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May 27, 2022

**Submitted Electronically**

Office of Exemption Determinations
Employee Benefits Security Administration
United States Department of Labor
200 Constitution Ave NW
Washington, DC 20210

**Re: Procedures Governing the Filing and Processing of Prohibited Transaction Exemption Applications (RIN 1210–ACO5)**

Dear Sir or Madam:

On behalf of the American Society of Appraisers ("ASA"),[1] we are writing to comment on the proposed rule issued by the U.S. Department of Labor ("Department') on "Procedures Governing the Filing and Processing of Prohibited Transaction Exemption Applications" ("Proposed Rule").[2]

Members of ASA are experts on the valuation of closely held businesses and generally accepted valuation principles, and regularly advise ERISA trustees on the fair market value of plan assets for employee stock ownership plan ("ESOP") transactions, annual ESOP valuations, and a range of other ERISA matters involving asset value. Thus, ASA and its members have a significant interest in the Proposed Rule because it proposes to redefine "qualified independent appraiser" and "qualified appraisal report," as those terms are used in the Department's Prohibited Transaction Exemption Procedures.[3]

ASA opposes the Proposed Rule for the reasons discussed below and urges the Department to withdraw the proposal entirely.

[1] ASA is a nonprofit, professional organization that teaches, tests, and credentials highly qualified appraisers of businesses and assets. ASA's mission is to foster public trust of members and the appraisal profession through the highest levels of ethical and professional standards. ASA fosters professional excellence through education, accreditation, publication, and other services with an emphasis on professional ethics to protect the public. ASA is a founding member of The Appraisal Foundation, authorized by Congress as the organization responsible for setting The Uniform Standards of Professional Appraisal Practice ("USPAP") for the valuation profession. ASA's world-renowned education programs are taught by leading appraisal experts.
[2] 87 Fed. Reg. 14722 (Mar. 15, 2022).
[3] *See* 29 C.F.R. § 2570.31(h) & (i).

## COMMENTS

### A. The Proposed Rule Would Erode Appraisers' Independence and Impartiality.

ASA shares the Department's policy objective of "ensur[ing] that the appraiser will not be pressured to deliver a valuation reflecting undue influence from the fiduciary."[4] Yet in proposing to—among other things—redefine "qualified appraisal report" to "require the report to be prepared solely on behalf of the plan" and therefore "only take[] into account the interest of the plan and its participants and beneficiaries when it produces the report[,]" the Department directly undermines that goal.[5] Indeed, the Proposed Rule would create internally inconsistent requirements that no appraisal report prepared in accordance with generally accepted ethical rules, appraisal standards, and valuation principles could ever satisfy.

Longstanding ethical standards of the valuation profession already require appraisers to perform appraisals independently and without bias in favor of any party. USPAP—which sets forth the generally recognized standards of the valuation profession—contains an Ethics Rule that imposes specific conduct requirements on valuation providers, including an impartiality requirement.[6] Appraisals performed in compliance with USPAP will not lead to a "valuation reflecting undue influence from the fiduciary."

The ASA's Principles of Appraisal Practice and Code of Ethics further underscore the professional obligation to remain impartial and independent in performing appraisal 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, and the dollar amount of an estimated earning power. *This numerical result must be developed objectively and without bias. It is unrelated to the desires, wishes, or needs of the client who engages the appraiser to perform the work.*[7]
>
> 4—Appraiser's Obligation to His/Her Client
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> The appraiser's primary obligation to his/her client is to *reach complete, accurate, and credible 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.[8]

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[4] *See* 87 Fed. Reg. at 14725.
[5] *Id.*
[6] *See Uniform Standards of Professional Appraisal Practice*, Appraisal Standards Board of the Appraisal Foundation, Ethics Rule (2020–2021 ed.) ([A]n appraiser "must not perform with bias" and "must not advocate the cause or interest of any party or issue….").
[7] *See Principles of Appraisal Practice and Code of Ethics*, American Society of Appraisers (Nov. 18, 2020) (emphasis added).
[8] *See Id.* (emphasis added).

