern with a perceived lack of independence and undisclosed conflicts of interest by valuation providers by using criteria that DOL has relied upon for decades. For example, it could develop a disclosure rule similar to Prohibited Transaction Exemption ("PTE") 84-24 that would require the valuation or fairness opinion provider to disclose all of its fees and any arrangement that could affect the impartiality of its advice so the decision-making fiduciary would be fully informed about its advisors and their advice before it makes an investment decision.[12]

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[12] It is unclear whether any additional action is even necessary given DOL's new rules amending the existing regulation under Section 408(b)(2) of ERISA. This new rule would address DOL's stated concerns with respect to a service provider's compensation and any potential conflicts that may affect the firm's performance of its duties. Under the interim final rules, a service provider receiving $1,000 or more in indirect compensation would be considered a "covered service provider" and would need to disclose to the ESOP fiduciary the nature and type of indirect compensation they receive in connection with the services being provided.

We further note that FINRA 5150 clearly outlines required disclosure procedures for fairness opinions. Those requirements provide, among other things, that the fairness opinion provider (a) make certain disclosures with respect to (i) material relationships between the opinion provider and the parties to the transaction, and (ii) particular types of compensation to be received by the opinion provider in connection with the transaction,

If DOL does not believe that disclosure is sufficient, it could consider direct requirements to establish independence. DOL has often defined independence by reference to the compensation a person receives as a percentage of its annual revenues, and something similar could be developed in the ESOP valuation area. *See, e.g.*, Prohibited Transaction Exemption Procedures; Employee Benefit Plans, 75 Fed. Reg. 53,172 (proposed Aug. 30, 2010). But the Firms believe the better approach would be for DOL to follow the lead of its sister agency, the IRS, which has promulgated regulations concerning who constitutes a "qualified independent appraiser" and what constitutes a "qualified appraisal." Valuation providers and their clients understand and have demonstrated the ability to conform their practices to them. In any event, this type of rule-making is superior to making providers of ESOP valuations and fairness opinions fiduciaries and hoping that a coherent "independence" rule will emerge in the legal jurisprudence.

2. DOL should provide guidance on critical ESOP valuation issues.

As discussed above, since DOL has not provided any supporting evidence, the Firms do not know what DOL means when it asserts that it has recently uncovered a material number of "inaccurate" or "faulty" valuations. We do not know whether DOL means that these valuations are not based on sufficient fact-gathering or analysis, whether they contain computational errors, whether they use assumptions on critical factors that can not be reasonably supported, or rely on valuation methodologies that DOL opposes as a policy matter.

The latter issue is of particular concern to the Firms. As noted, many professionals in the Firms are members of professional organizations that continually examine valuation issues in an attempt to reach a consensus on, for example, the treatment of the repurchase obligation, or whether put options provide marketability. To the extent that DOL wishes to weigh in on such issues, it should do so directly through a reasoned process that includes the solicitation of views from all affected parties.

If the Proposed Regulation becomes final, it raises the specter that a professional's position on such issues will be the subject of a claim of breach of fiduciary, which would force a court to make a decision on what could be a matter of considerable debate within the profession. As noted, a courtroom is a poor place to resolve these issues. Indeed,

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and (b) have written procedures in place that set forth the approval process for the issuance of fairness opinions.

there is a tension already in ESOP cases between the statute's focus on the due diligence, or good faith, of the ESOP trustee, and the extent to which one can engage in a post-hoc, "Monday morning quarterback" scrutiny of the underlying valuation and the assumptions and methods employed by the valuation firm. DOL was correct when it argued to the Fifth Circuit in the seminal case, *Donovan v. Cunningham,* 716 F.2d 1455 (5th Cir. 1983), that the job of the court is to assess whether the trustee had undertaken a good faith investigation of all the facts, including a careful review of the valuation opinion, and not to re-determine the price for itself *de novo. See id.* at 1467; *Henry,* 445 F.3d at 619. The former task is suited to the judicial process because there are well-known principles defining due diligence in the ERISA context; the latter task propels the court into an area where it lacks expertise, increasing the risk of inconsistent rules.

B. If DOL Determines To Issue The Proposed Regulation In Its Current Form, The Agency Should Clarify Certain Matters.

1. DOL should amend the Proposed Regulation to provide that the preparation of a private company ESOP annual valuation used for participant accounting and redemptions is not "investment advice."

The Proposed Regulation excludes the rendering of valuations "for compliance purposes" from the list of activities that would trigger fiduciary status. However, DOL proposes to take out of that exclusion valuations that are contained in a report that includes "assets for which there is not a generally recognized market and [which] serves as a basis on which a plan may make distributions to plan participants and beneficiaries." Proposed Regulation 29 C.F.R. § 2510.3-21(c)(2)(iii). Thus, it appears that a valuation professional who prepares an ESOP annual valuation report with respect to privately held company stock is considered to be providing investment advice. This is a problem for several reasons.

