Following is letter from Representative Rokita to the DOL and the DOL's response.

Representative Todd Rokita (IN)

Rokita Question 1: Employee Stock Ownership Plan (ESOP) companies must have annual valuations of their stock. Additional valuations associated with acquisitions and other business activity may need to be performed. It has been brought to my attention by constituents that a regulation proposed by the Department of Labor will redefine valuators of these companies' ESOPs as ERISA fiduciaries. (U.S. Department of Labor, Employee Benefits Security Administration, Definition of the Term fiduciary, Federal Register, October 22, 2010, page 65263.) It is my understanding that the proposed regulation will have an effect on many other activities in the financial sector, as well. This regulation will increase the cost of operating and establishing an ESOP by forcing valuators to obtain special ERISA fiduciary insurance, and in fact, many competent valuators may drop ESOP valuation work altogether, leaving less competition for ESOP companies to review before hiring a valuator.

I have been contacted by constituents in my area about this proposal that reverses the position of four Republican and two Democratic Administrations. You have received protests from the American Institute of CPAs, the American Council of Engineering Companies, the Food Marketing Institute, the Chamber of Commerce, and nearly all the employer groups.

A common complaint is your Department provides no data to support the claim that ESOP valuations are wrong. This proposal does not appear to address a documented problem and it will increase costs, discourage ESOP formation, and cause needless gridlock and confusion between ESOP trustees and the valuators. Please provide me with the data you used to document the need for regulatory action in this area and explain why this particular approach is the least burdensome means of achieving your objectives.

DOL Reponse

A: In the early 2000s, EBSA began to identify issues involving ESOPs, encompassing many different violations of ERISA and affecting over 500,000 participants. Based on this investigative experience, EBSA decided to address these issues through a national enforcement project which was established in FY 2005. EBSA continues to find fiduciary and self-dealing violations in connection with the ESOP enforcement project, and examples of these findings are set forth below.

In many instances, the most important investment advice to a plan concerns how much to pay for an asset. In the case of ESOPs, in particular, the key decision is typically not whether to buy stock – the plan was established precisely to buy and hold employer stock – but rather what price to pay for the stock. Accordingly, in the case of closely-held companies, ESOP trustees typically rely on professional appraisers and advisers to value the stock. Often, there is little or no negotiation over price. Because other plan fiduciaries are not valuation professionals, there is virtually total reliance on the appraiser and the price determined by the appraiser is often the price at which the transaction will take place. As a practical matter, the price is often effectively set by the appraiser. The appraisers routinely hold themselves out as offering a professional service to the plans that will be rendered with care, impartiality, and skill. Frequently, ESOP transactions involve most or all of a plan's assets, and the Department's own cases have involved transactions involving hundreds of millions of dollars and more. The proposed regulation reflects these realities. Although the current regulation expressly includes advice on the value of a security as covered advice, a 1976 Advisory Opinion stated that the valuation of closely held stock for ESOPs is not fiduciary advice. The proposed regulation simply corrects the Advisory Opinion, and ensures that appraisers can be held accountable under ERISA when they fall short of professional standards and cause losses to retirement plans.

ESOP transactions are not the only area where unqualified or conflicted appraisers can cause serious losses to retirement savings. In principle, we see no basis for distinguishing advice on how much to pay for an asset from advice on whether to buy an asset for a given price. Improper appraisals have been central to numerous Department investigations and enforcement actions. The Department has uncovered abuses reflecting flawed valuation methodologies, internally inconsistent valuation reports, the use of unreliable and outdated financial data, the apparent manipulation of numbers and methodologies to promote the preferred prices of selling shareholders (who are usually corporate insiders), and tax abuse. When an ESOP overpays for the stock of its employer sponsor, it is the workers in the plan that lose. Because under existing regulations the appraisers were not plan fiduciaries, however, they were not accountable for the losses that they caused to retirement plans. Examples from the Department's investigations and litigation include the following:

a. A valuation firm failed to properly consider $1.5 billion in debt on a company's books in addition to numerous other errors of analysis. The case ultimately settled for $38.7 million, none of which was paid by the appraisal firm.

b. A major valuation firm used earnings figures that were significantly greater than justified by the company's audited financial statements, applied a 30% control premium although the plan did not acquire control, and inconsistently applied different earnings measures from year to year. The case settled for over $71 million, none of which was paid by the appraisal firm, and injunctive relief.

c. A valuation firm accepted unrealistic company earnings projections and failed to consider the company's ability to repay its obligations, among other errors. The case ultimately settled for $17.5 million, none of which was paid by the appraiser.

d. ESOPs of several related companies purchased employer stock in reliance on an appraiser who had previously been convicted of felony embezzlement from a trust, who used false qualifications, and who lacked even a college degree. The appraisals used financial performance estimates, which had little or no connection to actual financial performance, and assumed unjustified and unsupportable levels of growth, profitability, and freedom from competition. For example, one of the valuations posited a wholly unrealistic return on invested capital of more than 11,000%. This case is currently in litigation.

e. A major valuation firm advised a large company to engage in a stock transaction – nominally involving $1 billion – involving an ESOP that the participants did not even know existed. We concluded the transaction was a tax sham. In settlement, the company was required to refund all of the tax benefits to the U.S. Treasury, and the plan's trustee was required to refund all of its fees. More than $220 million was paid to the Treasury.

f. In various transactions involving the Genovese crime family, an appraiser valued property at inflated amounts to justify plan loans and purchases. In one of the transactions, a member of the crime family first agreed to buy real estate for $7.46 million; the appraiser then valued the property at $15.8 million. The plan in turn loaned out $15.8 million based on the appraisal and the member of the crime family used the loan proceeds to buy the property for $7.46 million, pocketing the balance of the loan. An independent appraiser subsequently appraised the property for $5 million. Criminal forfeiture actions ultimately brought some restitution to the pension plan. The appraiser, however, was not a fiduciary under the current regulation.

Under Section 502(a)(2) of ERISA, a loss remedy is only available from plan fiduciaries. As a result, under the current regulatory structure, neither the Secretary nor plan participants can hold the appraiser directly accountable for disloyal or imprudent advice about the purchase price, no matter how critical that advice was to the transaction. The sole recourse available to the Secretary and plan participants is against the trustee who relied on the advice, rather than against the professional financial expert who rendered the valuation opinion that formed the necessary basis for the transaction. The Department appreciates the comments expressing concerns about potential cost increases, and remains committed to ensuring that the benefits of any proposed changes outweigh the costs. However, plans and employers – especially small employers -- are ill-served by the current regulation's failure to hold advisers accountable for failing to properly discharge their responsibilities. Employers and participants will benefit from being able to rely on professional impartial advice that adheres to the fundamental fiduciary duties of prudence and loyalty.

Further, with respect to additional data available on this question, the proposal specifically requests comment on the Department's cost estimate. We will actively consider the information provided to the Department in response to this request and expect to have a more fulsome economic analysis as part of the final regulation.