

GROOM LAW GROUP

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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:

The undersigned represent a group of providers of valuations and fairness opinions who submitted initial comments and whose representative, Jeffrey Tarbell, testified at the March 2nd Hearing (“Hearing”).¹ Having read the comments and listened to the Hearing testimony, the group remains deeply concerned about the unintended consequences of the proposed regulation on their professional responsibilities and on the millions of active and retired employees who rely on an ESOP for their retirement security.² In particular, the views expressed in the comments and testimony unanimously point to the same conclusion -- the proposed rule is diametrically at odds with the impartiality requirement under longstanding professional standards of valuation practice as well as the Internal Revenue Code. The witness testimony and other remarks made at the Hearing did nothing but reinforce the group’s view that the proposed rule and its obligation to be impartial are irreconcilable.

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

² In this respect, a number of comments, including ones issued by the American Society of Appraisers (“ASA”) and the American Institute for Certified Public Accountants (“AICPA”), offered practical solutions to many the problems asserted by the Department in its proposed rule.

These additional comments are directed at a principal focus of the Hearing, and one that is critical to the task of the Department of Labor (“DOL” or “Department”) under the law to show that the economic benefits of the proposed regulation exceed the projected costs. It is clear from the Hearing testimony and the remarks of Department officials that the benefits of the regulation do not outweigh the costs, particularly as it would affect valuation services related to ESOPs. In fact, as detailed below, the public record supports the opposite conclusion -- that the costs substantially outweigh the benefits of the proposed regulation.

- ***The record shows that the costs of the proposed rule on ESOP-related services would be substantial.***

Hearing witnesses persuasively testified that promulgation of the proposed regulation will require providers of ESOP valuations and fairness opinions to account for increased litigation risk. The main concern is not that a provider would be unable to defend its work in a proceeding, but that, as a result of litigation or other proceedings, the provider would be faced with significant defense costs just to establish its compliance with professional standards. Mr. Tarbell and Robert Reilly, on behalf of the AICPA, gave examples during the Hearing of firms which spent hundreds of thousands of dollars in defense costs in cases where the firms were eventually dismissed as defendants. March 2nd Tr. at 64, 119-120. For many firms, the cost to defend one case would likely exceed their annual profits. March 2nd Tr. at 119-120.³ Such defense costs are almost never paid in full by fiduciary liability insurance, which normally includes a high deductible to be satisfied before coverage begins. In addition, internal costs driven by the regulation, such as additional records maintenance, and the development of policies and procedures, also will be incurred.

Valuation and fairness opinion providers will need to consider this new risk in pricing their services. Therefore, one can expect that these providers will charge extra compensation on each assignment, which they hope will be sufficient to cover a particular transaction that results in litigation costs. These increased fees would not only

³ A 2003 fiduciary liability survey report issued by Towers Perrin, Tillinghast, underscores the significant costs involved in defending a fiduciary claim. The survey found that the average cost of defending a fiduciary claim to be roughly \$365,000, and factoring in amounts paid as a result of settlement or court adjudication, the average cost rose to \$994,000. Given that legal defense costs continue to rise, there is little doubt that these figures are significantly understated.

impose direct, immediate, and incremental costs on ESOP plan sponsors, but those costs would likely increase over time as the market for valuation and fairness opinion services became less competitive. In this respect, witnesses testified that many firms will have a disincentive to continue providing ESOP valuations and fairness opinions in light of the increased costs and the difficulty of raising prices to compensate for such risk. March 2nd Tr. at 54-56, 95, 106-107. One witness cited the example of the ESOP trustee market, where significant institutions left in reaction to increased litigation costs and negative publicity. March 2nd Tr. at 10, 54-55. In short, the evidence in the record is that valuation and fairness opinion providers would be driven out of the ESOP market, thereby reducing the supply of willing firms and inevitably increasing the cost of services further. March 2nd Tr. at 27-28, 95, 106-107.

While insurance has been used by plan fiduciaries to mitigate their ERISA litigation risk, the record is clear that no such product currently exists for ESOP valuation and fairness opinion providers. March 2nd Tr. at 117-118. Based on the stringent cost-benefit analysis that is now required by the executive branch to ensure responsible rule-making, Exec. Order 13563, 76 Fed. Reg. 3821 (Jan. 18, 2011), reliable data must be obtained to quantify the identified insurance cost. And yet, there is no evidence in the record as to the projected cost of that insurance, a fact that the Department acknowledged during the Hearing. March 2nd Tr. at 117.

The group has attempted to estimate the cost of a valuation-specific insurance product by considering the cost of fiduciary insurance coverage for ESOP trustees, which is typically based on assets under management. The group understands from conversations with industry representatives and other information in the public domain that premiums range between \$100 to \$200 per \$1 million of assets under management. *See* Fiduciary Insurance – Understanding Your Exposure, at 12, *available at* <http://www.naplia.com>. The ESOP trade associations project that the total assets owned by ESOPs are roughly \$900 billion. *See* National Center for Employee Ownership statistics, *available at* <http://www.nceo.org/main/articl/php/id/21>; The ESOP Association statistics, *available at* http://www.esopassociation.org/media/media_statistics.asp. Using that ratio, the aggregate fiduciary insurance costs for valuation and fairness opinion providers would range from \$90 million to \$180 million annually.

