

# Federal Register

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**Tuesday**  
**May 17, 1988**

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## **Part VI**

## **Department of Labor**

### **Pension and Welfare Benefits Administration**

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#### **29 CFR Part 2510**

#### **Regulation Relating to the Definition of Adequate Consideration; Notice of Proposed Rulemaking**

**DEPARTMENT OF LABOR****Pension and Welfare Benefits Administration****29 CFR Part 2510****Proposed Regulation Relating to the Definition of Adequate Consideration**

**AGENCY:** Pension and Welfare Benefits Administration, Department of Labor.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains a notice of a proposed regulation under the Employee Retirement Income Security Act of 1974 (the Act or ERISA) and the Federal Employees' Retirement System Act of 1986 (FERSA). The proposal clarifies the definition of the term "adequate consideration" provided in section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA for assets other than securities for which there is a generally recognized market. Section 3(18)(B) and section 8477(a)(2)(B) provide that the term "adequate consideration" for such assets means the fair market value of the asset as determined in good faith by the trustee or named fiduciary (or, in the case of FERSA, a fiduciary) pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. Because valuation questions of this nature arise in a variety of contexts, the Department is proposing this regulation in order to provide the certainty necessary for plan fiduciaries to fulfill their statutory duties. If adopted, the regulation would affect plans investing in assets other than securities for which there is a generally recognized market.

**DATES:** Written comments on the proposed regulation must be received by July 18, 1988. If adopted, the regulation will be effective for transactions taking place after the date 30 days following publication of the regulation in final form.

**ADDRESS:** Written comments on the proposed regulation (preferably three copies) should be submitted to: Office of Regulations and Interpretations, Pension and Welfare Benefits Administration, Room N-5671, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, DC 20216, Attention: Adequate Consideration Proposal. All written comments will be available for public inspection at the Public Disclosure Room, Pension and Welfare Benefits Administration, U.S. Department of Labor, Room N-5507, 200 Constitution Avenue NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Daniel J. Maguire, Esq., Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, Washington, DC 20210, (202) 523-9596 (not a toll-free number) or Mark A. Greenstein, Office of Regulations and Interpretations, Pension and Welfare Benefits Administration, (202) 523-7901 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:****A. Background**

Notice is hereby given of a proposed regulation under section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA. Section 3(18) of the Act provides the definition for the term "adequate consideration," and states:

The term "adequate consideration" when used in part 4 of subtitle B means (A) in the case of a security for which there is a generally recognized market, either (i) the price of the security prevailing on a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934, 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; and (B) in the case of an asset other than a security for which there is a generally recognized market, 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.

The term "adequate consideration" appears four times in part 4 of subtitle B of Title I of the Act, and each time represents a central requirement for a statutory exemption from the prohibited transaction restrictions of the Act. Under section 408(b)(5), a plan may purchase insurance contracts from certain parties in interest if, among other conditions, the plan pays no more than adequate consideration. Section 408(b)(7) 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 of Labor, only if the plan receives no less than adequate consideration pursuant to such conversion. Section 408(e) of the Act provides that the prohibitions in sections 406 and 407(a) of the Act shall not apply to the acquisition or sale by a plan of qualifying employer securities, or the acquisition, sale or lease by a plan of qualifying employer real property if, among other conditions, the acquisition, sale or lease is for adequate consideration. Section 414(c)(5) of the Act states that sections 406 and 407(a)

of the Act 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) (relating to the prohibition against holding excess employer securities and employer real property), and if the plan receives not less than adequate consideration.

Public utilization of these statutory exemptions requires a determination of "adequate consideration" in accordance with the definition contained in section 3(18) of the Act. Guidance is especially important in this area because many of the transactions covered by these statutory exemptions involve plan dealings with the plan sponsor. A fiduciary's determination of the adequacy of consideration paid under such circumstances represents a major safeguard for plans against the potential for abuse inherent in such transactions.