Indeed, it is because of this ethical commitment to objectivity and impartiality that courts frequently appoint appraisers to value disputed assets in accordance with USPAP and ASA principles.[9]

The American Institute of Certified Public Accountants ("AICPA") has similarly promulgated a Code of Conduct for its members, including certified public accountants ("CPAs") performing appraisal work. A fundamental precept of the Code of Conduct is that the appraiser must be "independent in the performance of professional services."[10] 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."[11]

Federal regulations promulgated by the Internal Revenue Service ("IRS") mirror these ethical standards. For example, IRS regulations provide that an ESOP can be considered a qualified trust under the Code only 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*."[12] Among other things, a "qualified independent appraiser" under these regulations "*is not a party to the transaction, and is not related to any party to the transaction*."[13] Under IRS advisory guidance, a "qualified appraisal" has been conducted by a "qualified appraiser" within the meaning of § 1.170A–13 only if it was conducted "in accordance with generally accepted appraisal standards."[14] The IRS has clarified that this would include appraisals "consistent with the substance and principles of [USPAP]."[15]

More fundamentally, the very concept of fair market value—the most widely recognized and accepted standard of value, and the standard of value required for ESOP valuations—depends on an appraiser's independence and impartiality. As defined by Internal Revenue Ruling 59–60, "fair market value" is:

> . . . the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the *hypothetical* buyer and seller are assumed to be able, as well as willing, to trade

[9] *See, e.g.*, *Bd. of Cnty. Sup'rs of Prince William Cnty.*, *Va. v. United States*, 47 Fed. Cl. 714, 717 & n.5 (2000) ("In light of the polarized positions of the parties on the issue of valuation after extensive litigation, and the highly suspect values assigned by prior expert witnesses, the parties agreed to a court appointed, neutral appraiser to assess the fair market value" of the disputed asset conducted in accordance with USPAP and the "code and standards . . . governing professional ethics and professional appraisal practice.").
[10] See AICPA Code of Professional Conduct, ET § 101.01.
[11] *Id.* at § 100–1.06.
[12] *See* IRC § 401 (a)(28)(C), as defined in Treasury regulations promulgated under Code § 170(a)(1) (emphasis added).
[13] *See* 26 C.F.R. § 1.170A–13(c)(5)(i)(emphasis added).
[14] *See* 2006–46 I.R.B. 902.
[15] Proposed Reg. 26 C.F.R. § 1.170A–17(a) (1)–(2) (proposing to codify guidance under I.R.B. 2006–46).

> and to be well informed about the property and concerning the market for such property.[16]

The construct of "hypothetical" buyers and sellers requires an appraiser seeking to determine an asset's fair market value to ignore any party's particular characteristics, interests, or motivations.[17] Simply put, "[f]air market value must be determined objectively."[18] And, an objective appraisal does not favor the interest of any party.

By requiring that a "qualified independent appraiser only take[] into account the interest of the plan and its participants and beneficiaries when it produces the [appraisal] report," the Proposed Rule would conflict with the standard of fair market value and would compel accredited appraisers to violate their ethical commitments and mandatory appraisal standards. Taking into account the interests of a party to a transaction—let alone doing so to the exclusion of any other party's interests, as the Proposed Rule commands—conflicts with the standard of fair market value.

To demonstrate, consider that fair market value is often expressed as a range of indicated value rather than a single-point dollar amount.[19] A party to a transaction involving an asset valued by an appraiser will naturally seek to maximize its returns by gravitating toward one end of that range: The buyer would prefer the lowest price on the range of indicated value, while the seller would prefer the highest price. Yet the appraiser's task is to "prepare the most soundly reasoned and thoroughly documented valuation possible," not to "become [an] advocate[] or perform advocacy functions with regard to valuation."[20]

In other words, it is up to the parties to determine at which price within the range of indicated fair market value to transact. But if, as the Proposed Rule instructs, an appraiser must account only for the interest of the plan and its participants and beneficiaries in preparing an appraisal report, then the appraiser must become an advocate for the plan by putting a thumb on the scale—that is, by skewing the range of indicated value downward or upward, depending on the plan's interest. Under the Proposed Rule, an appraiser confronted with this choice must *always* decide in accordance with the plan's interest, rather than relying on his or her own expert analysis and well-informed, independent, and professional judgment.

