The ESOP Association

May 27, 2022

SUBMITTED VIA REGULATIONS.GOV

Chris Cosby
Acting Office Director
Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue NW, Suite 400
Washington, DC 20210

Re: Comments on *Procedures Governing the Filing and Processing of Prohibited Transaction Exemption Applications*, 87 Fed. Reg. 14,722 (March 15, 2022) (RIN 1210-ACO5) (the "Proposed Rule")

Dear Acting Office Director Cosby:

We write on behalf of The ESOP Association (the "Association") and ESCA, the Employee-Owned S Corporations of America (collectively, the "Commenters"), to share our comments on the Proposed Rule. Although ESOPs rely on a statutory prohibited transaction exemption ("PTE") and do not typically need to apply for individual PTE relief, we are concerned that some of the principals in the Proposed Rule could have negative implications for ESOPs. As discussed in more detail below, our concerns are as follows:

- The Proposed Rule may be finalized as written and applied to statutory PTE transactions by underinformed courts or DOL field agents, using the Proposed Rule by way of reference or analogy, to ESOP transactions. The would subject ESOPs and their providers to considerably more confusion as to what guiding principles may be imposed upon them and subject ESOPs to further expensive, inappropriate controversy.

- The Proposed Rule may be a harbinger of further DOL guidance that may be issued with respect to ESOPs. We are concerned with augmented definitions in the Proposed Rule – specifically with respect to a "qualified independent appraiser" and a "qualified independent fiduciary" – that apply seemingly arbitrary and unworkable standards that may only serve to drive professional and qualified practitioners out of the community.

- The Proposed Rule appears to raise the standards for those seeking an individual PTE from those otherwise required by ERISA. Indemnification is specifically permitted by statute. However, the revised guidance indicates it should not be part of an engagement if an individual PTE is to be issued.

- The regulatory process seems to be circumvented by the revisions included in the Proposed Rule. Statutory PTEs should not face an environment where such transaction may have to meet inapplicable standards as such may be applied by an inexperienced arbiter (e.g., court or DOL field age).

Given the importance of the issues, we request that the Department hold public hearings on the Proposed Rule.

I. *Background on the Association and ESCA*

Formed in 1978, the Association is the largest and oldest non-profit organization representing the interests of businesses that sponsor Employee Stock Ownership Plans (ESOPs) and the myriad professionals and advisors who provide professional support for ESOPs. Organized as a 501(c)(6) entity under the Internal Revenue Code, the Association represents more than 2,100 U.S. companies in all 50 U.S. states that range in size from 280,000 employees to fewer than 50 employees. The typical Association corporate member will have between 100 and 250 employees and annual gross revenues of approximately $50-75 Million. Further, the Association also represents more than 1,100 professionals and their firms such as valuation advisors, accountants, trustees, attorneys, plan administrators, lenders and others doing professional work in the space.

ESCA is the Washington, DC voice for employee-owned S corporations, representing private employee-owned companies operating in every state across the nation, in industries ranging from heavy manufacturing to construction to grocery stores. The expansion of subchapter S corporation employee stock ownership plans (S ESOPs), following Congress' creation of that structure in 1998, is testimony to the fact that this business model offers a valuable way to transition ownership, empower workers, boost productivity and generate long term retirement savings for working Americans and their families.

II. *The Commenters are concerned that the DOL will finalize the Proposed Rule as written and subsequently seek to apply it to ESOPs through reference and other indirect mechanisms*

The Proposed Rule does not apply to ESOPs, and a final rule mirroring the Proposed Rule should not either.

We urge the DOL to clarify that the Proposed Rule, if finalized, has no implication on existing statutory PTEs, including ERISA section 408(e). Many of the processes and issues raised by the Proposed Rule arise in the ESOP context. Consequently, we are concerned that the DOL's positions in the Proposed Rule could be misunderstood by courts or the DOL's own field offices, resulting in improper application to ESOPs and raising unnecessary controversy and costs for ESOPs.

As the DOL is aware, Congress intended to facilitate ESOP creation by codifying a statutory PTE under ERISA section 408(e) to allow an ESOP's acquisition of qualifying employer securities. This statutory PTE has several conditions, including one that the acquisition or sale is for adequate consideration. The DOL issued a proposed regulation defining adequate consideration 35 years but never finalized the rule. In 2016, the DOL announced its intention to undertake a regulatory project on ESOP valuation issues. 81 Fed. Reg. 20946, 20969 (April 8, 2016). Specifically, the DOL stated that "ESOP valuations present special issues that should be the focus of a separate project" and "piecemeal determinations as to inclusions or exclusions of particular valuations may produce unfair or inconsistent results." Id. However, the DOL has not yet undertaken that project.