The Federal Employees' Retirement System Act of 1986 (FERSA) established the Federal Retirement Thrift Investment Board whose members act as fiduciaries with regard to the assets of the Thrift Savings Fund. In general, FERSA contains fiduciary obligation and prohibited transaction provisions similar to ERISA. However, unlike ERISA, FERSA prohibits party in interest transactions similar to those described in section 406(a) of ERISA only in those circumstances where adequate consideration is not exchanged between the Fund and the party in interest. Specifically, section 8477(c)(1) of FERSA provides that, except in exchange for adequate consideration, a fiduciary shall not permit the Thrift Savings Fund to engage in: transfers of its assets to, acquisition of property from or sales of property to, or transfers or exchanges of services with any person the fiduciary knows or should know to be a party in interest. Section 8477(a)(2) provides the FERSA definition for the term "adequate consideration" which is virtually identical to that contained in section 3(18) of ERISA. Thus, the proposal would apply to both section 3(18) of ERISA and section 8477(a)(2) of FERSA.

When the asset being valued is a security for which there is a generally recognized market, the plan fiduciary must determine "adequate consideration" by reference to the provisions of section 3(18)(A) of the Act (or with regard to FERSA, section 8477(a)(2)(A)). Section 3(18)(A) and section 8477(a)(2)(A) provide detailed reference points for the valuation of

securities within its coverage, and in effect provides that adequate consideration for such securities is the prevailing market price. It is not the Department's intention to analyze the requirements of section 3(18)(A) or 8477(a)(2)(A) in this proposal. Fiduciaries must, however, determine whether a security is subject to the specific provisions of section 3(18)(A) (or section 8477(a)(2)(A) of FERSA) or the more general requirements of section 3(18)(B) (or section 8477(a)(2)(B)) as interpreted in this proposal. 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 extent of market activity with regard to the security. Generally, the Department will examine whether a security is being actively traded so as to provide the benchmarks Congress intended. Isolated trading activity, or trades between related parties, generally will not be sufficient to show the existence of a generally recognized market for the purposes of section 3(18)(A) or section 8477(a)(2)(A).

In the case of all assets other than securities for which there is a generally recognized market, fiduciaries must determine adequate consideration pursuant to section 3(18)(B) of the Act (or, in the case of FERSA, section 8477(a)(2)(B)). Because it is designed to deal with all but a narrow class of assets, section 3(18)(B) and section 8477(a)(2)(B) are by their nature more general than section 3(18)(A) or section 8477(a)(2)(A). Although the Department has indicated that it will not issue advisory opinions stating whether certain stated consideration is "adequate consideration" for the purposes of section 3(18), ERISA Procedure 76-1, § 5.02(a) (41 FR 36281, 36282, August 27, 1976), the Department recognizes that plan fiduciaries have a need for guidance in valuing assets, and that standards to guide fiduciaries in this area may be particularly elusive with respect to assets other than securities for which there is a generally recognized market. See, for example, *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983) (court encourages the Department to adopt regulations under section 3(18)(B)). The Department has therefore determined to propose a regulation only under section 3(18)(B) and section 8477(a)(2)(B). This proposal is described more fully below.

It should be noted that it is not the Department's intention by this proposed regulation to relieve fiduciaries of the responsibility for making the required determinations of "adequate

consideration" where applicable under the Act or FERSA. Nothing in the proposal should be construed as justifying a fiduciary's failure to take into account all relevant facts and circumstances in determining adequate consideration. Rather, the proposal is designed to provide a framework within which fiduciaries can fulfill their statutory duties. Further, fiduciaries should be aware that, even where a determination of adequate consideration comports with the requirements of section 3(18)(B) (or section 8477(a)(2)(B) of FERSA) and any regulation adopted thereunder, the investment of plan assets made pursuant to such determination will still be subject to the fiduciary requirements of Part 4 of Subtitle B of Title I of the Act, including the provisions of sections 403 and 404 of the Act, or the fiduciary responsibility provisions of FERSA.

## B. Description of the Proposal

Proposed regulation 29 CFR 2510.3-18(b) is divided into four major parts. Proposed § 2510.3-18(b)(1) states the general rule and delineates the scope of the regulation. Proposed § 2510.3-18(b)(2) addresses the concept of fair market value as it relates to a determination of "adequate consideration" under section 3(18)(B) of the Act. Proposed § 2510.3-18(b)(3) deals with the requirement in section 3(18)(B) that valuing fiduciary act in good faith, and specifically discusses the use of an independent appraisal in connection with the determination of good faith. Proposed § 2510.3-18(b)(4) sets forth the content requirements for written valuations used as the basis for a determination of fair market value, with a special rule for the valuation of securities other than securities for which there is a generally recognized market. Each subsection is discussed in detail below.

