DEPARTMENT OF LABOR

Employee Benefits Security Administration

29 CFR Part 2510

RIN 1210-AC20

Proposed Regulation Relating to Application of the Definition of Adequate Consideration

AGENCY: Employee Benefits Security Administration, Department of Labor.

ACTION: Notice of proposed rulemaking with request for comments and withdrawal of previous proposed rule.

SUMMARY: This document contains a revised proposed rule that would clarify the term "adequate consideration" as set forth in section 3(18)(B) of the Employee Retirement Income Security Act of 1974 (ERISA) and govern the fiduciary determination of fair market value in connection with certain employee stock ownership plan (ESOP) transactions involving employer stock. If its conditions are satisfied, section 408(e) of ERISA permits an ESOP to engage in transactions involving qualifying employer securities, including employer stock, that would otherwise be prohibited by section 406 of ERISA. One of those conditions is that the transaction is for "adequate consideration." Section 3(18)(B) of ERISA provides that the term "adequate consideration" for assets other than securities for which there is a generally recognized market means the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. Additionally, section 346(c)(4)(B) of the SECURE 2.0 Act of 2022 provides that the Secretary of Labor, in consultation with the Secretary of the Treasury, shall issue formal guidance for acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an ESOP. This document proposes a rule that would provide such guidance and govern the determination of fair market value in accordance with the definition of the term adequate consideration under section 3(18)(B) of ERISA, as

applied to certain ESOP transactions involving employer stock. This document also withdraws a prior proposed regulation published in 1988 that addressed similar subject matter.

DATES: Comments on this proposed rule are due on [INSERT DATE 75 DAYS AFTER DATE OF PUBLICATION IN THE *FEDERAL REGISTER*].

ADDRESSES: The Employee Benefits Security Administration (EBSA) encourages interested persons to submit their comments on these proposed rules online. You may submit comments, identified by RIN 1210-AC20, by either of the following methods:

Federal eRulemaking Portal: https://www.regulations.gov. Follow the instructions for submitting comments.

Mail: Office of Regulations and Interpretations, Employee Benefits Security Administration, Room N–5655, U.S. Department of Labor, 200 Constitution Avenue NW, Washington, DC 20210, Attn: Adequate Consideration Regulation RIN 1210-AC20.

Instructions: All submissions must include the agency name and Regulatory Identifier Number RIN 1210-AC20 for this rulemaking. If you submit comments online, do not submit paper copies. All comments received will be posted without change on *https://www.regulations.gov* and *https://www.dol.gov/agencies/ebsa* and will be made available for public inspection at the Public Disclosure Room, N–1513, Employee Benefits Security Administration, U.S. Department of Labor, 200 Constitution Avenue NW, Washington, DC 20210. The short plain-language summary of the proposed rule required by the Providing Accountability Through Transparency Act of 2023, and other background documents, can be reviewed at the Federal eRulemaking Portal at *https://www.regulations.gov.*

Warning: Do not include any personally identifiable or confidential business information that you do not want publicly disclosed. Comments are public records that are posted online as received and can be retrieved by most internet search engines.

FOR FURTHER INFORMATION CONTACT: Fred Wong, Office of Regulations and Interpretations, Employee Benefits Security Administration, (202) 693-8500. This is not a toll-free number.

SUPPLEMENTARY INFORMATION:

I. Background

1. General

ERISA[1] is a "comprehensive statute designed to promote the interests of employees and their beneficiaries in employee benefit plans."[2] Under the statutory framework, Title I of ERISA imposes duties and restrictions on individuals who are "fiduciaries" with respect to employee benefit plans, including ESOPs. In particular, fiduciaries to Title I plans must adhere to duties of prudence and loyalty. ERISA section 404(a)(1) provides that Title I plan fiduciaries must act with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims," and that they also must discharge their duties with respect to a plan "solely in the interest of the participants and beneficiaries."[3]

The prohibited transaction provisions of ERISA "categorically bar[]" plan fiduciaries from engaging in transactions deemed "likely to injure the pension plan."[4] Among these provisions, sections 406(a)(1)(A), (B) and (D) of ERISA generally prohibit a fiduciary with respect to a plan from causing a plan to engage in a transaction if it knows or should know that such transaction constitutes a direct or indirect:

- sale or exchange or leasing of any property between a plan and a party in interest, or
- lending of money or other extension of credit between a plan and a party in interest, or

[1] 29 U.S.C. 1001, *et seq*.
[2] *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 90 (1983).
[3] ERISA section 404, 29 U.S.C. 1104.
[4] *Harris Trust Sav. Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238, 241-42 (2000) (citation and quotation marks omitted).

- a transfer to, or use for the benefit of, a party in interest, of any assets of the plan.

Sections 3(14)(A) and (C) of ERISA define a party in interest with respect to a plan to include a fiduciary of the plan and "an employer any of whose employees are covered by such plan."

Section 406(a)(1)(E) of ERISA further prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction if it knows or should know that such transaction constitutes a direct or indirect acquisition, on behalf of the plan, of any employer security in violation of section 407(a).[5]

Section 406(a)(2) prohibits certain fiduciaries from permitting a plan to hold any employer security if it knows or should know that holding such security violates section 407(a).

Additionally, the prohibitions in section 406(b) broadly forbid a fiduciary from "deal[ing] with the assets of the plan in his own interest or for his own account," and "receiv[ing] any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."[6]

ERISA includes statutory exemptions that provide conditional relief from the prohibited transaction restrictions.[7] A number of these statutory exemptions rely on the term "adequate consideration" (as defined in ERISA section 3(18)) as a central condition relating to the amount paid or received by a plan.[8] A fiduciary's determination of the adequacy of consideration paid

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[5] ERISA section 407(a) generally prohibits the acquisition or holding of any "employer security" that is not a "qualifying employer security" (as defined in ERISA section 407(d)(5)), and any "employer real property" that is not "qualifying employer real property" (as defined in ERISA section 407(d)(4)), and furthermore imposes certain percentage limitations with respect to such investments.

[6] ERISA section 406(b)(1), (3), 29 U.S.C. 1106(b)(1), (3).

[7] Congress also authorized the Department to grant conditional administrative exemptions from the prohibited transaction provisions, but only if the Department finds that the exemption is (1) administratively feasible for the Department, (2) in the interests of the plan and of its participants and beneficiaries, and (3) protective of the rights of participants and beneficiaries of such plan. ERISA section 408(a), 29 U.S.C. 1108(a).

[8] For instance, under section 408(b)(5) of ERISA, a plan may purchase insurance contracts from certain parties in interest if, among other conditions, the plan pays no more than adequate consideration. 29 U.S.C. 1108(b)(5). Section 408(b)(7) of ERISA provides that the prohibited transaction provisions of section 406 shall not apply to the exercise of a privilege to convert securities, to the extent provided in regulations of the Secretary, only if the plan receives no less than adequate consideration pursuant to such conversion. 29 U.S.C. 1108(b)(7). Additionally,

under such circumstances represents a critical safeguard for plans against the potential for conflicts of interest and abuse inherent in such transactions, which commonly involve transactions between the plan and the plan sponsor's owners and managers.

One such statutory exemption, at section 408(e) of ERISA, provides conditional relief from the prohibited transaction restrictions for the acquisition or sale by certain plans of qualifying employer securities if, among other conditions, the acquisition, sale or lease is for "adequate consideration."[9]

Section 3(18)(A) of ERISA states that the term "adequate consideration" when used in part 4 of subtitle B means, in the case of a security for which there is a generally recognized market,[10]"either (i) the price of the security prevailing on a national securities exchange which is registered under section 78f of Title 15, or (ii) if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest." Section 3(18)(B) provides that in the case of an asset other than a security for which there is a generally recognized market, "adequate consideration" means "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary." As discussed below, this proposed regulation would govern the fiduciary determination of fair market value under section 3(18)(B) of ERISA in connection with certain

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ERISA section 414(c)(5) states that sections 406 and 407(a) of ERISA shall not apply to the sale, exchange, or other disposition of property which is owned by a plan on June 30, 1974, and all times thereafter, to a party in interest, if such plan is required to dispose of the property in order to comply with the provisions of section 407(a), and if the plan receives not less than adequate consideration. 29 U.S.C. 1114(c)(5).

[9] ERISA section 408(e), 29 U.S.C. 1108(e); 29 CFR 2550.408e. Under 29 CFR 2550.408e(d)(1), adequate consideration in the case of a marketable obligation means a price not less favorable to the plan than the price determined under ERISA section 407(e)(1).

[10] ERISA does not define the term "generally recognized market." In the preamble to the 1988 proposed rulemaking on the definition of the term "adequate consideration," discussed below, the Department stated that the question of whether a security is one for which there is a generally recognized market requires a factual determination in light of the character of the security and the nature and the extent of market activity with regard to the security. The preamble further stated that isolated trading activity, or trades between related parties generally would not be sufficient to show the existence of a generally recognized market for purposes of ERISA section 3(18)(A). 53 FR 17632 (May 17, 1988) (1988 proposal).

ESOP transactions involving employer stock for which there is not a generally recognized market.

The proposed regulation does not address duties of ESOP fiduciaries related to compliance with requirements under section 401(a) of the Internal Revenue Code (Code). In this regard, we note that Code section 401(a)(28) requires that, in the case of an ESOP, employer securities which are not readily tradable on established securities markets must be valued by an independent appraiser, and section 401(a)(28)(C) states that the term "independent appraiser" means an appraiser meeting requirements similar to the requirements of regulations under section 170(a)(1) of the Code (relating to IRS verification of the value assigned for deduction purposes to assets donated to charitable organizations). The Department solicits comments on whether guidance is needed as to the interrelationship between the requirements of this proposed regulation and section 401(a)(28) of the Code (and any guidance thereunder).

2. *1988 Proposed Rule*

In 1988, the Department of Labor (Department) published in the *Federal Register* a notice of proposed rulemaking to provide guidance on application of the term "adequate consideration" in ERISA section 3(18)(B) and section 8477(a)(2)(B) of the Federal Employees' Retirement System Act of 1986 (FERSA).[11]

In general, the 1988 proposal set forth the following two-part inquiry for determining adequate consideration: "First, the value assigned to an asset must reflect its fair market value as determined pursuant to [the] proposed [rule]. Second, the value assigned to an asset must be the product of a determination made by the fiduciary in good faith, also as defined in [the proposed

[11] *See* 53 FR 17632. Section 8477(a)(2) of FERSA provides a definition of the term "adequate consideration" which is virtually identical to that contained in section 3(18) of ERISA. Unlike the 1988 proposal, this proposal is limited to adequate consideration for acquisition and sales of certain qualifying employer securities for which there is no ready market. Since FERSA plans do not buy and sell such securities, as defined under ERISA, this proposal does not address this FERSA provision.

rule]."[12] The proposal additionally enumerated specific elements necessary to satisfy the fair market value and good faith requirements.[13]

Under the 1988 proposal, a stock transaction would not satisfy the regulatory standard if the plan acquired employer stock for more than fair market value or sold plan holdings in employer stock for less than fair market value.

The term "fair market value" has an established meaning in the field of asset valuation,[14] and under the terms of the 1988 proposal, plans had to sell and acquire assets consistent with that meaning to meet the terms of the statutory exemption.

Further, the 1988 proposal recognized that Congress had assigned responsibility for ensuring plan compliance to ESOP fiduciaries who, as such, have to adhere to the stringent obligations of prudence and loyalty set forth in section 404(a) of ERISA. As the proposal made clear, these fiduciaries are obligated to determine fair market value in "good faith" in accordance with these fundamental fiduciary standards. To meet this good faith standard, it was not enough that the fiduciary had subjectively intended to do no harm. Rather, as the Fifth Circuit held in *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983), "[t]he statutory reference to 'good faith' had to be read in light of the overriding duties of Section 404." Consistent with that decision, the 1988 proposal's good faith requirement would have required a fiduciary to apply sound business principles of evaluation and to conduct a prudent investigation of the circumstances prevailing at the time of the valuation.[15]

Under the terms of the 1988 proposal, both the fair market value standard and the requirement of a good faith determination had to be met. Therefore, if a plan purchased

[12] 53 FR at 17633.
[13] 53 FR at 17634-5.
[14] See, e.g., 26 CFR 1.170A-1(c)(2) ("The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."), 26 CFR 20.2031-1(b) ("The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."), Connelly v. United States, 602 U.S. 546 (2024) (fair market value under 26 CFR 20.2031-1(b)).
[15] 53 FR at 17634.

employer stock for more than fair market value or sold employer stock holdings for less than fair market value, the transaction was not for adequate consideration, and the statutory exemption was not met, even if the fiduciary had acted prudently when setting the price. The preamble to that proposal stated:

> Even if a fiduciary were to meet the good faith standards contained in this proposed regulation, there may be circumstances in which good faith alone fails to insure an equitable result. For example, errors in calculation or honest failure to consider certain information could produce valuation figures outside of the range of acceptable valuations of a given asset. Because the determination of adequate consideration is a central requirement of the statutory exemptions discussed above, the Department believes it must assure that such exemptions are made available only for those transactions possessing all the external safeguards envisioned by Congress. To achieve this end, the Department's proposed regulation links fair market value and good faith requirements to assure that the resulting valuation reflects market considerations and is the product of a valuation process conducted in good faith.[16]

Although the Department never finalized the 1988 proposal, private parties and courts have frequently referred to its terms for guidance. Courts have also resolved numerous ESOP valuation cases since ERISA's enactment, and these cases provide a strong body of law on the proper application of ERISA in the context of fair market valuations and stock transactions involving employer stock. As discussed below, the Department has also published settlement agreements resolving ESOP valuation cases on its website, and these detailed agreements similarly provide guidance on fiduciaries' obligations with respect to the valuation and determination of stock prices in ESOP transactions. Neither the 1988 proposal nor the settlement agreements, however, are authoritative final agency rules. In light of Congress' mandate to provide formal guidance on good faith fair market value in the SECURE 2.0 Act of 2022,[17] and Congress' express delegation of authority to the Department with respect to the statutory definition of adequate consideration, the Department is restarting notice-and-comment rulemaking on the statutory definition of "adequate consideration." An important aim of this

[16] 53 FR 17633-34.

[17] See section 346(c)(4) of the SECURE 2.0 Act of 2022 (SECURE 2.0), Div. T, Title III, Sec. 346, Pub. L 117-328, 136 Stat. 5381 (Dec. 29, 2022) ("The Secretary shall issue formal guidance, for … acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan….").

rulemaking is to establish, in accordance with Congress' directives, standards for the resolution of questions relating to the fair market value of employer stock in ESOP transactions and ERISA's requirements for the determination of stock price. See section I.5 of this preamble for a discussion of section 346 of the SECURE 2.0 Act of 2022.

3. *Employee Stock Ownership Plans (ESOPs): Benefits to Employees and Risk for Abuse*

An ESOP is a tax-qualified retirement plan designed to invest primarily in qualifying employer securities of the company employing the ESOP's participants.[18] Pursuant to implementing regulations by the Department and the Department of the Treasury, "an ESOP must be formally designated as such in the plan document and must specifically state that it is designed to invest primarily in qualifying employer securities."[19] A leveraged ESOP is an ESOP that finances its purchase of such stock through securities acquisition debt obtained from, or guaranteed by, the sponsoring employer. A leveraged ESOP, operated in accordance with applicable regulations, holds the shares purchased with the proceeds of such a loan in a "suspense account," and releases them from the suspense account as the loan is repaid.[20]

ESOPs potentially offer benefits for both ESOP participants and employers. With regard to ESOP participants, ESOPs can offer employees a direct financial stake in their employer's growth, often fostering a greater sense of personal interest in the employer's success. With regard to employers, ESOPs "afford[] employers an innovative method of corporate capital

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[18] ERISA section 407(d)(6), 29 U.S.C. 1107(d)(6). ERISA section 407(d)(6) defines an "employee stock ownership plan" to be an individual account plan: (A) which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase plan both of which are qualified under section 401 of the Code, and which is designed to invest primarily in qualifying employer securities; and (B) which meets such other requirements as the Secretary of Treasury may prescribe by regulation under Code section 4975(e)(7). ERISA section 407(d)(5) defines the term "qualifying employer security" generally as an "employer security" which is stock or a marketable obligation. The term "employer security" is defined in ERISA section 407(d)(1) as a security issued by an employer of employees covered by the plan, or by an affiliate of such employer. Section 4975(e)(7) of the Code defines an "employee stock ownership plan" as a defined contribution plan (A) which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase plan both of which are qualified under Code section 401(a) and which are designed to invest primarily in qualifying employer securities; and (B) which is otherwise defined in regulations prescribed by the Secretary of the Treasury. Treasury Regulation section 54.4975-11(b), which defines ESOP requirements, provides that a plan constitutes an ESOP only if the plan specifically states that it is designed to invest primarily in qualifying employer securities.

[19] 29 CFR 2550.407d-6, 26 CFR 54.4975-11.

[20] 29 CFR 2550.408b-3(h); 26 CFR 54.4975-11(c).

financing"[21] and may also promote productivity and profitability for the employer that sponsors the ESOP.[22]

Pursuant to section 346 of SECURE 2.0, the Department recently established a new Division of Employee Ownership within EBSA to promote important economic and social goals associated with employee ownership. The Division will advance efforts related to worker participation and engagement in employee-owned companies while educating the public about options for employee ownership. The agency hopes these efforts will promote beneficial and financially viable worker ownership structures, including ESOPs that are designed to serve the financial interests of plan participants as required by ERISA.

It is important to recognize, however, that "[i]nvestment in employer securities through employer-sponsored retirement plans can present significant risks for employees. If the employees' retirement savings is largely in employer securities or other employer assets, employees risk losing not only their jobs should the company go out of business, but also a significant portion of their savings."[23] The dangers posed by the lack of diversification are compounded by the fact that the employee's present income and future retirement income all depend on the success of a single employer. This makes it all the more important that ESOPs are managed in strict adherence with ERISA's participant-protective terms.

In addition to the inherent risk associated with a lack of diversification, ESOP transactions often pose significant additional dangers because of potential conflicts of interest. For example, when an ESOP purchases employer stock from a selling shareholder, the seller has numerous roles that can allow them to influence the price paid by the ESOP. The seller may own the company, manage and oversee its operations, select subordinate managers and employees, and control the compilation and presentation of financial data by subordinates. It is

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[21] U.S. Gov't Accountability Office (GAO), *Employer Stock Ownership Plans: Who Benefits Most in Closely Held Companies?* (1980), at 1, https://www.gao.gov/assets/hrd-80-88.pdf.
[22] *See* GAO, Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership (1986), at 4, https://www.gao.gov/assets/pemd-87-8.pdf.
[23] GAO, *Private Pensions: Participants Need Information on the Risks of Investing in Employer Securities and the Benefits of Diversification* (2002), at 14, https://www.gao.gov/assets/gao-02-943.pdf.

especially important that the plan's fiduciaries act with independence and undivided loyalty to the interests of the plan and its participants because of the seller's influence and control over the company, its employees and service providers, and its financial data. In these transactions, the plan's interest as a buyer in getting the best possible price is diametrically opposed to the seller's interest in maximizing the purchase price. Consequently, it is critically important that the plan's fiduciaries serve as clear-eyed and independent advocates for the plan's interest as a buyer, rather than as agents or near-agents of the seller. In abusive transactions, this independence and loyalty is often missing and results in transactions that favor the seller at the expense of the plan and plan participants.

While ESOPs promote many important economic and social goals, they are nevertheless retirement plans and as such, they must be managed in accordance with the stringent fiduciary provisions under Title I of ERISA. As the Supreme Court held in *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 420-25 (2014), the fiduciaries must put the duty of prudence above any nonpecuniary goals, including the goal of promoting employee ownership of employer stock. As the Court noted, Congress pursued nonpecuniary goals by promoting ESOPs with tax incentives and by exempting ESOPs from ERISA's diversification requirement, but the Court was "not convinced that Congress *also* sought to promote ESOPs by further relaxing the duty of prudence as applied to ESOPs …." *Id*. at 422.

Abuse in the pricing of employer stock can have significant negative consequences for participants and beneficiaries. An ESOP may acquire stock from the employer, or from one or more selling shareholders. Often, the transaction is leveraged through borrowing, with the financing provided by a bank, the employer, the selling shareholder(s), or a combination of these parties. Excessive leverage can constrain the cash flow of a company and depress its equity value. When the transaction involves publicly traded stock, the ESOP's price is set by reference to the market price for the stock. In contrast, for non-publicly traded stock, the price paid by the ESOP is generally negotiated by the ESOP's trustee with the assistance of an expert valuation adviser. Because the price of non-publicly traded employer stock is not set by reference to a public market price, there is greater risk that an ESOP may pay more than fair market value in these transactions. These dangers are often compounded by the fact that the stock is being sold to the plan by individuals who are privy to information about the company not known to others, and who may have undue influence over the selection of the plan's fiduciaries, appraiser, and ultimately, over the determination of the purchase price. These company insiders may also have control and influence over the financial projections used by the appraiser.

Overpayments effectively divert value to the sellers, depriving the ESOP's participants and beneficiaries of important retirement benefits and full compensation for their labor. In the worst cases, inflated debt-financed purchase prices jeopardize not only the participants' interest in valuable retirement benefits, but the company's viability as an ongoing business (e.g., if revenues are not sufficient to both carry on business and repay the debt). If an ESOP transaction is financed by its sponsoring employer, overpayment can result in the employer taking on excessive debt, which can harm both the ESOP's investment in the employer as well as participants' jobs. The National Center for Employee Ownership (NCEO), a nonprofit organization that supports employee ownership, estimated in 2024 that more than 90 percent of existing ESOPs were sponsored by private companies, with roughly two-thirds of those ESOPs providing a market for the shares of a departing owner.[24] The lack of a readily ascertainable public market price creates significant potential for pricing abuse in these transactions that could ultimately result in detrimental impacts on a large number of ESOP participants. Similarly, when an ESOP sells stock to a party in interest, the lack of a price established by reference to a generally recognized market creates greater risk of the ESOP receiving less than fair market value for its shares.

4. Department of Labor ESOP Enforcement

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[24] NCEO, *ESOP (Employee Stock Ownership Plan) Facts*, https://www.esop.org/ (last accessed Aug. 1, 2024); NCEO, *Employee Ownership by the Numbers* (Feb. 2024), https://www.nceo.org/articles/employee-ownership-by-the-numbers.

In light of the potential for abuse described above, since 2005, the Department has maintained an ESOP National Enforcement Project, the purpose of which is to identify and correct violations of ERISA's fiduciary standards and prohibited transaction rules in connection with ESOPs and ESOP transactions.[25] In the course of carrying out its enforcement investigations, the Department has found repeated instances where a shareholder profited from an inflated valuation at the expense of the plan participants and beneficiaries. The cases pertaining to valuation—including issues related to purchase transactions, sales transactions, and annual valuations—from fiscal year 2014 through fiscal year 2024 resulted in $440.8 million in monetary results, of which approximately $424 million were related to purchase transactions.[26]

While many cases do not result in a finding of abusive transactions, noteworthy examples of ERISA violations found by the Department include cases in which: (1) the ESOP paid for stock on a controlling-interest basis (or paying a control premium), but the ESOP did not in fact gain control following the transaction; (2) the ESOP trustees hired a valuation advisor who previously worked for the selling shareholders to establish the sellers' offer price, or imprudently relied on a valuation that assumed that the company's revenues would grow at a rate that far exceeded its historical growth or the expected growth rates for industry peers; (3) the ESOP trustees disregarded their fiduciary duties in favor of maintaining ongoing ESOP business and referral relationships with sell-side agents; (4) the ESOP trustee relied on non-comparable companies as comparables; (5) the ESOP trustee disregarded pre-existing debt in arriving at the equity valuation; (6) the fiduciary did not use prudence when selecting an appraiser, as evidenced by the hired appraiser having a prior conviction for felony embezzlement from a trust; and (7) the fiduciary failed to take proper account of the company's dependence on a single supplier.

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[25] U.S. Dep't of Labor, EBSA, *Enforcement*, https://www.dol.gov/agencies/ebsa/about-ebsa/ouERr-activities/enforcement (last visited October 7, 2024).

[26] In this context, "monetary results" means monetary recoveries directly paid to plans, participants, and their beneficiaries, whether in the form of loss recoveries, disgorgement of unjust enrichment, or increased benefit payments from a correction of an ERISA breach.

As part of its enforcement project, the Department has filed numerous lawsuits to protect ESOP plan assets and participants' benefits from abusive transactions.[27] Many of these lawsuits resulted in settlements that included "process agreements" between the Department and an ESOP trustee. The process agreements detail the process requirements for ESOP transactions to ensure the independence of trustees and appraisers, the careful review of relevant financial information, and the accuracy of employer stock valuations. The agreements also include requirements for the selection and use of a valuation advisor, oversight of a valuation advisor, the use of financial statements, preservation of documents, and other matters relevant to ESOP transactions, such as controlling interests and indemnification.[28] The Department has directed the attention of the public to the requirements of these process agreements and believes that they provide a protective framework for complying with ERISA's obligations.[29]

While these process agreements provide valuable insight into how ERISA requirements are to be applied with regard to ESOP transactions, they are nevertheless tied to the specific facts and parties involved in each case. Therefore, they do not provide a comprehensive discussion of generally applicable principles in the same way that this proposal will do.

5. *Petition for Rulemaking and the SECURE 2.0 Act*

On September 22, 2022, The ESOP Association submitted to the Department a petition for notice-and-comment rulemaking relating to section 408(e) of ERISA.[30] The ESOP

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[27] *E.g.*, *Su v. Bensen*, No. CV-19-03178-PHX-ROS, 2024 WL 3825058 (D. Ariz. Aug. 15, 2024); Complaint, *Acosta v. BAT Masonry Company, Inc*., No. 6:15-CV-28 (W.D. Va. Aug. 28, 2015); Complaint, *Solis v. GreatBanc Trust Company*, No. 5:12-CV-1648 (C.D. Cal. Sept. 28, 2012).
[28] Copies of process agreements are available under the "National Enforcement Projects" heading at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement (last visited Sept. 19, 2023).
[29] *E.g.*, U.S. Dep't of Labor, EBSA News Release, *US Labor Department Reaches $5.25M Settlement with GreatBanc Trust* (June 30, 2014) (statement by then-Assistant Secretary of Labor for the Employee Benefits Security Administration that "[o]thers in the industry would do well to take notice of the protections put in place by th[e] [2014 process] agreement" between the Department and GreatBanc), https://www.dol.gov/newsroom/releases/ebsa/ebsa20141043; Frank Brown, *Q&A with Tim Hauser of the U.S. Department of Labor*, Willamette Mgmt. Assocs., INSIGHTS 77-78 (Spring 2015) (statement by senior EBSA official that ESOP "transactions would be much better if people really took the provisions in th[e] [2014 process] agreement [with GreatBanc] to heart and followed them.") (https://www.insights.willamette.com/assets/files/2015%20Spring%20-%20Corporate%20Transaction%20Financial%20Advisory%20Services.pdf).
[30] The ESOP Association, *Petition for Notice-and-Comment Rulemaking Regarding the Definition of "Adequate Consideration" Under Section 408(e) of the Employee Retirement Income Security Act of 1974* (Sept. 22, 2022),

Association asked the Department to engage in a rulemaking process that culminates "in a final regulation interpreting [adequate consideration] in the context of privately-held ESOP stock purchase and sale transactions."[31]

On December 29, 2022, while the Department was considering the petition, President Joseph R. Biden signed into law SECURE 2.0 as part of the Consolidated Appropriations Act, 2023.[32] Section 346(c)(4)(B) of SECURE 2.0[33] directs the Secretary of Labor to, in consultation with the Department of Treasury, issue "formal guidance[] for . . . acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan (as defined in section 407(d)(6) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1107(d)(6)))."[34]

In light of that congressional directive, the Department informed The ESOP Association in 2023 that it was denying the petition but was nevertheless moving forward with formal guidance. The Department informed The ESOP Association that it would "consult with the Department of the Treasury . . . and decide on formal guidance and timing of its issuance as part of its overall evaluation of regulatory priorities and available regulatory resources."[35] This proposal relates to the Secretary of Labor's obligations under section 346(c)(4)(B) of SECURE 2.0, and its express authority under ERISA section 3(18)(B) to issue regulations defining the meaning of "adequate consideration."

6. Need for Regulatory Action

Section 3(18)(B) provides, in relevant part, that the term "adequate consideration" means, in the case of an asset other than a security for which there is a generally recognized market, "the

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available at https://assets-tea.s3.us-east-2.amazonaws.com/assets/public/2022-09/DOL_Petition_cover_letter_and_petition_FINAL20220922.pdf (last visited October 7, 2024).

[31] *Supra*.

[32] Div. T, Title III, Sec. 346, Pub. L. 117-328, 136 Stat. 5381 (Dec. 29, 2022).

[33] Codified at 29 U.S.C. 3228.

[34] 29 U.S.C. 3228(c)(4)(B).

[35] Letter from Lisa M. Gomez, Assistant Secretary, EBSA, to The ESOP Association (March 3, 2023) (on file with the Department). The Department reiterated this in an April 12, 2023, letter in response to further correspondence from The ESOP Association. *See* Letter from The ESOP Association to Lisa M. Gomez, Assistant Secretary, EBSA (March 15, 2023) (on file with the Department).

fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and *in accordance with regulations promulgated by the Secretary*."[36] Moreover, ERISA "empowers the Secretary of Labor to 'prescribe such regulations as [the Secretary] finds necessary or appropriate to carry out' the statutory provisions securing employee benefit rights."[37] More recently, section 346(c)(4)(B) of SECURE 2.0 requires that the Department "issue formal guidance for . . . acceptable standards and procedures to establish good faith fair market value for shares of a business" to be acquired by an ESOP.[38]

In light of the directive in section 346(c)(4) of SECURE 2.0, the express delegation of authority under section 3(18)(B) of ERISA, the history of past abusive ESOP transactions, and insights gained from the Department's decades of enforcement experience and litigation related to such transactions,[39] the Department is withdrawing the 1988 proposal, and proposing this rule to guide plan fiduciaries on how to fulfill their statutory duties in the context of an ESOP transaction.