First, this part of the Proposed Regulation almost certainly would drive most, if not all the Firms out of the business of doing annual valuations. Annual valuations are priced very modestly, which reflects the high level of competition in this market. The Firms believe that the fees for this service would be grossly disproportionate to the increased litigation risk by being deemed fiduciaries. Nor would such increased cost provide demonstrable value to the participants who would directly bear the additional expense.

Second, the ESOP's annual financial statement audit uses the annual valuation. The audit process results in another professional, the plan's certified public accountant,

who acts along with the ESOP trustee as a check on the ESOP valuation. As DOL is aware, accountants have their own professional responsibilities with respect to fair value represented in a plan's financial statement. In the Firms' experience, accountants are very diligent in reviewing the ESOP valuation.

Third, it is not at all clear what making a provider of ESOP valuations and fairness opinions a fiduciary would accomplish in meeting DOL's objectives. As noted, the standards of the profession caution against professionals acting solely in the interests of any person, as opposed to simply trying to provide impartial advice. Making the valuation professional an advocate for his or her "client" is especially problematic in the case of annual valuations because the interests of the ESOP participants diverge: the participant who is nearing retirement has an interest in a high valuation while the newly-hired participant has an interest in a lower valuation.[13] Since most valuation professionals start with a range of value, a valuation conducted by a fiduciary could be held to violate the law to one set of participants or another, whichever end of the range he or she chose.

Finally, we presume that DOL's concern is with the participant nearing retirement because he or she is more directly affected by an annual ESOP valuation that is "too low." But making the valuation professional a fiduciary will not assist that participant in obtaining relief for an incorrectly calculated benefit. Any challenge by such a participant would have to be brought under section 502(a)(1)(B) of ERISA since it concerns the amount of "benefits due to him under the terms of the plan." The Supreme Court has held that, if a case can be brought under that section, then it cannot be brought as a breach of fiduciary duty case under other subsections of section 502. *Varity Corp. v. Howe*, 516 U.S. 489, 515 (1996). In short, making the person who performs an annual private

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[13] This is especially true in a leveraged ESOP where the participants have a put right back to the company at retirement. The younger participants clearly have an interest in a lower value so that the company does not exhaust its assets paying the older participants. Moreover, according to DOL, even though the company redeems the retiring participant's shares, it is the other participants that bear the burden since DOL believes that all the assets of an ESOP-owned company are plan assets within the meaning of ERISA and are therefore held for the benefit of the ESOP participants. *See Johnson*, 572 F.3d at 1080.

company ESOP valuation a fiduciary would have no effect on any participant who challenges the valuation.[14]

Given the above, we urge DOL to reconsider its position and eliminate the rendering of ESOP compliance valuations from the definition of investment advice.

2. DOL should expand the "sellers' limitation" to include providing valuation advice to a sponsoring ESOP company.

Under the Proposed Regulation, a person will not be deemed to be providing investment advice for a fee if, among other things, the person receiving the advice understands that the valuation professional is acting on behalf of a seller with interests adverse to the plan. Proposed Regulation, 29 C.F.R. § 2510.3-21(c)(1)(ii)(D). As noted, some of the Firms provide valuation services to shareholders who sell to an ESOP and they appreciate DOL's clarification of its intent regarding that situation. However, a number of the Firms occasionally advise a sponsoring ESOP company in connection with an ESOP-related transaction. For example, they may be retained to evaluate shareholder liquidity alternatives that may include an ESOP. If a Firm undertakes such an assignment from a sponsoring company, it may go on later to advise the seller, and the exclusion DOL has proposed would be available. However, there are transactions in which the seller and ESOP trustee retain their own advisors, and the financial advisor continues to advise the company.

We assume DOL would take the position that the valuation professional advising the company in a proposed transaction is not a fiduciary under the Proposed Regulation because he or she is not advising the ESOP trustee and the company is acting as a settlor. However, the current language of the Proposed Regulation could cause uncertainty since the financial advisor in that scenario is not representing the seller and is not "adverse" to the ESOP. Accordingly, if the DOL goes forward with the Proposed Regulation in its present form, we request that it confirm that a financial advisor that advises a company sponsor is not a fiduciary.

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[14] That does not mean that the valuation firm would be immune to suit under other subsections of ERISA § 502. Younger participants could theoretically file suit against the professional on the ground that the valuation is too high and is therefore causing a loss to the ESOP when retirees are paid on the basis of that valuation. This could lead to fiduciary valuation professionals erring on the side of lower valuations – the exact opposite of what DOL has presumably intended.

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Thank you for the opportunity to provide comments on the Proposed Regulation. As noted in our cover email, we will be requesting that a Firm representative be permitted to testify so as to share the Firms' views and answer any questions at the hearing scheduled on March 1st and possibly March 2nd. Please do not hesitate to contact either of us if you have any questions regarding the above.

Sincerely,

Groom Law Group, Chartered

By:
Edward A. Scallet

and

By:
Lars C. Golumbic