We are concerned that investigators and plaintiffs may misinterpret the Proposed Rule as being that project or, at the very least, having implications under ERISA section 408(e). This concern is exacerbated by the DOL's long history using the enforcement process to impose requirements on ESOPs that are not set forth in statutes or regulations. The Proposed Rule, without specific carve out language for statutory PTEs, raises a concern that the rule will be used by those not as well versed in the PTE requirements to augment definitions and obligations imposed on ESOPs and their providers.

For example, since 2005, the DOL has had in place a national enforcement project for review and investigation of ESOPs, focusing on transactions in which an ESOP might buy or sell shares of company stock (also referred to as qualifying employer securities). As part of that ongoing project, more than 2,000 ESOPs have come under investigation – nearly one in three companies sponsoring an ESOP. Through this project the DOL regulated ESOPs indirectly by negotiating a small number of individual fiduciary process agreements, and subsequently referencing those agreements as their expected standards for other ESOP fiduciaries to meet.

Moreover, in audits and enforcement actions against ESOPs, the DOL has historically applied regulatory definitions that appeared in proposed rules that were inapplicable to ESOPs and that were never finalized. Specifically, the definition of "adequate consideration" (codified in ERISA Section 3(18)) is defined by reference to proposed regulations that are more than 35 years old; such proposed regulations, do not have the force of law, yet in practice are held up as the standards and requirements to which ESOPs must comply.

We continue to believe that the lack of guidance related to ESOP valuations has resulted in inefficient regulation, litigation, and strained relationship between the DOL and the regulated community. It is in the best interest of current and future ESOP participants for the DOL to provide guidance through notice and comment rulemaking. However, the Proposed Rule is not the proper place as ESOP issues should be addressed through a separate rulemaking process.

Given the foregoing, we believe any final rule should expressly state that the rules, procedures, and principals in the rule are not intended to fill any gaps in, or otherwise interpret, ERISA Section 408(e). Specifically, we recommend the following:

> "[t]he Department will not review transactions which are entered into under the terms and requirements of ERISA Section 408(b), 408(c), 408(d), 408(e), 408(f), and 408(g) or which are otherwise permitted under such referenced subsections

under the terms of these rules of procedure and such rules of procedures shall not, in whole or in part, be read to apply to such transactions."

This language would ensure that parties involved in ESOP transactions and their plan sponsors can operate with certainty as to their governing requirements.

III. The DOL should narrow the scope of key regulatory definitions in any final rule to reduce the risk to ESOPs of misapplication of those definitions

As indicated above, the Commenters believe strongly that ESOP transactions that fit within a statutory exemption would fall outside the scope of a final rule that mirrors the Proposed Rule.

As noted, we are concerned that application of certain definitions in the Proposed Rule to the governance of ESOPs in the form of functional guidance or through analogy to similar definitions as provided for in governing statutes. Given this concern, we are commenting on key regulatory definitions in the Proposed Rule that would change the PTE application process. We do not believe the revisions to the definitions – especially to the extent such revisions indicate the DOL's current thoughts on requirements applicable to ESOPs and ESOP transactions – are appropriate.

- Definition of "qualified independent appraiser":

  The Proposed Rule would significantly expand the parties from whom the appraiser must be independent to include "any party involved in the exemption transaction," and "the qualified independent fiduciary." Under the Proposed Rule, a "party involved in the exemption transaction" includes "any party providing services to either the plan or a [party in interest or any party engaged in the transaction.]" With respect to ESOP standards this is a striking departure from the ERISA statute that focuses on connections between the parties in interest to the transaction and the appraiser. The appropriate measure of independence should be concentrated on relationships that would cause the appraiser to have a bias as to those actually participating in the transaction or a conflict of interest that would infringe on the appraiser's ability to correctly consider information on which a valuation might be based. Requiring the appraiser to be independent from the parties in interest succeeds in limiting undue influence by those for whom a transaction is designed to provide benefit. Expanding the parties from which the appraiser must be independent with respect, specifically, to an ESOP event is unnecessary in this manner. The Proposed Rule does not proofer any evidence of a nexus between the business relationships that the rule appears intended to target and an appraiser's ability to remain agnostic as to its/his/her work. Further, this is a substantial change that should be accomplished (if at all) via regulation or statutory revision to the extent it might otherwise be used to modify PTE requirements codified in ERISA. The Proposed Rule cannot amend the express language of the statute or congressional intent.

