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EMPLOYEE BENEFITS SECURITY ADMINISTRATION



EBSA NEEDS TO PROVIDE ADDITIONAL GUIDANCE AND OVERSIGHT TO ERISA PLANS HOLDING HARD-TO-VALUE ALTERNATIVE INVESTMENTS

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**U.S. Department of Labor
Office of Inspector General
Office of Audit**

BRIEFLY...

Highlights of Report Number 09-13-001-12-121, issued to the Assistant Secretary for Employee Benefits Security.

WHY READ THE REPORT

About 150 million Americans currently have approximately \$6.5 trillion invested in retirement accounts. How plans invested these funds has a direct – and sometimes harmful – effect on the retirement security of plan participants. The Employee Retirement Income Security Act of 1974 (ERISA) governs the investment of assets in private sector employee benefit plans, which include both retirement and health and welfare plans. The Employee Benefit Security Administration (EBSA) oversees private sector management of employee benefit plans.

ERISA places responsibility on plan administrators to accurately report the fair value of plan assets. An accurate valuation of plan assets plays a critical role in determining plan funding levels and payments to participants and beneficiaries because the assets in a plan determine its ability to pay beneficiaries.

EBSA faces challenges in meeting its mission because some plans have increasingly shifted assets from traditional investments, such as stocks and bonds, to complex alternative investments, such as limited partnerships, common collective trusts, and hedge funds. As of 2010, employee benefit plans had amassed almost \$3 trillion in alternative investments, of which EBSA estimated between \$800 billion and \$1.1 trillion were hard-to-value. In 2010, the Internal Revenue Service (IRS) Emerging Issues Task Force reported to EBSA that significant assets invested by plans in alternative investments may be a serious problem.

WHY OIG CONDUCTED THE AUDIT

Concerns by various parties, such as the Internal Revenue Service, General Accountability Office, and American Institute of Certified Public Accountants (AICPA) over plan assets invested into alternative and hard-to-value investments prompted the OIG to conduct an audit to determine if EBSA is providing adequate oversight of employee benefit plans that hold alternative investments.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full agency response, go to:

<http://www.oig.dol.gov/public/reports/oa/2013/09-13-001-12-121.pdf>

September 2013

EBSA NEEDS TO PROVIDE ADDITIONAL GUIDANCE AND OVERSIGHT TO ERISA PLANS HOLDING HARD-TO-VALUE ALTERNATIVE INVESTMENTS

WHAT OIG FOUND

EBSA has made efforts to improve its oversight of plans that hold hard-to-value alternative investments. Despite these efforts, however, EBSA must take further action to increase protections for participants and beneficiaries of plans investing in these types of investments. We found EBSA had not formalized into regulatory guidance a requirement that plan administrators identify and adequately support the fair value of hard-to-value investments nor implemented the 2006, 2008, and 2011 ERISA council recommendations on the same. As a result, plans are using poor practices in valuing these investments. Almost no plan administrator in our samples obtained an independent valuation or demonstrated an analytical process to determine the fair value of all their hard-to-value assets.

Plans can and have invested in unaudited alternative investments that self-report their asset values. This provides no independent opinion of asset values, and effectively no assurance that the assets in question even exist. Additionally, even audited fund values reported by alternative investment entities may not always translate into fair value for the plans invested because of complex factors such as illiquidity of ownership interests and other considerations. Compounding this problem is the fact that plan administrators have increasingly used limited scope audits, in which plan auditors do not test for existence or valuation of plan assets in certain cases. In 2010, approximately \$3 trillion in assets received only a limited scope audit.

Lastly, we found EBSA could improve procedures in enforcement reviews and Form 5500 reporting, data collection, and targeting for plans with hard-to-value alternative investments. EBSA has previously stated that in light of the challenges facing retirement plan fiduciaries and investors, such as Ponzi schemes and hard-to-value assets, participants need protection from potential losses.