To inform the current proposal, the Department engaged in outreach to broaden public participation and community engagement in the regulatory process. In October 2023, the Department began meeting with a range of stakeholders in the ESOP community, including representatives of ESOP sponsors, fiduciaries, and appraisers, to discuss issues and approaches to guidance. The discussions of these meetings focused on identifying areas where stakeholders believe guidance would be helpful, and on whether a principles-based or detailed approach to a regulation would be more helpful to the stakeholders. This regulatory action fulfills the directive from Congress that the Department "issue formal guidance [] for . . . acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an

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[36] ERISA sections 3(18)(B), 29 U.S.C. 1002(18)(B) (emphasis added).
[37] *Black & Decker Disability Plan v. Nord*, 538 U.S. 822, 831 (2003) (quoting ERISA section 505, 29 U.S.C. 1135).
[38] 29 U.S.C. 3228(c)(4).
[39] *See, e.g.*, *Perez v. Bruister*, 823 F.3d 250 (5th Cir. 2016); *Chao v. Hall Holding Co.*, 285 F.3d 415 (6th Cir. 2002); *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983); *Su v. Bensen*, No. CV-19-03178-PHX-ROS, 2024 WL 3825058 (D. Ariz. Aug. 15, 2024).

employee stock ownership plan."[40] This document proposes to define the circumstances where adequate consideration is paid for employer securities.

II. Overview of the Proposed Regulation

1. General

Proposed regulation 29 CFR 2510.3-18(b) would clarify the application of the definition of the term "adequate consideration" to assets covered by ERISA section 3(18)(B), *i.e.*, employer stock for which there is no generally recognized market. As was true of the 1988 proposal, the proposed regulation requires *both* that the plan fiduciaries make a good faith determination of fair market value in accordance with their fiduciary obligations of prudence and loyalty, *and* that the price established for the stock transaction, in fact, accords with the asset's fair market value. Under no circumstances is the plan exempt from ERISA's prohibited transaction provisions if the plan pays more than fair market value to acquire employer stock or sells its holdings of employer stock for less than fair market value, because in these situations, the adequate consideration requirements are not met.

In addition to requiring that the transaction accord with the asset's fair market value, the proposal requires that plan fiduciaries determine fair market value through a good faith process designed to ensure a sound conclusion as to the stock's fair market value in conformity with the fiduciary standards of prudence and loyalty, as set forth in ERISA section 404(a)(1)(A). The good faith standard as set forth in this proposal, requiring fiduciaries to thoroughly investigate the proposed transaction, reflects the substantial body of case law governing ESOP transactions.[41] The fiduciary good faith standard establishes an objective, rather than a

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[40] 29 U.S.C. 3228(c)(4)(B).

[41] *See variously*, *e.g.*, *Donovan v. Cunningham*, 716 F.2d 1455, 1467-68 (5th Cir. 1983) ("ESOP fiduciaries will carry their burden to prove that adequate consideration was paid by showing that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing."); *Perez v. Bruister*, 823 F.3d 250, 262 (5th Cir. 2016) (same); *Fish v. GreatBanc Tr. Co.*, 749 F.3d 671, 680 (7th Cir. 2014) ("Whether an ERISA fiduciary has acted prudently requires consideration of both the substantive reasonableness of the fiduciary's actions and the procedures by which the fiduciary made its decision[.]"); *Eyler v. Comm'r*, 88 F.3d 445, 455 (7th Cir. 1996) ("In reviewing the acts of ESOP fiduciaries under the objective prudent person standard, courts examine both the process used by the fiduciaries to reach their decision as well as an evaluation of the merits."); *see also*

subjective, standard of conduct.[42] Subject to the conditions in paragraphs (b)(3)(ii) through (iv), an assessment of whether the fiduciary has met the standard will be made in light of all the relevant facts and circumstances. Key components of such a process include the fiduciary's prudent selection of a qualified independent valuation advisor, as set forth in (b)(3)(ii), prudent oversight of a written valuation report that reflects current, complete, and accurate information about the issuer of the employer stock and the ESOP transaction, as set forth in (b)(3)(iii), and the prudent review of the valuation report and exercise of fiduciary judgment to ensure that the report may reasonably be relied upon as a basis for determining the price at which the transaction can occur. These principles, as well as the proposal's more detailed elaboration of these principles, are consistent with a broad and consistent body of case law.[43]

2. *Scope and Effect*

Paragraph (b)(1) of the proposal describes the general effect and scope of the regulation. Consistent with section 3(18)(B) of the Act, paragraph (b)(1)(i) states that, in the case of an asset other than a security for which there is a generally recognized market, the term "adequate consideration" means the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor.

Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1996) ("Like the inquiry into whether a fiduciary acted with loyalty and care, the inquiry into whether the ESOP received adequate consideration focuses on the thoroughness of the fiduciary's investigation."); *accord Henry v. Champlain Enterprises, Inc.*, 445 F.3d 610, 621 (2d Cir. 2006) ("Whether a fiduciary has made a proper determination of the 'fair market value' of an asset purchased by an ESOP depends on whether the parties are 'well-informed about the asset and the market for that asset.'") (quoting 1988 Proposal, 53 FR at 17634)).

[42] *Donovan v. Cunningham*, 716 F.2d at 1467 (5th Cir. 1983) ("this is not a search for subjective good faith - a pure heart and an empty head are not enough."); *Perez v. Commodity Control Corp.*, 2017 WL 1293619, *9-10 (March 7, 2017)(rejecting argument that good faith is matter of subjective intent); *Reich v. Valley Nat. Bank of Arizona*,, 837 F. Supp. 1259, 1273 (S.D.N.Y. 1993) (whether trustees conducted good faith inquiry subject to close scrutiny under the prudent person standard is objective standard focusing on conduct of fiduciary); *Keach v. U.S. Trust Co.*, 313 F. Supp. 2d 818, (C.D. Ill. 2004) (good faith requirement establishes objective rather than subjective standard of conduct, assessed in light of all relevant facts and circumstances); *Horn v. McQueen*, 215 F. Supp. 2d 867, 890 (W.D. Ky. Louisville Div., 2002) (defendants' subjective intent may have been good, and may have included benefiting ESOP participants, but objective evidence shows they were unable to transcend their corporate mindset and act solely and exclusively for participants); *Montgomery v. Aetna Plywood, Inc*., 39 F. Supp. 2d 915, 937 (N.D. Ill. Eastern Div., 1998) (good faith requirement establishes objective rather than subjective standard of conduct).

[43] *Id.*

The paragraph further explains that ERISA section 408(e) provides relief from the prohibitions contained in section 406 of the Act for certain transactions involving qualifying employer securities, but only if, among other conditions, the transaction is for "adequate consideration." Paragraph (b)(1)(i) provides that the regulation addresses the definition of adequate consideration within the meaning of section 3(18)(B) of ERISA, and applies in the context of the acquisition or sale by an employee stock ownership plan, as defined in section 407(d)(6) of ERISA, of an asset that is a qualifying employer security, which is stock within the meaning of section 407(d)(5) of ERISA, for which there is not a generally recognized market.

The1988 proposal addressed a range of assets and also applied for purposes of FERSA and other prohibited transaction exemptions in ERISA. In furtherance of the directive in section 346(c)(4)(B) of SECURE 2.0, however, this proposal more narrowly focuses on acquisitions and sales of employer stock by ESOPs for purposes of the exemption in section 408(e) of ERISA. Although section 346(c)(4)(B) of SECURE 2.0 expressly refers only to shares *acquired* by an ESOP, the proposal also addresses *sales* of shares by ESOPs because, after acquiring the stock, ESOPs subsequently may need to sell that stock. The Department believes similar issues may arise in connection with both ESOP acquisitions and sales of employer stock which can be addressed efficiently in the context of this proposal. The Department requests comment on the scope of the proposal, including whether it should be limited to ESOP acquisitions, and on whether it should conduct notice-and-comment rulemaking with respect to a broader range of assets, or to non-ESOP plans. As noted above, the 1988 proposal's scope included FERSA, but FERSA does not buy or sell employer stock as defined under ERISA.[44]

As discussed above, the purchase and sale of employer stock in ESOP transactions is generally prohibited by ERISA, unless the terms of the statutory exemption in ERISA section 408(e) are satisfied. Section 408(e), in turn, provides for an exemption from the statutory prohibitions, if (1) the acquisition or sale is for "adequate consideration," as defined in ERISA

[44] *See* supra at note 11.

section 3(18)(B); (2) no commission is charged with respect to the acquisition or sale; and (3) the plan is an eligible individual account plan (as defined in section 407(d)(3)).[45]

The current proposal, like the 1988 proposal, sets forth a conjunctive two-part test for adequate consideration, requiring both that the stock transaction accurately reflects the stock's fair market value and that the fiduciary's conclusion as to fair market value reflects a good faith determination made in accordance with the fiduciary's fundamental obligations of prudence and loyalty. This approach follows from the plain text of ERISA section 3(18)(B), which defines the term adequate consideration by reference both to the fair market value of the stock and to the fiduciary's good faith determination of that value. Thus, as a matter of statutory construction, a regulation that omits either part would ignore ERISA's plain text.[46] Further, a regulation that failed to include both procedural and substantive components would expose participants and beneficiaries to potential harm. For instance, even if a fiduciary were to meet the good faith standards contained in this proposal, there may be circumstances in which the plan significantly overpays for the stock, harming the plan and its participants. This could happen, for example, if the fiduciary was unaware of important information about the company's financial circumstances that the sellers failed to disclose or if the appraisal reflected inaccuracies in the company's financial statements through no fault of the appraiser or fiduciary. In such circumstances, however, the valuation could produce values well outside of the range of acceptable valuations

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[45] Section 407(d)(1) of ERISA defines the term "employer security," in part, to mean a security issued by an employer of employees covered by the plan, or by an affiliate of such employer. 29 U.S.C. 1107(d)(1). Under section 407(d)(5) of ERISA, the term "qualifying employer security" includes an employer security which is stock. The term "stock" is not defined in Title I of ERISA. 29 U.S.C. 1107(d)(5).

[46] A number of courts interpreting the meaning of "adequate consideration" under ERISA Section 3(18)(B) have adopted the conjunctive two-part test. *See, e.g., Chao v. Hall Holding Co., Inc.,* 285 F.3d 415, 436 (6th Cir. 2002) ("[T]he definition of 'adequate consideration' has two distinct parts. First, there is the 'fair market value' part, then there is the 'as determined in good faith by the trustee' part.") *See also Perez v. Commodity Control Corp.*, 2017 WL 1293619 at *8 (S.D. Fla. Mar. 7, 2017) (citing the 1988 proposal and holding that "[t]he DOL's proposed rule was based on the agency's conclusion that Congress intended to create a two-part inquiry when it defined adequate consideration under 29 U.S.C. § 1002(18) . . . [t]he Court agrees with the DOL's interpretation of Congress' intent in enacting the ERISA Section 408(e) exemption, finds it consistent with the overall purpose of ERISA, and therefore adopts the construction in the DOL's proposed regulation."). *But see Herman v. Mercantile Bank, N.A.*, 143 F.3d 419, 421-22 (8th Cir. 1998) (holding that fiduciary did not violate ERISA if he paid same price for stock as prudent fiduciary would have); *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346, 356–57 (4th Cir. 2014) (holding that fiduciary did not violate ERISA if despite imprudent decision-making process, ultimate investment decision was objectively prudent).

of a given asset, and cause harm to the plan and its participants. A conjunctive two-part test guards against these situations, and enables the plan to obtain appropriate redress (e.g., rescission).[47]

This approach also accords with Congress' determination to treat these stock transactions as "prohibited transactions," which are forbidden because of the dangers the transactions pose to plan participants and beneficiaries in the absence of an exemption like section 408(e).[48] The proper determination of fair market value is central to the adequate consideration requirement and its participant-protective purposes. Accordingly, as in the 1988 proposal, the proposed regulation "links the fair market value and good faith requirements to assure that the resulting valuation reflects market considerations and is the product of a valuation process conducted in good faith." As the Fifth Circuit held in *Donovan v. Cunningham*, 716 F.2d at 1467, "[t]he statutory reference to good faith . . . must be read in light of the overriding duties of Section 404 [general fiduciary duties under ERISA]."

In addition, as discussed above, the Department explained in the preamble to the 1988 proposal that there may be circumstances where good faith alone fails to ensure an equitable result. Accordingly, the Department concluded that, in setting a standard for a statutory exemption that would allow dealings between a plan and plan sponsor, the Department should assure application of all the external safeguards envisioned by Congress.[49] The Department continues to hold this view. A conjunctive two-part test requiring both fair market value and good faith, as set forth in this proposal, protects plan interests from the dangers posed by the otherwise prohibited stock transaction. For example, it would protect an ESOP in the circumstance where the ESOP trustee made a good faith and prudent effort to value the stock, but the seller, who owned and controlled the company, provided misleading or incorrect information about the company's financial circumstances (e.g., the seller knew that it was about

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[47] 53 FR 17633-4.
[48] *See* ERISA 406(a)(1)(A), 29 USC 1106(a)(1)(A).
[49] 53 FR 17632, 17634.

to lose a license that was critical to its continued operation, that a key customer had decided to terminate its relationship with the business, or that the company's financial statements were materially inaccurate, but failed to disclose the true state of affairs to the plan's fiduciary, despite the fiduciary's careful review of the company's business and prospects).

Under this proposal's conjunctive two-part test, the requirements of ERISA section 3(18)(B) t will not be met unless the value assigned to employer stock reflects the asset's fair market value as defined in paragraph (b)(2) of the proposal and is the result of a prudent determination made by the plan trustee or named fiduciary pursuant to a prudent process as described in paragraph (b)(3) of the proposal. Under this approach, a transaction similarly fails the adequate consideration standard when the fiduciary undertakes a prudent process but fails to arrive at fair market value. The fiduciary may not cause or commit the ESOP to pay, directly or indirectly, more for employer stock than its fair market value on the date of the transaction, or to receive, directly or indirectly, less than the stock's fair market value on the date of the transaction. Similarly, a transaction will fail the test if the fiduciary inadvertently arrives at fair market value, despite the lack of a prudent process.[50] Thus, even without a current financial harm, steps could be taken to protect the plan from potential future harm such as seeking removal of such a fiduciary who by mere happenstance approves a particular transaction for fair market value. A standard without both conditions would deprive the plan of a prophylactic remedy in cases when a fiduciary acting in an imprudent, disloyal, or abusive manner

[50] This generally is not a change from existing case law. *See, e.g., Chao v. Hall Holding Co.*, 285 F.3d 415, 436-7 (6th Cir. 2002) (good faith determination is a portion of definition of adequate consideration, so therefore court must give weight to how the fiduciary acted in selection of investment, not whether investments succeeded or failed); *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983) (when determining whether adequate consideration has been paid, test is expressly focused on conduct of fiduciaries); *Eyler v. C.I.R.*, 88 F.3d 445, 455 (7th Cir. 1996) (adequate consideration test focuses on conduct of fiduciaries in determining price, not the price itself); *DeFazio v. Hollister, Inc.*, 854 F. Supp. 2d 770, 801 (E.D. Cal. 2012) (citing *Hall Holding*). *But see Herman v. Mercantile Bank, N.A.*, 143 F.3d 419, 421-22 (8th Cir. 1998) ("Even if a trustee fails to make a good faith effort to determine the fair market value of the stock, he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyways."); *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346, 356–57 (4th Cir. 2014)("For '[e]ven if a trustee failed to conduct an investigation before making a decision,' and a loss occurred, the trustee 'is insulated from liability ... if a hypothetical prudent fiduciary would have made the same decision anyway.' *Plasterers' Local Union No. 96 Pension Plan v. Pepper,* 663 F.3d 210, 218 (4th Cir.2011) (quoting *Roth v. Sawyer–Cleator Lumber Co.,* 16 F.3d 915, 919 (8th Cir.1994))").

accidentally but luckily agreed to the same price that would have been chosen by a hypothetical prudent person.

The Department specifically seeks comments on the proposal's requirement that plan fiduciaries *both* implement a good faith process that meets the fiduciary standards of prudence and loyalty *and* that the fiduciary, in fact, gets the price right by meeting the fair market value standard. In the published cases in which the courts have found violations of the adequate consideration test, it has tended to be the case both that the fiduciaries failed to meet the prudence standard, and that the price did not accord with fair market value.[51] The Department is not aware of any published opinion in which the question of fair market value and prudence did not go hand in hand.

3. Fair market value

In paragraph (b)(2)(i), the Department proposes to define the term "fair market value," as used in section 3(18)(B) of ERISA, as the price at which the employer stock would change hands in an arm's length transaction 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, and the parties are both willing and able to trade and have reasonable knowledge of the facts relevant to the

[51] *See, e.g.*, *Fish v. GreatBanc Tr. Co.*, 749 F.3d 671, 680 (7th Cir. 2014) ("Whether an ERISA fiduciary has acted prudently requires consideration of both the substantive reasonableness of the fiduciary's actions and the procedures by which the fiduciary made its decision[.]"); *Keach v. U.S. Tr. Co.*, 419 F.3d 626, 636 (7th Cir. 2005) ("In order to rely on the adequate consideration exemption, a trustee or fiduciary has the burden to establish that the ESOP paid no more than fair market value for the asset, and that the fair market value was determined in good faith by the fiduciary."); *Chao v. Hall Holding Co.*, 285 F.3d 415, 436 (6th Cir. 2002) ("[T]he definition of 'adequate consideration' has two distinct parts. First, there is the 'fair market value' part, then there is the 'as determined in good faith by the trustee' part."); *Reich v. Valley Nat'l Bank of Arizona*, 837 F. Supp. 1259, 1280-81 (S.D.N.Y. 1993) ("The Secretary argues that it is unitary and conjunctive. The Secretary's reading is clearly the correct one. A court's review of a transaction determines whether the price paid was adequate consideration, i.e. 'the fair market value of the asset as determined in good faith.'").

stock's value. This proposed definition reflects the well-established meaning of fair market value as understood at the time Congress enacted ERISA in 1974.[52]

In this connection, the Department also notes that the fair market standard is not based on the unique circumstances, motivations, idiosyncrasies, or characteristics of a specific buyer or seller, but rather on the objective value as determined by reference to a hypothetical buyer and seller on the date of the transaction.[53] In other words, the fair market value standard is an objective standard focused on the price at which the asset would trade in the broader market, rather than on the investment value that a particular investor might ascribe to the asset based on the investor's unique attributes.[54]

Similarly, paragraph (b)(2)(ii) provides that fair market value is determined on the same basis as if the ESOP were purchasing the stock on a cash or cash equivalent basis, without any increase in the value imputed to the stock based on consideration of the terms of any debt, direct or indirect, used to finance the acquisition. For example, under this provision, the fair market value imputed to the stock would not be affected by the terms of the parties' financing of the transaction. The stock's fair market value is the same for all potential buyers, irrespective of whether the buyer pays cash or obtains third-party or seller financing for the transaction.[55]

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[52] *See*, *e.g.*, T.D. 6296, 23 FR 4529, 4545 (June 24, 1958), as amended by T.D. 6684, 28 FR 11408 (Oct. 24, 1963), and T.D. 6826, 30 FR 7708 (June 15, 1965) ("The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."); IRS Rev. Rul. 59-60, 1959-1 Cum. Bull. 237; *United States v. Cartwright*, 411 U.S. 546, 551 (1973).

[53] *See*, *e.g.*, *Reich v. Valley National Bank*, 837 F. Supp. at 1281-1283 (relating to "adequate consideration" under ERISA section 3(18); distinguishing between "fair market value" based on hypothetical willing buyer and seller with "investment value" that took into account post-transaction contributions that would be made to the ESOP); *Est. of Gimbel v. Comm'r*, 92 T.C.M. (CCH) 504, 2006 WL 3733277, at *5 (2006) (relating to estate tax); *Hess v. Comm'r*, 86 T.C.M. (CCH) 303, 2003 WL 21991627, at *5 n.11 (2003) (relating to estate tax); *Est. of Newhouse v. Comm'r*, 94 T.C. 193, 218 (1990) (relating to estate tax).

[54] For example, when an ESOP purchases stock issued by an S corporation, the ESOP has unique tax advantages, as opposed to other commercial actors. The additional tax benefits, however, are specific to the ESOP as a purchaser. Other buyers, in arm's length transactions involving the same company, would not reap those benefits; nor could the ESOP resell S corporation stock at a higher price to third parties based on the availability of tax benefits that are available solely to the ESOP. Accordingly, consistent with this proposal, the plan's fiduciaries could not transfer the value of the additional tax benefits to the sellers by inflating the purported fair market value of the stock to reflect the tax benefits that only the ESOP brought to the table.

[55] The Department has long taken the position, as a matter of enforcement policy, that it will not bring cases against ESOP fiduciaries solely on the basis that they failed to deduct the acquisition debt (and associated employer contribution obligation) incurred in the transaction from the enterprise value of the company when determining fair

To the extent that the transaction is debt-financed, however, the parties to the transaction must take care to ensure that the separate requirements of ERISA section 408(b)(3) and 29 CFR 2550.408b-3 are satisfied. Under the terms of ERISA section 408(b)(3), an ESOP loan is exempt from ERISA's prohibited transaction provisions only if the loan is "primarily for the benefit of participants and beneficiaries," and the loan's interest rate is "not in excess of a reasonable rate." To fully comply with ERISA, a leveraged ESOP transaction must satisfy both the adequate consideration requirement of ERISA section 408(e) and the requirements of section 408(b)(3). If, for example, a fiduciary causes the plan to pay more than fair market value for stock, it is no defense that the interest rate on the loan was reasonable or better than market rates.

Finally, paragraph (b)(2)(iii) of the proposal provides that the fiduciary must determine the fair market value of employer stock as of the date of the transaction, and that the determination must reflect appropriate consideration of all known or reasonably knowable information relevant to the value of the asset as of that date. The purpose of this requirement is to ensure that the assessment of fair market value is based on the most current data available, that projections used in the valuation appropriately account for current, accurate and relevant information, and that the valuation materially reflects the financial status of the company as of the date of the transaction. Under the proposal, a determination must appropriately reflect all known, or reasonably knowable, information affecting the value of the employer stock as of the transaction date.

4. *Good Faith Fiduciary Determination of Price – Prudence*

4.1. Paragraph (b)(3)(i)

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market value. While the impact of the debt incurred to finance the transaction is relevant to the overall prudence of the transaction more generally (for example, a prudent fiduciary would not enter into a transaction that saddles the company with an unsustainable debt load), as a matter of enforcement policy the Department has consistently disregarded the debt burden effectively incurred by the ESOP in the transaction in this manner. This proposal is consistent with the Department's enforcement policy. But see *Eyler v. Commissioner of Internal Revenue*, 88 F.3d 445 (7th Cir. 1996) (taxpayer liable for excise tax based, in part, on failure to consider acquisition debt in determining fair market value of stock purchased by ESOP).

Paragraph (b)(3) of the proposal describes the prudent process that must be followed by an ESOP trustee or named fiduciary to meet the regulation's adequate consideration standard. It reflects principles articulated in court decisions,[56] and elements from the Department's process agreements, described above,[57] which a number of participants in stakeholder outreach meetings suggested might be helpful as broadly applicable guidance. The process described in paragraph (b)(3) outlines a framework for an ESOP fiduciary's prudent reliance on a valuation report in making an adequate consideration determination under the proposed regulation. As discussed below, under this framework, a fiduciary must prudently select a qualified independent valuation advisor to prepare a written valuation report (paragraph (b)(3)(ii)), ensure that the valuation report is based on complete, current and accurate information (paragraph (b)(3)(iii)), and ensure that it is prudent to rely on the valuation report (paragraph (b)(3)(iv)).

Paragraph (b)(3)(i) provides that, in the context of evaluation of employer stock, a fiduciary independent of the plan's counterparty must prudently choose and engage a qualified independent valuation advisor to value the employer stock, prudently oversee the production of a written valuation report that satisfies paragraph (b)(4) of the regulation, conduct a prudent review of the valuation report, and exercise prudent judgment in arriving at determination of fair market value. It further states that the ultimate responsibility for determining whether and to what extent to rely upon the valuation, and for structuring the terms and price of the transaction, belongs to the fiduciary, and that the paragraph establishes an objective standard of conduct, which must be satisfied in light of all relevant facts and circumstances. Paragraphs (b)(3)(ii) through (iv) establish minimum requirements, which must be met in every case.

The fiduciary's independence from the plan's counterparties in the stock transaction is a key component of a good faith process and a critical protection of the proposal. Often, in ESOP

[56] *See*, *e.g.*, *Howard v. Shay,* 100 F.3d 1484 (9th Cir. 1996), *cert. denied*, 520 U.S. 1237 (1997); *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983).

[57] *See* https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement (last visited January 8, 2025) (list of ESOP Appraisal Process Agreements).

transactions, the plan is acquiring the stock from corporate officers, managers, and other persons who control the company, its financial data, and its employees. Because of their control over critical information and their authority over subordinate corporate employees, it can be all too easy for the sellers to dominate the fair market value determination, even though the sellers' interest is directly opposite the plan's interest as a buyer. As a result, it is critically important that the plan's interests in the transaction be represented by a truly independent fiduciary acting exclusively in the interest of the plan and its participants, and without regard to the competing financial interests of the plan's counterparties in the transaction.

Whether a fiduciary is independent of the plan's counterparty is a factual determination based on all relevant facts and circumstances. A useful starting point for evaluating independence of a fiduciary is an examination of formal relationships indicating that a counterparty may be in a position to effectively control the fiduciary. For example, the Department would not consider a fiduciary to be independent of the plan's counterparty if the fiduciary is directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with the counterparty or any of the counterparty's affiliates. Furthermore, the Department would not consider a fiduciary to be independent if the fiduciary is an officer, director, partner, employee, employer, or relative (as defined in section 3(15) of the Act and including siblings) of a counterparty; or is a corporation or partnership of which a counterparty is an officer, director or partner.

The Department stresses, however, that independence is not just a matter of form or appearance, but of reality. Plan fiduciaries must act with undivided loyalty to the plan and its participants, without regard to the competing interests of other parties to the transaction. *See*, e.g., *Brundle v. Wilmington Trust, N.A.*, 241 F. Supp. 3d 610, 643 (E.D. Va. 2017) (finding a prohibited transaction had occurred where there were significant business and financial ties between plan's fiduciary, consultant for the seller, and the appraiser, which may have contributed to failure to question appraisal or negotiate effectively for the plan). The Department requests comment on whether it should add a specific definition of independence to the proposal, and on the contours of such a definition.

4.2. Paragraph (b)(3)(ii)

A linchpin of a prudent process for determining fair market value is the selection and use of an independent expert who possesses the requisite expertise to value stock. *Cf.* 26 U.S.C. 401(a)(28)(C) (requiring that all valuations of employer securities (when not readily tradeable on an established securities market) be performed by an "independent appraiser").[58] Accordingly, the Department proposes in paragraph (b)(3)(ii) that, as part of the prudent process required under the regulation, a fiduciary must prudently select an independent qualified valuation advisor to perform a valuation of the employer stock being evaluated by the fiduciary. The Department solicits comment on the required use of an independent valuation advisor, including whether commenters believe there are circumstances under which use of an independent valuation advisor would be unnecessary or would not be in the best interest of a plan and its participants. For instance, if an ESOP trustee or named fiduciary itself has sufficient expertise and experience to prudently investigate and value a potential investment in employer stock, do commenters believe the regulation should provide flexibility for the fiduciary to forgo use of an independent valuation advisor?

Paragraph (b)(3)(ii) of the proposal provides that a fiduciary must prudently select a valuation advisor who is qualified with appropriate training and expertise to reasonably perform the valuation, who is independent from all parties to the transaction except the plan, and who was not selected by any of the other parties to the transaction. The requirement that a valuation advisor not be selected by any other party to the transaction would preclude, for instance, a plan counterparty from requiring an ESOP fiduciary to use a particular valuation advisor or a

[58] Shannon P. Pratt & Alina V. Niculita, Valuing a Business 814 (5th ed. 2008) (citing Code section 401(a)(28)(C) (26 U.S.C. 401(a)(28)(C)). Cf. Leigh v. Engle 727 F.2d 113, 129 (7th Cir. 1984) (fiduciaries faced conflicting loyalties, but undertook no genuinely independent investigation and failed to seek independent advice).

valuation advisor selected from a list of valuation advisors prepared by the counterparty. A prudent fiduciary, in an arm's length transaction, would not turn over the selection of an appraiser to the plan's counterparty, who has opposing interests in the transaction. The selection of the appraiser by the counterparty, or undue influence by the counterparty over the appraiser's selection, is inconsistent with the prudent good faith process required by the statute.

Paragraph (b)(3)(ii) also sets out minimum steps that a fiduciary must take in the prudent selection of an independent valuation advisor under the proposal. Under paragraph (b)(3)(ii)(A), the fiduciary must prudently engage in an objective process designed to obtain the information necessary to assess the qualifications of different providers to act as valuation advisor. This provision is consistent with guidance issued by the Department regarding fiduciary prudence in the selection of service providers generally, as well as consistent with established case law.[59] The fiduciary cannot make an informed decision on the appraiser without considering a range of possible appraisers and their varying qualifications for the job.