In short, applicants could rarely—if ever—satisfy the Department's Prohibited Transaction Exemptions requirements if the Proposed Rule were promulgated, because an applicant seeking an exemption must submit a "written appraisal report [that] determin[ed] the

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[16] Rev. Rul. 59–60, 1959–1 C.B. 237 (1959) (emphasis added); *see also* Shannon P. Pratt, *Valuing A Business: The Analysis & Appraisal of Closely Held Companies* 29 (2022 6th ed.) ("Both the buyer and seller are *hypothetical* parties. Therefore, specific individuals or parties who might have a particular interest in the subject of the appraisal are not considered as potential buyers or sellers.") (emphasis added).
[17] *Id.* at 42 ("[A] price would not be considered representative of fair market value if influenced by special motivations not characteristic of a typical buyer or seller.").
[18] *See Kraft, Inc. v. United States*, 30 Fed. Cl. 739, 766 (1994).
[19] *See* Pratt, *Valuing a Business* at 488 ("Experienced analysts expect to derive a range of value indications."); *see also CSX Transp., Inc. v. Ga. State Bd. of Equalization*, 552 U.S. 9, 16–17 (2007) ("Valuation is not a matter of mathematics [but a] range of possible market values.").
[20] *See* Pratt, *Valuing a Business* at 488.

fair market value of the subject asset(s),"[21] but no appraisal that "takes into account the interest of the plan and its participants and beneficiaries" can be considered an objective determination of fair market value. Indeed, appraisers conducting valuations in accordance with the Proposed Rule would be using a standard of value akin to investment value, which, in contrast to fair market value, is the "value of an asset or business to a *particular owner or prospective owner* for individual investment or operational objectives."[22] Thus, by redefining the Prohibited Transaction Exemption guidelines in the manner reflected by the Proposed Rule, the Department would effectively eliminate prohibited transaction exemptions altogether.

**B. The Proposed Rule Would Degrade the Quality of Appraisal Services Available to the Regulated Community.**

Aside from being inconsistent with the appraisal profession's ethical and professional commitments and incompatible with the premise of fair market value, the Proposed Rule's revenue limitation and prohibition on indemnification would degrade the quality of appraisal services available to the regulated community.

The Proposed Rule's redefinition of "qualified independent appraiser" to include a limit of two percent on "the amount of present and projected revenue an appraiser may receive from parties involved in the exemption transaction relative to revenues it received from all sources" underscores this likelihood. Assuming an appraisal firm charged $50,000 per engagement and took on 50 engagements a year (an aggressive workload for all but the largest firms), its annual revenue would be $2,500,000. To satisfy the two-percent-of-revenue requirement, that firm could *never* accept more than one assignment per client each year—if it did, the firm's revenue from that client would total $100,000, or 4% of the appraiser's $2,500,000 annual revenue, and would violate the Proposed Rule.

For smaller appraisal firms, where each client represents a larger proportion of annual revenue, satisfying the two-percent-of-revenue requirement would prove difficult if not impossible. It is difficult to see how new appraisers could enter the marketplace under the Proposed Rule—after all, a startup appraiser's first engagement would represent 100% of annual revenue. The report generated by that engagement would flunk the Proposed Rule, discouraging plan fiduciaries from engaging that otherwise qualified appraiser.

The Proposed Rule also would prohibit appraisal firms from including industry-standard indemnification agreements in their engagement letters. Large appraisal firms would likely respond to the indemnification prohibition by exiting the business of valuing ERISA plans' assets. In the appraisal of high-value or complex assets, for which plans most often engage large appraisal firms, this prohibition would expose appraisers to tens—or possibly hundreds—of millions of dollars of potential liability, dwarfing any fees associated with the assignment. Given this high-risk, low-reward calculus, large appraisers—which are commonly a practice group

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[21] *See* 29 C.F.R. § 2570.34(c)(4)(i).