### 1. General Rule and Scope.

Proposed § 2510.3-18(b)(1)(i) essentially follows the language of section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA and states that, in the case of a plan 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 (or, in the case of FERSA, a fiduciary) pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. Proposed § 2510.3-18(b)(1)(ii) delineates the scope of this regulation by establishing two criteria, both of which must be met for a valid determination of

adequate consideration. First, the value assigned to an asset must reflect its fair market value as determined pursuant to proposed § 2510.3-18(b)(2). Second, the value assigned to an asset must be the product of a determination made by the fiduciary in good faith as defined in proposed § 2510.3-18(b)(3). The Department will consider that a fiduciary has determined adequate consideration in accordance with section 3(18)(B) of the Act or section 8477(a)(2)(B) of FERSA only if both of these requirements are satisfied.

The Department has proposed this two part test for several reasons. First, Congress incorporated the concept of fair market value into the definition of adequate consideration. As explained more fully below, fair market value is an often used concept having an established meaning in the field of asset valuation. By reference to this term, it would appear that Congress did not intend to allow parties to a transaction to set an arbitrary value for the assets involved. Therefore, a valuation determination which fails to reflect the market forces embodied in the concept of fair market value would also fail to meet the requirements of section 3(18)(B) of the Act or section 8477(a)(2)(B) of FERSA.

Second, it would appear that Congress intended to allow a fiduciary a limited degree of latitude so long as that fiduciary acted in good faith. However, a fiduciary would clearly fail to fulfill the fiduciary duties delineated in Part 4 of Subtitle B of Title I of the Act if that fiduciary acted solely on the basis of naive or uninformed good intentions. See *Donovan v. Cunningham*, supra, 716 F.2d at 1467 ("[A] pure heart and an empty head are not enough.") The Department has therefore proposed standards for a determination of a fiduciary's good faith which must be satisfied in order to meet the requirements of section 3(18)(B) or section 8477(a)(2)(B) of FERSA.

Third, 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 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.

## 2. Fair Market Value

The first part of the Department's proposed two part test under section 3(18)(B) and section 8477(a)(2)(B) requires that a determination of adequate consideration reflect the asset's fair market value. The term "fair market value" is defined in proposed § 2510.3-18(b)(2)(i) 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 both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset. This proposed definition essentially reflects the well-established meaning of this term in the area of asset valuation. See, for example, 26 CFR 20.2031-1 (estate tax regulations); Rev. Rul. 59-60, 1959-1 Cum. Bull. 237; *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Estate of Bright v. United States*, 658 F.2d 999, 1005 (5th Cir. 1981). It should specifically be noted that comparable valuations reflecting transactions resulting from other than free and equal negotiations (e.g., a distress sale) will fail to establish fair market value. See *Hooker Industries, Inc. v. Commissioner*, 3 EBC 1849, 1854-55 (T.C. June 24, 1982). Similarly, the extent to which the Department will view a valuation as reflecting fair market value will be affected by an assessment of the level of expertise demonstrated by the parties making the valuation. See *Donovan v. Cunningham, supra*, 716 F.2d at 1468 (failure to apply sound business principles of evaluation, for whatever reason, may result in a valuation that does not reflect fair market value).<sup>1</sup>

<sup>1</sup> Whether in any particular transaction a plan fiduciary is in fact well-informed about the asset in question and the market for that asset, including any specific circumstances which may affect the value of the asset, will be determined on a facts and circumstances basis. If, however, the fiduciary negotiating on behalf of the plan has or should have specific knowledge concerning either the particular asset or the market for that asset, it is the view of the Department that the fiduciary must take into account that specific knowledge in negotiating the price of the asset in order to meet the fair market value standard of this regulation. For example, a sale of plan-owned real estate at a negotiated price consistent with valuations of comparable property will not be a sale for adequate consideration if the negotiating fiduciary does not take into account any special knowledge which he has or should have about the asset or its market, e.g., that the

The Department is aware that the fair market value of an asset will ordinarily be identified by a range of valuations rather than a specific, set figure. It is not the Department's intention that only one valuation figure will be acceptable as the fair market value of a specified asset. Rather, this proposal would require that the valuation assigned to an asset must reflect a figure within an acceptable range of valuations for that asset.