  The Proposed Rule would also apply a strict revenue test for independence (as opposed to a rebuttable presumption). It says that "[a]n appraiser will not be treated as independent if the revenues it receives or is projected to receive, within the current federal income tax year, from parties involved in the exemption transaction are more than two percent of such

appraiser's annual revenues from all sources based upon either its prior federal income tax year or the appraiser's projected revenues for the current federal income tax year, unless, in its sole discretion, the Department determines otherwise." The Proposed Rule would apply that test without defining how receipt of revenue is determined, exposing parties to risk that independence would be spoiled by tangential ties to parties in the transaction even if no actual dollars are paid between the parties. If the standard is going to focus on a seemingly formulaic test, the inputs for such formula must be stated clearly. Otherwise this test does not provide appropriate guidance to determine when the DOL considers a relationship problematic.

The expanded test for "independence" set forth in the Proposed Rule is overreaching, especially in the context of an ESOP transaction. First, as noted above, ESOPs have been held to a standard provided for in a proposed regulation for more than three decades. This rule has not been finalized or modified. The Association is hopeful that the DOL is not intending to use the Proposed Rule to further augment unfinalized requirements. To the extent the proposed regulations for adequate consideration are to be modified or finalized, such action should come through appropriate legislative or by following appropriate procedures and requirements of the Administrative Procedures Act process, not through reference to a rulemaking action that is not directed at ESOPs or transactions entered into by such plans. Second, the included definition of "independence" in the Proposed Rule is arbitrary – there is no basis that suggests a 2% revenue standard is appropriate or that revenue tangentially tied to other parties in a transaction governs independence – and seems to do little to ensure an independent review. Indeed, the DOL has referred to a 5% standard in advisory opinion (DOL Adv. Op. 2001-09). Any standard based on revenue is arbitrary and not a reliable indicator of a lack of "independence."

Moreover, whether an appraiser can meet a 2% standard is more likely to be based on the size of the appraiser organization than the ability of the appraiser to act independently. The reality is that larger accounting firms with small valuation groups can perform significantly more valuation work for the same client than small valuation firms focusing on one area of valuation. A 2% standard would preclude experienced appraisers from small or specialized valuation firms from participating in transactions on the arbitrary basis of the size of the firm. The perverse consequences of the proposed 2% standard are plain; any such arbitrary standard would likely have the effect of driving many highly qualified and skilled small appraisal firms from the market. The DOL's failure to acknowledge and account for those consequences in the Proposed Rule underscores the arbitrariness of the standard.

The DOL's use of the 2% standard is also inconsistent with the DOL's own practice. The DOL commonly uses the same valuation experts when reviewing ESOP transactions and therefore they could not meet the same standard of independence from the DOL as the agency seeks to apply to the private market. It is difficult to imagine that such valuators could ever meet the DOL's 2% standard. The DOL seems to have determined that their own stable of valuators that fail the 2% standard are objective, while those valuators working for parties to a transaction that fail a 2% standard cannot be objective.

- Definition of "qualified independent fiduciary":

  The Proposed Rule says that a fiduciary is independent only if the fiduciary is "independent of and unrelated to: any party involved in the exemption transaction….and any other party involved in the development of the exemption request." As with the qualified appraiser definition, use of the term "party involved in the exemption transaction" expands the definition from a party in interest to include "any party providing services to either the plan or a [party in interest or any party engaged in the transaction.] The fiduciary's revenues and projected revenues will be considered for purposes of determining independence and the same 2% standard will be applied in this instance.

  The Proposed Rule further amend the definition by stating that an entity may not be considered independent if it has an interest in the subject transaction or future transactions of the same nature or type. Such a prospective test not only is vague, it is impossible to apply. The DOL noted the supposed risk created by fiduciaries who have a "business interest" in participating in transactions, specifically calling out relationships with third parties such as investment advisors or banks. But this is nonsensical; continuing work as a service provider does not render a fiduciary dependent. It is also internally inconsistent with best practices and the DOL's stated preference for independent fiduciaries. Indeed, through this modification of the definition for fiduciary independence the DOL is by effect encouraging the use of "inside" trustees over those professionals who are educated in the requirements of ERISA and have none of the same actual or potential conflicts of interest. The DOL should drop the amendments from any final rule.