Paragraphs (b)(3)(ii)(B) and (C) require a fiduciary to prudently investigate the qualifications and integrity of the valuation advisor and determine that the valuation advisor is able to perform the valuation in accordance with the standards of professional conduct that a prudent advisor acting in a like capacity and familiar with such matters would use in a similar transaction. In complying with these provisions, a fiduciary would be expected to consider all relevant facts and circumstances, including whether a valuation advisor has sufficient experience in the industry of the company issuing the employer stock. A fiduciary also would be expected

[59] *See*, *e.g.*, Letter from Bette Briggs, Chief, Ofc. of Regulations and Interpretations, EBSA, to Diana Ceresi, Assoc. Gen. Counsel, SEIU, AFL-CIO, CLC (Feb. 19, 1998), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/02-19-1998; Bugielski v. AT&T Servs., Inc., 76 F.4th 894, 912-14 (9th Cir. 2023) (reversing and remanding dismissal of claim fiduciaries imprudently selected service provider, where plaintiffs provided testimony that fiduciaries had not considered compensation service provider received from another entity in connection with plan); Vellali v. Yale Univ., 308 F. Supp.3d 673, 685 (D.Conn. 2018) (plaintiffs stated quintessential prudence claims rooted in decision-making process of selecting recordkeeper); Thomson v. Caesars Holdings Inc., 661 F. Supp.3d 1043, 1060 (D.Nev. 2023) (plaintiffs stated claim against fiduciaries for imprudent selection of service provider that allegedly had conflict of interest and inferior track record compared to plan's existing menu); Liss v. Smith, 991 F. Supp. 278, 300-01 (S.D.N.Y. 1998) (trustees who never engaged in any comparative shopping or solicitation and consideration of other bids for service providers, even when those providers sought fee increases, breached their fiduciary obligations).

to consider whether a valuation advisor was the subject of any prior criminal, civil, or regulatory investigations or proceedings, and the outcome of any such proceedings or investigations, as well as other indications relating to the appraiser's integrity.

Next, paragraph (b)(3)(ii)(D) requires a fiduciary to ensure that the valuation advisor does not have relationships with any parties to the transaction that might influence the advisor in the performance of the valuation. This provision focuses on relationships that might compromise the independence of a valuation advisor in performing the valuation required under the regulation. For the same reasons as discussed above with respect to the proposal's independent fiduciary requirement, this provision does not include a formal definition of independence and does not expressly limit an evaluation of independence to a valuation advisor's formal relationships. Rather, this provision leaves it to the fiduciary selecting a valuation advisor to thoroughly and critically vet the advisor and take into account all relevant facts and circumstances. The Department requests comment on this approach, including comments on whether the provision should contain more detailed guidance on independence and how such guidance should be formulated.

Paragraph (b)(3)(ii)(E) reflects a fiduciary's overarching duties of prudence under ERISA and requires a fiduciary to ensure that it is otherwise reasonable to select the valuation advisor for the particular transaction at issue. The prudent selection of a qualified appraiser requires careful assessment of all the relevant facts and circumstances. A fiduciary may not ignore a matter relevant to the determination merely because it is not expressly included in paragraphs (b)(3)(ii)(A) through (D).

Finally, paragraph (b)(3)(ii)(F) requires the fiduciary to document the steps taken to satisfy paragraphs (b)(3)(ii)(A) through (E), consistent with the fiduciary's fundamental obligation of prudence. While fiduciaries should generally document their plan activities, the requirement is especially important in the context of ESOP purchases and sales because of the central importance of the stock transactions to the creation and operation of the ESOP, the dangers unsound valuations pose to participants and beneficiaries, and the adequate consideration requirement's inclusion as a condition of the statutory exemption in section 408(e) of ERISA. A fiduciary who causes a transaction prohibited by section 406 of ERISA but relies on a statutory exemption, such as the exemption set forth in ERISA section 408(e), has the burden of proving that they meet the conditions of the exemption.[60] The proposal's documentation requirement is a critical aspect of providing that proof.

4.3. Paragraph (b)(3)(iii)

The Department proposes in paragraph (b)(3)(iii) that, as part of the prudent process under the regulation, the fiduciary must prudently ensure that the valuation advisor receive complete, current, and accurate information about the issuer of the employer stock and transaction being evaluated by the fiduciary. An appraisal that is based on incomplete, outdated, or inaccurate information is unreliable, and a prudent fiduciary would not rely upon it to determine adequate consideration. The provision additionally sets out minimum requirements that should be satisfied to meet this overarching obligation. Thus, paragraph (b)(3)(iii)(A) requires that the fiduciary must prudently ensure that the valuation advisor is provided all material current financial information reflecting the issuer's current condition, performance, and prospects, including audited financial statements to the extent possible, as well as material historical data concerning the issuer's past performance and financial condition.

Paragraph (b)(3)(iii)(B) requires that the fiduciary ensure that the valuation advisor is informed of any recent expressions of interest or offers by third parties to purchase stock from the issuer. Such expressions of interest are not necessarily dispositive, but they provide critical data on the market value of the stock and the terms on which third parties are willing to sell or acquire the stock. Accordingly, a prudent fiduciary would make appropriate inquiries into such

[60] *See Harris v. Amgen, Inc.*, 788 F.3d 916, 943 (9th Cir. 2015), *rev'd on other grounds*, 577 U.S. 308 (2016) ("the existence of an exemption . . . is an affirmative defense"); *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996) (holding the defendant bears the burden of proving the applicability of an exemption).

contemporaneous offers or expressions of interest and ensure that the valuation advisor had available information on them.

Paragraph (b)(3)(iii)(C) requires a fiduciary to ensure that the valuation advisor is provided access to the issuer's management and personnel, as necessary to assess the company's financial condition, performance, and prospects. The ability to engage directly with relevant management and personnel, ask probing questions, and engage in a conversation on matters of concern to the valuation is integral to assessing the company's financial prospects, filling in the gaps in the financial statements and documentation, and testing the parties' assertions and analyses.

Finally, as part of the minimum established requirements under paragraph (b)(3)(iii), paragraph (b)(3)(iii)(D) requires a fiduciary to ensure that the valuation advisor is informed that the valuation report must satisfy paragraph (b)(4) of the regulation, and assents to the preparation of a report that comports with that paragraph. By requiring that the adviser is informed of, and assents to, the requirements of paragraph (b)(4), this proposal further assures compliance with its requirements.

The Department requests comment on this approach, including whether there are additional types of information that should be specified under paragraph (b)(3).

4.4. Paragraph (b)(3)(iv)

Consistent with the case law on ERISA's adequate consideration requirement, paragraph (b)(3)(iv) of the proposal requires the fiduciary to ensure that it is prudent to rely on the valuation report as a basis for determining the price at which the plan transaction should occur, and that the plan is not buying for more than fair market value or selling for less than the fair market value.[61] As the Fifth Circuit observed in *Donovan v. Cunningham*, 716 F.2d at 1474,

[61] *Donovan*, 716 F.2d at 1473-4 (imprudent for fiduciary to rely on appraisal when they failed to investigate sufficiently whether the appraisal remained a reasonable approximation of fair market value at the times they relied on it); *Howard v. Shay*, 100 F.3d 1484, 1489-90 (9th Cir. 1996) (prudent fiduciary would have questioned assumptions and adjustments in appraisal; fiduciary is required to make honest, objective effort to read valuation, understand it, and question methods and assumptions that do not make sense); *Reich v. Valley Nat. Bank of Arizona*,

"[a]n independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly."[62]

Paragraphs (b)(3)(iv)(A) through (J) set forth basic requirements for ensuring that the fiduciary can reasonably rely upon the appraisal as a tool for determining fair market value. In setting forth these requirements, the Department has sought to provide principles-based guidance that clearly sets forth the obligations of the fiduciaries, consistent with ERISA's fundamental duties of prudence and loyalty. It has not, however, attempted to provide a highly detailed and prescriptive guide to professional valuation standards that specifies precisely which methodologies, calculations, and operational approaches the fiduciary should take in every instance. The Department's aim in this regulation is to set forth the fiduciary framework for the proper use and development of appraisals, not to provide a detailed manual for appraisers or to specify precise methods and methodologies for resolving every issue that arises in the context of particular cases involving the enormous range of businesses, business practices, and securities in the national economy. The Department seeks public comment on whether it has struck the right balance in this regard, and whether there is need for greater specificity with respect to any of the particular elements set forth in paragraphs (b)(3)(iv)(A) through (J).

In this connection, the Department also notes that it is contemporaneously proposing a new class exemption in this issue of the *Federal Register* for the initial purchase of stock by a newly-formed ESOP that is much more prescriptive and provides a detailed pathway to compliance for transactions that fall within its terms. The exemption is not intended to provide

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837 F. Supp. 1259, 1274 (S.D.N.Y. 1993) (imprudent of fiduciary to make investment based on valuation report that relied solely on representations by the company as to its health and fairness of the deal*); Brundle v. Wilmington Trust, N.A.*, 919 F.3d 763, 774 (4th Cir. 2019) (factual findings supported district court's finding that trustee had not demonstrated that its reliance on valuation report was reasonably justified, because trustee had not shown that it thoroughly probed gaps and internal inconsistencies in report); *Perez v. Bruister*, 823 F.3d 250, 264-5 (5th Cir. 2016) (trustees who conducted insufficient investigation into appraiser's background and qualifications, overlooked communications in which appraiser and seller's attorney were working together to increase appraisal value, failed to inform appraiser of significant information that should have affected his valuation, and failed to double-check or significantly review appraiser's ultimate conclusions, were not reasonably justified in reliance on appraiser's valuation and therefore did not act prudently).

[62] See, e.g., *Howard v. Shay*, 100 F.3d at 1489-90; *Reich v. Valley Nat'l Bank of Arizona*, 837 F. Supp. at 1274.

the sole means for complying with this proposal, but rather to create a safe harbor for parties that choose to rely upon its terms. Thus, for example, it includes specific certification, insurance, and capitalization requirements that would not always be necessary outside the specific context of the exemption. By the same token, however, many of its specific requirements reflect the approaches that prudent fiduciaries would take in virtually any transaction involving the purchase of closely held stock. Accordingly, the Department seeks public comment on whether any of its more detailed provisions should be specifically incorporated in this proposal as generally applicable obligations for fiduciaries when determining fair market value for purposes of the adequate consideration requirement. Similarly, the Department seeks public comment on whether it should provide specific examples illustrating the application of this proposed rule and the proposed safe harbor exemption to various factual scenarios, as well as descriptions of the scenarios for which examples would be helpful.

As underscored in paragraph (b)(3)(i) of the proposal, the fiduciary has ultimate responsibility for determining whether and to what extent to rely upon the valuation and the terms and price of a transaction. Accordingly, before the fiduciary can rely on a valuation report, the fiduciary must take prudent steps to understand it and to ensure that it can reasonably be relied upon as a basis for determining the price in accordance with the principles set forth in paragraphs (b)(3)(iv)(A) through (J). This does not mean that the fiduciary must "become an expert in the valuation of closely held corporations."[63] It does mean, however, that the fiduciary must have and apply the expertise necessary to ensure the reliability of the appraisal by applying the principles set forth in this proposal. In some cases, if the fiduciary is unable to fully understand the report or verify its reliability without additional assistance, the fiduciary may need to consult a second expert.[64] As the person empowered to engage in transactions involving the investment of the majority of the plan's assets in employer stock (often, totaling millions or

[63] *Howard v. Shay*, 100 F.3d at 1490.
[64] *See Howard v. Shay*, 100 F.3d at 1490 ("If after a careful review of the valuation and a discussion with the expert, there are still uncertainties, the fiduciary should have a second firm review the valuation.").

hundreds of millions of dollars), the fiduciary must act with the care, skill, prudence, and diligence that knowledgeable financial professionals would apply in similar circumstances.

Paragraphs (b)(3)(iv)(A) and (B) respectively require that the fiduciary must prudently read and carefully review the valuation report and supporting documents and that the fiduciary must understand the report.[65] Clearly, a fiduciary cannot prudently rely on a valuation report if the fiduciary has not even read the valuation. Similarly, a fiduciary cannot prudently rely on a valuation without understanding the valuation, its methodologies, assumptions and logic sufficiently to assess the soundness and reliability of the appraisal.

Under paragraph (b)(3)(iv)(C) of the proposal, the fiduciary must identify, question, and evaluate the report's underlying assumptions (e.g., performance forecasts or projections); assess the reasonableness of those assumptions and the sensitivity of the appraisal's conclusions to those assumptions; and, to the extent that any alternative assumptions are reasonably plausible, assess the potential impact of reasonable changes in the assumptions on the valuation's conclusions (e.g., the impact of variations in forecasts or projections), and the need for adjustments to the assumptions. For example, as further indicated in the provision, the plan fiduciary must prudently assess the reliability and trustworthiness of any projections of future performance, consider the likely consequence of missed projections, and ensure that the appraisal is based upon reliable and trustworthy projections.

In purchase transactions, the Department is particularly concerned with use of inflated projections that reflect unduly optimistic views of future revenues or profit margins. In general, plan fiduciaries must critically probe whether the assumptions and financial projections relied upon in the appraisal are reasonable in fact. In this connection, plan fiduciaries should cast a particularly critical eye towards projections prepared by company management, which may have

[65] *E.g.*, *Howard v. Shay*, 100 F.3d 1484, 1490 (9th Cir. 1996) ("[T]he fiduciary is required to make an honest, objective effort to read the valuation, understand it, and question the methods and assumptions that do not make sense."); *Kindle v. Dejana*, 238 F. Supp. 3d 353, 370 (E.D.N.Y. 2017) (same); *see Scalia v. Reliance Trust Company*, No. 17-CV-4540, 2021 WL 795270, at *33 (D. Minn. Mar. 2, 2021) (citing the standard from *Shay*, 100 F.3d at 1490, as to a fiduciary's duty to read and understand a valuation report, as well investigate "methods and assumptions that do not make sense").

an incentive to boost projections, particularly when management owe their jobs to the seller, who has an obvious and direct interest in maximizing the purchase price that is directly counter to the plan's interest in getting the best possible deal.

Paragraph (b)(3)(iv)(D) of the proposal requires a fiduciary to prudently verify that the analyses in the valuation report are consistent with application of sound valuation and financial principles, reflect an accurate assessment of the company's current financial condition and prospects, and that the report is internally consistent, well-reasoned, and consistent with available data. While the fiduciary need not be a valuation expert, the fiduciary must have the financial acumen and familiarity with valuation methodologies necessary to ensure that the valuation methods are reasonable, the inputs and assumptions correspond with the facts, and the appraisal's logic is sound. This is not a check the box exercise of papering a transaction, but rather an undertaking that requires the fiduciary to actively engage with the appraisal and its underpinnings.

If, for example, the appraisal relies upon a comparison of the appraised company with publicly traded companies, the fiduciary would need to consider whether the "comparable" companies were well chosen (e.g., whether they are comparable in terms of industry, size, customer concentration, earnings volatility, access to the capital markets); evaluate the relevant similarities and differences between the appraised company and the companies chosen for comparison; consider the range of multiples reflected in the data on the "comparable" public companies (and review the basis for choosing the particular multiple selected to arrive at fair market value); consider how corporate debt was accounted for in arriving at the equity value; and identify and review any other important assumptions. Similarly, if the appraisal relies on discounted cash flow analysis, the fiduciary must carefully consider the projections used in the analysis, the logic behind the discount rate selected (such as the various components of the weighted average cost of capital, if used to determine the discount rate), the risk assumptions reflected in the analysis, any firm-specific risks, and any other material assumptions or parameters.

Paragraph (b)(3)(iv)(D) requires that the fiduciary prudently verify that the analyses in a valuation report reflect an accurate assessment of the company's current financial condition and prospects, and that the report is internally consistent, well-reasoned, and consistent with available data. A critical aspect of prudent review is to identify and explore apparent inconsistencies, flaws in reasoning, and improper or incorrect assumptions, and address them. The fiduciary could not turn a blind eye to such flaws, but rather would have to ensure that they were corrected, and if they were not corrected, reject the report as a prudent basis for determining price.

Paragraph (b)(3)(iv)(E) similarly requires that a fiduciary verify that the valuation report is based on complete, current, and accurate financial information about the issuer of stock. If an appraisal is based on incorrect premises, it is unreliable. A valuation may rely on apparently sound methodologies that are consistent with professional valuation standards, but if the inputs are wrong, the conclusions are unreliable. Accordingly, the fiduciary must verify that the final report is based on sound and current data.

Paragraph (b)(3)(iv)(F) requires a fiduciary to ensure that a valuation report properly accounts for the impact of the grant or assignment of any interests, rights, or claims to potential income streams or corporate assets to parties other than the plan shareholder. If, for example, in a stock purchase transaction, the sellers to the plan are granted warrants that will give them stock ownership rights based on the issuer's future performance, the dilutive impact of the warrants must be reflected in an appropriate reduction of the fair market value and associated purchase price. The plan should not pay for potential upside that, in fact, has been assigned to third parties or retained by the sellers. For example, if the sellers have been granted warrants with strike prices below the price paid by the ESOP, which are expected to result in the seller's retention of a significant equity stake in the company, the plan should not pay for the equity stake that has effectively been retained by the sellers. A stock purchase transaction unencumbered by the issuance of such warrants to a third party is worth more to the plan than an otherwise identical transaction encumbered by warrants, and the fair market valuation should reflect that fact.

Under paragraph (b)(3)(iv)(G) of the proposal, the fiduciary must prudently ensure that any adjustment to value based on a controlling or non-controlling interest is consistent with the circumstances surrounding the transaction, including the degree of control that the plan will have after the transaction and its ability to use that control to affect the stock's value. If, for example, the relevant transaction and governance documents establish that the plan will not have meaningful control over the actions of the corporation post-acquisition, it should not pay on a control basis. An ESOP may only pay a sales price based on obtaining a controlling interest where, based on the facts and circumstances, actual control (both in form and substance) is passed to the ESOP purchaser with the sale.

Under this proposal, facts and circumstances relevant to determining whether control has passed to the ESOP include, but are not limited to, the ESOP's enforceable power or authority to: appoint or select a majority of the board of directors or other management of the company; unilaterally direct corporate action; decide the amount of distribution; rearrange the corporation's capital structure; decide whether to liquidate, merge, or sell assets; independently exercise voting powers, in greater amount than a minority shareholder is able to; direct others in voting their shares; countermand the board's or company management's instructions; negotiate its interests in a sale as a controlling owner, using the methods of control listed above, rather than simply as a selling shareholder; and otherwise control the company's actions in ways other than the ways open to any minority shareholder. However, an ESOP would not be considered to have actual control by reason of having voting control over some or all of the factors listed above if the ESOP is constrained, in practice or operation (by corporate documents or other documents such as bylaws or investors' rights documents), from exercising its voting control. If the plan has no ability to effect change in the operations or management of the company based on new authority over the company, it has no basis for paying a premium for the stock. Before a fiduciary agrees to a fair market value determined on a control basis, the fiduciary must be able to identify the source of the incremental value and its basis for concluding that the ESOP can be expected to realize that value.

Paragraph (b)(3)(iv)(H) requires a fiduciary to ensure that a report value reflects an appropriate discount for lack of marketability and prudently justifies the discount selected. Because the stock at issue in this regulation is stock for which there is "not a generally recognized market," a prudent fiduciary would ensure that the purchase price reflected the reduced marketability of the stock, as compared to publicly traded securities. In general, a discount for lack of marketability is used to reduce the value of the stock of a closely held corporation to reflect the lack of a public market for the shares.[66] Such a discount reflects a hypothetical buyer's concern that, without a ready market, the buyer would experience difficulties when it decides to sell the stock. An assessment of marketability would address the difficulties and restrictions that both the ESOP and the ESOP participants may face in deciding to sell employer stock. In arm's length transactions involving closely held companies, parties commonly insist on substantial marketability discounts to reflect the difficulties of marketing such stock.[67]

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[66] The Department notes that "marketability discounts" are frequently discussed interchangeably with "minority discounts." However, these are two distinct concepts. Unlike a "marketability discount," "a minority discount in valuing stock allows an appraiser to adjust for a lack of control over the corporation on the theory that the minority shares of stock are not worth the same as the majority holdings due to the lack of voting power." 18A Am. Jur. 2d Corporations § 367 (citation omitted).

[67] See, e.g., *The Discount for Lack of Marketability: Update on Current Studies and Analysis of Current Controversies*, by Rober Reilly and Aaron Rotkowski (2007). The authors reviewed various studies and models that have been used to estimate the discount for lack of marketability (DLOM). Among other things, the authors concluded the restricted stock studies conducted prior to 1990 indicated price discounts of around 35%, and after 1990, the DLOM indicated in the restricted stock studies decreased to around 25%. The article can be found here: https://heinonline.org/HOL/Page?collection=journals&handle=hein.journals/txlr61&id=254&men_tab=srchresults. See also "Value & Cents: The Evolution of the Discount for Lack of Marketability" by Boris J. Steffen, American Bankruptcy Journal, March 2023, p. 14 ("For privately held companies, an investor's ability to sell their stock is diminished, as the stock is not registered with the Securities and Exchange Commission or publicly traded. The risk attributable to this limitation may result in a lower valuation for the stock, holding all else equal. For example, the traditional view of investment bankers and business appraisers has been to apply a discount of from 25 percent to 35 percent when valuing an interest in a stock having a two-year restriction period. [Francis A. Longstaff, "How Much Can Marketability Affect Security Values?," Journal of Fin. 50 (1995), 1767-1774.] The Internal Revenue Service (IRS) also recognizes this implicitly in Revenue Ruling 77-287, which states in part that "[s]ecurities traded on a

Numerous factors may affect marketability, depending on the facts and circumstances of the proposed transaction.[68] In addition, employer stock held by an ESOP is commonly subject to a "put" option whereby individual participants may, upon retirement, sell their shares back to the employer, who is obligated to re-purchase the shares. Stakeholders have questioned whether some kinds of "put" options may diminish the need to discount the value of the securities due to lack of marketability. However, the valuations at issue concern the block purchase or sale of employer stock by the plan, and the plan fiduciary has no right to put the stock acquired in the transaction back to the company on behalf of the plan. The valuation is performed with respect to the entire block of shares, and the right to the put belongs to the plan participant, not the ESOP. The ESOP could not sell its stock holdings to a third party at a markup based on the put option, which is only available to individual participants. Moreover, the seller does not need to be compensated for the put, which the seller neither provides nor guarantees, but rather reflects a post-transaction obligation of the company.

Nevertheless, the Department recognizes that the 1988 proposal contemplated that the valuation could consider the put option when valuing the stock, and the Department specifically requests comment on the proper weight, if any, to give the put option when determining fair market value. Even if it were appropriate to take the put option into account in certain circumstances, the Department cautions that a reduction in the discount for a lack of marketability could only be considered, if at all, after the fiduciary gives due consideration to whether the "put" option is enforceable, and whether the company has and may reasonably be expected to continue to have, adequate resources to meet its obligations under the put option. In addition, even if these considerations are satisfied, the Department notes that the stock lacks the protection of an objective price established through trading on a public exchange, but instead

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public market generally are worth more to investors than those that are not traded on a public market." This discount is known as, and measured by, the discount for lack of marketability (DLOM).").

[68] *See*, *e.g.*, *Mandelbaum v. Comm'r*, 69 T.C.M. (CCH) 2852 (T.C. 1995), *aff'd* 91 F.3d 124 (3d Cir. 1996).

depends on the assessment of fair market value, without benefit of a clear market-determined price. This too supports the need for a marketability discount. The Department also notes that paragraph (b)(3)(iv)(K) of the proposal, discussed below, requires a fiduciary to ensure that a valuation report reflects, among other things, the prudent consideration of the issuer's ability to meet its stock repurchase obligations.

Paragraph (b)(3)(iv)(I) requires that a fiduciary must ensure that the report and the transaction are free from bias or undue influence by any counterparty. A good faith process for determining fair market value must be free from bias in favor of selling shareholders or other counterparty. Thus, for example, a prudent fiduciary would not permit the seller to choose the appraiser or give the plan's counterparty authority over the oversight and preparation of the valuation advisor. Plan fiduciaries must guard against indicators of bias, such as prior or existing business relationships between the counterparty and the appraiser, preferential access to the appraiser, or other indicators of undue influence or control by the plan's counterparty.

Paragraph (b)(3)(iv)(I) is being proposed to provide additional protection and work in conjunction with the other protections under the regulation. As a fiduciary evaluates a valuation report and proposed transaction, under this provision the fiduciary would be expected to scrutinize those areas where the valuation advisor exercised any discretion or judgment (e.g., selection or application of valuation methodologies, selection of assumptions, or acceptance of projections) and evaluate the basis for the valuation advisor's decision.

Paragraph (b)(3)(iv)(J) requires a fiduciary to ensure that a valuation report's projected return on the ESOP's price per share over an appropriate period is consistent with the rates of return demanded by equity investors in similar transactions and is commensurate with the risks associated with the stock purchase. Because equity investors are paid only after holders of debt and other instruments that are senior to equity, such investors take on additional risk and look for returns commensurate with that risk when purchasing stock.

In addition, the Department's investigative program has identified abusive transactions which were engineered to maximize tax benefits to the plan sponsor, even as they were specifically designed to release stock to plan participants that was worth less than the amount paid for the stock. For example, in one case the ESOP borrowed money from the plan sponsor, a large publicly traded company, to acquire preferred stock, which, when released to participant accounts, was converted to common stock that was worth less than the amount paid for the stock. As a matter of design, plan participants' accounts received stock that was worth less than the plan had expended on the preferred stock.[69] Accordingly, and to prevent this sort of abuse, paragraph (b)(3)(iv)(J) further provides that the fiduciary must ensure that the transaction is reasonably expected to result in the ultimate release of shares to plan participants that are worth at least the amount paid per share by the plan, plus a reasonable rate of return. Comments are requested on the scope and administrability of this rule, including whether it could be more narrowly targeted to provide greater certainty while still addressing the identified abuse.

Finally, paragraph (b)(3)(iv)(K) requires a fiduciary to ensure that a valuation report reflects the prudent consideration of the issuer's ability to meet its stock repurchase obligations, comply with its contribution obligations, and meet any debt or other obligations on the terms established in connection with the transaction. As noted above, the Department, as a matter of enforcement policy, does not bring cases against ESOP fiduciaries solely on the basis that they failed to deduct the debt incurred in the transaction from the enterprise value of the company when determining fair market value (or, similarly, failed to deduct the impact of the associated contribution obligation which the sponsoring employer was expected to incur in connection with the ESOP's contemplated stock purchase). However, a prudent fiduciary would never engage in such a leveraged transaction if the company would likely be unable to service the resulting debt,

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[69] See e.g., US Department of Labor recovers $131.8M for Wells Fargo 401(k) participants after investigation finds plan overpaid for company stock | U.S. Department of Labor.

potentially jeopardizing both the plan participants' retirement income and their livelihood.[70] Under this provision, a fiduciary would be expected to carefully consider a company's ability to meet its obligations and the associated risk of insolvency, as well as the sensitivity of the ability to meet these obligations in response to reasonable changes in assumptions reflected in the valuation report

The Department requests comment on the general approach taken under paragraph (b)(3), including whether there are additional components to a prudent process that the Department should consider. Alternatively, do interested parties believe any of the elements identified in paragraph (b)(3) are not good indicators of a prudent process? If interested parties believe that certain items should or should not be considered as part of a prudent process, the Department requests specific explanation with support for the position.

5. *Valuation Report Content*

Paragraph (b)(4) of the proposal addresses the content of the written valuation report required under the regulation. It provides that a valuation report must be prepared in accordance with generally accepted professional standards for performance of valuations and must contain all the information that the valuation advisor reasonably determines may materially affect the value of the employer stock which, at a minimum, includes the information necessary for a prudent fiduciary to satisfy their obligations under paragraph (b)(3) of the proposal. The Department also notes that information required for compliance with paragraph (b)(3) is only a minimum. Under paragraph (b)(4), a valuation report would be expected to contain all

[70] *Cf. Eyler v. Comm'r*, 88 F.3d 445, 453-56 (7th Cir. 1996) (upholding finding by U.S. Tax Court that ESOP fiduciaries failed to exercise the necessary prudence when determining the fair market value of employer stock because that determination relied, in part, on a valuation that had not accounted for (1) the company's worsened cash flow following "shelved" initial public offering, (2) the establishment of the ESOP and the company's obligation to make contributions to the ESOP, or (3) that the company guaranteed a $10 million loan to the ESOP—a debt reflected on the company's balance sheet); *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983) (holding that an employer sponsor's contributions to an ESOP amount to a "cash drain" and "additional labor cost," the effects of which "upon the financial condition of the company must be taken into account by fiduciaries in their decision to fund and operate an ESOP").

information that the valuation advisor reasonably determines may materially affect the value of the employer stock.

The Department requests comment on the approach taken under paragraph (b)(4), including whether more or different information should be required in a valuation report under the regulation. Interested commenters should identify information and provide explanation. Also, in contrast to the broad description of information in proposed paragraph (b)(4), should the Department instead prescribe a specific list of information that must be contained in a valuation report? Furthermore, should the regulation require a valuation report to include an opinion by the valuation advisor as to the reasonableness of any projections used in the report?

6. Effective Date

In paragraph (b)(6), the Department proposes that the regulation will be effective for transactions taking place on or after the date that is 60 days after publication of the final regulation in the *Federal Register*. For this purpose, the date of the acquisition or sale is the relevant transaction. The Department invites comment on this standard and whether the final regulation should be made effective on a different date, including whether any transition or applicability date provisions should be added to the regulation for a transaction that a plan engages in pursuant to a binding agreement entered into before publication of the final regulation.

7. Severability

The Department considered but rejected a specific severability clause. Courts have held that "[i]f parts of a regulation are invalid and other parts are not, we set aside only the invalid parts unless the remaining ones cannot operate by themselves or unless the agency manifests an intent for the entire package to rise or fall together." *Bd. of Cnty. Commissioners of Weld Cnty., Colorado v. Env't Prot. Agency*, 72 F.4th 284, 296 (D.C. Cir. 2023). *See* also *Belmont Mun. Light Dep't v. FERC*, 38 F.4th 173, 187–88 (D.C. Cir. 2022). The view of the Department is that this normal judicial standard makes sense here, without need of any special rule provision.

However, the intent of the Department is that neither the fair market value provision nor the good faith fiduciary determination provision can operate by itself.

III. Regulatory Impact Analysis

This section analyzes the economic impact of the proposed rule and class exemption. The Department is publishing the proposed class exemption elsewhere in this issue of the *Federal Register*. Collectively, the proposed rule and exemption are referred to as the "rulemaking" for this section for ease of discussion.

The proposed rule and exemption are designed to work together, although each are separate regulatory actions. In order to consider the full impact of the regulatory actions, the costs, benefits, transfers, and alternatives to each aspect of this rulemaking are discussed below.

