Prepared Statement of Jeffrey Tarbell, Houlihan Lokey
House Subcommittee on Health, Employment, Labor and Pensions
Redefining "Fiduciary": Assessing the Impact of the Labor Department's Proposal on Workers and Retirees
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Introduction

Good morning. Thank you Chairman Roe, Ranking member Andrews, and members of the Subcommittee for the opportunity to testify this morning. My name is Jeff Tarbell. I am a Director with Houlihan Lokey, an investment bank that, among other things, provides valuation and fairness opinion services related to Employee Stock Ownership Plans ("ESOPs"). I have more than 20 years of experience rendering valuations and fairness opinions, many of these related to ESOPs.

I am testifying today to voice concerns regarding certain unintended consequences of the proposed regulation issued by the Department of Labor ("DOL"), which would amend the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). These concerns are not shared simply by Houlihan Lokey, but by other providers of ESOP valuations and fairness opinion services whom I

am representing today,[1] by groups engaged in the management of real estate assets and the business of valuing and appraising real estate belonging to employee benefit plans subject to ERISA, and by the major professional associations, including The ESOP Association, the American Society of Appraisers ("ASA"), and the American Institute of Certified Public Accountants ("AICPA").

As reflected at the DOL's March 1st and 2nd hearing on the subject, our concerns are two-fold: (1) the costs of the proposed rule on employee benefit plans and the employers who sponsor them would be significant; and (2) the proposed rule directly conflicts with longstanding professional and regulatory standards of valuation practice requiring that an appraiser provide an independent and impartial opinion of value. Furthermore, if the DOL's goal is to regulate valuation and fairness opinion providers directly, then the agency first needs to put in place regulatory standards governing the provision of valuations and fairness opinions. Houlihan Lokey and other providers of valuations and fairness opinions, as well as the ASA, are ready and willing to discuss a reasonable framework of standards and enforcement, but enforcement through fiduciary labeling is a misguided and problematic approach.

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[1] The firms include: Chartwell Capital Solutions, Columbia Financial Advisors, Inc., ComStock Advisors, Duff & Phelps, LLC, Houlihan Lokey, Prairie Capital Advisors, Inc., Stout Risius Ross, and Willamette Management Associates.

Before specifically addressing those concerns, it should be noted that the DOL's proposed rule represents a sudden reversal of the agency's longstanding treatment of providers of valuations and fairness opinions related to employee benefit plans. Firms providing ESOP valuations and fairness opinions long have relied on the DOL's 1976 advisory opinion that a person retained to conduct a valuation of privately held stock to be offered to, or held by an ESOP <u>does not</u> function as a fiduciary under ERISA. The factual bases for that advisory opinion continue to be true today. As the DOL noted in that opinion, an ESOP valuation or fairness opinion does not make a recommendation as to a particular investment decision, does not address the relative merits of purchasing particular employer securities, nor does the ESOP valuation or fairness opinion provider have any decision making authority over a trustee's decision whether to purchase or sell the employer securities. In other words, an ESOP valuation or fairness opinion does not constitute "investment advice." Consequently, it is contrary to the DOL's 35 year-old position and unreasonable that ESOP valuation and fairness opinion providers, or other providers valuing assets belonging to ERISA plans, now should be singled out for fiduciary treatment.

<u>Concerns with the DOL's Proposed Fiduciary Definition</u>

I. The Public Record Shows That The Costs Of The Proposed Rule Would Be Substantial To Employee Benefit Plans And Their Employer Sponsors.

As you know, earlier this year, the White House issued an Executive Order directing federal agencies to use "the least burdensome tools for achieving regulatory

ends," and to "select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits." Executive Order 13563, 76 Fed. Reg. 3821 (Jan. 18, 2011). However, the DOL has provided no meaningful cost-benefit analysis that would satisfy the Administration's directive.

