ESCA

EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

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Before the Department of Labor
Public Hearing on
"Definition of Fiduciary – Investment Advice"

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Good morning. My name is Linda E. Carlisle. I am a partner at White & Case LLP and I have served as general counsel to the Employee-Owned S Corporations of America ("ESCA") since its creation. ESCA is the national voice for S corporations owned by employee stock ownership plans ("ESOPs"). ESCA's members include privately-held ESOP-owned S corporations and many professional advisory firms that serve the ESOP community.

ESCA, its member companies, and their tens of thousands of employee owners appreciate the opportunity to address the Department of Labor's ("DOL's") proposed amendments to regulation 29 C.F.R. § 2510.3-21 (the "Proposed Regulation") that would expand the types of advice and recommendations that constitute rendering "investment advice" for purposes of the definition of a "fiduciary" under section 3(21)(A)(ii) of the Employee Retirement Income Security Act ("ERISA"). In particular, the Proposed Regulation would make the provision of an appraisal or fairness opinion to an ESOP concerning the value of securities or other property "investment advice" with the result that the duties and liabilities of an ERISA fiduciary would be imposed on any person providing such an appraisal or fairness opinion.

ESOPs are required under section 4975(e)(7) of the Internal Revenue Code to be designed to invest primarily in employer securities. Section 401(a)(28)(C) of the Internal

Revenue Code requires an ESOP to obtain valuations of employer securities by an independent appraiser at least annually. In addition, section 4975(d)(13) of the Internal Revenue Code and section 408(e) of ERISA provide that an ESOP may not purchase employer securities for more than "adequate consideration" (*i.e.*, the fair market value of the employer securities as determined in good faith by the ESOP trustee or the named ERISA fiduciary). Since S corporation stock is not publicly traded, the ESOP trustee (or the named ERISA fiduciary with respect to the ESOP) cannot rely on market prices or quotations to determine the fair market value of employer securities. Accordingly, such ESOP trustee or ERISA fiduciary generally engages an expert appraiser to give advice regarding the fair market value of the employer securities. ESCA members therefore have a keen interest in the effects that the Proposed Regulation would have on the advisors who provide appraisal services to S corporation ESOPs and the ability of the S corporation ESOPs to obtain expert assistance and advice in performing required valuations of employer securities.

Background.

Section 3(21)(A)(ii) of ERISA defines a "fiduciary" with respect to an employee benefit plan to include any person that renders "investment advice" for a fee or other compensation with respect to any moneys or other property of such plan or has any authority or responsibility to do so. Regulations issued by the DOL in 1975 (the "Regulation") further defined the circumstances under which a person is considered to render investment advice to an employee benefit plan within the meaning of section 3(21)(A)(ii) of ERISA. Under the Regulation, a person that does not have discretionary authority or control with respect to the purchase or sale of securities or other property for the plan is considered to render investment advice only if five conditions are met:

1. Such person renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property;
2. Such advice is rendered on a regular basis;
3. Such advice is rendered pursuant to a mutual agreement, arrangement, or understanding, with the plan or a plan fiduciary;
4. Such mutual agreement, arrangement or understanding is that the advice will serve as a primary basis for investment decisions with respect to plan assets; and
5. Such mutual agreement, arrangement, or understanding is that the advice will be individualized based on the particular needs of the plan.

Shortly after the promulgation of the Regulation, the DOL in 1976 issued Advisory Opinion 76-65A, which concluded that a valuation of closely-held employer securities to be purchased by an ESOP that did not involve an opinion as the relative merits of purchasing the securities, but that would be relied upon in purchasing such securities, would not constitute investment advice under the Regulation. Thus, in Advisory Opinion 76-65A, the DOL specifically considered whether a person who provides an ESOP with a valuation opinion with respect to closely-held employer securities would be considered to be rendering investment advice and concluded that rendering such an opinion, by itself, would not constitute rendering investment advice for purposes of section 3(21)(A)(ii) of ERISA. ERISA fiduciary status, therefore, is not imposed on persons by reason of their providing valuation opinions to an ESOP for purposes of the required annual valuation of employer securities held by the ESOP or for purposes of a purchase of employer securities by the ESOP under the current DOL interpretation of ERISA.