In addition to the cost of insurance, retention and regulatory compliance, witnesses at the Hearing testified that providers would also bear the cost of hiring separate ERISA

counsel to represent them in ESOP transactions, and likely some valuations as well.⁴ March 2nd Tr. at 11, 118. The group believes that retaining ERISA counsel would add \$30,000 to \$100,000 to the overall cost of each ESOP purchase or sale transaction. This estimate is based on what an ESOP trustee's ERISA counsel generally charges in a transaction, and the cost of legal counsel retained by valuation or fairness opinion providers in non-ERISA transactions. One ESOP trade organization estimates that, on average, approximately 1,000 ESOP transactions occur annually. Using that figure, the projected added cost for ESOP transactions would range from \$30,000,000 to \$100,000,000 annually. In addition, assuming the average cost of retaining an attorney to review a valuation to be, on average, approximately \$5,000, the total cost for the 11,500 existing ESOP companies exceeds \$50 million a year.

- ***The public record shows no economic benefit to ESOPs that would be derived from the proposed regulation.***

At the Hearing, Department officials suggested that conferring fiduciary status on an ESOP valuation or fairness opinion provider would correct the “common problem” of substandard valuation and fairness opinion provider work. *See* March 2nd Tr. at 121-127; *see also* Preamble to Proposed Rule, 75 Fed. Reg. 65265. The Department officials remarked in this regard that being a fiduciary under ERISA means being “careful.” While no one claims that there has never been “schlocky” ESOP-related valuation work,⁵ *see* March 2nd Tr. at 115, there is no evidence that the proposed regulation would change professional behavior by turning careless work into careful work. Nor is there any evidence that, even if true, being careful would result in identifiable economic benefits for ESOP participants. Compared to careful work, careless valuations or fairness opinions are as likely to lead to higher as to lower purchase and sale prices, or be incorrect in one party's favor or another.

⁴ On March 30, 2011, the Department issued a “fact sheet” concerning the proposed regulation. In the overview section, the Department did not indicate that the preparation of a private company ESOP annual valuation used for participant accounting and redemptions would be considered “investment advice” under the proposed rule. We would ask the Department to clarify whether the preparation of such annual valuations still would fall under the proposed amendment to the definition of investment advice.

⁵ We note that the primary mission of the Valuation Advisory Committee to The ESOP Association over the past fifteen years has been to improve the quality of valuations prepared by ESOP valuation providers.

The DOL also has cited, without explanation, to “valuation bias” as a ground for covering ESOP valuation and fairness opinion providers under the proposed rule. *See* Preamble to Proposed Rule, 75 Fed. Reg 65273. In its initial comments, the group pointed out that the Department does not have a study on the economic effect of this “valuation bias” on prices or returns similar to the Government Accountability Office study that found lower investment returns for plans that use investment consultants with financial incentives to recommend particular investment products. We assumed, therefore, that the Department’s position would be that the proposed rule would have the effect of skewing a valuation or fairness opinion determination in favor of the ESOP, thereby conferring benefits for the participants in those plans.

However, the testimony at the Hearing was that valuation providers currently attempt to calculate the “correct” range of value and that ESOP trustees, as ERISA fiduciaries, have a duty to analyze the valuation provider’s work pursuant to the prudent person standard and to reach a result that is unbiased. That would still be the case if the valuation provider were a fiduciary along with the ESOP trustee. Indeed, Department officials commented throughout the Hearing that imposing fiduciary status would mean no change to the current standards applicable to valuation providers under the Internal Revenue Code. March 2nd Tr. at 30, 107, 136. In particular, Department officials continually asserted that valuation providers could – and should – continue to perform valuations independently and impartially under the proposed rule. Thus, a provider would not be required, in the words of one Department official, to put his or her “finger on the scale” in valuing employer stock. March 2nd Tr. at 32. Even if it were true that an ESOP’s valuation provider determines the price at which a security trades in any transaction – a proposition that our group and every other witness characterized as a mischaracterization of the transaction process⁶ – Department officials stated unequivocally that the proposed regulation is not intended to, and would not, benefit ESOP participants economically by moving transaction prices in their favor. March 2nd Tr. 129-131.

The only evidence in the record that arguably would support a conclusion that the proposed regulation would confer any financial benefit is the possibility of additional monetary recoveries for ESOPs and their participants through enforcement actions. But

⁶ In many transactions, there is already a proposed price and the ESOP trustee asks the valuation provider to opine whether that price which the parties are already considering is within the range of value. There was no evidence at the Hearing or in the record that the valuation provider ever has the authority to dictate price to either party.

even that assertion is questionable. While the Department did express a desire to be able to institute enforcement actions against valuation and fairness opinion providers, its interest seems to be based on its view that the Internal Revenue Service, remedies available under state law, and the profession's self-regulatory bodies and procedures, are not doing an effective job of advancing and maintaining an acceptable level of competence within the profession. Still, the Department's stated desire to regulate valuation and fairness opinion providers through expensive litigation would not, by its own admission, confer economic benefits in the form of material monetary recoveries. The Department has not offered an estimate as to the likely monetary recoveries if the proposed regulation were finalized, or the substantial costs the Department and ultimately the taxpayers would incur from an attempt to create this new enforcement program. Indeed, the Department remarked at the Hearing that historically, the agency rarely has brought ESOP lawsuits, and only has done so in extremely abusive situations. March 2nd Tr. at 34. Accordingly, we are not aware of Department estimates of monetary recoveries as result of the proposed rule, and any such estimates would have to account for the Department's enforcement practices in the past.

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We appreciate the opportunity to submit comments, provide testimony, and submit these additional comments. We are confident that the Department will base its decision on the public record and that it will conclude that the proposed regulation cannot be justified under the requirements of administrative law.

Sincerely,

Groom Law Group, Chartered

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and

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