While insurance has long been used by plan fiduciaries to mitigate their ERISA litigation risk, the administrative record is clear that no such product currently exists for firms providing valuation and fairness opinion services related to ERISA-covered plans. Based on the stringent cost-benefit analysis that is now required by the executive branch, reliable data must be obtained to quantify the identified insurance cost. And yet, no evidence has been introduced by the DOL as to the projected cost of that insurance. The group of firms that I represent has attempted to estimate the cost of a valuation-specific insurance product by considering the cost of fiduciary insurance coverage for ESOP trustees, which is typically based on assets under management. The group understands from conversations with industry representatives and other information in the public domain that premiums range between \$100 to \$200 per \$1 million of assets under management. *See* Fiduciary Insurance – Understanding Your Exposure, at 12, *available at* http://www.naplia.com. The ESOP professional associations project that the total assets owned by ESOPs are roughly \$900 billion. *See* National Center for Employee Ownership statistics, *available at* http://www.nceo.org/main/articl/php/id/21; The ESOP Association statistics, *available at*

http://www.esopassociation.org/media/media_statistics.asp. Using that ratio, the aggregate fiduciary insurance costs for valuation and fairness opinion providers would range from $90 million to $180 million annually.

In addition to increased insurance costs, the proposed rule also would lead to a substantial increase in litigation costs to valuation and fairness opinion providers. As I understand it, fiduciary insurance policies often contain a high deductible before coverage begins. Thus, a provider may be faced with substantial out-of-pocket costs just to establish its compliance with professional standards. For many firms, the cost to defend a single case would likely exceed their annual profits. Those increased costs would translate into higher fees for the employee benefit plans and their sponsors.

In addition, internal costs driven by the regulation, such as additional records maintenance, and the development of policies and procedures, also will be incurred. Valuation and fairness opinion providers would need to consider these new costs in pricing their services. These increased fees would not only impose direct, immediate, and incremental costs on employers, most of whom are small or mid-size businesses, but those costs would likely increase over time. In this regard, given all the direct costs and increased risk, many firms, including my own, would find it difficult to continue providing valuation and fairness opinions services relating to ERISA plans. Thus, commentators believe that many firms—particularly the larger, better capitalized firms—would have a disincentive to continue providing valuations and fairness opinion to

ERISA plans in light of the increased costs and litigation risk. Such a decrease in competition would result in further increasing costs which, again, would translate into higher fees for employee benefit plans and their sponsors.

In addition to the cost of insurance, retention and regulatory compliance, ESOP valuation and fairness opinion providers, as proposed fiduciaries, also would bear the cost of hiring their own separate ERISA counsel to represent them in ESOP engagements. It is projected that retaining ERISA counsel would add $30,000 to $100,000 to the overall cost of each ESOP purchase or sale transaction. This estimate is based on what an ESOP trustee's ERISA counsel generally charges in a transaction, and the cost of legal counsel retained by valuation or fairness opinion providers in non-ERISA transactions. One ESOP trade organization estimates that, on average, approximately 1,000 ESOP transactions occur annually. Using that figure, the projected added cost for ESOP transactions would range from $30,000,000 to $100,000,000 annually. In addition, assuming the cost of retaining counsel to review a valuation is, on average, approximately $5,000, the total cost for the 11,500 existing ESOP companies would exceed $50 million a year. Again, these costs would be passed directly on to plans and their sponsors.

II. DOL's Proposed Rule Is At Odds With Impartiality And Independence Requirements Under Professional Standards Of Valuation Practice And The Internal Revenue Code

The core elements of the ethical standards of the valuation profession require a

valuation to be performed independently and without bias in favor of any party. The Uniform Standards of Professional Appraisal Practice ("USPAP"), which are the generally recognized ethical standards of the valuation profession, contains an ethics rule which imposes specific conduct requirements on valuation providers, including an impartiality requirement. *See* USPAP Ethics Rule, http://www.uspap.org/2010USPAP/USPAP/frwrd/uspap_toc.htm. (appraiser "must not perform with bias" and "must not advocate the cause or interest of any party or issue….").