[22] *See* Pratt, *Valuing a Business* at 30 (emphasis added); *see also Reich v. Valley Nat. Bank of Arizona*, 837 F. Supp. 1259, 1282 (S.D.N.Y. 1993) ("Investment value to the ESOP is not the same as fair market value, and it is the latter which is required by ERISA § 3(18).").

within a diversified investment bank or financial advisory firm—would shift their resources to providing financial advisory services to non-ERISA plan clients.

Lacking a diverse client base and unequipped to provide an array of financial services to which they could redirect their resources, smaller appraisal firms would be left as the sole providers of appraisal services to ERISA plans. This is not a speculative or de minimis concern. The ASA is aware that one large financial advisory services firm already has ceased servicing the regulated community given the Department's informal insistence on removing these standard and customary engagement provisions in the exemption application process.

Alternatively, if large appraisers decide to remain in the marketplace, they would necessarily increase their fees significantly as a form of self-insurance if indemnification provisions are eliminated from appraisal agreements. That is because indemnification provisions—industry standard in valuation engagements—allow valuation and other financial advisory services firms to reduce their fees by shifting costs arising from litigation risk to clients. Absent the fee reductions enabled by this risk-shifting, only deep-pocketed clients could afford the services of large appraisal firms, leaving clients of more modest means to select from only among smaller appraisers—who, for the reasons described above, would face difficulty meeting the Proposed Regulation's definition of a "qualified independent appraiser."

The Proposed Rule has the real prospect of significantly—and negatively—affecting the quality of appraisals of ERISA plan assets by simultaneously making it harder for smaller appraisers to qualify as "qualified independent appraisers" while also either hastening large appraisers' exit from the marketplace or significantly increasing the cost of appraisals to the regulated community. The result would be that a higher percentage of valuation work would go to low-cost, less-qualified providers that compensate for a lack of experience and training by offering their services at prices more qualified firms with experienced professionals and rigorous quality-control procedures cannot match. These small, undercapitalized firms may not appreciate, or be as concerned as more established firms about the risks of conducting appraisals without indemnifications or limitations of liability, because they are, in essence, judgment-proof. Thus, in seeking to protect plan participants and beneficiaries, the Proposed Rule would likely have the unintended opposite effect by forcing fiduciaries to rely on riskier, lower quality appraisal reports from less-qualified appraisers.

## C. The Department Has Not Demonstrated that the Proposed Rule Would Lead to Improved Appraisal Services.

As set forth above, ASA is gravely concerned that the Proposed Rule would negatively affect the quality of appraisal services available to the regulated community while raising the bar for prohibited transaction exemptions to a level that may be practically impossible to satisfy. In short, the Proposed Rule's foreseeable effect is to fundamentally alter the appraisal landscape with respect to ERISA plan assets.

One would expect the Department to offer a compelling justification for a rulemaking likely to have such a significant impact on the status quo. Yet the Department offers no empirical justification at all. In introducing the proposed revisions of the definitions used throughout the Prohibited Transaction Exemption procedures, the Department notes only that the "changes are proposed to address issues that the Department has often experienced in its regular review of exemption applications." In justifying the imposition of a requirement that qualified independent appraisers derive no more than two percent of their annual revenue from any party to a transaction, the Department explains, without any empirical support, that it is based on "the Department's default assumption that a two percent limitation is essential to ensuring the appraiser's independence."

Moreover, the Department describes the revised definition of "qualified appraisal report" to require that an appraiser only take into account the interest of the plan and its participants and beneficiaries as "[f]urther bolstering the independence of the appraiser"—which, rather than justify the revision in empirical terms, simply restates its aim. In explaining the prohibition on indemnification and limitation of liability provisions in appraisal agreements, the Department states only that these provisions "undermine the protective conditions of the exemption, compromise the independence of their services, and cast doubt on the reliability of the service providers' work." These justifications amount to no more than the unverifiable, anecdotal views of the Department and its enforcement staff, who—while dedicated public servants—are not valuation experts, and paint those who provide professional valuation services in the worst possible light.