WHAT OIG RECOMMENDED

We recommended the Assistant Secretary for Employee Benefits Security take the following actions for plans holding hard-to-value alternative investments: (1) propose and formalize guidance and evaluate the ERISA Council recommendations, (2) improve procedures in enforcement reviews, and (3) improve Form 5500 data collection, analysis, and targeting.

In response, EBSA stated that it did not believe the trillions of dollars of plan assets invested in alternative investments and hard-to-value assets pose significant valuation concerns, that ERISA already provided sufficient guidance, that its investigative procedures were sufficient, and that the Form 5500 already focuses on asset valuation. EBSA agreed to further consider the OIG recommendations, but did not provide any explicit corrective actions.

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U.S. Department of Labor

Office of Inspector General
Washington, D.C. 20210



September 30, 2013

Assistant Inspector General's Report

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Almost half the population of the United States – about 150 million Americans – has invested approximately \$6.5 trillion in retirement accounts. How plans invest these funds has a direct – and sometimes harmful – effect on the retirement security of plan participants. The Employee Retirement Income Security Act of 1974 (ERISA) governs the investment of assets in private sector employee benefit plans. ERISA charges the Secretary of Labor with overseeing private sector management of employee benefit plans. The Department of Labor (DOL), Employee Benefit Security Administration (EBSA) carries out the Secretary's oversight role.

In the context of our report, the terms "fiduciary" and "plan administrator" refer to a person or entity who has control over plan assets, gives investment advice, or has responsibility for plan administration. ERISA requires that plan fiduciaries: 1) carry out their duties with care, skill, prudence, and diligence; 2) use independent qualified public accountants (IQPAs) to audit employee benefit plan financial statements in the case of most large funded employee benefit plans; and 3) report the current value of plan assets annually on the plans Form 5500 Annual Return/Report of Employee Benefit Plan. An accurate fair market valuation of plan assets plays a critical role in determining plan funding levels and payments to participants and beneficiaries. Only audits that meet professional standards assist plan administrators in meeting their responsibility for proper valuation and reporting of plan assets. Since 1984, the OIG has recommended that EBSA seek legislation to strengthen the quality of employee plan audits. The ultimate responsibility for accurately reporting the fair market value of plan assets, however, lies with plan administrators.

EBSA faces challenges meeting its mission because some plans have increasingly shifted assets from traditional investments, such as stocks and bonds, into an array of complex, hard to define alternative investments, such as common collective trusts, private equity funds, limited partnerships, hedge funds, and real estate. As of 2010, the latest year for which data is available, employee benefit plans had amassed almost

\$3 trillion in these alternative investments.¹ Of this amount, EBSA estimated that anywhere between \$800 billion and \$1.1 trillion should be considered hard-to-value as approximately \$2 trillion can be traced to other line items that generally would not include hard-to-value assets. However, there is not sufficient information in the Form 5500 Annual Return/Report schedules for EBSA to positively state, and the OIG to verify, this amount, a fact which further emphasizes the need to improve the Form 5500's data gathering abilities.

The Financial Accounting Standards Board (FASB) established a framework for measuring fair value. The framework provides a fair value hierarchy that ranks investments into three levels – level 1 for assets with quoted prices in actively traded markets to level 3 for assets that are hardest to value because they lack a generally recognized market. However, plan administrators cannot easily determine the fair market value of alternative investments for a number of reasons. First, alternative investment entities may be unaudited, not listed on any national exchange, and not subject to state or federal regulation. Second, plans are not required to obtain an independent valuation to demonstrate the fair market value of these types of investments. Third, ERISA allows plans to elect a “limited scope audit” for purposes of filing the Form 5500 Annual Return/Report. In such audits, IQPAs perform no auditing procedures to test for existence or valuation of plan assets held and “certified” by a qualifying financial institution. Fourth, financial institutions holding these plan assets need not certify for purposes of a limited scope audit that they are reporting the assets at fair market value, but only that the records are “complete and accurate.” Lastly, the financial institutions’ records could be nothing more than a pass through of estimated values the institutions received directly from the alternative investment entity, which gives rise to a conflict of interest when it comes to reporting investment losses.