Federal regulations promulgated by the Internal Revenue Service ("IRS") incorporate these industry ethical standards. In particular, IRS regulations provide that an ESOP can only be considered a qualified trust under the Code 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*," *see* Code § 401(a)(28)(C), as defined in Treasury regulations promulgated under Code § 170(a)(1) (emphasis added). A "qualified independent appraiser" under these regulations is a person who, among other things "*is not a party to the transaction, and is not related to any party to the transaction*." 26 C.F.R. § 1.170A-13(c)(5)(i)(emphasis added). Under IRS advisory guidance, a "qualified appraisal" has been conducted by a "qualified appraiser" within the meaning of § 1.170A-13 only if it is done "in accordance with generally accepted appraisal standards." I.R.B. 2006-46. The IRS has clarified that this would include appraisals "consistent with the substance and principles of [USPAP]." *See*

Proposed Reg. 26 C.F.R. § 1.170A-17(a) (1)-(2) (proposing to codify guidance under I.R.B. 2006-46).

It is impossible for a valuation provider to provide an impartial opinion of the value of privately held securities and be a fiduciary to the holder, purchaser or seller of those securities, as required by the proposed regulation. As a fiduciary, the valuation provider's fiduciary duty to act "solely in the interest of the participants and beneficiaries" would contradict the provider's ability to act impartially. For example, the valuation provider would have a fiduciary duty to advocate the advisability of making a particular investment. However, the standards under the Code and well-established professional standards provide that the role of such a person is not to advocate for a value, or an investment, on behalf of anyone, but instead provide an impartial opinion as to the value of a particular security, no matter who asks the question. Asking a valuation provider to ignore its ethical responsibility and be partial to plan participants is akin to asking a judge to be biased in handing down a verdict to his own client.

III. If The DOL Wishes To Correct Any Perceived Problems With Valuation Standards Of Practice, The Agency Should Establish What Those Standards Are First Before Turning To The Question Of Enforcement.

The DOL has claimed that the proposed rule is designed to correct the "common problem" of substandard valuation and fairness opinion provider work. However, the DOL has provided no empirical support in the record showing that such a "problem" is widespread, and, to my knowledge, has no in-house expertise to even make such a

determination. The agency also has provided no explanation as to the nature of the problem; that is, whether "faulty" valuations are the product of insufficient fact-gathering or analysis, computational errors, unreasonable use of assumptions on critical factors, or improper reliance on valuation methodologies that the DOL opposes as a policy matter.

The DOL's stated goal to regulate valuation and fairness opinion providers by making them fiduciaries, will lead to expensive litigation brought by plaintiffs' firms, but it will not transform those careless valuation providers into careful ones. Nor does the agency's stated goal actually articulate any standards by which the agency would evaluate whether valuation work is satisfactory or substandard. The DOL issued a proposed adequate consideration regulation more than twenty years ago that was intended to provide standards relating to ESOP valuation. *See* Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632 (1988). Ironically, that proposed guidance has never been finalized. Valuation and fairness opinion providers are willing to work with the DOL to develop guidance on valuation issues of concern to the Agency. Established standards would be important not only for firms providing valuation and fairness opinion services, but for ERISA fiduciaries and DOL personnel charged with reviewing and evaluating such valuations or opinions. Whether that person is an "internal" fiduciary within the company, or retained independently, the ERISA fiduciary must conduct a prudent investigation as to the merits of a proposed transaction and, therefore, would need to have a basic understanding of governing standards.

As it stands, the DOL's proposed rule is the proverbial example of putting the cart before the horse. Regulatory standards of practice governing valuation and fairness opinion provider services should be agreed upon before turning to the question of enforcement of such standards. With respect to enforcement, for the reasons above, making a valuation or fairness opinion provider a fiduciary is a misguided approach because it imposes unnecessary costs on the backs of ERISA plans and their employer sponsors, and directly contradicts established professional and regulatory standards.

I close by noting that valuation professionals like me join the DOL's desire to make sure valuations are prepared carefully and appropriately. To that end, my firm and the other valuation and fairness opinion firms I am representing welcome an opportunity to discuss standards and an appropriate enforcement framework that avoids the unintended consequences and insurmountable conflicts posed by the DOL's proposed rule.

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I appreciate the opportunity to testify this morning and welcome any questions from you, Ranking member Andrews or other members of the Subcommittee at this time.