In addition to this general formulation of the definition of fair market value, the Department is proposing two specific requirements for the determination of fair market value for the purposes of section 3(18)(B) and section 8477(a)(2)(B). First, proposed § 2510.3-18(b)(2)(ii) requires that fair market value must be determined as of the date of the transaction involving that asset. This requirement is designed to prevent situations such as arose in *Donovan v. Cunningham, supra*. In that case, the plan fiduciaries relied on a 1975 appraisal to set the value of employer securities purchased by an ESOP during 1976 and thereafter, and failed to take into account significant changes in the company's business condition in the interim. The court found that this reliance was unwarranted, and therefore the fiduciaries' valuation failed to reflect adequate consideration under section 3(18)(B). *Id.* at 1468-69.

Second, proposed § 2510.3-18(b)(2)(iii) states that the determination of fair market value must be reflected in written documentation of valuation<sup>2</sup> meeting the content requirements set forth in § 2510.3-18(b)(4). (The valuation content requirements are discussed below.) The Department has proposed this requirement in light of the role the adequate consideration requirement plays in a number of statutory exemptions from the prohibited transaction provisions of the Act. In determining whether a statutory exemption applies to a particular transaction, the burden of proof is upon the party seeking to make use of the statutory exemption to show that all the requirements of the provision are met. *Donovan v. Cunningham, supra*, 716 F.2d

property's value should reflect a premium due to a certain developer's specific land development plans.

<sup>2</sup> It should be noted that the written valuation required by this section of the proposal need not be a written report of an independent appraiser. Rather, it should be documentation sufficient to allow the Department to determine whether the content requirements of § 2510.3-18(b)(4) have been satisfied. The use of an independent appraiser may be relevant to a determination of good faith, as discussed with regard to proposed § 2510.3-18(b)(3), *infra*, but it is not required to satisfy the fair market value criterion in § 2510.3-18(b)(2)(i).

at 1467 n.27. In the Department's view, written documentation relating to the valuation is necessary for a determination of how, and on what basis, an asset was valued, and therefore whether that valuation reflected an asset's fair market value. In addition, the Department believes that it would be contrary to prudent business practices for a fiduciary to act in the absence of such written documentation of fair market value.

## 3. Good Faith

The second part of the Department's proposed two-part test under section 3(18)(B) and section 8477(a)(2)(B) requires that an assessment of adequate consideration be the product of a determination made in good faith by the plan trustee or named fiduciary (or under FERSA, a fiduciary). Proposed § 2510.3-18(b)(3)(i) states that as a general matter this good faith requirement establishes an objective standard of conduct, rather than mandating an inquiry into the intent or state of mind of the plan trustee or named fiduciary. In this regard, the proposal is consistent with the opinion in *Donovan v. Cunningham, supra*, where the court stated that the good faith requirement in section 3(18)(B):

is not a search for subjective good faith \* \* \* The statutory reference to good faith in Section 3(18) must be read in light of the overriding duties of Section 404.

716 F.2d at 1467. The inquiry into good faith under the proposal therefore focuses on the fiduciary's conduct in determining fair market value. An examination of all relevant facts and circumstances is necessary for a determination of whether a fiduciary has met this objective good faith standard.

Proposed § 2510.3-18(b)(3)(ii) focuses on two factors which must be present in order for the Department to be satisfied that the fiduciary has acted in good faith. First, this section would require 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. This requirement reflects the *Cunningham* court's emphasis on the use of prudent business practices in valuing plan assets.

Second, this section states that either the fiduciary making the valuation must itself be independent of all the parties to the transaction (other than the plan), or the fiduciary must rely on the report of an appraiser who is independent of all the parties to the transaction (other than the plan). (The criteria for determining

independence are discussed below.) As noted above, under ERISA, the determination of adequate consideration is a central safeguard in many statutory exemptions applicable to plan transactions with the plan sponsor. The close relationship between the plan and the plan sponsor in such situations raises a significant potential for conflicts of interest as the fiduciary values assets which are the subject of transactions between the plan and the plan sponsor. In light of this possibility, the Department believes that good faith may only be demonstrated when the valuation is made by persons independent of the parties to the transaction (other than the plan), *i.e.*, a valuation made by an independent fiduciary or by a fiduciary acting pursuant to the report of an independent appraiser.

The Department emphasizes that the two requirements of proposed § 2510.3-18(b)(3)(ii) are designed to work in concert. For example, a plan fiduciary charged with valuation may be independent of all the parties to a transaction and may, in light of the requirement of proposed § 2510.3-18(b)(3)(ii)(B), decide to undertake the valuation process itself. However, if the independent fiduciary has neither the experience, facilities nor expertise to make the type of valuation under consideration, the decision by that fiduciary to make the valuation would fail to meet the prudent investigation and sound business principles requirement of proposed § 2510.3-18(b)(3)(ii)(A).