As a result, a potentially unaudited investment entity – which may have an incentive to report gains and asset growth rather than losses – can provide the values of alternative investments to a financial institution which, in turn, transmits these values to plan administrators without employing any audit procedures, analyses, or due diligence to verify the information provided by the investment entity. This lack of transparency and accountability places participants and beneficiaries at increased risk for losses.

Because of these concerns, we conducted an audit to answer the following question:

Is EBSA providing adequate oversight of employee benefit plans that use alternative investments?

To answer this question, we reviewed accounting and pension industry professional standards, applicable regulations, and EBSA policies and procedures. We also reviewed a sample of EBSA's Office of Enforcement investigations of plans with hard-to-value investments from FYs 2008 through 2012 and a sample of records from retirement plans.

¹ Data is based on 2010 Form 5500 filings for plans with 100 or participants and audited financial statements.

RESULTS IN BRIEF

EBSA's oversight of plans that invest in alternative investments included issuing guidance on certain types of investments, providing compliance assistance and outreach, conducting regional enforcement projects on plans with hard-to-value investments, and targeting studies on how plans report fair market valuation. Despite these efforts, EBSA must take further action as plan participants and beneficiaries of plans investing in alternative investments need stronger assurances that EBSA is providing effective guidance and oversight, because:

- 1) EBSA has not recently issued uniform formal guidance on prudent valuation and reporting for hard-to-value alternative investments;
- 2) Plans are using poor practices in valuing alternative investments;
- 3) The use of limited scope audits is increasing;
- 4) Improvements are needed in enforcement review procedures for plans with these types of assets; and
- 5) Form 5500 reporting and data collection for hard-to-value investments has certain limitations.

As a result, participants and beneficiaries who invested in plans to accrue retirement income are at an increasing risk of loss as employee benefit plan assets invested in alternative investments grow. Both EBSA and the Securities and Exchange Commission (SEC) have filed numerous civil actions and made significant recoveries against plan management and fiduciaries for significant losses to plan participants and beneficiaries resulting from hard-to-value alternative investments.

Lack of Uniform Guidance for Hard-to-Value Alternative Investments

While the ERISA Advisory Council, General Accountability Office, and the American Institute of Certified Public Accountants (AICPA) have all recommended EBSA provide guidance to fiduciaries using alternative investments, EBSA has not yet implemented these recommendations. In addition, EBSA has not formalized into regulatory guidance a letter the Boston Regional Office Director issued to specific plans notifying them that failure to properly value alternative investments or establish a process to evaluate the fair market value of these investments violates ERISA. Similarly, EBSA proposed, but never finalized, guidance that would have required written documentation relating to the determination and basis of fair market value of securities without a generally recognized market. In 2010, the Internal Revenue Service (IRS) Emerging Issues Task Force determined and reported to EBSA that significant assets invested by plans in alternative investments may be a serious problem.

Lack of Appropriate and Independent Valuation

Plan management could not always demonstrate that it prudently monitored and valued plan assets invested in hard-to-value alternative investments. Approximately 90 percent of plans in our sample of both EBSA investigative case files (39 out of 46), and

responses we received from retirement plans (42 out of 45), representing about \$24 billion in assets, either did not obtain independent valuations or demonstrate an analytical process to determine their fair market value. Plans also relied on client statements and general partners' estimated values without additional analysis to ensure that the alternative investments were reported at fair market value.

Increased Use of Limited-Scope Audits

In 2010, approximately \$3 trillion in assets received only a limited-scope audit, up from \$520 billion in 1989. Limited scope audits present challenges for plan administrators in accurately valuing and reporting hard-to-value alternative investments. IQPAs do not test for the existence or valuation of assets certified by financial institutions. Further, qualified institutions are not required to certify plan assets at fair market value, but only as complete and accurate as reflected in their records. For hard-to-value investments, records of the certifying institution could be nothing more than a pass through of estimated values directly from the alternative investment entity. Compounding the problem is the fact that plan assets may be invested in non-publicly traded entities, which themselves may not be subject to annual financial statement audits. As a result, potentially unaudited private investment entities can self-report their assets to plans that may only obtain limited-scope audits, thus providing no assurance of asset existence or valuation. The OIG has previously recommended that EBSA seek repeal of the limited scope audit, and in the interim clarify the requirements needed to hold and certify plan assets and provide guidance to plan administrators to identify and adequately support the current value of plan assets in limited scope audits.