ESOPs are defined contribution retirement plans designed to invest primarily in qualifying employer securities, as defined by ERISA section 407(d)(6) and Code section 4975(e)(8).[71] An ESOP operates as a trust, holding the employer stock on behalf of plan participants and allocating employer stock to participant retirement accounts over time.[72] When a participant either leaves the company or retires, the participant receives a distribution of the stock allocated to them at the fair market value. The allocation may be subject to vesting.[73]

With its general principles, the proposed rule would provide clarity in defining the term "adequate consideration" as defined in section 3(18)(B) of ERISA in connection with certain ESOP transactions involving employer stock and the determination of the fair market value. While not the sole means of complying with the proposed rule, the proposed class exemption would be a safe harbor for parties that choose to rely on its conditions, and as such, would provide relief from the ERISA and Code prohibitions to allow an ESOP to purchase non-publicly

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[71] 29 U.S.C. 1107(d)(6); 26 U.S.C. 4975(e)(8).

[72] *See*, *e.g.*, *Chesemore v. Fenkell*, 829 F.3d 803, 807 n.1 (7th Cir. 2016) ("An ESOP is a trust into which the sponsoring company contributes stock, apportioning shares to its employees as a retirement benefit; on retirement the employee's equity is repurchased by the ESOP.").

[73] NCEO, *Using an Employee Stock Ownership Plan (ESOP) for Business Continuity in a Closely Held Company,* (Jan. 22, 2024), https://www.nceo.org/articles/esop-business-continuity#:~:text=At%20least%20all%20employees%20who,that%20is%20repaid%20that%20year.

traded employer stock so long as certain protective conditions are met. The proposed class exemption would provide relief for the following parties: selling shareholders, trustees that are independent of the employer and represent the interests of the ESOP in the transaction, appraisers that are independent of the employer and represent the interests of the ESOP in the transaction, and fiduciaries of the ESOP with authority to hire, monitor, or fire the aforementioned trustees.

The Department has examined the effects of these proposed rules as required by Executive Order 12866,[74] Executive Order 13563,[75] Executive Order 14094,[76] the Paperwork Reduction Act of 1995,[77] the Regulatory Flexibility Act,[78] section 202 of the Unfunded Mandates Reform Act of 1995,[79] and Executive Order 13132.[80]

1. *Executive Orders 12866, 14094 and 13563*

Executive Orders 12866 (as amended by 14094) and 13563 direct agencies to assess all costs and benefits of available regulatory alternatives. If regulation is necessary, agencies must select regulatory approaches that maximize net benefits, including potential economic, environmental, public health and safety effects, distributive impacts, and equity. Executive Order 13563 emphasizes the importance of quantifying costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

Under Executive Order 12866, "significant" regulatory actions are subject to review by the Office of Management and Budget (OMB). As amended by Executive Order 14094, section 3(f) of the Executive Order 12866 defines a "significant regulatory action" as any regulatory action that is likely to result in a rule that may:

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74 Regulatory Planning and Review, 58 FR 51735 (Oct. 4, 1993).
75 Improving Regulation and Regulatory Review, 76 FR 3821 (Jan. 18, 2011).
76 Modernizing Regulatory Review, 88 FR 21879 (Apr. 6, 2023).
77 44 U.S.C. 3506(c)(2)(A) (1995).
78 5 U.S.C. 601 et seq. (1980).
79 2 U.S.C. 1501 et seq. (1995).
80 Federalism, 64 FR 153 (Aug. 4, 1999).

(1) have an annual effect on the economy of $200 million or more (adjusted every 3 years by the Administrator of Office of Information and Regulatory Affairs (OIRA) for changes in gross domestic product); or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, territorial, or Tribal governments or communities;

(2) create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) materially alter the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or

(4) raise legal or policy issues for which centralized review would meaningfully further the President's priorities or the principles set forth in this Executive order, as specifically authorized in a timely manner by the Administrator of OIRA in each case.

It has been determined that this rulemaking is significant within the meaning of section 3(f) of the Executive Order, but not under section 3(f)(1). Therefore, the Department has provided an assessment of the potential costs, benefits, transfers, and alternatives and OMB has reviewed this proposed rulemaking.

2. *Requests for Comment*

The Department invites comments addressing its estimates of the benefits, costs, and transfers associated with the proposed rulemaking, as well as any quantifiable data that would support or contradict any aspect of its analysis. Specifically, the Department requests comment on:

- How common it is, under the current regulatory environment, to hire an independent fiduciary or independent valuation adviser in transactions covered by the proposed rule and class exemption;

- Whether the proposed rulemaking, particularly the proposed class exemption, would encourage more employers to sponsor ESOPs based on initial stock transactions that comply with the adequate consideration requirement;
- How often entities would rely on the proposed class exemption (specifically whether the Department's estimate of 25 percent of transactions eligible for the proposed class exemption ultimately relying on it is reasonable);
- How often entities relying on the proposed class exemption would also rely on the special rule for Selling Shareholders;
- How the restriction of the proposed class exemption to operating companies (as that term is defined in 29 CFR 2510.3-101(c)) would affect the number of transactions conducted under the proposed class exemption;
- What types of professionals would be involved with satisfying the requirements of the proposed rulemaking (and whether the Department's labor cost estimates are appropriate);
- How the requirements in the proposal would affect the cost to engage an independent fiduciary or independent valuation adviser;
- How the proposed requirements would affect the cost to obtain fiduciary insurance; and
- Whether ESOPs not reporting assets on the Form 5500 would be more or less likely to engage in a covered transaction.

3. *Baseline*

3.1. Federal Regulatory Baseline

While the first ESOP was created in 1956, ESOPs were not addressed by legislation until the passage of ERISA in 1974.[81] Section 408(e) of ERISA creates a statutory exemption for

[81] John Menke, *The Origin and History of the ESOP and Its Future Role as a Business Succession Tool,* (May 12, 2011), https://www.menke.com/esop-archives/the-origin-and-history-of-the-esop-and-its-future-role-as-a-business-

ESOPs from prohibited transactions under sections 406(a), 406(b)(1), and 406(b)(2). As such ESOPs may engage in transactions between the plan and party in interest or between the plan and fiduciary[82] so long as they meet the following conditions:

1) The acquisition, sale, or lease must be for adequate consideration;
2) No commission may be charged directly or indirectly to the plan with respect to the transaction; and
3) In the case of an acquisition or lease of qualifying employer real property, or an acquisition of qualifying employer securities, by a plan other than an eligible individual account plan (as defined in section 407(d)(3) of the Act), the acquisition or lease must comply with the requirements of section 407(a) of the Act.

Section 3(18)(B) defines adequate consideration for a security for which there is not a generally recognized market as the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. In 1988, the Department issued a notice of proposed rulemaking which sought to clarify the meaning of "fair market value" and "good faith" in this context.[83] The proposal acknowledged that securities without a generally recognized market "pose special valuation problems because they are not traded or are so thinly traded that it is difficult to assess the effect on such securities of the market forces usually considered in determining fair market value."[84] In response, the proposal established a nonexclusive list of factors to be considered in valuing the security, modeled, "with certain additions and changes," after the requirements set forth by the IRS in its 1959 Revenue Ruling 59-60.[85]

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succession-tool/#:~:text=The%20First%20ESOP%20(1956),successors%2C%20the%20managers%20and%20employees.

[82] The statutory exemption provides relief for 406(b)(1) and 406(b)(2) for transactions between plans and fiduciaries.

[83] 53 FR 17632.

[84] Id. At 17635.

[85] 53 FR at 17635 (discussing Rev. Rul. 59-60, 1959-1 Cum. Bull. 237).

Further, to demonstrate adequate consideration under the 1988 proposed rule, the Department proposed to require that the following criteria be satisfied:

(1) The value assigned to an asset must reflect its fair market value, and

(2) The value assigned to an asset must be the product of a determination made by the fiduciary in good faith.[86]

The proposal further defined "fair market value" as the price at which an asset 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, and where both parties are able to trade and are well-informed about the asset and the market for that asset.[87] Additionally, the proposal stated that the value must be determined as of the date of the transaction involving that asset.[88] However, this proposed rulemaking was never finalized.

The meaning of ERISA's adequate consideration definition is central to the recent congressional directive in section 346 of SECURE 2.0.[89] Section 346 of SECURE 2.0 mandated the Secretary of Labor to issue formal guidance on the "acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan."[90] In addition, section 346 also directed the Secretary of Labor to establish an "Employee Ownership Initiative" that would support States with existing programs and facilitate States in forming new programs designed to promote employee ownership.[91]

3.2. Trustee Process Agreements and Case Law

As discussed in detail in the preamble, in certain lawsuits brought by the Department over ESOP transactions, ESOP fiduciaries settled with the Department, which resulted in trustee process agreements. These agreements established steps trustees must take when selecting a valuation advisor and reviewing that advisor's valuation report. These process agreements

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[86] *Id.* at 17633.
[87] *Id.* at 17634, 17637.
[88] *Id.*
[89] *See* Div. T, Title III, Sec. 346, Pub. L 117-328, 136 Stat. 5381.
[90] *Id.*; 29 U.S.C. 3228(c)(4)(B).
[91] 29 U.S.C. 3228(b).

provide a "best practices" guide for ESOP trustees to ensure the independence of fiduciaries and appraisers, the careful review of relevant financial information, and the accuracy of employer stock valuations. The Department has posted many of the trustee process agreements on EBSA's website.[92] While each agreement reflects, to some extent, the specific facts of the case that was the subject of that agreement, these process agreements provide considerable insight into what is expected of ESOP fiduciaries and have been widely referenced by the industry.[93]

3.3. Common Business Practice

Despite the 1988 proposal never being finalized, the standards laid out in the proposal have become widely utilized by the industry. For instance, one source states, "While the [1988] Regulation is technically only 'proposed,' the [Department of Labor] and the Federal Courts have relied on th[e] definition [of adequate consideration in the proposal] since 1988. Every valuation professional doing ESOP work assumes the Regulation to be in effect."[94] Another source notes that the 1988 proposal has continued to serve as "a guide to valuation professionals and the banking communities, including the FDIC."[95] One guide published by an industry group in 2019 remarks that the 1988 proposal "has until recently served as the best definition of how adequate consideration would be evaluated by the [Department]."[96]

The Department expects, and this analysis assumes, that fiduciaries already are following a well-established body of case law that deals with fiduciary reliance on expert valuations as part of a prudent process for arriving at fair market value of employer stock to be purchased by an ESOP. Courts have found that the fiduciaries relying on expert valuations must 1) prudently investigate the appraiser's qualifications in selecting the appraiser; 2) ensure that the appraisal is

[92] *See* https://www.dol.gov/agencies/ebsa/employers-and-advisers/employee-ownership-initiative; https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement (last visited September 20, 2024).
[93] *See* Theodore M. Becker, Richard J. Pearl, and Allison Wilkerson, *The* DOL Fiduciary Process Agreement for ESOP Transactions (June 2021), NCEO.
[94] Scott Miller, *Buyouts: Success for Owners, Management, PEGs, Families, ESOPs, and Mergers and Acquisitions* pp. 44 (2012), John Wiley & Sons, Inc.
[95] James Hitchner, *Financial Valuation: Applications and Models* pp. 806 (2017), John Wiley & Sons, Inc.
[96] Association of International Certified Professional Accountants, *What Every Valuation Analyst Should Know About Employee Stock Ownership Plans (ESOPs)* (2019),

based upon complete, current, and accurate information; and 3) make certain that reliance on the expert's advice is reasonably justified under the circumstances.[97] These general principles are reflected in paragraph (b)(3) of the proposed regulation, which outlines a framework for an ESOP fiduciary's prudent reliance on a valuation report in making an adequate consideration determination. The proposal's more detailed elaboration of these principles is derived from both court decisions as well as the Department's process agreements, discussed above, and other enforcement experience.

Given the industry's wide utilization of the 1988 proposal and the standards laid out in the publicly available trustee process agreements, this analysis considers the requirements included in those documents to be standard business practice and therefore establishes the baseline. The Department requests comment on this assumption.

4. *Need for Regulation*

As discussed in the Baseline discussion above, the SECURE 2.0 Act mandated that the Secretary of Labor issue formal guidance on the question of adequate consideration in the context of certain ESOP transactions. The proposed rulemaking not only fulfills the SECURE 2.0 directive, it also provides clarity regarding the meaning of adequate consideration. The additional clarity would better protect ESOP participants and beneficiaries.

Over the years, ESOPs have attracted a lot of attention, often for their benefits to employees. In theory, by providing an equity stake in their employer, ESOPs could enhance employee productivity, employee tenure and firm profitability. ESOPs also benefit the companies that sponsor them. For example, ESOPs can be used to raise equity to refinance outstanding debt. Because contributions to an ESOP are tax-deductible, employers can fund both the principal and interest payments on the ESOP's debt service obligation with pre-tax dollars.[98]

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[97] *See*, *e.g.*, *Brundle v. Wilmington Trust*, 919 F.3d 763, 773 (4th Cir. 2019); *Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 430 (6th Cir. 2002); *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996), *cert. denied*, 520 U.S. 1237 (1997); *cf. Bussian v. RJR Nabisco*, 223 F.3d 286, 301 (5th Cir. 2000).

[98] For a larger discussion on how ESOPs can be used by firms for financing and tax purposes, refer to the Literature Review section.

Despite evidence of benefits to employees of holding employer stock, the framework of ESOPs is not without risks. This is particularly true for ESOPs in companies that are not publicly traded. For non-publicly traded securities, there is no ready market price to assist the parties in arriving at a fair market value determination. Participants and beneficiaries must instead rely on the ESOP fiduciary to determine the fair market value.

In a market of publicly traded securities, buyers and sellers determine their bid and ask prices, respectively, based on the information that is available to them. Prices that fully reflect all available information result in an "efficient market."[99] When a security is not publicly traded, however, the seller has information that the buyer is not privy to and therefore has an advantage over the buyer. This information asymmetry can result in a price that does not accurately reflect the value of the asset, resulting in over- or underpayment for the asset, which in turn disrupts the market's equilibrium and leads to a market failure.

In a transaction between a selling or purchasing shareholder and an ESOP, in which the ESOP is purchasing or selling employer stock, there is not only asymmetric information but also an inherent conflict of interest. The employer is also commonly the selling or purchasing shareholder, and as such is responsible for providing the information necessary to determine fair market value, including current financial data and projections of future performance. Further, in the relationship between an ESOP and an employer, it may be difficult to separate the intentions of one from the other to ensure that the transaction occurs at arm's length and that the shareholder does not impose undue influence over the transaction given their position of authority over plan decisions. Therefore, it is imperative for an appraisal to be based on accurate data and proper application of valuation principles, and for the appraisal to be evaluated by a fiduciary who is independent of the employer or shareholder.

[99] Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work,* 25(2) The Journal of Finance pp. 383-417 (1970).

Overpayments for securities, especially in a leveraged transaction, can diminish or jeopardize employees' retirements, and even put their jobs at risk if the employer cannot meet the financial obligations undertaken as part of the transaction. The proposed rulemaking would provide clarity on the general standards and procedures for determining the price when an ESOP is buying or selling employer stock from or to a shareholder. Further, the proposed class exemption would provide ESOP fiduciaries with a clear roadmap to ensure that they comply with their duties of prudence and undivided loyalty with regard to the transaction, resulting in an ESOP paying no more than fair market value to the employer.

In recent years there has been a renewed support for promoting employee ownership. Several States passed legislation promoting ESOP creation, including support programs and tax incentives.[100] As discussed in the Baseline section, section 346 of SECURE 2.0 directs the Department to establish the Employee Ownership Initiative to promote employee ownership, including through ESOPs. The increasing focus on promoting ESOPs underscores the need for the Department to provide clarity in the definition of adequate consideration for a stock without a generally recognized market.

4.1. Incentives for ESOP Formations and Potential Risks

Proponents of ESOPs have argued that broad-based employee ownership aligns worker and management incentives by giving employees a stake in the firm's success and a larger voice in the firm's governance. Consistent with these arguments, Congress has continued to encourage ESOPs, through tax incentives and the expansion of eligibility requirements, in order to promote employee participation in corporate ownership and provide additional retirement security for employees.[101] Studies examining the effects of broad-based employee ownership support the

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[100] NCEO, *State Legislation on Employee Ownership,* (Sept. 2023), https://www.nceo.org/article/state-legislation-employee-ownership-0 (last accessed October 7, 2024).

[101] *See*, *e.g.*, Tax Reform Act of 1976, tit. VIII, sec. 803(h), Pub. L. 94-455, 90 Stat. 1590 (reciting how through various laws, including ERISA, Congress "ha[d] made clear its interest in encouraging [ESOPs] as a bold and innovative method of strengthening the free private enterprise system which will . . . bring[] about stock ownership by all corporate employees").

concept that ESOPs are associated with positive outcomes for both companies and employees;[102] however, the literature also finds that ESOPs are not without risk.

In terms of the benefits of ESOPs to employees, as employees become owners in the firm, they stand to gain from increases in shareholder value. However, when both an employee's wages and retirement benefits are tied to the performance of their employer, the risk to the employee's financial well-being can be exacerbated. Increased employee ownership often comes at the risk of reduced diversification. As a result, workers may be exposed to excessive financial risk, especially when employee ownership is a large share of a worker's wealth, when employer stock grants substitute for more traditional forms of labor compensation, and when the employer has control over how the stock is valued.

Anderson (2009) examines how ESOPs compare to Modern Portfolio Theory and argues ESOPs' inherent under-diversification violates sensible investment principles. The author theorizes that ESOPs carry residual risks that diversification would reduce or eliminate. Additionally, the author highlights that under Modern Portfolio Theory it is possible to select a diversified portfolio of investments that will provide the same expected return at a lower risk than any single investment, suggesting that ESOP returns are insufficient for the risk.[103]

Meulbroek (2005) similarly finds that holding company stock is inefficient for all employees. The author compares holdings of company stock to diversified stock portfolios with equivalent volatility, while assuming standardized individual risk preferences. They then estimate the corresponding value of the company holdings necessary to compensate for the added risk of under-diversification, or "how great a return undiversified employee investors

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[102] Richard B. Freeman, Joseph R. Blasi, & Douglas L. Kruse, *Introduction*, *in Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options* (D. L. Kruse, R. B. Freeman, & J. R. Blasi eds., 2010). Douglas L. Kruse, *Does Employee Ownership Improve Performance?*, 311 IZA World of Labor (2022). Joseph Blasi, Michael Conte, & Douglas Kruse, *Employee Stock Ownership and Corporate Performance among Public Companies*, 50(1) Industrial and Labor Relations Review pp. 60–79 (1996). Richard B. Freeman, Joseph R. Blasi, & Douglas L. Kruse, *Introduction*, *in Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options* (D. L. Kruse, R. B. Freeman, & J. R. Blasi eds., 2010). Yael V. Hochberg & Laura Lindsey, *Incentives, Targeting, and Firm Performance: An Analysis of Non-Executive Stock Options*, 23(11) The Review of Financial Studies pp. 4148–86 (2010).

[103] Sean M. Anderson, Risky Retirement Business: How ESOPs Harm the Workers They Are Supposed to Help, 41 Loy. U. Chi. L. J. 1 (2009). Available at: http://lawecommons.luc.edu/luclj/vol41/iss1/2

would need to be indifferent to holding only their firm's stock versus holding an efficiently diversified portfolio levered to a volatility equal to that of the firm's stock." This difference between the discounted private value and market value of the stock is considered to be the cost of holding an undiversified portfolio of company stock. [104]

Using 1998 stock market price data for 1,549 publicly traded firms and assuming employees hold their company stock for 3 to 15 years, the author finds that employee investors would be better off holding a diversified portfolio of comparable risk, gaining an average of 42 percent of their company stock value by being diversified.[105] Even under a three-year horizon, an undiversified employee misses out on potential gains worth 33 percent of the company stock's market value.[106]

This study also considers the implications of holding company stock by firm size. They find that holding company stock in smaller firms poses substantially more diversification risk than doing so in large firms. For instance, for the largest ten percent of firms, the value of company stock to undiversified employees as a share of market value was 84 percent after three years and fell to 43 percent after 15 years. For the smallest decile, this was 61 percent after three years falling to only 12 percent after 15 years. Further, the study finds that increased diversification lowers the cost of holding company stock, as the diversification offsets firm-specific risk. Among firms with defined contribution plans holding employee stock, larger firms, on average, hold a higher proportion of those assets in company stock. [107] These findings suggest that while ESOP participants in smaller firms have higher risks associated with holding company

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[104] Meulbroek, Lisa K., "Company Stock in Pension Plans: How Costly is it?" The Journal of Law & Economics, Vol 48, No. 2 (October 2005), pp. 443-474

[105] The sample used to estimate returns from company stock ownership explicitly excludes nonpublic firms.

[106] Meulbroek, Lisa K., "Company Stock in Pension Plans: How Costly is it?" The Journal of Law & Economics, Vol 48, No. 2 (October 2005), pp. 443-474

[107] The authors clarify that large companies are also more likely to offer a defined benefit plan in addition to the defined contribution plan, ultimately lowering the diversification risk suggested by considering defined contribution investments alone.

stock, this risk may be mitigated, on average, by lower exposure to company stock in defined contribution plans.[108]

The argument that diversification risk may be mitigated provided that employer-stock ownership is part of a diversified portfolio is further supported by Kruse et al. (2022). Using 2004-2016 Survey of Consumer Finances (SCF) data, the authors estimate that 15.3 percent of families held employer stock in 2016. Among these families with employer stock holdings, 22 percent held stakes greater than 10 percent of their net worth. The authors theorize that, based on Modern Portfolio Theory, only the families with greater than 10 percent of their net worth in employer stock potentially face excessive financial risk.[109]

In fact, many participants in ESOPs are able to diversify their investments. Of the 6,465 ESOPs in 2022, 973 were KSOPs (i.e., they reported having a 401(k) feature), and 4,026 were stand-alone ESOPs offering a defined contribution plan or defined benefit plan in addition to the ESOP. [110] In other words, only 1,466 of the firms offering ESOPs, or 23 percent, did not offer opportunities for further diversification.

Importantly, not all participants in KSOPs or stand-alone ESOPs that offer an additional plan are necessarily well diversified. For instance, participants of a KSOP plan may not elect to contribute to the 401(k) plan feature and diversify from their exposure to their employer's stock. Additionally, while Form 5500 filings indicate how many firms offering an ESOP offer an additional defined contribution or defined benefit plan, the Department does not have data on how many ESOP participants are eligible to participate in, or elect to participate in, these other plans.

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[108] Meulbroek, Lisa K., "Company Stock in Pension Plans: How Costly is it?" The Journal of Law & Economics, Vol 48, No. 2 (October 2005), pp. 443-474

[109] Kruse, D., Blasi, J., Weltmann, D., Kang, S., Kim, J. O., & Castellano, W. (2022). Do Employee Share Owners Face Too Much Financial Risk? ILR Review, 75(3), 716-740. https://doi.org/10.1177/00197939211007394

[110] U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2022 Form 5500 Annual Reports*, (Sep. 2024), https://www.dol.gov/sites/dolgov/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletins-abstract-2022.pdf.

The benefits to employees of participating in an ESOP may be offset if the motivations of a firm deciding to start an ESOP are unrelated to the employees' welfare. Firms may instead be focused on the potential benefits of ESOPs on business operations, including transition of business ownership, the prevention of hostile takeover bids, the divestiture or acquisition of subsidiaries, and as a corporate financing mechanism. For example, by utilizing a leveraged ESOP, a firm may borrow from the ESOP, instead of from an outside lender, and then make tax-deductible contributions to the ESOP as its loan payments. This would enhance the firm's cash flow and capital.[111]

The most cited benefit to firms of ESOPs is their built-in tax advantages, which vary depending on whether the corporation is a C corporation[112] or an S corporation.[113] Similar to 401(k) contributions, C corporations and S corporations can deduct ESOP contributions from Federal income taxes;[114] however, a C corporation may also deduct dividends used to pay principal and interest on an ESOP loan. Additionally, the selling shareholders of a C corporation may defer capital gains taxes from a sale of employer stock.[115] If the firm is an S corporation, the percentage owned by the ESOP is exempt from Federal income taxes and State income taxes in most States. As such, an S corporation owned entirely by an ESOP operates as a tax-exempt entity.[116,117] Despite the tax advantages to businesses of these arrangements, it is not clear that these benefits permeate to ESOP participants and beneficiaries. As the IRS reported in 2023:

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111 James Hitchner, *Financial Valuation: Applications and Models* pp. 801-802 (2017), John Wiley & Sons, Inc.
112 A C corporation is a separate taxpaying entity that conducts business, realizes net income or loss, pays taxes, and distributes profits to shareholders. *See* IRS, *Forming a Corporation,* https://www.irs.gov/businesses/small-businesses-self-employed/forming-a-corporation.
113 An S corporation passes corporate income, losses, deductions, and credits through to their shareholders. *See* IRS, *S Corporations,* https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations#:~:text=S%20corporations%20are%20corporations%20that,shareholders%20for%20federal%20tax%20purposes.
114 BDO USA, *ESOP FAQs: Frequently Asked Questions Related to Employee Stock Ownership Plans,* https://www.bdo.com/insights/tax/frequently-asked-questions-related-to-employee-stock-ownership-plans-(esops)#15.
115 Employee Ownership Foundation, *Tax Advantages of ESOPs for Business Planning,* https://www.employeeownershipfoundation.org/articles/tax-advantages-of-esops-for-business-planning.
116 BDO USA, *ESOP FAQs: Frequently Asked Questions Related to Employee Stock Ownership Plans,* https://www.bdo.com/insights/tax/frequently-asked-questions-related-to-employee-stock-ownership-plans-(esops)#15.
117 NCEO, *ESOPs in S Corporations,* (Sept. 2018), https://www.nceo.org/articles/esops-s-corporations.

"the IRS has seen schemes where a business creates a 'management' S corporation whose stock is wholly owned by an ESOP for the sole purpose of diverting taxable business income to the ESOP."[118]

The effect of an ESOP on a firm's market value can be measured by studying stock price reactions for publicly held companies surrounding the announcement of a new ESOP. The price change of a particular company can be measured in relation to any contemporaneous change in the overall market, by identifying net-of-market (e.g., the firm's return minus the equally weighted market index) or cumulative excess returns during a particular window surrounding the announcement. Several studies, which vary by type of ESOPs and the time periods considered, that examine two-day cumulative excess returns (on the day prior to, and day of, the announcement) find ESOP announcements result in positive market reactions with estimated excess returns of approximately one percent.[119]

In such cases, positive price reactions reflect the beliefs of market participants that an ESOP will enhance shareholder wealth by increasing the value of the firm—whether by reducing agency conflicts (i.e., better aligning employee and shareholder interests), allowing for favorable tax treatments, improving the firm's capital structure, or by another mechanism. A notable exception, however, is when the implementation of an ESOP is widely understood to serve as an antitakeover mechanism. When an ESOP adoption appears intended to entrench existing management, studies find the corresponding market reaction to instead be neutral or negative.[120]

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[118] Internal Revenue Service, *IRS Cautions Plan Sponsor to be Alert to Compliance Issues Associated with ESOPs,* (Aug. 2023), https://www.irs.gov/newsroom/irs-cautions-plan-sponsors-to-be-alert-to-compliance-issues-associated-with-esops.

[119] Saeyoung Chang & David Mayers, *Managerial Vote Ownership and Shareholder Wealth: Evidence from Employee Stock Ownership Plans*, 32 Journal of Financial Economics pp. 103-132 (1992). Anne Beatty, *The Cash Flow and Informational Effects of Employee Stock Ownership Plans*, 38(2) Journal of Financial Economics pp. 211–40 (1995). Peter Cramton, Hamid Mehran, & Joseph Tracy, *ESOP Fables: The Impact of Employee Stock Ownership Plans on Labor Disputes*, 347 Federal Reserve Bank of New York Staff Reports (2008).

[120] For example, Gordon and Pound (1990) identify a mean excess return of -4.0% percent for firms subject to an attempted takeover and 1.7 percent for those who are not. Similarly, Beatty (1995) finds mean excess returns of -1.3 percent for takeover targets and 1.5 percent for nontargets. *See* Lilli A. Gordon & John Pound, *ESOPs and Corporate Control*, 27(2) Journal of Financial Economics pp. 525–55 (1990), Anne Beatty, *The Cash Flow and Informational Effects of Employee Stock Ownership Plans*, 38(2) Journal of Financial Economics pp. 211–40 (1995) And Susan Chaplinsky & Greg Niehaus, *The Role of ESOPs in Takeover Contests*, 49(4) The Journal of Finance pp. 1451–70 (1994).

However, for non-publicly held ESOPs, which is more than 90 percent of all ESOPs, the market is unable to adjust the share prices based on its interpretation of the ESOP sponsor's motivations.[121] Rather, an independent fiduciary is often selected to make the investment decision in an ESOP transaction, including whether the recommended share price is fair. The independent fiduciary, however, is typically selected by the employer who in turn is often controlled by the selling or purchasing shareholder. The independent fiduciary then relies on information provided by the employer, including its current financials and projected future performance, to make its determination.

Given the incentives for an employer to engage in an ESOP transaction to improve the company's financial situation discussed above, and the undue influence the seller has on the independent fiduciary, the Department is concerned that this influence may lead to biased appraisals of the share price, resulting in harm to participants and beneficiaries. This concern is exacerbated by documented issues with appraisal bias in other industries.

4.2. Appraisal Bias

An appraisal of an asset without a well-established market requires a certain degree of judgement and, accordingly, is subject to influence. When the entity overseeing the hiring or firing of an appraiser has a financial interest in the outcome of the appraisal, the appraiser may feel compelled to give a more favorable valuation of the asset. This is often referred to as appraisal bias.