Proposed § 2510.3-18(b)(3)(iii) defines the circumstances under which a fiduciary or an appraiser will be deemed to be independent for the purposes of subparagraph (3)(ii)(B), above. The proposal notes that the fiduciary or the appraiser must in fact be independent of all parties participating in the transaction other than the plan. The proposal also notes that a determination of independence must be made in light of all relevant facts and circumstances, and then delineates certain circumstances under which this independence will be lacking. These circumstances reflect the definitions of the terms "affiliate" and "control" in Departmental regulation 29 CFR 2510.3-21(e) (defining the circumstances under which an investment adviser is a fiduciary). It should be noted that, under these proposed provisions, an appraiser will be considered independent of all parties to a transaction (other than the plan) only if a plan fiduciary has chosen the appraiser and has the right to terminate that appointment, and the

plan is thereby established as the appraiser's client.<sup>3</sup> Absent such circumstances, the appraiser may be unable to be completely neutral in the exercise of his function.<sup>4</sup>

#### 4. Valuation Content—General

Proposed § 2510.3-18(b)(4)(i) sets the content requirements for the written documentation of valuation required for a determination of fair market value under proposed § 2510.3-18(b)(2)(iii). The proposal follows to a large extent the requirements of Rev. Proc. 66-49, 1966-2 C.B. 1257, which sets forth the format required by the IRS for the valuation of donated property. The Department believes that this format is a familiar one, and will therefore facilitate compliance. Several additions to the IRS requirements merit brief explanation.

First, proposed paragraph (b)(4)(i)(E) requires a statement of the purpose for which the valuation was made. A valuation undertaken, for example, for a yearly financial report may prove an inadequate basis for any sale of the asset in question. This requirement is intended to facilitate review of the valuation in the correct context.

Second, proposed paragraph (b)(4)(i)(F) requires a statement as to the relative weight accorded to relevant valuation methodologies. The Department's experience in this area indicates that there are a number of different methodologies used within the appraisal industry. By varying the treatment given and emphasis accorded relevant information, these methodologies directly affect the result of the appraiser's analysis. It is the Department's understanding that appraisers will often use different methodologies to cross-check their results. A statement of the method or methods used would allow for a more accurate assessment of the validity of the valuation.

<sup>3</sup> The independence of an appraiser will not be affected solely because the plan sponsor pays the appraiser's fee.

<sup>4</sup> With regard to this independence requirement the Department notes that new section 401(a)(28) of the Code (added by section 1175(a) of the Tax Reform Act of 1986) requires that, in the case of an employee stock ownership plan, employer securities which are not readily tradable on established securities markets must be valued by an independent appraiser. New 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 notes that the requirements of proposed regulation § 2510.3-18(b)(3)(iii) are not the same as the requirements of the regulations issued by the IRS under section 170(a)(1) of the Code. The IRS has not yet promulgated rules under Code section 401(a)(28).

Finally, proposed subparagraph (b)(4)(i)(G) requires a statement of the valuation's effective date. This reflects the requirement in proposed § 2510.3-18(b)(ii) that fair market value must be determined as of the date of the transaction in question.

#### 5. Valuation Content—Special Rule

Proposed § 2510.3-18(b)(4)(ii) establishes additional content requirements for written documentation of valuation when the asset being appraised is a security other than a security for which there is a generally recognized market. In other words, the requirements of the proposed special rule supplement, rather than supplant, the requirements of paragraph (b)(4)(i). The proposed special rule establishes a nonexclusive list of factors to be considered when the asset being valued is a security not covered by section 3(18)(A) of the Act or section 8477(a)(2)(A) of FERSA. Such securities 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. The Internal Revenue Service has had occasion to address the valuation problems posed by one type of such securities—securities issued by closely held corporations. Rev. Rul. 59-60, 1959-1 Cum. Bull. 237, lists a variety of factors to be considered when valuing securities of closely held corporations for tax purposes.<sup>5</sup> The Department's experience indicates that Rev. Rul. 59-60 is familiar to plan fiduciaries, plan sponsors and the corporate community in general. The Department has, therefore, modeled this proposed special rule after Rev. Rul. 59-60 with certain additions and changes discussed below. It should be emphasized, however, that this is a non-exclusive list of factors to be considered. Certain of the factors listed may not be relevant to every valuation inquiry, although the fiduciary will bear the burden of demonstrating such irrelevance. Similarly, reliance on this list will not relieve fiduciaries from the duty to consider all relevant facts and circumstances when valuing such securities. The purpose of the proposed