  We also reiterate that a 2% revenue test – or any revenue test – is arbitrary and without a basis whatsoever for indicating that such threshold converts an otherwise independent party to an interested party in a transaction.

- Disallowance of Indemnification:

  The Proposed Rule states that an application for a PTE should "[i]nclude any provision that provides for the direct or indirect indemnification or reimbursement of the independent appraiser, auditor, or accountant by the plan or another party for any failure to adhere to its contractual obligations or to federal and state laws applicable to the appraiser's, auditor's, or accountant's work." The PTE application must also note "any provision that provides for the direct or indirect indemnification or reimbursement of the independent fiduciary by the plan or other party for any failure to adhere to its contractual obligations or to state or federal laws applicable to the independent fiduciary's work."

  The Preamble indicates that the engagement letter for the appraiser or fiduciary should not include direct or indirect indemnification provisions. The DOL seems to indicate that such provisions are required to ensure accountability of these parties, noting "[w]hen parties agree to relieve appraisers, auditors, and accountants from accountability through releases, waivers, and indemnification or reimbursement agreements, they undermine the protective conditions of the exemption, compromise the independence of their services, and cast doubt on the reliability of the service providers' work."

The DOL's approach departs from the statute and DOL guidance. Indemnification does not run afoul of ERISA Section 410, which expressly allows for plans and plan sponsors to provide insurance for fiduciaries. Shortly after ERISA was enacted, the DOL recognized in its own guidance that indemnification is permissible. Such action does not relieve the fiduciary from responsibility but merely permits another party to satisfy the liability. Denying such protections to parties would run contrary to the letter and spirit of ERISA Section 410. The DOL does not have the ability to modify ERISA Section 410 through this type of rulemaking action. Further the DOL does not have the authority to issue commentary on legal provisions from other transactions not otherwise governed under the Proposed Rule. As such we again note that inclusion of provisions that seem more directed at other industries or actions is inappropriate and reiterate our ask for clarification that nothing in the Proposed Rule applies to any action taken under another section of ERISA, including without limitation the Statutory Exemptions or ERISA Section 410.

IV. The Proposed Rule Appears to be Action Outside of the Regulatory Process

The DOL appears to have increased its efforts to regulate through issuance of best practice guidance (*e.g.*, Cybersecurity Best Practices Guidance) and the institution of investigations and/or litigation-generated settlements with single parties (*e.g.*, continued attempted rulemaking relating to ESOP fiduciary process through one-off agreed to "fiduciary process agreements" (FPAs)) instead of adhering to well established regulatory procedure that is designed to discourage the arbitrary application of *ad hoc* determinations to actions that are otherwise governed by statutory authority. While it is helpful to continue to get input on how the Department views certain risks to ERISA governed arrangements, the standards for consideration of certain actions (e.g., retirement plan investment in cryptocurrency), and indications of how transactions should be conducted, the trend as to governing adjacent to the regulatory process versus through appropriate issuance of statutory authority creates confusion and concern as to what *legal* standards are required.

With respect to ESOPs, we have seen enforcement goals and expectations set by the DOL without engaging in the formal notice-and-comment process that would otherwise be mandated for the issuance of regulatory guidance. ESOPs are now regulated by the DOL largely on the based on "policies and procedures" which have not been established through the formal regulatory process.

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To reiterate, the Commenters remain concerned that the DOL will attempt to apply any final rule to ESOPs through indirect mechanisms such as audits and enforcement actions. The use of any final rule in that way would be inconsistent with the DOL's statutory authority, the Administrative Procedure Act, and good governance. We therefore emphasize our request that any final rule state expressly that it does not purport to fill gaps or interpret ambiguities in any statutory exemptions.

Notwithstanding our concerns, we respect and support the important and at times complex mission of the DOL in investigating and regulating ESOP transactions and agree that such transactions must comply with all applicable and issued statutory authority. Parties that act contrary to such rules must be held accountable. We want to work with the DOL to identify approaches that will help the DOL achieve its mission, and are always prepared to meet with the DOL to that end.

Sincerely yours,

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