EBSA Enforcement Review Procedures

In our sample of regional office case files, we found EBSA lacked specific investigative procedures to identify whether plans obtained independent valuations or plan management had established a process to evaluate the fair market value of all hard-to-value plan investments. In addition, although there is a formal referral procedure in place for regional offices to refer cases to EBSA's Office of Chief Accountant, there are no specific procedures to refer cases with substandard audit quality.

Limitations in Form 5500 Reporting and Data Collection for Hard-to-Value Investments

The Form 5500 is an important compliance, research, and disclosure tool for EBSA. The Form, however, has a limited ability to capture information on hard-to-value investments. While the Form 5500 Schedule H² provides information on specific asset classes, it does not contain sufficient data to determine the specific types of plan investments that lack a generally recognized market. More detailed information on specific asset classes is generally contained in the plans' financial statements, which

² Schedule H of the Form 5500 captures financial details about the plan's assets, liabilities, and investments, among others.

are attached to the Form 5500 filing. However, EBSA cannot adequately electronically search and correlate the data contained in the attachment. As a result, EBSA can neither effectively determine the total amount of hard-to-value investments nor target plans for compliance with reporting requirements. In fact, EBSA has provided us varying estimates for hard-to-value assets, pointing out that a firm number for these assets cannot be readily derived in an automated way from Form 5500 filings.

EBSA needs to provide additional oversight and guidance to ERISA plans that hold hard-to-value alternative investments. Without adequate assurances that plan management and administrators prudently select, monitor, and value plan investments, ERISA plans invested in these types of assets can sustain losses from imprudent, speculative, Ponzi, and other fraudulent schemes, which are prime examples of why assurances of existence and valuation matter. Participants and beneficiaries hoping to accrue retirement income are at an increasing risk of loss as employee benefit plan assets invested in alternative investments grow.

We recommend EBSA propose and formalize guidance and evaluate the ERISA Council recommendations, improve procedures in enforcement reviews, and improve Form 5500 data collection, analysis, and targeting.

EBSA’S RESPONSE

In response, the Assistant Secretary for Employee Benefits Security stated that EBSA did not believe the trillions of dollars of plan assets invested in alternative investments and hard-to-value assets pose significant valuation concerns. EBSA asserted that ERISA, along with some other materials issued by EBSA, provide sufficient guidance to plan administrators. EBSA also stated its investigative procedures were sufficient and the Form 5500 already addresses valuation issues. EBSA agreed to further consider the OIG recommendations, but did not provide explicit corrective actions. The Assistant Secretary’s entire response is contained in Appendix D.

The OIG disagrees with EBSA’s response. As a result, we made no changes to our conclusions and recommendations, as they already adequately address all of the relevant points in EBSA’s response. We made some technical corrections to our report based mostly on EBSA’s revised estimate of the total value of hard-to-value assets.

RESULTS AND FINDINGS

The term “alternative investments” generally describes assets that are not traded on a generally recognized financial market. These can be as simple as real estate – whose value may fluctuate unpredictably, as demonstrated by recent events, or as complex as hedge funds and private equity funds. In some cases, for example real estate, the value of the underlying assets can be determined with relatively uncomplicated procedures, such as appraisals. In other cases, asset values can be more elusive. For example, private equity funds may intentionally keep their inner workings opaque so they do not

have to divulge their investment strategies as a means to gaining a competitive advantage.

The AICPA defines alternative investments as assets that are not listed on any national exchange or over-the-counter market, or for which quoted market prices are not available from sources such as publications, the financial markets, or the National Association of Securities Dealers Automated Quotations System (NASDAQ). These investments generally do not fall under any federal or state regulator and have greater flexibility in investment strategies than publicly traded, registered investment companies.