<sup>5</sup> Rev. Rul. 59-60 was modified by Rev. Rul. 65-193 (1965-2 C.B. 370) regarding the valuation of tangible and intangible corporate assets. The provisions of Rev. Rul. 59-60, as modified, were extended to the valuation of corporate securities for income and other tax purposes by Rev. Rul. 68-609 (1968-2 C.B. 327). In addition, Rev. Rul. 77-287 (1977-2 C.B. 319), amplified Rev. Rul. 59-60 by indicating the ways in which the factors listed in Rev. Rul. 59-60 should be applied when valuing restricted securities.

list is to guide fiduciaries in the course of their inquiry.

Several of the factors listed in proposed § 2510.3-18(b)(4)(ii) merit special comment and explanation. Proposed subparagraph (G) states that the fair market value of securities other than those for which there is a generally recognized market may be established by reference to the market price of similar securities of corporations engaged in the same or a similar line of business whose securities are actively traded in a free and open market, either on an exchange or over the counter. The Department intends that the degree of comparability must be assessed in order to approximate as closely as possible the market forces at work with regard to the corporation issuing the securities in question.

Proposed subparagraph (H) requires an assessment of the effect of the securities' marketability or lack thereof. Rev. Rul. 59-60 does not explicitly require such an assessment, but the Department believes that the marketability of these types of securities will directly affect their price. In this regard, the Department is aware that, especially in situations involving employee stock ownership plans (ESOPs),<sup>6</sup> the employer securities held by the ESOP will provide a "put" option whereby individual participants may upon retirement sell their shares back to the employer.<sup>7</sup> It has been argued that some kinds of "put" options may diminish the need to discount the value of the securities due to lack of marketability. The Department believes that the existence of the "put" option should be considered for valuation purposes only to the extent it is enforceable and the employer has and may reasonably be expected to continue to have, adequate resources to meet its obligations. Thus, the Department proposes to require that the plan fiduciary assess whether these "put" rights are actually enforceable, and whether the employer will be able to pay for the securities when and if the "put" is exercised.

Finally, proposed subparagraph (I) deals with the role of control premiums in valuing securities other than those for

which there is a generally recognized market. The Department proposes that a plan purchasing control may pay a control premium, and a plan selling control should receive a control premium. Specifically, the Department proposes that a plan may pay such a premium only to the extent a third party would pay a control premium. In this regard, the Department's position is that the payment of a control premium is unwarranted unless the plan obtains both voting control and control in fact. The Department will therefore carefully scrutinize situations to ascertain whether the transaction involving payment of such a premium actually results in the passing of control to the plan. For example, it may be difficult to determine that a plan paying a control premium has received control in fact where it is reasonable to assume at the time of acquisition that distribution of shares to plan participants will cause the plan's control of the company to be dissipated within a short period of time subsequent to acquisition.<sup>8</sup> In the Department's view, however, a plan would not fail to receive control merely because individuals who were previously officers, directors or shareholders of the corporation continue as plan fiduciaries or corporate officials after the plan has acquired the securities. Nonetheless, the retention of management and the utilization of corporate officials as plan fiduciaries, when viewed in conjunction with other facts, may indicate that actual control has not passed to the plan within the meaning of paragraph (b)(4)(ii)(I) of the proposed regulation. Similarly, if the plan purchases employer securities in small increments pursuant to an understanding with the employer that the employer will eventually sell a controlling portion of shares to the plan, a control premium would be warranted only to the extent that the understanding with the employer was actually a binding agreement obligating the employer to pass control within a reasonable time. See *Donovan v. Cunningham, supra*, 716 F.2d at 1472-74 (mere intention to transfer control not sufficient).

<sup>8</sup> However, the Department notes that the mere pass-through of voting rights to participants would not in itself affect a determination that a plan has received control in fact, notwithstanding the existence of participant voting rights, if the plan fiduciaries having control over plan assets ordinarily may resell the shares to a third party and command a control premium, without the need to secure the approval of the plan participants.