Though there is not an extensive body of research directly investigating appraisal biases in ESOP valuations, the Department believes that ESOP valuations face similar conflicts of interest as those in audits, real estate appraisals, and security credit ratings, in that the party selecting the audit, appraisal, or rating professional has a vested interest in the outcome and

[121] NCEO, *ESOP (Employee Stock Ownership Plan) Facts*, https://www.esop.org/ (last accessed Aug. 1, 2024); NCEO, *Employee Ownership by the Numbers* (Feb. 2024), https://www.nceo.org/articles/employee-ownership-by-the-numbers.

undue influence of the process. The research literature discussed below explores the conflicts in these markets and provides insight into the types of conflicts and consequences that may exist in the non-public ESOP market.

4.2.1. Auditor Bias

In the 1984 case of *United States v. Arthur Young & Company*, the Supreme Court opined:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[122]

However, as described by Bazerman et al. (1997), even if the auditor is supposed to act in the interest of external users, their client is ultimately the firm that they are auditing.[123] The fact that the firm being audited may hire, negotiate, and fire an auditor creates a conflict of interest where the firm has undue influence over the auditor and creates a risk for bias in the resulting audits.

Moore et al. (2010) studied the psychology of conflicts of interest though a series of experiments, and whether who an auditor represents affects their findings.[124] They find evidence of bias in auditors' judgement in favor of the firm that hires them. Specifically, the authors found that for professional auditors reviewing difficult accounting issues without clear GAAP guidance, those assigned the role of being hired by the firm were significantly more likely to

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[122] *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984).

[123] Max Bazerman, Kimberly Morgan, and George Loewenstein, *Opinion: The Impossibility of Auditor Independence,* 38(4) Sloan Management Review (Summer 1997).

[124] Moore, Don A., Lloyd Tanlu, and Max H. Bazerman, "Conflict of Interest and the Intrusion of Bias," Judgment and Decision Making, Vol. 5, No. 1, 2010, pp. 37-53. https://www.cambridge.org/core/journals/judgment-and-decision-making/article/conflict-of-interest-and-the-intrusion-of-bias/E07C226B58445EE1DA8C0C83D61D9572 The 139 participating auditors were employed by the "Big Four" accounting firms. Each auditor was assigned five different auditing vignettes and asked to come to a judgment regarding the proper accounting.

approve the firm's accounting than individuals assigned the role of being hired by outside investors. Moreover, the authors found that while agents were aware of the bias, they underestimated its degree. Even when offered incentives to correct for it, they were unable to do so.

In the aftermath of several accounting fraud scandals, such as Enron and WorldCom, Congress enacted the Sarbanes-Oxley Act (SOX) in 2002.[125] SOX specifically addressed conflicts of interest arising from the audited entity being the client of the auditor. For instance, SOX ensured that oversight of accounting and financial reporting processes needed to be conducted by audit committees.[126] The legislation further specifies that each member of the audit committee must be independent, in that, they may not accept any consulting, advisory, or other compensatory fee from their client or be affiliated with the client or any subsidiary of the client.[127] Additionally, SOX prohibits an auditor from contemporaneously providing non-audit services, unless preapproved by the audit committee.[128] It also prohibits an auditor from providing audit services to a client for more than five consecutive years, in which the individual auditor had the primary responsibility for conducting the audit or reviewing the audit.[129]

However, it is important to note that SOX did not rid the audit industry of all conflicts. For instance, Bruynseels and Cardinaels (2014) investigated whether social ties[130] between the CEO and members of the audit committees had consequences on audit committee actions. Examining the data of nearly 3,000 companies between 2004 and 2008, they found that approximately 39 percent of audit committees had social ties to the CEO. Using data from Compustat, they then identified firms that reported negative earning or negative operating cash

[125]Pub. L. 107-204, 116 Stat. 745.
[126] *See* 15 U.S.C. 78j-1.
[127] *Id*. at 78j-1(m)(3).
[128] *Id*. at 78j-1(g)-(i).
[129]*Id*. at 78j-1(j).
[130] Bruynseels and Cardinaels (2014) identify three types of social ties: present employment ties (e.g. external directors in another company), education ties, and friendship network ties (e.g. present or past membership in the same charity, leisure club, country club, or other non-profit association). The information on social ties was gathered using data from BoardEx and manually collected information.

flows. The authors found that when the CEO of a distressed firm had "friendship" social ties to the audit committee, they were significantly less likely to receive a going-concern opinion from their auditor, suggesting that audit committees with social ties to the CEO are more likely to engage in earning mismanagement.[131]

Additionally, in a literature review commissioned by the Department, Burke et al. (2015) examined whether professional auditors are biased by financial or non-financial conflicts of interest. They found support that "auditors may be more willing to accept dubious company assumptions when conflicted" and that bias in assumptions is more likely when total fees are high or when there is a long-term relationship between the firm and the auditor.[132]

4.2.2. Real Estate Appraisal Bias

In the residential real estate market, appraisals are traditionally required as part of the mortgage underwriting process for both purchase transactions and refinancings.[133] The appraisal process for this market came under scrutiny in the aftermath of the late 2000s housing market crash for contributing to risky mortgages and unsustainable home prices. [134] The ensuing foreclosure crisis prompted a flurry of academic research as well as subsequent efforts by regulators to mitigate conflicts of interest.

In the real estate market, appraisals yield an "opinion of value," or estimate of the market value of the underlying collateral. While sometimes using a cost-based approach, appraisers typically develop estimates based on recent sales of properties deemed appropriately similar, with adjustments to account for salient differences between the subject and comparable

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[131] Liesbeth Bruynseels & Eddy Cardinaels, *The Audit Committee: Management Watchdog or Personal Friend of the CEO?* 89(1) The Accounting Review pp. 113-145, (2014).

[132] Jeremy Burke, Angela Hung, Jack Clift, Steven Garber, & Joanne Yoong*, Impacts of Conflicts of Interest in the Financial Services Industry*, Working Paper, RAND Labor & Population (Feb. 2015), https://www.rand.org/pubs/working_papers/WR1076.html.

[133] For first-lien residential mortgages made in 2010, lenders obtained appraisals on 98 percent of purchase mortgages and 88 percent of refinance mortgages. U.S. Government Accountability Office, *Residential Appraisal: Opportunities to Enhance Oversight of an Evolving Industry,* GAO-11-653 (2011), https://www.gao.gov/assets/gao-11-653.pdf.

[134] The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

properties.[135] The process is intended to equip mortgage underwriters with a valuation independent of the accepted offer price, by producing valuations based on other arms-length market transactions.

However, bias in this setting may lead to mortgage approvals in excess of a home's true valuation. Research suggests that appraisal overvaluations may stem from selection bias (e.g., a greater reliance on high-valued properties as representative comparables) or confirmation bias (e.g., anchoring effects based on an appraiser's prior knowledge of the subject property's sale price). In addition, the individual incentives of various stakeholders involved in the process, together with institutional conflicts of interest, may challenge the independence of the valuation. For example, higher appraisals enable homeowners to access additional capital or refinance under more favorable terms, provide larger commissions for real estate agents, and allow mortgage lenders to generate more revenue. These incentives may manifest in institutional pressures as well. The Financial Crisis Inquiry Commission reported that lenders pressured appraisers to artificially inflate properties by "assigning business only to appraisers who would hit the desired price targets."[136]

Several academic studies seek to quantify the extent of bias in appraisal valuations. Agarwal et al. (2015) examine bias in refinancing appraisals by comparing the purchase prices of properties to prior valuations from refinance transactions for the same property.[137] By examining over one million pairs of transactions, and using pairs of successive purchase transactions as controls, they find an average appraisal bias above five percent. In separate analyses, Griffin and Maturana (2016) and Kruger and Maturana (2021) both measure potential bias by comparing

[135] Alternatively, for commercial real-estate markets, appraisals are often based on the income the property generates and either applying a capitalization approach to the valuation (net operating income/capitalization rate) or the discounted cash flow method (estimating future cash flows generated by the property and then discounting them over the expected duration of the income stream).

[136] The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[137] Sumit Agarwal, Itzhak Ben-David & Vincent Yao, *Collateral Valuation and Borrower Financial Constraints: Evidence from the Residential Real Estate Market*, 61(9) Management Science pp. 2220–2240 (2015).

appraiser valuations against corresponding values from automated valuation models (AVMs).[138] Studying a sample of more than 3 million loans from 2002 to 2007, Griffin and Maturana (2016) document that nearly 45 percent of securitized loans had overstated appraisals, with such loans associated with higher delinquency rates. Using a different data provider, Kruger and Maturana (2021) look at a sample of nearly 6 million loans originated between 2001 and 2007 and find that appraisals exceeded AVM valuations 60 percent of the time, with appraisal valuations 5 percent higher than AVM values on average.

Eriksen et al. (2020) consider whether an appraiser's awareness of the purchase price is a possible source of bias.[139] They study properties appraised within six months of one another by two different appraisers, before and after sale contract finalization. Post-contract appraisals, in which appraisers are aware of sale prices, had valuations four to eight percent higher even when controlling for nearby home price changes between the two appraisal dates. In addition, post-contract appraisals were more than twice as likely to yield valuations at least equal to contract price.

In related studies, Calem et al. (2015) and Calem et al. (2021) expand on the role of confirmation bias in the appraisal process.[140] After determining that appraisals below the purchase price are exceedingly rare (less than 10 percent in each sample), both studies develop and test quantitative models to explain this behavior. Calem et al. (2015) highlight the presence of incentives against these "negative appraisals," as reductions in the property's collateral value can jeopardize the transaction completion.[141] In addition, Calem et al. (2021) find 30 percent of

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[138] John M. Griffin & Gonzalo Maturana, *Who Facilitated Misreporting in Securitized Loans?*, 29(2) The Review of Financial Studies pp. 384–419 (2016). Samuel Kruger & Gonzalo Maturana, *Collateral Misreporting in the Residential Mortgage-Backed Security Market*, 67(5) Management Science pp. 2729–2750 (2021).
[139] Michael D. Eriksen, Hamilton B. Fout, Mark Palim & Eric Rosenblatt, *Contract Price Confirmation Bias: Evidence from Repeat Appraisals*, 60(1) The Journal of Real Estate Finance and Economics pp. 77–98 (2020).
[140] Paul S. Calem, Lauren Lambie-Hanson & Leonard I. Nakamura, *Information Losses in Home Purchase Appraisals*, 15–11 Federal Reserve Bank of Philadelphia Working Paper Series (2015) https://ssrn.com/abstract=2646084. Paul Calem, Jeanna Kenney, Lauren Lambie-Hanson & Leonard Nakamura, *Appraising Home Purchase Appraisals*, 49(S1) Real Estate Economics pp. 134–168 (2021).
[141] Federal regulations require that the property be valued as the lesser of the transaction price and appraised value. As a result, appraisals with valuations below the transaction price mechanically increase the loan-to-value ratio and often alter the corresponding interest rate or loan terms. *See* Paul S. Calem, Lauren Lambie-Hanson & Leonard I.

all appraisals to be exactly at the initial contract price, and estimate that mortgages of this type are more likely to default, even after controlling for borrower and loan-level characteristics. Their results also suggest that, due to this confirmation bias, appraisals are less informative than AVMs in predicting default risk.

For real estate appraisals however, appraisal bias is not uniform and is typically incentive driven and influenced by many factors. The documented bias is often larger for highly leveraged transactions and in low-information settings.[142] In addition, inflated valuations are often influenced by relational contracts, including hopes of repeat business.[143]

4.2.3. Security Credit Rating Bias

Credit rating agencies (CRAs) evaluate the creditworthiness of issuers of debt securities, assigning a credit rating to a debt security that is often relied on by investors. However, many CRAs are paid by the issuer of the debt security. In an Investor Bulletin released in 2017, the SEC warned that "[t]his creates a potential conflict of interest in that the credit rating agency may be influenced to determine more favorable (i.e., higher) ratings than warranted to retain the obligors or issuers as clients and to obtain new obligor or issuer clients."[144]

In 2007, the SEC examined how the actions of the three largest CRAs contributed to the deterioration of the subprime mortgage-backed security market, leading up to the financial crisis. The examination noted that the "issuer pays" conflict of interest is exacerbated by the issuer having oversight over which credit agency to engage. As the CRA was typically only paid if the credit rating was made public,[145] CRAs faced an incentive to accommodate the issuer engaging them. While CRAs are required to establish, maintain, and enforce policies and procedures to

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Nakamura, *Information Losses in Home Purchase Appraisals*, 15–11 Federal Reserve Bank of Philadelphia Working Paper Series (2015) https://ssrn.com/abstract=2646084.

142 Sumit Agarwal, Itzhak Ben-David & Vincent Yao, *Collateral Valuation and Borrower Financial Constraints: Evidence from the Residential Real Estate Market*, 61(9) Management Science pp. 2220–2240 (2015). Sumit Agarwal, Brent W. Ambrose & Vincent W. Yao, *Can regulation de-bias appraisers?*, 44 Journal of Financial Intermediation 100827 (2020).

143 Sumit Agarwal, Changcheng Song & Vincent W. Yao, *Relational Contracts in the Housing Market*, SSRN Electronic Journal (2020), https://dx.doi.org/10.2139/ssrn.3076944.

144 U.S. Securities and Exchange Commission, *Updated Investor Bulletin: the ABCs of Credit Ratings,* (Oct. 2017), https://www.sec.gov/resources-for-investors/investor-alerts-bulletins/ib_creditratings.

145 In some cases, a credit rating agency may receive a "breakup fee" to compensate them for their analytic work.

address the conflict of interest of the "issuer pays" model, the SEC found that the policies and procedures failed to mitigate the existing conflicts of interest and that analysts at the CRAs were often aware of the fees and business interest associated with the security they were evaluating.[146] In a testimony to Congress, Jerome Fons, a former executive of the credit rating agency Moody's, confirmed this risk in their testimony to Congress in 2008:

> Rating agencies were well aware of the conflicts of interest posed by the "issuer-pays" business model. By accepting payment from an issuer, a rating agency sacrifices its independence. Rather than being an impartial party, it has a vested interest in the success of a bond offering and in the welfare of the issuer.[147]

A white paper released by the Federal Reserve Bank of New York in 2010 analyzed credit ratings given to 3,144 subprime[148] and Alt-A MBS deals[149] between 2001 and 2007. The study observed that between 2005 and 2007, several factors indicated that credit risk was increasing, including: increased early payment default, the unprecedented slowing of home price appreciation, and a general deterioration in major loan underwriting characteristics. Using a loan level mortgage default, logit model, the study finds that credit rating agencies failed to incorporate this heightened risk when issuing credit ratings. While the authors acknowledge that some of the difference between their estimates and those from credit rating agencies may be attributable to model methods that would delay a response, the authors note that a credit rating agency's "incentives to misreport ratings are driven by a tradeoff between current revenues and future reputational cost."[150]

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[146] U.S. Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies,* (July 2008), https://www.sec.gov/files/craexamination070808.pdf (Last accessed November 13, 2024).
[147] Jerome S. Fons, Testimony Before the Committee on Oversight and Government Reform, U.S. House of Representatives, October 2008.
[148] The study states that "subprime loans are considered to be of the lowest credit quality, and will generally have the poorest underwriting characteristics, such low FICO scores and high [loan-to-value] and [debt-to-income] ratios."
[149] The study states that "Alt-A loans have stronger average underwriting characteristics [than subprime loans] and are made to borrowers with stronger credit histories. However, they are more likely to include risky contract features or limited documentation [compared to prime loans]."
[150] Adam Ashcraft, Paul Goldsmith-Pinkham & James Vickery, *MBS Ratings and the Mortgage Credit Boom*, 449 Federal Reserve Bank of New York Staff Reports (2010), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr449.pdf (Last accessed October 7, 2024).

Bolton et al. (2012) explores the tradeoff revenue and reputational cost by creating a theoretical framework, comparing a market in which there is a monopoly or a duopoly and in which investors are more likely to be trusting or sophisticated. The framework posits that when investors are more likely to be trusting, there is a lower reputation cost associated with inflated ratings. As such, the framework suggests that CRAs may be more likely to inflate ratings during times of economic boom, when investors have less of a reason to perform due diligence or to be skeptical of credit ratings. Further, the framework finds that when issuers are able to "shop" for credit ratings, in that they have the power to both hire a CRA and decide whether to publish the rating provided by a CRA, having competition in the marketplace increases the likelihood that the issuer will shop for ratings to mislead investors.[151]

Congress responded to the role of CRAs in the financial crisis with the enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd Frank Act). The legislation stated that "the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers."[152] The reforms laid out in the legislation sought to decrease the reliance upon credit ratings by regulators and investors, increase the legal liability for CRAs, and increase the regulatory oversight of credit ratings.[153]

4.2.4. Appraisal Bias in the ESOP Context

The throughline across valuations for non-public ESOPs, audits, real estate appraisals, and security credit ratings is that when an auditor or appraiser is hired and overseen by a party in interest, the party may impose undue influence over the auditor or appraiser, creating a conflict of interest for them. As discussed above, auditors or appraisers faced with this conflict of interest are more likely to issue a finding that is biased in favor of that entity. Moreover, in the absence

[151] Patrick Bolton, Xavier Freixas & Joel Shapiro, *The Credit Ratings Game*, 67(1) The Journal of Finance pp. 85–111 (2012).
[152] Tit. IX, sec. 931(3), Pub. L. 111-203, 124 Stat. 1872.
[153] *See generally* Pub. L. 111-203, 124 Stat. 1376.

of public data, appraisers are reliant on their subject to provide the necessary and unbiased information to perform the appraisal itself.

Through the course of its oversight responsibilities, the Department has identified a number of issues with non-public ESOP appraisals. These include: unrealistic growth rates, improper discount rates (e.g. using low-risk rates to discount risky returns), inconsistent assumptions between or within appraisals, reliance on unreliable or out-of-date financials, failure to test assumptions or conduct sensitivity analyses, failure to consider debt, and inappropriate adjustments to a company's financials. In 2023 alone, the Department's intervention resulted in over $140 million in valuation corrections for ESOPs.[154] As such, the Department is concerned that, without appropriate safeguards, appraisals in the context of non-public ESOPs are at risk of bias that favors the selling (purchasing) shareholder or employer, which increases the risk that ESOPs, participants, and beneficiaries overpay (are undercompensated) for employer stock.

The additional protections in this proposed rulemaking will ensure that prices associated with transactions for non-public ESOPs are unbiased and do not harm participants and beneficiaries. Moreover, the proposed rulemaking will not only provide ESOP fiduciaries with a clear roadmap for ensuring that the transaction price reflects the fair market value for the employer stock but will also ensure that ESOP fiduciaries comply with their duties of prudence and undivided loyalty with regard to the transaction.

5. *Accounting Table and Discussion*

In accordance with OMB Circular A–4, table 1 depicts an accounting statement summarizing the Department's assessment of the benefits, costs, and transfers associated with this regulatory action. The Department is unable to quantify all benefits, costs, and transfers of the rulemaking but has sought, where possible, to describe these non-quantified impacts.

Table 1 — Accounting Statement
Benefits and Transfers:
Non-Quantified:

[154] EBSA enforcement data based on recognized results in FY2023.

<table>
<tr><th colspan="5">Table 1 — Accounting Statement</th></tr>
<tr><td colspan="5">The Department expects that the proposed rulemaking would result in the following benefits:
• Increased clarity in the meaning of adequate consideration, reducing the litigation risk for fiduciaries determining adequate consideration.
• Provision of a universally applicable, sound process in complying with duties of prudence and loyalty.
• Increased competition of service providers offering trustee and appraisal services to ESOPs.
• Assurance that a fiduciary’s representation of the ESOP is truly independent and not tainted by undue influence of a selling or purchasing shareholder or employer.
• Assurance that the determination of the ESOP’s purchase price and transaction terms reflect fair market value and are made with complete independence from competing interests.
• Prevention of employers from taking on unsustainable debt related to overvalued stock prices.
• Increased likelihood that ESOPs would be made whole if they are injured by a violation of ERISA’s fiduciary standards.
• Improved price efficiency due to better information being provided and considered.

If the rulemaking prevents a selling or buying shareholder from engaging in imprudent practices which would have resulted in an inflated purchase price or deflated selling price without impacting price efficiency, the correction of such behavior under the proposed rulemaking would result in a transfer from the selling or buying shareholder to ESOP participants and beneficiaries.</td></tr>
<tr><td colspan="5">Costs and Transfers:</td></tr>
<tr><td>Costs</td><td>Estimate</td><td>Year Dollar</td><td>Discount Rate</td><td>Period Covered</td></tr>
<tr><td>Annualized Monetized ($million/Year)</td><td>$1.4</td><td>2024</td><td>2 percent</td><td>2024-2033</td></tr>
<tr><td colspan="5">Quantified:

The Department expects that entities will incur the following costs due to the proposed rulemaking:
• Cost related to reviewing the rulemaking.
• Costs related to selecting and hiring an independent fiduciary and engaging an independent valuation appraiser to produce a valuation report.
• Costs related to producing written certifications, maintaining sufficient fiduciary liability insurance or capitalization (Independent Trustee), writing Independent Trustee and Independent Appraiser contracts, and documenting internal deliberations (Independent Trustee).

As discussed above with Benefits, if the correction of imprudent practices under the proposed rulemaking results in the transaction price being different than under the status quo, the price change would represent a transfer between participants and beneficiaries and selling or buying shareholders. This would manifest as a lower selling price for selling shareholders or a higher purchasing price for buying shareholders.</td></tr>
</table>

6. *Affected Entities*

In 2022, there were 6,465 ESOPs, of which 3,024 were large plans, defined as having 100 or more participants, while 3,415 ESOPs were small plans, defined as having less than 100 participants. These 6,465 ESOPs include 973 KSOPs, or ESOPs with a 401(k) plan feature.[155] There were 14.9 million participants in ESOPs with $1.8 trillion in assets in 2022.[156]

Table 2 shows the number of ESOPs, leveraged ESOPs, and nonleveraged ESOPs between 2010 and 2022 based on Form 5500 filings. Until 2019, the number of nonleveraged ESOPs outnumbered the number of leveraged ESOPs. Of the 6,465 ESOPS in 2022, 55 percent were leveraged, while 45 percent were nonleveraged. In 2022, 13.1 million participants with $1.5 trillion in assets were in nonleveraged ESOPs.[157] The breakdown of leveraged and nonleveraged ESOPs in this analysis relies on self-reported ESOP Form 5500 filings. The Department acknowledges that there is some misreporting of leveraged status among ESOPs in Form 5500 filings. The Uncertainty section explores how misreporting may affect the estimates throughout this document.

Table 2 — Number of ESOPs

Plan Year	ESOPs		
	Total	*Leveraged*	*Nonleveraged*
2010	6,968	3,069	3,899
2011	6,801	2,976	3,825
2012	6,787	3,018	3,769
2013	6,685	2,966	3,718
2014	6,608	2,955	3,652
2015	6,561	2,956	3,605
2016	6,529	2,996	3,533
2017	6,457	3,042	3,415
2018	6,400	3,114	3,286
2019	6,380	3,176	3,204
2020	6,383	3,267	3,115
2021	6,445	3,445	3,000
2022	6,465	3,566	2,899

Source: Internal Department calculations based on Form 5500 filings.

[155] U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2022 Form 5500 Annual Reports*, (Sep. 2024), https://www.dol.gov/sites/dolgov/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletins-abstract-2022.pdf.
[156] U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2022 Form 5500 Annual Reports*, (Sep. 2024), https://www.dol.gov/sites/dolgov/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletins-abstract-2022.pdf.
[157] Internal Department calculations based on Form 5500 filings.

The proposed rule and class exemption will only affect non-public ESOPs; based on analysis by the NCEO, the Department assumes 91.4 percent of ESOPs, which includes 81.8 percent of large ESOPS and 100 percent of small ESOPs, hold stock that is not readily tradable on an established securities market.[158]

Transactions affected by the proposed rulemaking would occur at the initial establishment of an ESOP, when an existing ESOP purchases or sells employer stock, or when an ESOP terminates and sells its employer stock. Entities engaging in such transactions would generally need to comply with the statutory exemption, as clarified in the proposed rule.

The proposed class exemption would provide an alternative path to the statutory exemption for a subset of these transactions, ESOPs making initial purchases of employer common stock from a controlling shareholder. ESOPs and controlling shareholders engaging in a transaction that are eligible for relief are not required to rely on the class exemption, and the Department acknowledges that many may choose to continue to rely on the statutory exemption.

Table 3 shows the number of total ESOPs, new leveraged ESOPs, and nonleveraged ESOPs between 2010 and 2022. Over the past 10 years, new, leveraged ESOPs have accounted for 2.8 percent of total ESOPs and new, nonleveraged ESOPs have accounted for 1.4 percent of total ESOPs, on average. Many new ESOPs that report being nonleveraged are ESOPs that have not yet purchased employer stock. In the Department's experience, approximately 40 percent of

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[158] The NCEO estimated that there were 5,973 ESOPs in privately held companies and 560 ESOPs in publicly traded companies in 2021. Based on these values, the Department estimates that 91.4 percent of ESOPs are held by privately held companies. In addition, the NCEO estimates that there are 3,421 small plans held by private companies. Comparing this to the number of small plans in the Form 5500, the Department expects that nearly all small ESOPs will be in privately held companies, and that all 560 ESOPs in publicly traded companies correspond to large plans. As such, in this analysis, the Department assumes that all small ESOPs are in privately held companies and that approximately 81.8 percent of large ESOPs are held in privately held companies. *See* NCEO, Employee Ownership by the Numbers, (Feb. 2024), https://www.nceo.org/articles/employee-ownership-by-the-numbers; U.S. Department of Labor, Employee Benefits Security Administration, Private Pension Plan Bulletin: Abstract of 2022 Form 5500 Annual Reports, (Sep. 2024), https://www.dol.gov/sites/dolgov/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletins-abstract-2022.pdf.

nonleveraged, new ESOPs become leveraged in the following years.[159] After making this adjustment, the Department estimates that approximately 3.3 percent of ESOPs are new ESOPs engaging in a leveraged transaction, while 0.8 percent of ESOPs are new ESOPs engaging in a nonleveraged transaction.

Table 3 — Reported Number of New or Newly Leveraged ESOPs

Plan Year	New Leveraged ESOPs	New Nonleveraged ESOPs
2010	127	97
2011	119	104
2012	170	92
2013	100	98
2014	144	96
2015	147	106
2016	178	95
2017	188	97
2018	190	96
2019	180	89
2020	165	61
2021	268	95
2022	237	51

Source: Internal Department calculations based on historical Form 5500 filings.
Note: This table reflects unedited Form 5500 filings. The Department also conducted a sensitivity analysis on the accuracy of those filings in identifying when a new ESOP is leveraged or nonleveraged. Refer to the discussion in the Uncertainty section for more information.

To estimate how many transactions would occur annually due to employer stock purchases or sales for existing ESOPs and employer stock sales due to the termination of an ESOP under the proposed rule and proposed class exemption, the Department analyzed trends in data from the Form 5500 between 2013 and 2022. The Department's estimates rely on a 10-year average of the percent of ESOPs that would fall into each category of transaction.

The table below summarizes the Department's estimates of the percent of ESOPs engaging in a transaction that would be under the proposed rule or the proposed class exemption.

Table 4 - Percent of ESOPs Likely to Engage in a Transaction Under the Proposed Rule or Proposed Class Exemption [a]

	Proposed Rule	Proposed Class Exemption

[159] This estimate is based on an analysis of a sample of new ESOPs that reported being nonleveraged in 2021 and 2022.

	Nonleveraged	Leveraged	Nonleveraged	Leveraged
ESOPs that Are New	0.8%	3.3%	0.8%	3.3%
Existing ESOPs Purchasing Employer Stock [b]	1.2%	0.6%	-	-
Existing ESOPs Selling Employer Stock [c]	0.2%	0.2%	-	-
Terminated ESOPs [d]	0.8%	0.5%	-	-
Total	3.0%	4.6%	0.8%	3.3%

[a] The percentages in this table reflect the annual average of the percent of ESOPs that would fall into each category of transaction, based on Form 5500 data between 2013 and 2022.

[b] The Department estimates the percent of ESOPs that are not new and purchase additional employer stock through a leveraged transaction as the percent of ESOPs reporting a 10 percent or more increase in their acquisition indebtedness in a single year. The Department estimates the percent of ESOPs that are not new and purchase additional shares through a nonleveraged transaction as the percent of ESOPs reporting a 10 percent or more increase in the value of employer securities, after accounting for employer contributions and unrealized gains.

[c] The Department estimates the percent of ESOPs that are not new and sell employer stock as the percent of standalone ESOPs that report a 30 percent or more decrease in the reported value of employer securities, after accounting for unrealized gains. As declines in employer stock for KSOPs may be attributable to other factors, KSOPs are not used when obtaining this percentage. This estimated percentage is applied to all ESOPs including KSOPs.

[d] The Department estimates the percent of ESOPs that are selling shares due to a termination as the percent of ESOPs that report assets in the beginning of the plan year and zero assets at the end of the plan year.

As shown in table 5, the Department estimates that, on average, there would be 449 covered transactions annually, of which 272 would involve leverage and 177 would not involve leverage. Of these transactions, 242 are estimated to be eligible to rely on the class exemption, including 195 leveraged transactions and 47 nonleveraged transactions. Only transactions involving Employer common stock are eligible for relief under the class exemption. The Department does not have data on what proportion of ESOP transactions would fall outside the proposed class exemption's definition of a covered transaction. As such, this may overestimate the number of transactions eligible for relief under the class exemption.

Table 5 — Transactions

	ESOPs	*Percent Not Publicly Traded*	*Percent Engaging in Nonleveraged Transactions*	*Percent Engaging in Leveraged Transactions*	*Nonleveraged Transactions*	*Leveraged Transactions*	*Total Transactions*
	(A)	(B)	(C)	(D)	(E) = (A x B x C)	(F) = (A x B x D)	(G) = (E + F)
Transactions Affected by the Proposed Rule					**177**	**272**	**449**
Large ESOPs	3,050	81.8%	3.0%	4.6%	75	115	190
Small ESOPs	3,415	100.0%	3.0%	4.6%	102	157	259
Transactions Affected by the Proposed Class Exemption					**47**	**195**	**242**
Large ESOPs	*3,050*	*81.8%*	*0.8%*	*3.3%*	*20*	*82*	*102*
Small ESOPs	*3,415*	*100.0%*	*0.8%*	*3.3%*	*27*	*113*	*140*

This analysis assumes that the number of covered transactions, and as a result the number of affected ESOPs, would remain constant over time. However, the Department acknowledges that the number of covered transactions in future years may be affected in the future by the establishment of the Department's Employee Ownership Initiative, State programs promoting employee ownership, and the proposed class exemption's guidance for the successful first-time purchase of employer common stock. The Department requests comment on how such initiatives, programs, and the proposed regulation could affect the number of transactions under the proposed rulemaking.

