

The ESOP Association's
Statement to the Subcommittee on Health, Education, Labor, and Pensions
*July 26, 2011 Hearing --- "Redefining 'Fiduciary': Assessing the Impact of the Labor
Department's Proposal on Workers and Retirees"*

Statement on behalf of The ESOP Association, a national 501(c)(6) business trade association representing nearly 1,400 U.S. corporations that are partially, or wholly owned by an employee stock ownership plan (ESOP), and over 900 professionals who provide services to corporations with ESOPs. The ESOP Association's contact information is below:

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STATEMENT SUMMARY

The ESOP Association's statement for the record will cover several topics concerning the Department of Labor's (DOL) proposed regulation on the definition of a fiduciary including:

Part I. Association's Education Mission Focuses on ERISA Compliance

Part I explains why education is an important tool in helping to create well-managed, high performing ESOP companies.

Part II. Concerns Regarding the Definition of a Fiduciary

The ESOP community address its concerns with the appropriateness of converting ESOP appraisers into ERISA fiduciaries.

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

Part III will address the following concerns:

- The Proposed Regulation Exceeds the DOL's Authority
- The Proposed Regulation Interferes with the Trustee's Traditional Oversight Role over the Appraiser

Part IV. Negative Impacts on Pension Benefits

In Part IV, how making an ESOP appraiser an ERISA fiduciary will create a negative impact on retirement benefits.

Part V. Alternative Approaches

Two alternative approaches will be discussed:

- Provide Guidance
- Appraiser Credentials

Part VI. Conclusion

Final thoughts on the negative impact the DOL's proposed regulation on the definition of a fiduciary will have on the ESOP community.

THE ESOP ASSOCIATION'S STATEMENT FOR THE RECORD

The following information will give you an understanding of the Association and its membership. These statistics are intended to provide 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.
- 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 65263-65278, October 22, 2010, Proposed Regulation).

On behalf of our membership, the Association appreciates the opportunity to express its views in regard to redefining of the term fiduciary.

Part I. Association's Education Mission Focuses on ERISA Compliance

The mission of the Association 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.

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.

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.

Part II. Concerns Regarding the Definition of a Fiduciary

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 Department of Labor (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 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 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.

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

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.

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.

Part 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.

Part V. Alternative Approaches

Provide Guidance

We are not aware, and do not acknowledge, 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.

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.

Part VI. Conclusion

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.