## 6. Service Arrangements Subject to FERSA

Section 8477(c)(1)(C) of FERSA permits the exchange of services between the Thrift Savings Fund and a party in interest only in exchange for adequate consideration. In this context, the proposal defines the term "adequate consideration" as "reasonable compensation", as that term is described in sections 408(b)(2) and 408(c)(2) of ERISA and the regulations promulgated thereunder. By so doing, the proposal would establish a consistent standard of exemptive relief for both ERISA and FERSA with regard to what otherwise would be prohibited service arrangements.

## Regulatory Flexibility Act

The Department has determined that this regulation would not have a significant economic effect on small plans. In conducting the analysis required under the Regulatory Flexibility Act, it was estimated that approximately 6,250 small plans may be affected by the regulation. The total additional cost to these plans, over and above the costs already being incurred under established valuation practices, are estimated not to exceed \$875,000 per year, or \$140 per plan for small plans choosing to engage in otherwise prohibited transactions that are exempted under the statute conditioned on a finding of adequate consideration.

## Executive Order 12291

The Department has determined that the proposed regulatory action would not constitute a "major rule" as that term is used in Executive Order 12291 because the action would not result in: an annual effect on the economy of \$100 million; a major increase in costs of prices for consumers, individual industries, government agencies, or geographical regions; or significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States based enterprises to compete with foreign based enterprises in domestic or export markets.

## Paperwork Reduction Act

This proposed regulation contains several paperwork requirements. The regulation has been forwarded for approval to the Office of Management and Budget under the provisions of the Paperwork Reduction Act of 1980 (Pub. L. 96-511). A control number has not yet been assigned.

<sup>6</sup> The definition of the term "adequate consideration" under ERISA is of particular importance to the establishment and maintenance of ESOPs because, pursuant to section 408(e) of the Act, an ESOP may acquire employer securities from a party in interest only under certain conditions, including that the plan pay no more than adequate consideration for the securities.

<sup>7</sup> Regulation 29 CFR 2550.408b-(j) requires such a put option in order for a loan from a party in interest to the ESOP to qualify for the statutory exemption in section 408(b)(3) of ERISA from the prohibited transactions provisions of ERISA.

**Statutory Authority**

This regulation is proposed under section 3(18) and 505 of the Act (29 U.S.C. 1003(18) and 1135); Secretary of Labor's Order No. 1-87; and sections 8477(a)(2)(B) and 8477(f) of FERSA.

**List of Subjects in 29 CFR Part 2510**

Employee benefit plans, Employee Retirement Income Security Act, Pensions, Pension and Welfare Benefit Administration.

**Proposed Regulation**

For the reasons set out in the preamble, the Department proposes to amend Part 2510 of Chapter XXV of Title 29 of the Code of Federal Regulations as follows:

**PART 2510—[AMENDED]**

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

**Authority:** Sec. 3(2), 111(c), 505, Pub. L. 93-406, 88 Stat. 852, 894, (29 U.S.C. 1002(2), 1031, 1135); Secretary of Labor's Order No. 27-74, 1-86, 1-87, and Labor Management Services Administration Order No. 2-6.

Section 2510.3-18 is also issued under sec. 3(18) of the Act (29 U.S.C. 1003(18)) and secs. 8477(a)(2)(B) and (f) of FERSA (5 U.S.C. 8477).

Section 2510.3-101 is also issued under sec. 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 FR 1065, January 3, 1978); 3 CFR 1978 Comp. 332, and sec. 11018(d) of Pub. L. 99-272, 100 Stat. 82.

Section 2510.3-102 is also issued under sec. 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 FR 1065, January 3, 1978), and 3 CFR 1978 Comp. 332.

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

**§ 2510.3-18 Adequate Consideration**

(a) [Reserved]

(b)(1)(i) *General.* (A) Section 3(18)(B) of the Employee Retirement Income Security Act of 1974 (the Act) provides that, in the case of a plan 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.

(B) Section 8477(a)(2)(B) of the Federal Employees' Retirement System Act of 1986 (FERSA) provides 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 a fiduciary or fiduciaries in accordance with regulations prescribed by the Secretary of Labor.

(ii) *Scope.* The requirements of section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA will not be met unless the value assigned to a plan asset both reflects the asset's fair market value as defined in paragraph (b)(2) of this section and results from a determination made by the plan trustee or named fiduciary (or, in the case of FERSA, a fiduciary) in good faith as described in paragraph (b)(3) of this section. Paragraph (b)(5) of this section contains a special rule for service contracts subject to FERSA.