7. Benefits and Transfers

The discussion below highlights the specific benefits that the Department expects to result from the proposed rulemaking. The Department requests comments about the specific benefits that may flow from the proposed class exemption and invites commenters to submit anecdotal or quantifiable data that would inform the Department's assertions and estimates.

7.1. Benefits for ESOP Participants and Beneficiaries

The Department is concerned that some fiduciaries conduct their roles in a manner that is inconsistent with protecting the interests of participants and beneficiaries. This may occur because the fiduciaries overseeing the transaction are often selected by or at the discretion of the employer, who is also the shareholder engaging in the transaction. These existing relationships can call into question the fiduciary's true independence.

The proposed rulemaking's conditions are designed to ensure that a fiduciary's representation of the ESOP is truly independent and not tainted by undue influence of the selling or purchasing shareholders and that the determination of the transaction price and terms are made with complete independence from the selling or purchasing shareholder's competing interests. As a result, the proposed rulemaking is designed to ensure that ESOPs (and their participants and beneficiaries) pay no more than the fair market value for employer stock.

Furthermore, the conditions of this rulemaking are designed to avoid employers taking on debt associated with overvalued employer stock prices. In 2022, approximately 55 percent of ESOPs were leveraged,[160] meaning that 55 percent of employers financed ESOP transactions through incurring debt from a bank, the shareholder(s), or both. When employer stock is overvalued, the ESOP may take on an excessive amount of debt that is disproportional to the value of the company. This increases the likelihood that the company will face bankruptcy or other negative outcomes, placing both workers' jobs and their retirement security at risk. The proposed rulemaking would ensure that valuations occur at a fair market value, decreasing the risk that participants and beneficiaries have historically faced in leveraged ESOPs.

The Department expects that the proposed class exemption conditions prohibiting fiduciaries from relying on certain indemnification provisions, requiring fiduciary liability insurance, and precluding the waiver of State-law rights and claims against independent valuation advisers would provide numerous benefits to participants and beneficiaries of ESOPs. For example, these class exemption conditions are designed to increase the likelihood that ESOPs would be made whole if they are injured by a violation of ERISA's fiduciary standards and deter misconduct involving ESOPs purchasing employer stock.

[160] Department estimates from the 2022 Form 5500 Pension Research File.

Furthermore, the proposal would require the valuation report to account for the grant or assignment of any interests, rights, or claims to future income streams or corporate assets to parties other than the plan shareholder. This would include the issuance of stock warrants, which grant the holder the right to purchase a certain number of shares of stock at a future date for a specified price. For warrants classified as a liability, accounting standards dictate that companies determine the fair value rate at each reporting date and note changes in the fair value in the company's income statement. Moreover, they must disclose the exercise price, expiration date, and any conditions that affect the ability to exercise the warrant.[161]

Stock warrants are often referred to as dilutive securities because, if the owner of the security exercises their option to purchase, it would reduce, or dilute, the value of existing shares.[162] Dilution is often considered in terms of whether the action would dilute the earnings per share, a common measure to value stock. In requiring the valuation to consider the dilutive effects of stock warrants, the proposal would further protect ESOP participants from overpaying for employer stock.

7.2. Price Changes Resulting in Benefits and Transfers

A primary goal of this proposed rulemaking is to ensure that ESOPs are paying no more than the fair market value for employer stock. If the price determined by the fiduciary under the proposed rulemaking better reflects the fair market value, due to improved information, than the price at which the transaction would have occurred under the status quo, the difference would represent a benefit. If instead the price determined under the proposed rulemaking is merely different than it otherwise would have been under imprudent practices, the difference would generally be considered a transfer.

The proposed rulemaking would result in a benefit of fairer and more transparent prices and greater market efficiency. The proposed rulemaking would require the plan fiduciary to act

[161] *See* https://accountinginsights.org/warrant-accounting-and-valuation-a-comprehensive-guide/
[162] Donald Kieso, Jerry Weygandt, & Terry Warfield, Intermediate Accounting (14 ed. 2012).

with prudence and loyalty when selecting a qualified, independent valuation advisor. It would also require the plan fiduciary to ensure the valuation report reflects current, complete and accurate information. These actions reduce information asymmetries and improve price efficiency, producing a benefit to ESOPs and their participants and beneficiaries.

In the case in which the rulemaking prevents a selling or purchasing shareholder from engaging in imprudent practices which would have resulted in an inflated purchase price or deflated selling price, the correction of such behavior under the proposed rulemaking would result in a transfer from the selling or buying shareholder to ESOP participants and beneficiaries.

The Department is unable to estimate how large the benefits and transfers might be. However, in the course of carrying out its enforcement investigations, the Department has found repeated instances where a shareholder profited from an inflated valuation at the expense of the plan participants and beneficiaries. Between 2018 and 2023, the Department identified instances related to valuation issues for ESOPs, including issues related to purchase transactions, sales transactions, and annual valuations, which resulted in $322.5 million in monetary results, of which $311.5 million were related to purchase transactions.[163]

These monetary results cannot be directly interpreted as the amount of harm suffered by ESOP participants due to imprudent valuation practices; however, this figure provides a sense of magnitude of the issue. When considering this amount, there are a few factors to keep in mind. For instance, it does not reflect the entirety of the sum lost by participants and beneficiaries, but rather the amount of damages paid back to participants and beneficiaries as a result of a lawsuit. Often participants and beneficiaries are not able to recoup the entirety of what is lost, and on occasion, they may obtain non-monetary reparations such as shares of stock. Additionally, not all ESOPs undergo a Departmental investigation and not all instances of an ESOP paying more than the fair market value result in a lawsuit.

[163] The case count for valuation, in general, includes cases related to purchase transactions, sales transactions, and annual valuations. Monetary results between 2018 and 2022 varied annually between $25 million and $52 million. Monetary results in 2023 were $140 million.

The Department requests comment on its characterization of these transfers and, as with the Benefits section, invites commenters to submit quantifiable data that would inform the Department's estimates.

7.3. Benefits for Fiduciaries and Employers

This proposed rulemaking would provide the ESOP's fiduciaries, including the independent fiduciary, with a universally applicable, sound process for ensuring that ESOPs and their fiduciaries 1) pay no more than fair market value for the employer stock and 2) comply with their duties of prudence and undivided loyalty with regard to the transaction.

The proposed class exemption is broadly consistent with the practices set forth in the Department's trustee process agreements. By formalizing these requirements in this administrative class exemption, the Department would provide one path for ESOP fiduciaries to ensure they avoid engaging in a non-exempt prohibited transaction when the ESOP makes its initial purchase of employer common stock from a Selling Shareholder. ESOP fiduciaries would not be required to comply with the proposed exemption provided that they comply with the statutory exemption in ERISA section 408(e), but doing so would provide a safe harbor for the fiduciaries engaging in the Covered Transaction. Accordingly, the proposed class exemption would reduce the legal exposure and litigation risk for ESOP fiduciaries.

Further, the provisions in SECURE 2.0 combined with the increased clarity provided from the proposed rulemaking and the consequent reduced legal exposures would likely encourage more service providers to offer independent trustee or appraisal services for ESOP transactions. Increasing the number of entities offering these services would provide fiduciaries with more options when selecting a trustworthy service provider. This increase in service providers would also promote more competition among them in the market. The Department expects that the increased competition among services providers, in combination with the standards set forth in the proposed rulemaking, would encourage better practices among service providers.

Parties who rely on the proposed class exemption would also be able to focus on meeting the specific terms of the exemption and would thereby benefit from having a compliance roadmap for managing ESOP transactions. The Department expects that this relief would (as compared with hypothetical issuance of the proposed rule without an accompanying class exemption) benefit fiduciaries engaging in a covered transaction by specifying the scope of inquiry that professionals retained in connection with the transaction would have to undertake, reducing the fiduciaries' legal exposure and litigation risk.

8. Costs and Transfers

To estimate compliance costs associated with the proposed rulemaking, the Department considers the marginal cost relative to existing business practices and regulatory requirements. The Department estimates that this proposed rulemaking would impose total costs of $8.2 million in the first year and $468,000 in each subsequent year. Over 10 years, the costs associated with the proposed rulemaking would total approximately $12.4 million, annualized to $1.4 million per year using a 2 percent discount rate, or roughly 0.0001 percent of total ESOP assets in 2022.

8.1. Preliminary Assumptions and Cost Estimate Inputs

The Department assumes that communications between businesses would be sent entirely by electronic means. As such, the Department has not estimated any material or postage costs associated with such communications.

Additionally, the Department assumes that compliance with the rulemaking would require tasks to be performed by several different types of personnel. In the analysis below, tasks performed by a selling or purchasing shareholder or monitoring fiduciary are assumed to incur an hourly labor cost equivalent to that of an internal legal professional, estimated as $177.97.[164]

[164] Internal Department calculation based on 2023 labor cost data and adjusted for inflation to reflect 2024 wages. For a description of the Department's methodology for calculating wage rates, see EBSA, *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research's Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculations,* EBSA, https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf.

Tasks performed by an independent fiduciary or independent valuation adviser are assumed to incur an hourly labor cost equivalent to the average labor cost of an external legal professional, external paralegal, actuary, and accountant, estimated as $249.08.[165] Tasks performed exclusively by an external legal professional are assumed to incur an hourly labor cost of $437.00.[166]

Finally, as discussed further in the Baseline section, many of the requirements in this proposal are common business practice. This analysis considers the marginal costs relative to other regulatory requirements and common business practice. The Department invites comment on this assumption and its application.

8.2. Summary of Affected Entities

As discussed in more detail in the Affected Entities section of this document, this analysis assumes that there are 6,465 ESOPs, of which 5,909 are privately owned. Further, this analysis assumes that there would be approximately 449 transactions covered by the proposed rule, of which 242 would be eligible for the proposed class exemption.

However, due to the costs and other requirements of the proposed class exemption, the Department assumes for this analysis that many parties would choose instead to continue to rely upon the statutory exemption. In this analysis, the Department assumes that 25 percent of transactions eligible to use the proposed class exemption, or 61 transactions, would do so. The Department requests comment on how often parties would rely on the proposed class exemption

[165] This estimate reflects the equally-weighted average of labor costs for an actuary, accounting, external paralegal, and external attorney. Based on internal Department calculations based on 2023 labor cost data and adjusted for inflation to reflect 2024 wages, the hourly labor cost of an actuary is $201.37 and the hourly labor cost of an accountant is $118.93. (EBSA, *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research's Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculations,* EBSA, https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf.). According to the Laffey Matrix, the hourly cost for a paralegal and an attorney one to three years out of law school is $239 and $437, respectively. *Laffey Matrix*, (2024), https://www.laffeymatrix.com/see.html. Accordingly, this value is estimated as: ($201.37 + $118.93 + $239 + $437) / 4 = $249.08.

[166] According to the Laffey Matrix, the hourly cost for an attorney one to three years out of law school is $437, respectively. *Laffey Matrix*, (2024), https://www.laffeymatrix.com/see.html.

and whether the proposed class exemption would encourage more employee ownership in the future.

In table 6, these estimates are broken down by size of entity and whether the transaction involves leverage.

Table 6 — Transactions

	Number of ESOPs		Transactions		
	Total	*Non-Public*	*Nonleveraged*	*Leveraged*	*Total*
Transactions Affected by the Proposed Rule					
Total	6,465	5,909	177	272	449
Large	3,050	*2,494*	75	115	190
Small	3,415	*3,415*	102	157	259
Transactions Affected by the Proposed Class Exemption					
Total	6,465	5,909	47	195	242
Large	3,050	*2,494*	20	82	102
Small	3,415	*3,415*	27	113	140

8.3. Costs to Review the Proposed Rule and Class Exemption

The Department understands that parties engaging, or considering to engage, in a covered transaction would need to review the rule and class exemption to understand how their business practices would be affected. The Department expects that time spent in reviewing would vary by entity. For instance, prospective selling or purchasing shareholders and ESOPs may only review the rulemaking if they are expecting to engage in a covered transaction, whereas all entities acting as trustees or appraisers in such a covered transaction would need to review the rulemaking to ensure that they are compliant. However, some trustees or appraisers could be servicing multiple covered transactions for multiple ESOPs. These entities would not need to review the rulemaking for each transaction.

With this acknowledgement, the Department estimates that it would take, on average, three hours for an external legal professional employed by each non-public ESOP (be it the ESOP itself or a legal professional hired by the ESOP) to review both the proposed rule and class exemption.[167] The Department believes that this is a simplified overestimate and that most ESOPs would only review the rulemaking prior to a covered transaction and that not all ESOPs would review both the rule and the exemption. The results are shown in table 7.

Table 7 — Costs Associated with Rule Review

ESOPs	*Hours*	*Hourly Wage*	*Total Costs*
(A)	(B)	(C)	(D) = (A x B x C)
5,909	3	$437.00	$7,746,699

For trustees and appraisers engaged by the ESOP, the Department expects that the increased cost associated with reviewing the rulemaking would be reflected in increased fees. These costs are discussed and estimated below.

8.4. Costs Associated with the Proposed Rule

For direct or indirect acquisitions or sales of a qualifying employer stock by an ESOP for which there is not a generally recognized market, the proposed rule provides a definition for fair market value as used in section 3(18)(B) of ERISA. The proposed rule also requires that, before the acquisition or sale, an independent fiduciary must choose and engage a qualified independent valuation adviser, oversee the production of a written valuation report, review the valuation report, and determine the fair market value of the employer stock. As discussed below, the Department does not expect the clarifying provisions in the proposed rule to impose meaningful costs on affected entities.

8.4.1. Costs Associated with Paragraph (b)(3): Prudence

For qualifying employer stock, the proposal would require an independent fiduciary to act prudently to select a valuation adviser who has appropriate training and expertise and is independent from all parties in the transaction, except for the plan. Additionally, the proposal would require the independent fiduciary to ensure that the valuation report is based on complete,

[167] This estimate accounts for the time it would take to read the proposed rule operative text and preamble, proposed class exemption operative text and preamble, and regulatory impact analysis, assuming a reading speed of 250 words per minute.

current, and accurate information. The independent fiduciary must ensure the valuation adviser is provided with all material current financial information. In particular, they would need to ensure that the valuation adviser is informed of recent serious expressions of interest from third parties to purchase stock, that the valuation adviser has access to the issuer's management and personnel, and that the valuation adviser is informed that the valuation report must satisfy paragraph (b)(4) of the proposal.

The independent fiduciary ultimately determines the price at which the plan transaction should occur. As such, the proposal would require the independent fiduciary to ensure that they can prudently rely on the valuation report prepared by the valuation adviser. The proposed rule states that, at a minimum, the independent fiduciary would need to critically review the report and assess the reliability and trustworthiness of any projections. The proposed regulation provides specific factors that the independent trustee must consider in its review in paragraph (b)(3)(iv)(A)-(J). Notably, in paragraph (b)(3)(iv)(F), the proposed rule specifies that the valuation report must account for the grant or assignment of interest, rights, or claims to future income or corporate assets to parties other than ESOP participants, such as stock warrants.

The Department believes that an independent fiduciary engaging a valuation advisor would already provide material information to the valuation adviser, as a matter of prudence under ERISA section 404, prudent compliance with ERISA section 408(e), case law, and existing business practices. Further, these requirements are consistent with existing trustee process agreements, which are readily available to the public. Therefore, the Department expects that while paragraph (b)(3) provides clarity around the role of an independent fiduciary, these requirements would not impose additional costs.

8.4.2. Costs Associated with Paragraph (b)(4): Valuation Content

The proposal requires that the valuation report be prepared in accordance with generally accepted professional standards for performance of valuations and must contain all information that the valuation adviser reasonably determines may materially affect the value of the employer stock. The preamble of this document includes additional information on what the valuation report should include.

Section 401(a)(28)(C) of the Code requires that all valuation of employer securities not readily traded on an established securities market be conducted by an independent valuation adviser.[168] Drawing from the requirement under the Code, as well as industry guidelines discussed in the Baseline section, the Department believes that the reliance upon an independent valuation adviser for the type of transaction covered by the proposed class exemption is standard practice and thus would not impose additional costs.

8.5. Costs Associated with the Class Exemption

The proposed administrative class exemption would provide a detailed compliance roadmap for Independent Trustees, Independent Appraisers, Selling Shareholders, and Monitoring Fiduciaries to comply with the proposed adequate consideration regulation published elsewhere in this issue of the *Federal Register.* Specifically, the class exemption would provide prohibited transaction relief when an ESOP makes an initial purchase of non-publicly traded, common stock (referred to as "eligible transactions" throughout this section) with appropriate guardrails in order to protect the interest of ESOPs and their participants and beneficiaries.

The trustee process agreements, discussed above, laid the groundwork for the requirements of this proposed class exemption. While each process agreement was specific to the facts and parties in each case, there are common standards and themes across the agreements, and they provide insight into what may be required of an ESOP fiduciary. The standards included in the trustee process agreements have been widely publicized and followed by the ESOP industry[169] and are available on the Department's website.[170]

[168] 26 U.S.C. 401(a)(28)(C).
[169] *See* Theodore M. Becker, Richard J. Pearl, and Allison Wilkerson, *The* DOL Fiduciary Process Agreement for ESOP Transactions (June 2021), NCEO.
[170] *See* https://www.dol.gov/agencies/ebsa/employers-and-advisers/employee-ownership-initiative; https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement (last visited September 20, 2024).

However, the proposed class exemption would clearly articulate the prohibited indemnification of the Independent Trustee and Independent Appraiser and would require additional certifications for Independent Trustees of non-publicly traded ESOPs, which may be costly. These impediments may prove to be significant and result in the class exemption not being widely used by industry. The Department requests comment on the impediments and potential use of the proposed class exemption.

Given the lack of information on how many transactions would rely upon the proposed class exemption, this analysis estimates the per transaction cost associated with complying with it and then shows cost estimates for varying levels of usage. For the main analysis, the Department chose to model the cost with a small, but reasonable estimate that approximately 25 percent of eligible transactions, or 61 transactions, would rely on the class exemption annually.

8.5.1. Costs Associated with Section III, General Conditions

Section III of the proposed class exemption would limit the types of transactions that can rely on the exemption and would require that the terms of the Covered Transaction[171] be set forth in a written contract. The Department expects that such a transaction would universally require such a contract, and as such, the Department has not attributed any costs to this requirement. The Department requests comment on this assumption.

8.5.2. Costs Associated with Section IV, Conditions for Selling Shareholders

The class exemption would impose conditions on Selling Shareholders. Specifically, Selling Shareholders may not be involved in the ESOP's decision-making, must take steps prudently designed to ensure their independence, and must provide complete, current, and accurate information that is not misleading.

Section IV(d) would require all Selling Shareholders to certify in writing, without disclaimers or qualifications, that they have complied with paragraphs IV(a), (b), (c) and (d)(1),

[171] The proposed class exemption defines a Covered Transaction as the initial acquisition of non-publicly traded Employer Stock by an ESOP directly from a Selling Shareholder.

and that they are unaware of any material omissions or inaccuracies in the information provided to the Independent Trustee and Independent Appraiser.

Additionally, section IV(e) would provide a special rule for Selling Shareholders to rely on the exemption if they receive written certifications from the other parties confirming compliance with the proposed class exemption's conditions. Relying on this special rule would be optional for transactions relying on the proposed class exemption. However, in this analysis, the Department assumes that all transactions relying on the exemption would also rely on the special rule for Selling Shareholders. The Department requests comment on this Assumption.

For each transaction, four certifications would need to be prepared, including a certification from the Monitoring Fiduciary, Independent Trustee, Independent Appraiser, and Selling Shareholder. The Department estimates that the preparation of each certification will take on average 30 minutes. The resulting costs are summarized in table 8.

Table 8 — Per-Transaction Costs Associated with Section (IV)

	Hours	*Hourly Wage*	*Per-Transaction Cost*
	(A)	(B)	(C) = (A x B)
Written Certifications From:			
Monitoring Fiduciary	0.5	$177.97	$89
Independent Fiduciary	0.5	$249.08	$125
Independent Appraiser	0.5	$249.08	$125
Selling Shareholder	0.5	$177.97	$89
Total			**$427**

While the Department does not attribute a significant cost to drafting these certifications, the requirement to make such certifications would increase the liability for these parties in the event of misconduct. This increased liability is reflected in the increased cost to engage an Independent Trustee and Independent Appraiser, discussed in greater detail below.

8.5.3. Costs Associated with Section V, Conditions for Monitoring Fiduciaries

The proposed class exemption would require a Monitoring Fiduciary to act prudently and loyally in investigating, selecting, and appointing an Independent Trustee to oversee the Covered Transaction. The selection of an Independent Trustee would be done by a Monitoring Fiduciary.

The Department estimates that, on average, the process to select an Independent Trustee would take a Monitoring Fiduciary an additional five hours beyond what they currently do. The estimated costs are explained in table 9.

Additionally, the proposed class exemption would require the Monitoring Fiduciary to determine that the Independent Trustee has sufficient financial resources, including fiduciary liability insurance, to provide restitution to the plan for losses resulting from any breach by the Independent Trustee of its ERISA fiduciary obligations or the conditions of the class exemption. The Monitoring Fiduciary may determine that fiduciary liability insurance is sufficient if it is available to cover losses equaling at least 20 percent of the purchase price. The Department estimates that it would take a Monitoring Fiduciary approximately six hours to analyze an Independent Trustee's capitalization and estimate the amount required. The estimated costs are explained in table 9.

The class exemption would also require the Monitoring Fiduciary to ensure the Independent Trustee receives complete, current, and accurate information, including audited, unqualified financial statements for the preceding 5 years, or as far back as administratively feasible. They would also be required to make available any requested officer, employee, or contractor of the Employer for interview by the Independent Trustee. The Department believes that the provision of this information, regardless of whether it is being delivered to the Independent Trustee and Independent Appraiser, would generally be required as a matter of prudence under ERISA section 404, prudent compliance with ERISA section 408(e), case law, and existing business practices. As such, the Department expects that this requirement would not impose an additional burden on Monitoring Fiduciaries.

The proposed class exemption further requires the Monitoring Fiduciary to oversee the actions of the Independent Trustee. Section V would require the Monitoring Fiduciary to replace the Independent Trustee if needed or stop the transaction from occurring if the Monitoring Fiduciary has reason to believe that the Independent Trustee has failed to meet its responsibilities under ERISA, the Code, the conditions of the exemption, or its Independent Trustee Contract. Such actions would likely have significant costs. The Department requests comment on how common it would be necessary to take such actions and the associated cost.

Table 9 — Per-Transaction Costs Associated with Section V

	Hours	*Hourly Wage*	*Total Costs*
	(A)	(B)	(C) = (A x B)
Conditions for Monitoring Fiduciary:			
Selection of an Independent Trustee	5	$177.97	$890
Determination of Fiduciary Insurance or Capitalization Requirements	6	$177.97	$1,068
Total			**$1,958**

8.5.4. Costs Associated with Section VI, Conditions for Independent Trustees

The proposed exemption provides a roadmap for the Independent Trustee in their selection of the Independent Appraiser, evaluation of the appraisal report, and determination of the stock price. The proposed class exemption requires an Independent Trustee to have appropriate technical training and proficiency, avoid conflicts of interest, enter into a written contract, have sufficient financial resources, and preserve independence. The written contract with the ESOP must specify that, among other things, the Independent Trustee is an ERISA fiduciary with respect to the Covered Transaction and that the Independent Trustee will comply with the conditions of the exemption. The Department expects that most non-public ESOPs are already engaging an Independent Trustee and that a written contract between the ESOP and Independent Trustee is common business practice. However, due to the additional specificity of the class exemption, the Department estimates, that on average, drafting such a contract would take an internal lawyer at an ESOP 30 additional minutes. This estimation is explained in table 11.

The Department expects that Independent Trustees would already be satisfying most of the conditions specified in the proposed class exemption relating to the selection of an Independent Appraiser, evaluation of the appraisal report, and determination of the stock price in accordance with prudence under ERISA section 404, prudent compliance with ERISA section 408(e), case law, and existing business practices.

However, due to the increased requirements set forth in the proposal and the added requirement to certify their compliance with the exemption, the Department assumes that an Independent Trustee would likely increase fees for their services. If it were assumed that the additional requirements proposed in the rule would require 10 additional hours of labor from the Independent Trustee, this would result in a $2,500 increase in costs per-transaction cost.[172] Depending on the size and complexity of the transaction, this would be between a three percent and eight percent increase in costs.[173] For the purposes of this analysis, the Department estimates that, on average, an Independent Trustee under the proposed class exemption would increase their fees by five percent.

The Department considers four categories of ESOP transactions:

(1) transactions without leverage in small companies,

(2) transactions with leverage in small companies,

(3) transactions without leverage in large companies, and

(4) transactions with leverage in large companies.

Independent Trustee fees vary based on the complexity of the ESOP transaction. As such, the costs associated with hiring an Independent Trustee are likely to be more expensive for large companies or for transactions involving leveraged ESOPs than for small companies or for transactions that do not involve leverage.[174] In 2018, NCEO estimated that outside trustees for most transactions range between $25,000 and $70,000,[175] or approximately between $30,000 and

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[172] This is estimated as: 10 hours x $249.08 labor cost per hour for an independent trustee = $2,490.75, rounded to $2,500.

[173] This range is based on ratio of the estimated increased labor cost to the estimated cost to hire an independent trustee. Such that: $2,490.75 / $30,000 = 8.3 percent, rounded to 8 percent; $2,490.75 / $60,000 = 4.2 percent, rounded to 4 percent; and $2,490.75 / $90,000 = 2.8 percent, rounded to 3 percent.

[174] NCEO, *How Small is Too Small for an ESOP?* (July 2022), https://www.nceo.org/articles/too-small-for-esop.

[175] NCEO, Are ESOPs Really More Complex and Costly Than Other Ways to Sell a Business? (September 2018), https://www.nceo.org/articles/esops-complexity-selling-business.

$90,000 in 2024 after adjusting for inflation.[176] The estimated increase in the cost to hire an Independent Trustee is explained in table 10.

Table 10 — Estimated Cost to Hire an Independent Trustee by ESOP Type

	Independent Trustee Cost	*Percent Increase in Cost Attributable to Proposal*	*Increase in Cost Attributable to Proposal*
	(A)	(B)	(C) = (A x B)
Small, Nonleveraged	$30,000	5%	$1,500
Small, Leveraged	$60,000	5%	$3,000
Large, Nonleveraged	$60,000	5%	$3,000
Large, Leveraged	$90,000	5%	$4,500

To satisfy the conditions of the proposed class exemption, an Independent Trustee would be required to maintain sufficient financial resources, including fiduciary liability insurance, to provide restitution to the plan for losses resulting from any breach by the Independent Trustee of its ERISA fiduciary obligations or the conditions of this exemption. Fiduciary liability insurance may be treated as sufficient if it is available to cover losses equaling at least 20 percent of the purchase price,

The Department believes that most Independent Trustees already have fiduciary liability insurance; however, their current coverage may fall short of the minimum coverage requirements. While the requirement for sufficient capitalization or coverage and the clarification of indemnification provisions in the proposed class exemption would likely increase the costs associated with insurance coverage, the fiduciary compliance roadmap provided in the proposed class exemption would likely reduce the reliance on insurance to make payments for fiduciary breaches and may ultimately decrease the costs associated with insurance coverage.

For the purposes of this analysis, the Department assumes that, when combined, these opposing factors will ultimately have an insignificant effect on fiduciary liability insurance costs. The Department does not have sufficient data to quantify the effect of the proposed class

[176] These values are adjusted using the seasonally adjusted All Items in U.S. City Average Consumer Price Index for All Urban Consumers for January 2018 and January 2024. These values are rounded to the nearest $10,000 for illustrative purposes.

exemption on insurance premiums, and therefore, requests data that it could use to quantify such impacts.

The estimated marginal cost burden associated with the requirement to hire an Independent Trustee is shown in table 11.

Table 11 — Per-Transaction Costs Associated with Section VI

	Hours	*Hourly Wage*	*Other Costs*	*Per-Transaction Costs*
	(A)	(B)	(C)	(D) = [(A x B) + (C)]
Increased Cost Associated with Independent Trustee Contract				
	0.5	$177.97		$89
Hiring an Independent Trustee				
Small, Nonleveraged			$1,500	$1,500
Small, Leveraged			$3,000	$3,000
Large, Nonleveraged			$3,000	$3,000
Large, Leveraged			$4,500	$4,500

8.5.5. Costs Associated with Section VII, Conditions for the Independent Appraiser

The proposed class exemption requires an Independent Appraiser to enter into a written contract with the Independent Trustee, setting forth the duties of the Independent Appraiser and specifying that they must comply with the conditions of the class exemption. The Department expects that a written contract between the Independent Trustee and Independent Appraiser is already common business practice; however, due to the additional specificity of the class exemption, the Department estimates, that on average, drafting such a contract would take an Independent Trustee 30 additional minutes. This estimation is explained in the table 13.

The Internal Revenue Code requires that all valuations of employer securities not readily traded on an established securities market be conducted by an independent valuation adviser.[177] Drawing from this requirement, as well as requirements in trustee process agreements and industry guidelines discussed in the Baseline section, the Department believes that the reliance

[177] 26 U.S.C. 401(a)(28)(C). Technically, the language under the code is that the subject valuations be conducted by an "independent appraiser." *Id.*

upon an independent valuation adviser for the type of transaction covered by the proposed class exemption is standard practice.