The FASB established a framework for measuring fair value. The framework provides a fair value hierarchy that ranks investments into three levels – level 1 for assets with quoted prices in actively traded financial markets, level 3 for assets that are the hardest to value because they lack a generally recognized market.

ERISA requires plan fiduciaries to carry out their duties with the care, skill, prudence and diligence of a knowledgeable person under similar circumstances, and ultimately, the responsibility for properly investing, managing, and reporting on plan assets – including valuing alternative investments – falls on the plan administrator and other fiduciaries.³ EBSA, however, provides in large part the regulatory framework that helps guide administrators and other fiduciaries and defines their responsibilities.

EBSA has taken some actions in response to the proliferation of alternative investments. EBSA's oversight of plans that invest in alternative investments has included issuing guidance on investments in derivatives, providing compliance assistance and outreach, conducting regional enforcement projects on plans with hard-to-value investments, and targeting studies on how plans report fair market valuation. EBSA, however, can take further actions to improve protections for plan participants and beneficiaries.

We reviewed a sample of EBSA enforcement cases files for FYs 2008 and 2012 of plans with hard-to-value investments to evaluate EBSA's oversight of employee benefit plans investing in these types of investments (the "enforcement sample"). We also reviewed a sample of employee benefit plans that had twenty percent or more of plan assets invested in alternative investments for the 2010 filing year. For this sample, we contacted plan administrators to obtain documentation to determine how they ensured the fair value of the plan's hard-to-value alternative investments (the "plans sample").

³ 29 CFR 2550.404.

Objective — Has EBSA Provided Adequate Oversight of ERISA Plans Investing In Alternative Investments?

EBSA Needs to Increase Protections For Employee Benefit Plans Investing in Hard-to-Value Alternative Investments

Finding 1 — Additional Guidance is Needed for Plans Investing in Hard-to-Value Alternative Investments to Increase Protections for Plan Participants and Beneficiaries

As of 2010, the latest year for which data is available, retirement plans had amassed almost \$3 trillion in alternative investments, of which EBSA estimated amounts between \$800 billion and \$1.1 trillion were hard-to-value. Estimates of the total dollars invested in retirement plans vary, but are generally thought to be around \$6.5 trillion. In 2010, the Internal Revenue Service (IRS) Emerging Issues Task Force determined and reported to EBSA that significant assets invested by plans in alternative investments may be a serious problem.

The ERISA Advisory Council, General Accountability Office, and AICPA have all recommended EBSA provide guidance to fiduciaries using alternative investments, EBSA has not yet implemented these recommendations. In addition, EBSA has not formalized into regulatory guidance a letter (the “Benages” letter) issued to specific plans notifying them that failure to properly value alternative investments or establish a process to evaluate the fair market value of these investments violates ERISA. Similarly, EBSA proposed, but never finalized, guidance that would have required written documentation relating to the determination and basis of fair market value of securities without a generally recognized market.

Plan management could not always demonstrate that it prudently monitored and valued all plan assets invested in hard-to-value alternative investments. In approximately 90 percent of both our “enforcement” and “plans” samples, representing about \$24 billion in assets, plan administrators either did not obtain independent valuations or demonstrate an analytical process to determine their fair market value. Plans also relied on client statements and general partners’ estimated values without additional analysis to ensure the alternative investments were reported at fair market value.

In 2010, approximately \$3 trillion in assets received only a limited-scope audit, up from \$520 billion in 1989. ERISA allows plans to elect a “limited scope audit,” whereby IQPAs perform no auditing procedures to test for existence or valuation of plan assets held and “certified” by a qualifying financial institution. Financial institutions are not required to certify that they are reporting the assets at fair market value, but only that the records are “complete and accurate,” which can result in a pass-through of estimated values the institutions received directly from the alternative investment entity. Compounding the problem is the fact that plan assets may be invested in non-publicly traded entities, which themselves may not be subject to annual financial statement audits. As a result, potentially unaudited private investment entities self-report their assets to plans that

may only obtain limited-scope audits, thus providing little assurance of asset existence or valuation.