The evident lack of empirical support, and its reliance on issues known only to the Department, underscores a larger issue. A notice of proposed rulemaking must not only provide notice of what the agency proposes to do, but must also reveal the factual bases for its proposed rule.[23] Because the Proposed Rule as it relates to appraisers rests on "issues" encountered by the Department but unknown to the public, the Department's privately developed "default assumptions," and the Department's undisclosed perceptions about appraisers' independence, the Department's notice of proposed rulemaking is deficient.

For example, the effect of indemnification and limitation of liability provisions on professional service provider's independence is the subject of robust academic and regulatory inquiry. The Public Company Accounting Oversight Board's standing advisory group has issued public reports on the effects on independence of indemnification clauses in audit engagement letters.[24] Only after considering multiple data sources and conferring with relevant industry representatives such as the AICPA, the advisory group concluded that while certain indemnification provisions assuring an accountant of immunity for liability arising from his own negligence would impair the auditor's independence, that independence is not impaired by indemnification provisions relieving the auditor from any liability arising from the client's misrepresentations.[25]

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[23] *See* Administrative Procedure Act ("APA") § 553(b); *see Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 393 (D.C. Cir. 1973) ("It is not consonant with the purpose 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 Com. v. SEC*, 443 F.3d 890, 899 (D.C. Cir. 2006) ("[T]he information that must be revealed for public evaluation are the technical studies and data upon which the agency relies" in its rule-making.) (internal quotation marks omitted).

[24] *See* PCAOB, *Emerging Issue – The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters* (Feb. 9, 2006), https://pcaobus.org/News/Events/Documents/02092006_SAGMeeting/Indemnification.pdf.

[25] *Id*. at 2–3.

The process the advisory group undertook was in some respects more important than that process's result. Rather than rely on unsupported anecdotal views and private assumptions, as the Department has done in developing the Proposed Rule, the advisory group issued a detailed, turn-by-turn roadmap of its deliberations. The community potentially affected by the advisory group's decision-making could grasp the group's rationale and probe its justifications. The same cannot be said for the Proposed Rule.

In short, the Department has not established empirically that there are issues with appraisers' independence necessitating revisions to the Prohibited Transaction Exemption guidelines or explained how the Proposed Rule would resolve those issues. Indeed, if, as the Department claims, the Proposed Rule would affect no more than "20 small plans (0.0031% of small plans) [that] file prohibited transaction exemption applications each year,"[26] the Proposed Rule appears to be no more than a solution in search of a problem. Yet it is unlikely that the Proposed Rule's effects will be confined to a handful of prohibited transaction applications each year, and they will instead reverberate throughout the Department's entire ERISA-enforcement program. For example, the Department may adopt the position during ESOP investigations that valuations not prepared in accordance with the Proposed Rule do not qualify as independent, lest inconsistencies in the Department's enforcement program arise. In this way, the Proposed Rule could have drastic repercussions in the regulated community.

For all the reasons described above, the Proposed Rule's likely consequence will be to degrade, rather than improve, the quality—and increase the cost—of appraisal services available to the regulated community. Moreover, the Proposed Rule will likely have far more wide-ranging effects that the Department appears not to have fully considered. ASA urges the Department to withdraw this proposal entirely and, where it sees issues with the quality of work being performed, engage with ASA and others in the valuation profession to address these issues.

* * *

We appreciate the chance to comment on the Proposed Rule and would welcome the opportunity to discuss ASA's views more fully at any hearing on the Proposed Role that should be scheduled. Please do not hesitate to contact either of us if you have any questions regarding the above.

Sincerely,

American Society of Appraisers

[26] 87 Fed. Reg. at 14738.