DOL's Stated Reasons for Changes Affecting ESOP Appraisals.

The preamble to the Proposed Regulation notes that a common ERISA violation found in the DOL's ESOP enforcement initiatives is the incorrect valuation of employer securities and that these cases include instances in which plan fiduciaries have reasonably relied on faulty valuations prepared by professional appraisers. The preamble states that the DOL believes that broadening the definition of investment advice to include appraisals and fairness opinions provided in connection with a plan's purchase of securities or other property may directly or indirectly address these enforcement issues and align the duties of the persons providing such appraisals or opinions with those of the plan fiduciaries that rely upon such appraisals or opinions.

Proposed Changes Affecting ESOP Appraisals.

The Proposed Regulation would expand the types of advice and recommendations that result in fiduciary status under section 3(21)(A)(ii) of ERISA to include the provision of an appraisal or fairness opinion concerning the value of securities or other property under an agreement, understanding or arrangement that such appraisal or opinion may be considered in connection with making investment decisions. This change would supersede DOL Advisory Opinion 76-65A. Thus, ERISA fiduciary status would be imposed on all persons who provide an ESOP with the required annual appraisal of employer securities held by the ESOP or an appraisal of employer securities to be purchased by the ESOP.

ESCA's Concerns Regarding the Proposed Regulation.

The Proposed Regulation would expose ESOP appraisers to a major expansion of legal liability and increased costs of insurance. ESCA understands that for many of the top-tier appraisal firms, ESOP appraisals are not a major component of the firm's business. ESCA is

concerned that such established and well-respected appraisal firms will choose to discontinue their ESOP appraisal business rather than face the additional legal exposure and insurance costs that would result from the Proposed Regulation. Removing the most experienced and competent ESOP appraisers from the ESOP appraisal marketplace will force many ESOPs to use smaller and less-experienced appraisers, who may not be able to provide superior service and necessary ESOP expertise to ESOPs.

In addition, the increased insurance costs that ESOP appraisers will incur will inevitably be passed on to the ESOPs. ESCA is concerned that such increased costs imposed on the ESOP-owned S corporation structure will diminish the retirement savings of the S corporation ESOP participants and may discourage the formation of new S corporation ESOPs.

Thus, ESCA is concerned that expanding the definition of "investment advice" to include the valuation of closely-held employer securities that an ESOP is required to obtain at least annually or when purchasing employer securities will not improve the quality of the appraisals or valuation advice obtained by ESOPs from their current advisors, but will have the perverse effect of reducing the number of competent appraisers available to make such valuations and would significantly increase the ESOP's cost of obtaining this necessary service.

Alternatives.

Comments with respect to the Proposed Regulation have suggested alternative approaches to the problem of incorrect valuations of employer securities held by an ESOP. ESCA has not endorsed any specific alternative approaches, but urges the DOL to consider alternative means of ensuring correct valuations of employer securities.

Among the alternative approaches suggested in other comments to the Proposed Regulation is that the DOL issue regulations that provide more specific guidance to ESOP

fiduciaries regarding their duties to correctly value employer securities. The DOL issued proposed regulations in 1988 that set forth guidance regarding how ESOP fiduciaries should determine the fair market value of closely-held employer securities to ensure that such valuations are good faith determinations of fair market value. The DOL, however, has never finalized those proposed regulations. Guidance issued by the DOL in final regulations need not be limited to the guidance in the 1988 DOL proposed regulations and could provide specific guidance regarding the necessary expertise, training, or experience of persons providing valuations opinions to an ESOP.

Conclusion.

It has been 35 years since the DOL first issued the regulations that govern the types of investment advice relationships that give rise to fiduciary duties on the part of an investment advisor. Given the potential problems raised by the Proposed Regulation, ESCA respectfully requests that the DOL not adopt the Proposed Regulation until it has thoroughly considered other ways to ensure that ESOP-owned S corporations receive reliable appraisals.