The proposed class exemption also requires the Independent Appraiser to prepare a written report setting forth the Fair Market Value and specific bases for its determination of the Fair Market Value. The Department assumes transactions like those covered under the proposed class exemption would already result in a valuation report. However, the Department acknowledges the specificity of the proposed class exemption and the requirement for the Independent Appraiser to certify compliance may increase the costs associated with engaging an Independent Appraiser.

In 2018, NCEO estimated that the cost for valuations for most ESOP transactions range between $15,000 and $25,000,[178] or approximately between $19,000 and $30,000 in 2024 after adjusting for inflation.[179] One company offering business valuation services, including independent ESOP valuations, cited costs between approximately $2,000 for a small business valuation and $6,000 for a premium, detailed valuation.[180] While not specifically addressing ESOP valuation, another company offering business valuation services, including a report, estimates that they charge between $2,000 and $10,000 for a small business, between $10,000 and $50,000 for a mid-sized business, and between $50,000 and $100,000 for a large business.[181]

For the purposes of this analysis, the Department estimates that the average cost for a typical valuation report would be $10,000 for transactions without leverage in small companies, $30,000 for transactions with leverage in small companies, $30,000 for transactions without leverage in large companies, and $50,000 for transactions with leverage in large companies.

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[178] NCEO, *Are ESOPs Really More Complex and Costly Than Other Ways to Sell a Business*, (September 2018), https://www.nceo.org/articles/esops-complexity-selling-business.
[179] These values are adjusted using the seasonally adjusted All Items in U.S. City Average Consumer Price Index for All Urban Consumers for January 2018 and January 2024. These values are rounded to the nearest $10,000 for illustrative purposes.
[180] Stanton Park Capital, *Business Valuation & Appraisal Services,* (2023), https://stantonparkllc.com/business-valuation/.
[181] Eton Venture Services, *How Much Does a Business Valuation Cost in 2024?* (March 2024), https://etonvs.com/valuation/business-valuation-services-cost/.

If it were assumed that additional requirements proposed in the class exemption would require five additional hours of labor from the independent valuation appraiser, this would result in an estimated increase in per-transaction cost of approximately $1,200.[182] Depending on the size and complexity of the transaction, this would be between a two percent and eight percent increase in costs.[183] As shown in table 12, the Department estimates that, on average, the cost of the valuation report could increase by five percent in order to comply with the proposed requirements.

Table 12 — Estimated Cost of the Valuation Report

	Independent Valuation Report	*Percent Increase in Cost Attributable to Proposal*	*Increase in Cost Attributable to Proposal*
	(A)	(B)	(C) = (A x B)
Small, Nonleveraged	$10,000	5%	$500
Small, Leveraged	$30,000	5%	$1,500
Large, Nonleveraged	$30,000	5%	$1,500
Large, Leveraged	$50,000	5%	$2,500

The Department uses plan size as a proxy for company size. The estimated increased cost attributable to the proposal is shown in table 13.

Table 13— Per-Transaction Costs Associated with Section VII

	Hours	*Hourly Wage*	*Other Costs*	*Per-Transaction Costs*
	(A)	(B)	(C)	(D) = [(A x B) + (C)]
Increased Cost Associated with the Independent Appraiser Contract				
	0.5	$249.08		$125
Increased Cost Associated with the Valuation Report				
Small, Nonleveraged			$500	$500
Small, Leveraged			$1,500	$1,500
Large, Nonleveraged			$1,500	$1,500
Large, Leveraged			$2,500	$2,500

182 This is estimated as: 5 hours x $249.08 labor cost per hour for an independent trustee = $1,245.38, rounded to $1,200.

183 This range is based on ratio of the estimated increased labor cost to the estimated cost to hire an independent trustee. Such that: $1,248.38 / $50,000 = 8.3 percent, rounded to 8 percent; $1,248.38 / $30,000 = 4.2 percent, rounded to 4 percent; and $1,248.38 / $15,000 = 2.5 percent, rounded to 2 percent.

8.5.6. Cost Associated with Section VIII, Recordkeeping

The proposed class exemption would require the Independent Trustee to maintain, for six years, the records necessary to determine whether the conditions of this class exemption have been met. Additionally, the Independent Trustee would be required to make the records available to any authorized employee or representative of the Department or Department of Treasury, including the Internal Revenue Service, any fiduciary of an ESOP that engaged in a Covered Transaction, any employee organization whose members are covered by an ESOP, or any participant or beneficiary of an ESOP. The Department assumes that many firms already maintain records as part of their regular business practices. Accordingly, the Department expects that the recordkeeping requirement would impose a negligible burden.

8.5.7. Summary

For the purposes of this analysis, the Department assumes that 25 percent of the transactions eligible for relief under the proposed class exemption, or 61 transactions, would rely on the proposed class exemption. Table 14 summarizes estimated the per-transaction costs by leverage status and size of ESOP as well as the total estimated cost associated with the proposed class exemption.

Table 14 — Summary of Costs

	Leveraged Transactions		Unleveraged Transactions		Total
	Small	Large	Small	Large	
Number of Transactions	28	21	7	5	61
Per-Transaction Costs Associated with the Proposed Class Exemption by Section					
Section IV	$427	$427	$427	$427	
Section VI	$1,958	$1,958	$1,958	$1,958	
Section VI	$3,089	$4,589	$1,589	$3,089	
Section VII	$1,625	$2,625	$625	$1,625	
Total Cost	**$198,751**	**$201,563**	**$32,188**	**$35,491**	**$467,992**

8.6. Transfers Between Selling or Buying Shareholders and Participants and Beneficiaries

As discussed in the Benefits and Transfers sections, the primary goal of this proposed rulemaking is to ensure that ESOPs are paying no more than the fair market value of employer stock. If the rulemaking prevents a selling or buying shareholder from engaging in imprudent practices which would have resulted in an inflated purchase price or deflated selling price, the correction of such behavior under the proposed rulemaking would result in a transfer from the selling or buying shareholder to ESOP participants and beneficiaries.

9. Uncertainty

As discussed in the Affected Entities section, the breakdown of leveraged and nonleveraged ESOPs in the main analysis relies on how an ESOP self-reports on their Form 5500 filing. However, relying solely on this self-reported coding may overestimate the number of nonleveraged transactions.

To give scope to the scale of potential miscoding, this analysis looks at other data fields from the Form 5500 that would suggest that a new ESOP is leveraged. The Department would expect nonleveraged ESOPs to report having a stock bonus; or require that all or part of employer contributions be invested and held, at least for a limited period, in employer securities. Table 15 compares the number of new leveraged and nonleveraged ESOPs as self-reported on the Form 5500 and reported in the Cost Section, to the number of new leveraged and nonleveraged ESOPs adjusted for this other information. Under this measure, on average, approximately one-third of new ESOPs that self-reported they are nonleveraged included codes on their self-reported Form 5500 filing that are consistent and indicate an ESOP being non-leveraged.

Table 15 — Number of New or Newly Leveraged ESOPs

	As Reported		**Adjusted**	
Plan Year	*New Leveraged ESOPs*	*New Nonleveraged ESOPs*	*New Leveraged ESOPs*	*New Nonleveraged ESOPs*
2010	127	97		
2011	119	104	207	16
2012	170	92	246	16

Table 15 — Number of New or Newly Leveraged ESOPs				
	As Reported		Adjusted	
Plan Year	*New Leveraged ESOPs*	*New Nonleveraged ESOPs*	*New Leveraged ESOPs*	*New Nonleveraged ESOPs*
2013	100	98	178	20
2014	144	96	223	17
2015	147	106	230	23
2016	178	95	239	34
2017	188	97	247	38
2018	190	96	243	43
2019	180	89	229	40
2020	165	61	193	33
2021	268	95	333	30
2022	237	51	266	22

Source: Internal Department calculations based on 2022 Form 5500 filings

As discussed in the Affected Entities section, the Department estimates that there would be 272 leveraged and 177 nonleveraged transactions under the rule and 195 leveraged and 47 nonleveraged transactions eligible to rely on the class exemption. The Department assumes that 25 percent of transactions eligible for the exemption, or 49 leveraged transactions and 12 nonleveraged transactions, would choose to rely on the exemption. If it were assumed that two-thirds of self-reported non-leveraged transactions should be coded as leveraged transactions, this would result in an estimate of 57 leveraged transactions and four nonleveraged transactions.

As shown in table 16, and discussed in greater detail in the Cost section, the per-transaction cost to comply with the proposed class exemption varies by size and whether the leverage is involved. As such, assuming that the number of leveraged transactions is higher would result in a greater cost. Assuming that two-thirds of self-reported non-leveraged transactions should be coded as leveraged transactions would result in a 4.3 percent increase in total costs.

Table 16 — Sensitivity Analysis					
	Leveraged Transactions		*Unleveraged Transactions*		*Total*
	Small	*Large*	*Small*	*Large*	
Per-Transaction Costs					

Table 16 — Sensitivity Analysis					
	Leveraged Transactions		*Unleveraged Transactions*		*Total*
	Small	*Large*	*Small*	*Large*	
Per-Transaction Cost	$7,098	$9,598	$4,598	$7,098	
Sensitivity Analysis					
Transactions Eligible for the Proposed Class Exemption					
Number of Transactions	113	82	27	20	242
Total Cost	$802,101	$787,055	$124,152	$141,965	$1,855,273
Eligible Transactions Assumed to be Relying on the Proposed Class Exemption [a]					
Number of Transactions	28	21	7	5	61
Total Cost	$198,751	$201,563	$32,188	$35,491	$467,992
Adjusted Eligible Transactions for the Proposed Class Exemption [b]					
Number of Transactions	33	24	2	2	61
Total Cost	$234,242	$230,358	$9,196	$14,196	$487,992

[a] The Department assumes that 25 percent of transactions eligible for the exemption would rely on it.
[b] The Department estimates that approximately one-third of nonleveraged ESOPs may be miscoded.

10. Alternatives

This proposed rulemaking is designed to satisfy the requirement of SECURE 2.0's directive in section 346 that the Department issue formal guidance on the "acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan."[184] This analysis discusses alternative approaches considered by the Department for the rulemaking.

10.1. Alternatives to the Proposed Rule

The proposed rule takes a principles-based approach, elaborating on principles set forth in ERISA section 404, prudent compliance with ERISA section 408(e), case law, and existing business practices. By taking this approach, the Department satisfies the Congressional directive to provide clarity in defining the term "adequate consideration" in connection with transactions

[184] Div. T, Title III, Sec. 346, Pub. L 117-328, 136 Stat. 5381.

involving employer stock and the determination of the fair market value. Moreover, this approach avoids imposing additional compliance costs on those entities.

10.1.1. Reproposing the 1988 Proposed Rule

The Department considered reproposing the 1988 proposal, as this could be a logical starting point to resume notice-and-comment rulemaking on the definition of adequate consideration. The Department understands that private parties as well as the courts have widely utilized that proposal in whole or in part as guidance, even though it never became an agency final rule. The primary benefit of this alternative is that the ESOP community is by now very familiar with the four corners of the 1988 proposal. The familiarity with that proposal would enable commenters to easily refer to elements the commenters support versus those the commenters believe are in need of improvement. Clear commentary based on familiarity with regulatory provisions could benefit the rulemaking process.

The Department, however, did not choose this alternative, despite the benefits of some stakeholders' familiarity with the 1988 proposal. While certain elements of the 1988 proposal have been carried forward into this proposal, the pre-rule outreach conducted earlier this year by the Department, and the Department's own enforcement experience over the past decade, allowed the Department to develop a better starting point than the 1988 proposal. This proposal reflects both the principles articulated in the court decisions issued after the 1988 proposal, cited earlier in this preamble, and certain elements from the Department's process agreements, also issued well after the 1988 proposal. The Department concluded that proposing a new rule and administrative class exemption that incorporates these recent developments would, in the end, produce a more informative rulemaking record.

10.2. Alternatives to the Administrative Class Exemption

10.2.1. Not Provide an Administrative Class Exemption

The Department could have chosen to only issue a regulation and not also provide the administrative class exemption. Under this scenario, ESOP transactions could still be performed under the statutory exemption. However, ERISA fiduciaries, particularly independent fiduciaries overseeing transactions, would no longer have certainty that, by following the roadmap provided in the class exemption, they will receive relief from the applicable prohibited transaction provisions. By not offering this class exemption, independent fiduciaries overseeing covered ESOP transactions would no longer accrue the benefits of reduced legal exposure and litigation risk. Conversely, by not offering this class exemption, the Department would also be eliminating its burden, as described in the Costs Associated with the Class Exemption section of this regulatory impact analysis.

However, the Department believes that offering this class exemption is consistent with renewed support in recent years for promoting employee ownership. Several States passed legislation promoting ESOP creation, including support programs and tax incentives.[185] As discussed in the Baseline section, section 346 of the SECURE 2.0 Act directs the Department to establish the Employee Ownership Initiative to support existing programs and facilitate further creation of new programs within States that promote employee ownership. By providing an administrative class exemption, the Department helps to promote the creation of new ESOPs and provide newly formed ESOPs with a roadmap for the successful first-time purchase of employer common stock. Other alternatives discussed below focus on the inclusion of specific requirements of the administrative class exemption.

10.3. Scope of the Proposed Class Exemption

The proposed class exemption provides a detailed compliance roadmap for parties involved in a transaction limited to an initial purchase of non-publicly traded, common stock. The Department summarizes the estimated number of transactions relying on the proposed class exemption, the per-transaction costs, and the total costs. For more information, refer to the discussion in the Cost section of this document.

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[185] NCEO, *State Legislation on Employee Ownership,* (September 2023), https://www.nceo.org/article/state-legislation-employee-ownership-0.

Table 17 — Costs Associated with Broadening the Scope of the Exemption

	Type of ESOP				*Total*
	Small Leveraged	Large Leveraged	Small Nonleveraged	Large Nonleveraged	
Estimated Number of Transactions Relying on the Class Exemption	28	21	7	5	61
Per-Transaction Costs	$7,098	$9,598	$4,598	$7,098	
Total Costs					$467,992

10.3.1. Alternative 1: Whether to Restrict Transactions to Initial Transactions and Common Stock

The proposed class exemption can only be used for initial transactions involving common stock of a C corporation or an S corporation. It clarifies that the transaction cannot include other types of investments or securities, such as convertible preferred stock, debt securities, or synthetic equity. The Department considered making the class exemption available for all non-public transactions.

The proposed class exemption provides a clear set of requirements an entity would need to satisfy to ensure compliance with the proposed rule. The proposed class exemption is able to provide a prescriptive path to compliance for simple, straightforward transactions that ensure the participants and beneficiaries of the ESOP are protected. However, more complicated transactions would require the actions taken by parties involved to be responsive to the complexities specific to the transaction. As such, the Department chose to not provide a roadmap for compliance that would be sufficient to cover more complex situations. Accordingly, the Department decided that it would be necessary to restrict the exemption to initial transactions of common stock.

As discussed in this analysis, there is significant uncertainty about how many transactions would ultimately rely on the exemption, due to the increased risk associated with the certification of compliance. In the Cost section, it is assumed that 25 percent of eligible transactions would rely on the exemption. It is uncertain how many more transactions would be conducted under the exemption if the restriction to only initial transactions involving common stock was removed. Additionally, the Department acknowledges that the costs associated with complying with the exemption would be higher for more complex types of transactions. The table below provides a scenario analysis of how costs to comply with the exemption might change, depending on how many transactions are conducted under the exemption. To capture this, the costs in the table below assume that the average per-transaction cost for each transaction type would increase by ten percent.

Table 18 — Alternative 1: Removing Restrictions on Transactions to Initial Transactions and Common Stock (Scenario Analysis)

	Type of ESOP				Total	Cost Increase from the Proposal
	Small Leveraged	*Large Leveraged*	*Small Nonleveraged*	*Large Nonleveraged*		
Per-Transaction Costs [a]	$7,808	$10,558	$5,058	$7,808		
Scenario: All Transactions Rely on the Proposed Exemption						
Transactions	157	115	102	75	449	
Total Cost					$3,541,570	$3,073,577
Scenario: 25% of All Transactions Rely on the Proposed Exemption						
Transactions	39	29	26	19	113	
Total Cost					$890,561	$422,568
Scenario: 15% of All Transactions Rely on the Proposed Exemption						
Transactions	24	17	15	11	67	
Total Cost					$528,640	$60,648

[a] The per-transaction costs in this table assume a 10 percent increase in per-transaction costs due to the increased complexity of the transactions.

10.3.2. Alternative 2: Whether to Further Restrict Transactions to Not Cover Leveraged Transactions

The proposed class exemption would allow leveraged and nonleveraged transactions to rely on it, so long as the transaction meets the other conditions. The Department considered further restricting the definition of a covered transaction to only include initial transactions for common stock that do not rely on debt financing. The Department has been particularly concerned with ESOPs utilizing overpayments in leveraged transactions in order to take on debt which can diminish or jeopardize employees' retirements, and even put their jobs at risk if the employer cannot meet the financial obligations undertaken as part of the transaction. As shown in table 19, restricting use of the class exemption to initial, nonleveraged common stock transactions, would substantially reduce the number of transactions utilizing the class exemption which in turn would significantly decrease the costs of the proposal.

Table 19 — Alternative 2: Restricting Covered Transaction to Only Nonleveraged Transactions

	Type of ESOP		Total	Cost Increase (Decrease) from the Proposal
	Small Nonleveraged	*Large Nonleveraged*		
Number of Nonleveraged Transactions	7	5	12	
Per-Transaction Costs	$4,598	$7,098		
Total Costs			$67,679	$(400,314)

However, as discussed above, the Department restricted the transactions covered by the proposed class exemption in order to ensure that the roadmap provided offers sufficient protection for those transactions. One of the goals of the proposed class exemption was to provide a roadmap of compliance specifically for leveraged transactions, and as such, the Department designed the provisions to ensure that the requirements were sufficiently protective for leveraged transactions.

IV. Paperwork Reduction Act

As part of its continuing effort to reduce paperwork and respondent burden, the Department conducts a preclearance consultation program to allow the general public and Federal agencies to comment on proposed and continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA).[186] This helps to ensure that the public understands the Department's collection instructions, respondents can provide the requested data in the desired format, reporting burden (time and financial resources) is minimized, collection instruments are clearly understood, and the Department can properly assess the impact of collection requirements on respondents.

[186] 44 U.S.C. 3506(c)(2)(A) (1995).

Currently, the Department is soliciting comments concerning the proposed information collection request (ICR) included in the proposed rulemaking. To obtain a copy of the ICR, contact the PRA addressee shown below or go to https://www.RegInfo.gov.

The Department has submitted a copy of the proposed rule to the Office of Management and Budget (OMB) in accordance with 44 U.S.C. 3507(d) for review of its information collections. The Department and OMB are particularly interested in comments that:

- Evaluate whether the collection of information is necessary for the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology (e.g., permitting electronic submissions of responses).

Commenters may send their views on the Department's PRA analysis in the same way they send comments in response to the proposed rule as a whole (for example, through the link at https://www.regulations.gov), including as part of a comment responding to the broader proposed rule. Comments are due by [INSERT DATE 75 DAYS AFTER DATE OF PUBLICATION IN THE *FEDERAL REGISTER*] to ensure their consideration.

ICRs are available at https://www.RegInfo.gov (https://www.reginfo.gov/public/do/PRAMain). Requests for copies of the ICR can be sent to the *PRA addressee*:

By mail	PRA Officer Office of Research and Analysis Employee Benefits Security Administration U.S. Department of Labor 200 Constitution Avenue NW Room N-5718 Washington, DC 20210
By email	ebsa.opr@dol.gov

Trustees that have complied with ERISA section 404 and followed additional guidance provided by the Department are likely already performing much of the required work and documentation. While the incremental burden of the proposed class exemption is small, the full burden of the requirements is included below to allow for evaluation of the requirements in the required information collection.

1. *Preliminary Assumptions*

The Department assumes that communications between businesses would be sent entirely by electronic means. As such, the Department has not estimated any material or postage costs associated with such communications.

Additionally, the Department assumes that compliance with the rulemaking and class exemption would require tasks to be performed by several different types of personnel. In the analysis below, tasks performed by a selling or purchasing shareholder or monitoring fiduciary are assumed to incur an hourly labor cost equivalent to that of an internal legal professional, estimated as $177.97.[187] Tasks performed by an independent fiduciary or independent appraiser are assumed to incur an hourly labor cost equivalent to the average labor cost of an external legal

[187] Internal Department calculation based on 2023 labor cost data and adjusted for inflation to reflect 2024 wages. For a description of the Department's methodology for calculating wage rates, see EBSA, *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research's Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculations,* https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf.

professional, external paralegal, actuary, and accountant, estimated as a combined rate of $249.08.[188]

2. *Summary of Affected Entities*

As discussed in the Affected Entities section of the regulatory impact analysis, this analysis assumes that there are 6,465 ESOPs, of which 5,909 are privately owned. Further, this analysis assumed that there would be approximately 449 transactions covered by the proposed rule and 242 transactions eligible for relief under the proposed class exemption. These estimates are broken down by size of entity and whether the transaction involves leverage in table 20.

Table 20 — Transactions

	Number of ESOP		Transactions		
	Total	*Non-Public*	*Nonleveraged*	*Leveraged*	*Total*
Transactions Affected by the Proposed Rule					
Nonleveraged	6,465	5,909	177	272	449
Large	*3,050*	*2,494*	75	115	190
Small	*3,415*	*3,415*	102	157	259
Transactions Affected by the Proposed Class Exemption					
Leveraged	6,465	5,909	47	195	242
Large	*3,050*	*2,494*	*20*	*82*	*102*
Small	*3,415*	*3,415*	*27*	*113*	*140*

3. *Costs Unique to Paperwork Reduction Act*

3.1. *Costs Associated with Paragraph (b)(3) of the Rule*

The proposed rule requires that, before the acquisition or sale of qualifying employer stock for which there is not a generally recognized market, an independent fiduciary must choose and engage a qualified independent valuation adviser to help determine the fair market value of the employer stock. Section (b)(3)(ii) of the proposed rule specifies minimum requirements for

[188] This estimate reflects the equally-weighted average of labor costs for an actuary, accounting, external paralegal, and external attorney. Based on internal Department calculations based on 2023 labor cost data and adjusted for inflation to reflect 2024 wages, the hourly labor cost of an actuary is $201.37 and the hourly labor cost of an accountant is $118.93. According to the Laffey Matrix, the hourly cost for a paralegal and an attorney one to three years out of law school is $239 and $437, respectively. (*Laffey Matrix*, (2024), http://www.laffeymatrix.com/see.html.). Accordingly, this combined rate is estimated as: ($201.37 + $118.93 + $239 + $437) / 4 = $249.08.

an independent fiduciary to satisfy prudence in their selection of an independent valuation adviser, including an obligation to document the steps taken in selecting the valuation adviser. In the regulatory impact analysis, the Department estimates the total increase in cost to engage an independent fiduciary, whereas the Paperwork Reduction Act focuses specifically on the costs associated with information collection. Accordingly, this analysis only considers the costs associated with the documentation requirement of section (b)(3)(ii).

The Department estimates that it will take an independent trustee 3 hours, on average, to document the selection of a valuation adviser. Results are shown in table 21.

Table 21 — Hour Burden and Equivalent Cost Associated with Section (b)(3)(ii)

	ESOPs	*Hours*	*Hourly Wage*	*Burden Hours*	*Equivalent Burden Cost*
	(A)	(B)	(C)	(D) = (A x B)	(E) = (C x D)
Documentation of Selection of Valuation Appraiser					
Total (Annual)	449	3	$249.08	1,347	$335,504

4. *Other Costs Associated with the Rule and Class Exemption*

Additional costs associated with paperwork burdens stem from requirements in sections IV, VI, and VII of the proposed class exemption. These requirements, along with their corresponding hour and cost burdens, are summarized in table 22. The Costs section of the regulatory impact analysis describes the cost calculations and any associated assumptions in greater detail. For each requirement, table 22 includes the corresponding section of the regulatory impact analysis that provides additional information.

5. *Total Burden for Proposed Rulemaking*

The Department estimates that the requirements of the proposed rule would result in an annual hour burden of 1,347 hours with an equivalent cost of $335,504, and that the requirements of the proposed class exemption would result in an hour burden of 183 hours with an equivalent cost of $39,075 and a cost burden of $105,500.

Table 22 — Summary of Paperwork Reduction Act Costs						
	Description of Burden	*Associated RIA Section*	*Hour Burden*	*Equivalent Cost Burden*	*Cost Burden*
Costs Associated with the Rule					
Section (b)(3)(ii)	Associated with Documentation of Internal Deliberation	N/A	1,347	$335,504	$0
Costs Associated with the Exemption					
Section IV	Associated with Written Certifications	7.5.2	122	$26,050	$0
Section VI	Associated with Independent Trustee Contract	7.5.4	31	$5,428	$0
Section VII	Associated with Independent Appraiser Contract	7.5.5	31	$7,597	$0
Section VII	Associated with the Valuation Report	7.5.5	0	$0	$105,500
Section VIII	Associated with Recordkeeping	7.5.6	0	$0	$0
Total Cost			1,530	$374,579	$105,500

A summary of paperwork burden estimates follows:

Type of Review: New collection

Agency: Employee Benefits Security Administration, U.S. Department of Labor.

Title: Proposed ESOP Prohibited Transaction Exemption

OMB Control Number: 1210–NEW.

Affected Public: Businesses or other for-profits; not for profit institutions.

Estimated Number of Respondents: 449

Estimated Number of Annual Responses: 876

Frequency of Response: Occasionally

Estimated Total Annual Burden Hours: 1,530

Estimated Total Annual Burden Cost: $105,500

V. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA)[189] imposes certain requirements on rules subject to the notice-and-comment requirements of section 553(b) of the Administrative Procedure Act or any other law.[190] Under section 603 of the RFA, agencies must submit an initial regulatory

[189] 5 U.S.C. 601 et seq.

[190] 5 U.S.C. 601(2), 603(a); *see also* 5 U.S.C. 551.

flexibility analysis (IRFA) of a proposal that is likely to have a significant economic impact on a substantial number of small entities, such as small businesses, organizations, and governmental jurisdictions.

The proposed rule would provide guidance for acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an ESOP. Additionally, the Department is proposing a class exemption that would provide relief that is comparable to the statutory exemption set forth in ERISA section 408(e), while also establishing conditions that would provide a roadmap for satisfying the “adequate consideration” component of ERISA section 408(e). The Department has determined that this proposed class exemption is likely to have a significant impact on a substantial number of small entities. Therefore, the Department provides its IRFA of the proposed rule, below.

1. *Need for and Objectives of the Rule*

The SECURE 2.0 Act mandated that the Secretary of Labor issue formal guidance on the question of adequate consideration in the context of certain ESOP transactions.[191] While this mandate prompted action from the Department, the proposed rulemaking is also necessary to clarify the meaning of adequate consideration in a broader range of ESOP transactions and to protect ESOP participants and beneficiaries.

For non-public securities, there is no ready market price for the securities to assist the parties in arriving at a fair market value determination. Participants and beneficiaries must rely on their ESOP’s fiduciaries to determine the fair market value. The proposed rulemaking would provide clarity in how the price should be determined in a transaction between an ESOP and a selling or purchasing shareholder involving employer stock. Further, the proposed class exemption would provide ESOP fiduciaries with a clear roadmap for ensuring that an ESOP pays no more than fair market value for the employer stock and that they comply with their duties of prudence and undivided loyalty with regard to the transaction.

[191] Div. T, Title III, Sec. 346, Pub. L 117-328, 136 Stat. 5381.

2. Affected Small Entities

For purposes of the IRFA, the Department considers employee benefit plans with fewer than 100 participants to be small entities.[192] The basis of this definition is found in ERISA section 104(a)(2), which permits the Secretary of Labor to prescribe simplified annual reports for plans that cover fewer than 100 participants. Under ERISA section 104(a)(3), the Secretary may also provide for exemptions or simplified annual reporting and disclosure for welfare benefit plans. Pursuant to the authority of section 104(a)(3), the Department has previously issued simplified reporting provisions and limited exemptions from reporting and disclosure requirements for small plans, including unfunded or insured welfare plans, that satisfy certain requirements.[193]

While some large employers have small plans, small plans are generally maintained by small employers. Thus, the Department believes that assessing the impact of this proposed class exemption on small plans is an appropriate way to evaluate its effect on small entities. The definition of small entity applied for this purpose differs, however, from a definition of small business based on size standards promulgated by the Small Business Administration[194] pursuant to the Small Business Act.[195] Therefore, the Department requests comments on the appropriateness of the size standard used in evaluating the impact of this proposed rule on small entities.

In 2022, there were 6,465 ESOPs, of which 3,415 ESOPs were small plans, per the Department's definition of having less than 100 participants.[196] Of these 3,415 small ESOPs, 57 percent (1,953 plans) were leveraged, while 43 percent (1,462 plans) were nonleveraged.[197]

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[192] The Department consulted with the Small Business Administration's Office of Advocacy before making this determination, as required by 5 U.S.C. 603(c) and 13 C.F.R. 121.903(c). Memorandum received from the U.S. Small Business Administration, Office of Advocacy on July 10, 2020.

[193] *See* 29 CFR 2520.104–20, 2520.104–21, 2520.104–41, 2520.104–46, 2520.104b–10.

[194] 13 CFR 121.201.

[195] 15 U.S.C. 631 et seq. (2011).

[196] U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2022 Form 5500 Annual Reports*, (Sep. 2024), https://www.dol.gov/sites/dolgov/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletins-abstract-2022.pdf.

[197] Internal Department calculations based on Form 5500 filings.

There were approximately 153,000 participants in small ESOPs with $23.4 billion in assets in 2022, of which approximately 60,000 participants with $6.6 billion in assets were in nonleveraged ESOPs.[198]

The proposed rule and class exemption will only affect non-public ESOPs; based on analysis by the NCEO, the Department assumes 81.8 percent of large ESOPS and all small ESOPs hold stock that is not readily tradable on an established securities market.[199] Accordingly, as shown in table 23, the Department estimates that there are 1,953 small, leveraged ESOPs and 1,462 small, nonleveraged ESOPs affected by the proposed rulemaking.