(2) *Fair Market Value.* (i) Except as otherwise specified in this section, the term "fair market value" as used in section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA means 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 both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset.

(ii) The fair market value of an asset for the purposes of section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA must be determined as of the date of the transaction involving that asset.

(iii) The fair market value of an asset for the purposes of section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA must be reflected in written documentation of valuation meeting the requirements set forth in paragraph (b)(4), of this section.

(3) *Good Faith*—(i) *General Rule.* The requirement in section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA that the fiduciary must determine fair market value in good faith establishes an objective, rather than a subjective, standard of conduct. Subject to the conditions in paragraphs (b)(3) (ii) and (iii) of this section, an assessment of whether the fiduciary has acted in good faith will be made in light of all relevant facts and circumstances.

(ii) In considering all relevant facts and circumstances, the Department will not view a fiduciary as having acted in good faith unless

(A) The fiduciary has arrived at a determination of fair market value by way of a prudent investigation of circumstances prevailing at the time of the valuation, and the application of sound business principles of evaluation; and

(B) The fiduciary making the valuation either,

(1) Is independent of all parties to the transaction (other than the plan), or

(2) Relies on the report of an appraiser who is independent of all parties to the transaction (other than the plan).

(iii) In order to satisfy the independence requirement of paragraph (b)(3)(ii)(B), of this section, a person must in fact be independent of all parties (other than the plan) participating in the transaction. For the purposes of this section, an assessment of independence will be made in light of all relevant facts and circumstances. However, a person will not be considered to be independent of all parties to the transaction if that person—

(1) Is directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with any of the parties to the transaction (other than the plan);

(2) Is an officer, director, partner, employee, employer or relative (as defined in section 3(15) of the Act, and including siblings) of any such parties (other than the plan);

(3) Is a corporation or partnership of which any such party (other than the plan) is an officer, director or partner.

For the purposes of this subparagraph, the term "control," in connection with a person other than an individual, means the power to exercise a controlling influence over the management or policies of that person.

(4) *Valuation Content.* (i) In order to comply with the requirement in paragraph (b)(2)(iii), of this section, that the determination of fair market value be reflected in written documentation of valuation, such written documentation must contain, at a minimum, the following information:

(A) A summary of the qualifications to evaluate assets of the type being valued of the person or persons making the valuation;

(B) A statement of the asset's value, a statement of the methods used in determining that value, and the reasons for the valuation in light of those methods;

(C) A full description of the asset being valued;

(D) The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the property;

(E) The purpose for which the valuation was made;

(F) The relevance or significance accorded to the valuation methodologies taken into account;

(G) The effective date of the valuation; and

(H) In cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed.

(ii) *Special Rule.* When the asset being valued is a security other than a security covered by section 3(18)(A) of the Act or section 8477(a)(2)(A) of FERSA, the written valuation required by paragraph (b)(2)(iii) of this section, must contain the information required in paragraph (b)(4)(i) of this section, and must include, in addition to an assessment of all other relevant factors, an assessment of the factors listed below:

(A) The nature of the business and the history of the enterprise from its inception;

(B) The economic outlook in general, and the condition and outlook of the specific industry in particular;

(C) The book value of the securities and the financial condition of the business;

(D) The earning capacity of the company;

(E) The dividend-paying capacity of the company;

(F) Whether or not the enterprise has goodwill or other intangible value;

(G) The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;

(H) The marketability, or lack thereof, of the securities. Where the plan is the purchaser of securities that are subject to "put" rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well as the company's ability to meet its obligations with respect to the "put" rights (taking into account the company's financial strength and liquidity);

(I) Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account:

(1) Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and

(2) It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.

— (5) *Service Arrangements Subject to FERSA.* For purposes of determinations pursuant to section 8477(c)(1)(C) of FERSA (relating to the provision of services) the term "adequate consideration" under section 8477(a)(2)(B) of FERSA means "reasonable compensation" as defined in sections 408(b)(2) and 408(c)(2) of the Act and §§ 2550.408b-2(d) and 2550.408c-2 of this chapter.

(6) *Effective Date.* This section will be effective for transactions taking place after the date 30 days following publication of the final regulation in the Federal Register.

Signed in Washington, DC, this 11th day of May 1988.

David M. Walker,

Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor.

[FR Doc. 88-10934 Filed 5-16-88; 8:45 am]

BILLING CODE 4510-29-M