Alternative Investments that are Hard-to-Value Pose Increased Risks to Plans and Have Resulted in Large Losses

Both EBSA and the Securities and Exchange Commission (SEC) have filed numerous civil actions and made significant recoveries totaling more than \$900 million against plan management and fiduciaries for losses to plan participants and beneficiaries resulting from hard-to-value alternative investments. For example:

- In *Solis v. Beacon Associates LLC*, the DOL alleged dozens of employee benefit plans lost hundreds of millions in assets and violated ERISA by recommending, making, and maintaining investments with Bernard L. Madoff Investment Securities LLC (“BLMIS”), resulting in the loss of hundreds of millions of dollars.
- In *Chao v. Maddaloni*, the DOL sued the trustees of a pension fund to remove them as plan trustees and restore losses in connection with the imprudent management of the plan’s \$800 million investment in a country club in Florida.
- In *Chao v Circle Trust Company*, the DOL sued Circle Trust Company (CTC) of Darien, CT, to restore millions of dollars in losses on imprudent and risky investments with the “Trust Advisors Stable Value Plus Fund” (SVF), a collective trust administered by CTC. Circle Trust served as a trustee to SVF, which had invested approximately \$200 million from 1,500 pension plans nationwide.

Guidance Issued by EBSA

EBSA has stated that in light of the challenges facing retirement plan fiduciaries and investors, such as Ponzi schemes and hard-to-value assets, participants need protection from potential losses. However, the guidance EBSA has issued, although sound, has not provided a comprehensive framework that plan administrators could use to determine the appropriate way to value alternative investments. EBSA’s specific guidance has been limited and targeted at specific plans or types of investments. The guidance included the following documents:

- On June 26, 1979, EBSA issued a regulation, 29 CFR 2550.404a-1, regarding the investment duties of plan fiduciaries relating to any types of investments they would consider.
- On May 17, 1988, EBSA proposed a regulation which would have established “...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.” Additionally, in DOL’s view, written documentation relating to the valuation was 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. Moreover, DOL believed it would be contrary to prudent business practices for a fiduciary to act in the absence of such written documentation of fair market value. The proposed regulation, which detailed the analysis and documentation required to support the valuation of such assets, was never finalized. EBSA, however, noted in its July 19, 2007, Kansas City Regional Office investigation manual, that although DOL never finalized this proposed regulation, most valuation practitioners do consider DOL's proposed regulation in discharging their responsibilities.

- On March 21, 1996, EBSA issued an Information Letter to the Comptroller of the Currency regarding ERISA plans' investments in derivatives (the "Ludwig" letter). The letter indicated that, among other things, plan fiduciaries have a duty to determine the appropriate methodology to use to evaluate market risk and the information that must be collected to do so. The Ludwig letter, however, specifically targeted derivatives and did not address other hard-to-value investments.
- On July 1, 2008, the Director of EBSA's Boston regional office sent a letter to specific plan administrators located within the jurisdiction of the Boston regional office to advise them that failure to have an established process by which the fair-market value of alternative investments can be determined violates ERISA. He further advised that if the plan administrators did not adopt such a process, EBSA could be prompted to file a lawsuit against a plan. EBSA has not, however, formalized the letter as agency policy.

EBSA stated that a decision to initiate rulemaking to re-propose the 1988 regulation or formalize the 2008 Boston letter would have to be considered in the context of EBSA's other regulatory priorities and resource constraints.

Sources of Guidance Exist

ERISA provides for the establishment of an Advisory Council on Employee Welfare and Pension Benefit Plans, known as the ERISA Advisory Council. The duties of the Council are to advise the Secretary of Labor and submit recommendations regarding the Secretary's functions under ERISA.