Table 23 — Affected Small Entities

	Non-Public ESOPs
Type of ESOP	
Nonleveraged	1,462
Leveraged	1,953
Total	**3,415**

As shown in table 24, this analysis further assumes that of the approximately 449 transactions covered annually by the proposed rule and class exemption, 259 would pertain to small entities. The Affected Entities section of the regulatory impact analysis provides additional detail regarding the underlying assumptions to obtain these estimates. This analysis includes ESOPs that report having no assets. The Department requests comment on how it should consider these ESOPs in its analysis.

Table 24 — Transactions Pertaining to Small Entities

[198] Internal Department calculations based on Form 5500 filings.
[199] The NCEO estimated that there were 5,973 ESOPs in privately held companies and 560 ESOPs in publicly traded companies in 2021. Based on these values, the Department estimates that 91.4 percent of ESOPs are held by privately held companies. In addition, the NCEO estimates that there are 3,421 small plans held by private companies. Comparing this to the number of small plans in the Form 5500, the Department expects that nearly all small ESOPs will be in privately held companies, and that all 560 ESOPs in publicly traded companies correspond to large plans. As such, in this analysis, the Department assumes that all small ESOPs are in privately held companies and that approximately 81.8 percent of large ESOPs are held in privately held companies. *See* NCEO, *Employee Ownership by the Numbers*, (Feb. 2024), https://www.nceo.org/articles/employee-ownership-by-the-numbers; U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2022 Form 5500 Annual Reports*, (Sep. 2024), https://www.dol.gov/sites/dolgov/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletins-abstract-2022.pdf..

	Non-Public ESOPs	*Percent Engaging in Nonleveraged Transactions*	*Percent Engaging in Leveraged Transactions*	*Nonleveraged Transactions*	*Leveraged Transactions*	*Total Transactions*
	(A)	(B)	(C)	(D) = (A x B)	(E) = (A x C)	(F) = (D + E)
Transactions Affected by the Proposed Rule						
Small ESOPs	3,415	3.0%	4.6%	102	157	259
Transactions Affected by the Proposed Class Exemption						
Small ESOPs	3,415	0.8%	3.3%	27	113	140

3. Impact of the Rule

The Department estimates that this proposed rulemaking would impose total costs of $4.7 million in the first year and $0.2 million in subsequent years on small entities. With the exception of the cost associated with reviewing the rule and class exemption in the first year, all other costs would only be incurred by an ESOP engaging in a covered transaction. That is, most ESOPs would not incur an annual cost associated with the proposed rulemaking. The average per-transaction cost for a non-public ESOP engaging in a covered transaction is estimated to be $7,909 in the first year, including the cost to review the rule and class exemption, and $6,598 in subsequent years. As discussed below, the average cost for leveraged transactions are estimated to be higher than the cost for nonleveraged transactions.

3.1. Costs Associated with the Rule and Class Exemption

Costs pertaining to the rulemaking stem from time spent reviewing the proposed rule and class exemption, as well as requirements in paragraphs (b)(3)(i) and (b)(4) of the proposed rule, and sections IV, VI, and VII of the proposed class exemption. These requirements, along with the associated per-transaction and total costs, are summarized in tables 25 and 26. Table 25 includes a summary of the associated costs for small, nonleveraged entities, while table 26 summarizes costs for small, leveraged entities.

In estimating these associated compliance costs, the Department considers the marginal cost relative to existing business practices and regulatory requirements. The methods used to estimate these costs, including any associated assumptions, are discussed in the Costs section of the regulatory impact analysis. For each requirement, tables 25 and 26 include the corresponding section of the regulatory impact analysis that provides additional information. Although the methodology of all cost calculations in the Regulatory Flexibility Act analysis is consistent with the corresponding elements in the regulatory impact analysis, cost figures vary due to differences in the number of affected entities. In addition, while tables 25 and 26 disaggregate the costs by nonleveraged and leveraged entities, the related cost analysis in the regulatory impact analysis does not.

Table 25 — Summary of Per-Transaction Costs for Small, Nonleveraged Entities

	Description of Burden	*Associated RIA Section*	*Per-Transaction Cost*
Costs to Review the Proposed Rule and Class Exemption		7.3	$1,311
Costs Associated with the Rule			$0
Section (b)(3)	Prudence	7.4.1	$0
Section (b)(4)	Valuation Content	7.4.2	$0
Costs Associated with the Class Exemption			$4,598
Section IV	Written Certifications	7.5.2	$427
Section V	Selection of an Independent Trustee	7.5.3	$890
Section V	Determination of Fiduciary Insurance Capitalization Requirements	7.5.3	$1,068
Section VI	Independent Trustee Contract	7.5.4	$89
Section VI	Hiring an Independent Trustee	7.5.4	$1,500
Section VII	Independent Appraiser Contract	7.5.5	$125
Section VII	Valuation Report	7.5.5	$500
Section VIII	Recordkeeping	7.5.6	$0
Total Cost			**$5,909**

Table 26 — Summary of Per-Transaction Costs for Small, Leveraged Entities

	Description of Burden	*Associated RIA Section*	*Per-Transaction Cost*
Costs to Review the Proposed Rule and Class Exemption		7.3	$1,311
Costs Associated with the Rule			$0
Section (b)(3)	Prudence	7.4.1	$0
Section (b)(4)	Valuation Content	7.4.2	$0
Costs Associated with the Class Exemption			$7,098
Section IV	Written Certifications	7.5.2	$427
Section V	Selection of an Independent Trustee	7.5.3	$890
Section V	Determination of Fiduciary Insurance Capitalization Requirements	7.5.3	$1,068
Section VI	Independent Trustee Contract	7.5.4	$89

Table 26 — Summary of Per-Transaction Costs for Small, Leveraged Entities			
Section VI	Hiring an Independent Trustee	7.5.4	$3,000
Section VII	Independent Appraiser Contract	7.5.5	$125
Section VII	Valuation Report	7.5.5	$1,500
Section VIII	Recordkeeping	7.5.6	$0
Total Cost			**$8,409**

3.2. Impact of the Purposed Rulemaking on Small Plans

To comply with the conditions set forth in the proposed rulemaking, the Department estimates that all small non-public ESOPs would incur a cost to review the rule. Additionally, each non-public ESOP engaging in a covered transaction would incur a cost to comply with the requirements. As discussed in further detail below, the Department expects leveraged ESOPs would incur a higher cost than nonleveraged ESOPs. Table 27 summarizes the Department's per transaction cost estimates for small plans.

Table 27 — Per-Transaction Small Plan Costs

	Total ESOPs		Nonleveraged ESOPs		Leveraged ESOPs	
	Year 1	Subsequent	Year 1	Subsequent	Year 1	Subsequent
Total	$7,909	$6,598	$5,909	$4,598	$8,409	$7,098
Review	*$1,311*	*$0*	*$1,311*	*$0*	*$1,311*	*$0*
Proposed Rule	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
Proposed Class Exemption	*$6,598*	*$6,598*	*$4,598*	*$4,598*	*$7,098*	*$7,098*

To understand the magnitude of these costs, it is helpful to compare the costs to plan assets. Table 28 shows mean plan assets of ESOPs with less than 100 participants reported on the 2022 Form 5500, as well as assets of plans at the 10^{th}, 25^{th}, 50^{th}, and 75^{th} percentiles.[200] Each column of the table shows a separate distribution of plan assets. As an example, table 28 shows for nonleveraged ESOPs the smallest 10 percent of plans have assets of $216,726 or less.

Table 28 — Distribution of Plan Assets by Percentile, For ESOPs with Less than 100 Participants

	Total ESOPs	*Nonleveraged ESOPs*	*Leveraged ESOPs*
Mean	$7,325,581	$5,007,520	$8,962,502
10th Percentile	$370,181	$216,726	$595,079

[200] This analysis excludes ESOPs with assets equal to zero.

Table 28 — Distribution of Plan Assets by Percentile, For ESOPs with Less than 100 Participants			
	Total ESOPs	*Nonleveraged ESOPs*	*Leveraged ESOPs*
25th Percentile	$1,245,934	$865,635	$1,690,876
50th Percentile	$3,559,750	$2,388,280	$4,302,441
75th Percentile	$8,285,107	$6,512,441	$9,625,612

Table 29 summarizes how many ESOPs fall into each of the percentiles shown in table 29. Approximately six percent of all ESOPs report having no assets.

Table 29 – Plan Count by Percentile of Assets for ESOPs with Less than 100 Participants [a]			
Percentile of Assets	Total ESOPs	Nonleveraged ESOPs	Leveraged ESOPs
No Assets	227	142	85
Less than the 10th percentile [b]	319	132	187
10th to the 25th percentile	478	198	280
25th to the 50th percentile	797	330	467
50th to the 75th percentile	797	330	467
75th percentile	797	330	467
Total	3,415	1,462	1,953

[a] This data is calculated using the 2022 Form 5500. However, the Form 5500 does not include information on what percent of these ESOPs are non-public. Throughout this analysis, the Department has assumed that 91.4 percent of ESOPs are non-public in accordance with NCEO data, and that of these, 100 percent of small plans are non-public. The Department has applied this proportion accordingly.
[b] Excluding ESOPs that report zero assets.

While the Department assumes that all ESOPs would need to review the rulemaking in the first year, ESOPs would otherwise only incur a cost if they are engaging in a covered transaction. As such, in a given year, most ESOPs would not incur additional costs under the proposed rulemaking. As shown in table 30, when looking at ESOPs with a covered transaction in the 10th percentile of plan assets, the Department's estimates account for approximately two percent of plan assets.

Table 30 — Costs as a Percent of Plan Assets for ESOPs with Less than 100 Participants						
	Total ESOPs		Nonleveraged ESOPs		Leveraged ESOPs	
	Year 1	*Subsequent*	*Year 1*	*Subsequent*	*Year 1*	*Subsequent*
Costs for ESOPs without a Covered Transaction (Rule Review Only)						
Mean	0.0%		0.0%		0.0%	
10th Percentile	0.4%		0.6%		0.2%	
25th Percentile	0.1%		0.2%		0.1%	
50th Percentile	0.0%		0.1%		0.0%	

Table 30 — Costs as a Percent of Plan Assets for ESOPs with Less than 100 Participants

	Total ESOPs		Nonleveraged ESOPs		Leveraged ESOPs	
	Year 1	*Subsequent*	*Year 1*	*Subsequent*	*Year 1*	*Subsequent*
75th Percentile	0.0%		0.0%		0.0%	
Costs for ESOPs with a Covered Transaction (Rule Review, Exemption, and Rule)						
Mean	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
10th Percentile	2.1%	1.8%	2.7%	2.1%	1.4%	1.2%
25th Percentile	0.6%	0.5%	0.7%	0.5%	0.5%	0.4%
50th Percentile	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
75th Percentile	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%

4. *Descriptions of Alternatives Considered*

Section 604 of the RFA requires the Department to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. However, as this rulemaking is intended to provide clarity regarding the meaning of adequate consideration to ESOP plan fiduciaries and to ensure ESOP participants and beneficiaries receive fair market value for ESOP transactions, the benefits of this rulemaking flow directly to small business ESOP owners and their employees.

The requirements in the proposed rulemaking provide clarity on acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an ESOP. The proposed rulemaking was designed to protect plan participants and beneficiaries from risks associated with such transactions. These risks exist for participants and beneficiaries in large and small plans alike, and, as such, the Department's ability to craft specific alternatives for small plans is limited. The Department did not identify any special consideration that could be made for small plans that would not lessen the protection of participants and beneficiaries in small plans.

As discussed in the regulatory impact analysis and this RFA, the Department expects that covered transactions involving small employers likely will be less labor and cost intensive, under the assumption that the financial structure and associated analysis would be simpler. This is reflected and discussed in the cost estimates of the regulatory impact analysis and RFA. While the Department did not identify alternatives specifically for small entities, the Department has considered several alternatives. These alternatives are summarized below. For additional information on the Department's consideration of these alternatives, refer to the Alternatives section of the regulatory impact analysis.

The Department also considered not requiring the Selling Shareholder and ESOP to receive certifications from the Monitoring Fiduciary, Independent Trustee, and Independent Appraiser that they have complied with the exemption. Without this requirement, Selling Shareholders would be able to rely on the exemption without taking any steps to ensure that other parties are complying with the exemption's conditions. The Department did not choose this alternative because it would be less protective of plan participants, as Selling Shareholders would not have an incentive to ensure the other parties have complied. The Department does not consider the cost savings to be justifiable, given the potential harm to plan participants.

The Department contemplated including more specific requirements that the Monitoring Fiduciary would need to consider in its selection of the Independent Trustee. For instance, the Department considered requiring the Monitoring fiduciary to evaluate at least three Independent Trustees and to document its basis for selecting the Independent Trustee that is ultimately hired. Ultimately, this alternative would provide more security for plan participants, as the process would encourage the engagement of higher quality Independent Trustees. However, the Department does not have evidence to suggest that such a process would significantly improve the protections or prevent conflicts of interest. The Department did not pursue this alternative because the additional costs imposed on the Monitoring Fiduciary would likely outweigh the benefits to the plan.

The Department also considered eliminating the requirements for the Independent Trustee to be selected by a Monitoring Fiduciary, instead allowing for the Selling Shareholder to select the Independent Trustee directly. While there may be some differences in process in how a Monitoring Fiduciary and a Selling Shareholder would investigate and engage an Independent

Trustee, the Department expects that this alternative would not result in a meaningful change in costs. However, this would allow a conflicted party with undue influence over the transaction (i.e. the Selling Shareholder) to select the party that would ultimately decide on the price of the Employer Stock. This would greatly reduce the protections to plan participants provided in this proposed rulemaking. As this alternative would reduce the benefits while not lowering the associated costs, the Department decided against this alternative.

The Department weighed requiring specific accreditation demonstrating that the Independent Trustee has appropriate technical training and proficiency under section VI(a) of the proposed exemption. Such a requirement would provide more protections for plan participants because the Department could ensure the quality of the technical training. However, requiring all Independent Trustees to obtain a specific accreditation would impose significant costs on those not already carrying the specific designation, who would in turn likely charge more for Independent Trustee services. These costs are expected to ultimately be passed onto ESOPs and plan participants.

The Department believes that the current requirements in the proposed class exemption that an Independent Trustee must have appropriate technical training and expertise in ESOPs and valuation in non-public stock would ensure that Monitoring Fiduciaries are selecting Independent Trustees who are qualified to perform their duties under the proposed rulemaking, in addition to ERISA. As such, the Department does not believe that the benefits of this alternative would justify the costs. Finally, the Department has thought about removing the insurance or capitalization requirement in the proposed class exemption. As in the regulatory impact analysis, the Department is requesting comment on how the proposed requirements would affect fiduciary insurance costs and whether the fiduciary insurance requirement in the proposed class exemption would hinder firms from providing these services. The Department is concerned, however, that without this provision, the Independent Trustee could be underinsured, leaving plan participants vulnerable to a breach of fiduciary duty. This could potentially mean that plan participants risk not being made whole for any losses from such a breach.

5. *Duplicate, Overlapping, or Relevant Federal Rules*

The proposed rule would define the term adequate consideration as defined in section 3(18)(B) of ERISA in connection with certain ESOP transactions involving employer stock. The proposed class exemption would provide exemptive relief from certain prohibited transaction restrictions contained in ERISA and the Code conditionally available to specified parties to a non-public ESOP transaction.

Section 346(c)(4)(B) of SECURE 2.0 provides that the Secretary of Labor, in consultation with the Secretary of the Treasury, shall issue formal guidance for acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an ESOP. The proposed rulemaking is in response to this mandate, and therefore is designed to be consistent with this legislation as well as with the existing requirements under ERISA.

The proposed class exemption would not conflict with any relevant Federal rules. The application of these prohibited transaction rules to the non-public ESOP transactions described above is unique and, thus, does not overlap with the laws and rules of other Federal agencies. However, some of the requirements of the class exemption may overlap with requirements from other Federal agencies. For instance, section 401(a)(28)(C) of the Code requires that all valuation of employer securities not readily traded on an established securities market be conducted by an independent appraiser.[201] While this requirement overlaps with the proposed requirements, the requirements are consistent and do not conflict with existing obligations.

The Department is monitoring other Federal agencies whose statutory and regulatory requirements overlap with ERISA.

VI. Unfunded Mandates Reform Act

[201] 26 U.S.C. 401(a)(28(C).

Title II of the Unfunded Mandates Reform Act of 1995 requires each Federal agency to prepare a written statement assessing the effects of any Federal mandate in a proposed or final agency rule that may result in an expenditure of $100 million or more (adjusted annually for inflation with the base year 1995) in any one year by State, local, and Tribal governments, in the aggregate, or by the private sector.[202] In 2024, that threshold is approximately $183 million. For purposes of the Unfunded Mandates Reform Act this proposed class exemption does not include any Federal mandate that the Department expects would result in such expenditures by State, local, or Tribal governments, or the private sector.

VII. Federalism Statement

Executive Order 13132 outlines fundamental principles of federalism, and requires the adherence to specific criteria by Federal agencies in the process of their formulation and implementation of policies that have "substantial direct effects" on the States, the relationship between the National Government and States, or on the distribution of power and responsibilities among the various levels of government.[203] Federal agencies promulgating regulations that have federalism implications must consult with State and local officials and describe the extent of their consultation and the nature of the concerns raised in the preamble to the final rule.

In the Department's view, the proposed rulemaking would not have federalism implications because it would not have direct effects on the States, on the relationship between the National Government and the States, nor on the distribution of power and responsibilities among various levels of government. ERISA section 514 provides, with certain exceptions specifically enumerated, that the provisions of ERISA Titles I and IV supersede any and all laws of the States as they relate to any ERISA covered employee benefit plan. The requirements implemented in this proposed class exemption do not alter the fundamental provisions of the statute with respect to employee benefit plans, and as such will have no implications for the

[202] 2 U.S.C. 1501 et seq. (1995).
[203] Federalism, 64 FR 43255 (Aug. 4, 1999).

States or the relationship or distribution of power between the National Government and the States.

The Department welcomes input from States regarding this assessment.

VIII. Withdrawal of Proposed Regulation

Paragraph (b) of the proposed regulation relating to the definition of "adequate consideration" (proposed 29 CFR 2510.3-18) that was published in the *Federal Register* on May 17, 1988 (53 FR 17632) is hereby withdrawn. The proposed regulations were never finalized, never went into effect, and did not indicate that persons could rely upon them. Given the length of time that has passed since the 1988 proposal, the Department's subsequent experience with ESOPs, the new provisions of section 346 of SECURE 2.0 Act of 2022, Worker Ownership, Readiness, and Knowledge, and the associated need for a public notice-and-comment process, the Department has determined to withdraw the 1988 proposal and propose this rulemaking, which will provide clarity on the meaning of adequate consideration in ESOP transactions. As indicated above, the 1988 proposal was broader than the current proposal and comments are requested on whether the Department should conduct notice-and-comment rulemaking with respect to a broader range of assets (i.e., assets other than employer stock). Pending a decision on this issue, the Department does not intend to contest parties' reasonable and good faith reliance on the 1988 proposal in situations that fall outside the current proposal.

IX. Authority

This regulation is proposed pursuant to the authority in section 3(18) and section 505 of ERISA (Pub. L. 93–406, 88 Stat. 894 (Sept. 2, 1974); 29 U.S.C. 1135), Sec. 346, Div. T, Title III, Pub. L. 117-328, 136 Stat. 5381 (Dec. 29, 2022)) (codified at 29 U.S.C. 3228), section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713 (Oct. 17, 1978)), 3 CFR, 1978 Comp. 332, effective December 31, 1978 (44 FR 1065 (Jan. 3, 1979)), 3 CFR, 1978 Comp. 332, 5 U.S.C. App. 237, and under Secretary of Labor's Order No. 1– 2011, 77 FR 1088 (Jan. 9, 2012).

List of Subjects in 29 CFR Part 2510

Employee benefit plans, Employee retirement income security act, Pensions, Plan assets.

For the reasons set forth in the preamble, the Department is proposing to amend part 2510 of subchapter B of chapter XXV of title 29 of the Code of Federal Regulations as follows:

PART 2510 – DEFINITIONS OF TERMS USED IN SUBCHAPTERS C, D, E, F, AND G OF THIS CHAPTER

1. The authority citation for part 2510 is revised to read as follows:

Authority: 29 U.S.C. 1002(1)-(8), 1002(13)-(16), 1002(18), 1002(20), 1002(21), 1002(34), 1002(37), 1002(38), 1002(40)-(44), 1031, and 1135; Div. O, Title I, Sec. 101, Pub. L. 116-94, 133 Stat. 2534 (Dec. 20, 2019); Div. T, Title I, Sec. 105, Pub. L. 117-328, 136 Stat. 4459 (Dec. 29, 2022); Secretary of Labor's Order 1-2011, 77 FR 1088 (Jan. 9, 2012); Secs. 2510.3-21, 2510.3-101 and 2510.3-102 also issued under Sec. 102 of Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 752 (2018) (E.O. 12108, 44 FR 1065 (Jan. 3, 1979)), and 29 U.S.C. 1135 note. Section 2510.3-38 also issued under Sec. 1(b) Pub. L. 105-72, 111 Stat. 1457 (Nov. 10, 1997).

2. Section 2510.3-18 is added to read as follows:

§ 2510.3-18 Adequate Consideration

(a) [Reserved]

(b) *Adequate consideration*—(1) *Certain employer securities*—(i) *General*. Section 3(18)(B) of the Employee Retirement Income Security Act of 1974 (the Act) provides that, in the case of an asset other than a security for which there is a generally recognized market, the term “adequate consideration” when used in part 4 of subtitle B of title I of the Act means the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. Section 408(e) of the Act provides relief from the prohibitions contained in section 406 of the Act for certain transactions involving qualifying employer securities, but only if, among other conditions, the transaction is for "adequate consideration." This paragraph (b) addresses the definition of adequate consideration within the meaning of section 3(18)(B) of the Act in the context of an acquisition or sale by an employee stock ownership plan as defined in section 407(d)(6) of the Act (ESOP or plan) of certain qualifying employer securities.

(ii) *Scope*. For direct or indirect acquisitions or sales described in section 408(e) of the Act by an ESOP, with respect to an asset that is a qualifying employer security which is stock within the meaning of section 407(d)(5) of the Act and for which there is not a generally recognized market (employer stock), the requirements of section 3(18)(B) of the Act will not be met unless the value assigned reflects the asset's fair market value as defined in paragraph (b)(2) of this section and is the result of a prudent determination made by the plan trustee or named fiduciary pursuant to a prudent process as described in paragraph (b)(3) of this section, and the fiduciary satisfies paragraph (b)(5) of this section..

(2) *Fair market value*—(i) *General*. In the context of an asset that is employer stock, the term "fair market value" as used in section 3(18)(B) of the Act means the price at which the employer stock would change hands in an arm's length transaction 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, the parties are both willing and able to trade and have reasonable knowledge of the facts relevant to the stock's value.

(ii) *Cash basis*. For purposes of paragraph (b)(2)(i) of this section, fair market value is determined on the same basis as if the ESOP were purchasing the stock on a cash or cash equivalent basis, without any increase in the purchase price based on consideration of the terms of any debt, direct or indirect, used to finance the acquisition.

(iii) *Value determined as of date of transaction*. The fair market value of an asset that is employer stock for the purposes of section 3(18)(B) of the Act must be determined as of the date of the transaction involving that asset and must reflect consideration of all known or reasonably knowable information relevant to the value of the asset as of that date.

(3) *Good faith fiduciary determination of price*—(i) *General rule*. In the context of an asset that is employer stock, a trustee or named fiduciary independent of the plan's counterparty must prudently choose and engage a qualified independent valuation advisor to value the employer stock, prudently oversee the production of a written valuation report that satisfies paragraph (b)(4) of this section, conduct a prudent review of the valuation report, and exercise prudent judgment in arriving at determination of fair market value. The ultimate responsibility for determining whether and to what extent to rely upon the valuation, and for structuring the terms and price of the transaction, belongs to the fiduciary. This paragraph (b)(3)(i) establishes an objective standard of conduct and an assessment of whether the standard is satisfied will be made in light of all relevant facts and circumstances. However, a fiduciary fails to satisfy the requirements of this paragraph (b)(3)(i) unless the requirements of paragraphs (b)(3)(ii) through (iv) of this section are met.

(ii) *Selection of qualified independent valuation advisor*. The trustee or named fiduciary must prudently select a valuation advisor to perform a valuation of the employer stock who is qualified with appropriate training and expertise to reasonably perform the valuation, who is independent from all parties to the transaction except the plan, and who was not selected by any of the other parties to the transaction. At a minimum, the fiduciary must prudently:

(A) Engage in an objective process designed to obtain the information necessary to assess the qualifications of different providers to act as valuation advisor.

(B) Investigate the qualifications and integrity of the valuation advisor.

(C) Determine that the valuation advisor is able to perform the valuation in accordance with standards of professional conduct that a prudent advisor acting in a like capacity and familiar with such matters would use in a similar transaction.

(D) Ensure that the valuation advisor does not have relationships with any parties to the transaction that might influence the advisor in the performance of the valuation.

(E) Ensure that it is otherwise reasonable to select the valuation advisor for the particular transaction at issue; and

(F) Document the steps taken to satisfy paragraphs (b)(3)(ii)(A) through (E) of this section.

(iii) *Written valuation report based on complete, current, and accurate information*. The trustee or named fiduciary must prudently ensure that the valuation report prepared by the valuation advisor is based on complete, current, and accurate information about the issuer of the employer stock and the transaction involving the ESOP. At a minimum, the fiduciary must prudently:

(A) Ensure that the valuation advisor is provided all material current financial information reflecting the issuer's current condition, performance, and prospects, including audited financial statements to the extent possible, as well as material historical data concerning the issuer's past performance and financial condition.

(B) Ensure that the valuation advisor is informed of any recent expressions of interest or offers by third parties to purchase stock from the issuer;

(C) Ensure that the valuation advisor is provided access to the issuer's management and personnel, as necessary to assess the company's financial condition, performance, and prospects; and

(D) Ensure that the valuation advisor is informed that the valuation report must satisfy paragraph (b)(4), and assents to the preparation of a report that comports with that paragraph.

(iv) *Prudent reliance on valuation report*. A trustee or named fiduciary must ensure that it is prudent to rely on the valuation report as a basis for determining the price at which the plan transaction should occur, and that the plan is not paying for more than fair market value or selling for less than the fair market value. At a minimum, the fiduciary must prudently:

(A) Read and critically review the valuation report and supporting documents.

(B) Understand the report.

(C) Identify, question, and evaluate the report's underlying assumptions (e.g., performance forecasts or projections); assess the reasonableness of those assumptions and the sensitivity of the appraisal's conclusions to those assumptions; and, to the extent that any alternative assumptions are reasonably plausible, assess the potential impact of reasonable changes in the assumptions on the valuation's conclusions (e.g., the impact of variations in forecasts or projections), and the need for adjustments to the assumptions. For example, the plan fiduciary must prudently assess the reliability and trustworthiness of any projections of future performance, consider the likely consequence of missed projections, and ensure that the appraisal is based upon reliable and trustworthy projections.

(D) Verify that the analyses in the valuation report are consistent with application of sound valuation and financial principles, reflect an accurate assessment of the company's current financial condition and prospects, and that the report is internally consistent, well-reasoned, and consistent with available data.

(E) Verify that the report is based on complete, current, and accurate financial information about the issuer of stock.

(F) Ensure that the report properly accounts for the impact of the grant or assignment of any interests, rights, or claims to potential income streams or corporate assets to parties other than the plan shareholder. The fair market value attributed to the stock purchased by the plan must not include the value of equity interests or potential upside that is effectively allocated to parties other than the plan. If, for example, in a stock purchase transaction, the sellers have been granted warrants with strike prices below the price paid per share by the ESOP, which are expected to result in the seller's retention of a significant equity stake in the company, the dilutive impact of the warrants must be reflected in an appropriate reduction of the fair market value and associated purchase price.

(G) Ensure that any adjustment to value based on a controlling or non-controlling interest is consistent with the circumstances surrounding the transaction, including the degree of control that the plan will have after the transaction and its ability to use that control to affect the stock's value. An ESOP may only pay a sales price based on obtaining a controlling interest where, based on the facts and circumstances, actual control (both in form and substance) is passed to the ESOP purchaser with the sale and the ESOP has the means to effectuate changes to enhance value. If, for example, the relevant transaction and governance documents establish that the plan will not have meaningful control over the actions of the corporation post-acquisition, it should not pay a premium for control. A fiduciary that agrees to a fair market value determined on a control basis must be able to identify the source of the incremental value and its basis for concluding that the ESOP can be expected to realize the value.

(H) Ensure that the report value reflects an appropriate discount for lack of marketability, and prudently justifies the discount selected;

(I) Ensure that the report and the transaction are free from bias or undue influence by any counterparty;

(J) Ensure that the report's projected return on the ESOP's price per share over an appropriate period is consistent with the rates of return demanded by equity investors in similar transactions and is commensurate with the risks associated with the stock purchases. Similarly, the fiduciary must ensure that the transaction is reasonably expected to result in the ultimate release of shares to plan participants that are worth at least the amount paid per share by the plan, plus such a reasonable rate of return; and

(K) Ensure that the report reflects the prudent consideration of the issuer's ability to meet its stock repurchase obligations, comply with its contribution obligations, and meet any debt or other obligations on the terms established in connection with the transaction.

(4) *Valuation content*. A valuation report must be prepared in accordance with generally accepted professional standards for performance of valuations and must contain all information that the valuation advisor reasonably determines may materially affect the value of the employer

stock which, at a minimum, includes the information necessary for a prudent trustee or named fiduciary to satisfy their obligations under paragraph (b)(3) of this section.

(5) *Effective date*. This section will be effective for transactions taking place on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF FINAL RULE].

Signed at Washington, DC, this 13th day of January 2025.

Lisa M. Gomez,

Assistant Secretary,
Employee Benefits Security Administration, U.S. Department of Labor

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