The ERISA Advisory Council made numerous recommendations to EBSA in 2006, 2008, and 2011. For example, the Council recommended in 2008 that DOL should issue guidance that defines and addresses the complex nature and distinct characteristics of hard-to-value assets and describe the ERISA obligations when selecting, valuing, accounting for, monitoring and disclosing/reporting these assets. EBSA has been reviewing, but has made no decisions on, the Advisory Council's 2006, 2008, and 2011 recommendations.

GAO and the AICPA have recommended EBSA provide guidance to fiduciaries of employee benefit plans investing in alternative investments, but EBSA has not yet implemented these recommendations. Other sources of guidance available to plan administrators include the AICPA, the Financial Accounting Standard Board (FASB) and Generally Accepted Accounting Principles (GAAP).

The AICPA's position on the valuation of alternative investments is that valuation of these assets is problematic. Determining the value of alternative investments, which can fluctuate substantially and may not have readily available market value, can be extremely difficult. The AICPA noted that valuations were subjective, often required the assistance of third party specialists, and complicated by limited transparency. The AICPA also noted that valuations of alternative investments were frequently a "pass through" of values provided by the fund companies. The AICPA and FASB have both issued guidance regarding both valuation and disclosure of alternative investments.

The AICPA has issued guidance on valuing alternative investments, noting that plan management is responsible for asset valuations and financial statement disclosures. Even if plan management uses third parties, such as custodians, asset or fund managers, or other service providers to assist in determining the value of investments reported in the plan's financial statements and on Form 5500, the DOL holds plan management responsible for the proper reporting of plan investments. This responsibility cannot be outsourced or assigned to a party other than plan management. While plan management may look to the service provider for the mechanics of the valuation, it must have sufficient information to evaluate and independently challenge the valuation. Moreover, depending on the method of accounting, the asset values presented by alternative investments entities on their audited financial statements may be at something other than fair value. Finally, even audited fund values reported by alternative investment entities may not be at fair value because of complex factors, such as illiquidity of ownership interests, possible sale restrictions, or other considerations. Therefore, it is important that plan management become familiar with the plan's investments and the methods and significant assumptions used to value them, especially for hard-to-value investments.

GAAP requires that plan management establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP. EBSA however, cannot enforce this specific GAAP requirement.⁴

In its response, EBSA takes the position that ERISA Sec. 404 (a) provides adequate guidance to plan fiduciaries. In addition, EBSA asserts that the 1996 Ludwig letter which provided guidance on investments in derivatives, would be "equally applicable ... [to]

⁴ Technically, EBSA can require plans to be compliant with GAAP reporting inasmuch as the agency can reject Form 5500 filings that are deficient, but EBSA performs only a limited number of reviews of filings for this purpose.

hard to value alternative investments.” However, this letter was never formalized as guidance for investments other than derivatives; even so, EBSA’s position on guidance is not supported by the OIG’s findings and the statements and recommendations made by the ERISA Council, AICPA, IRS, and GAO, all of which have found that more guidance is necessary.

Plans Did Not Demonstrate Fair Value of Assets by Either an Established Process or Independent Valuations

Given this lack of guidance, we found that in approximately 90 percent of plans in both the “enforcement” (39 out of 46) and “plans” samples (42 out of 45), representing about \$24 billion in assets, the associated plan administrators either had not obtained independent valuations or could not demonstrate they had applied an appropriate analytical process to determine the fair market value of all⁵ hard-to-value alternative investments. Plans in our samples reported values and performance that were passed on to them from other entities, often the investment entity. Plans did not demonstrate written documentation relating to the valuation as 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. EBSA has previously stated 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.

We asked the administrators of the plans sample to show us how they ensured they presented plan assets at fair market value. Only one plan was able to provide an independent valuation or demonstrate an established process to evaluate and determine the fair market value of all the plan’s hard-to-value investments. We determined:

- One plan administrator generally relied on unaudited estimates of value for \$28 million of hard-to-value limited partnerships and hedge funds out of total plan assets of \$70 million.
- Another plan administrator provided documentation that did not support the fair value for \$1.3 billion of hard-to-value investments (39 percent of the plan’s totals assets of \$3.1 billion). The plan invested in more than 50 limited partnerships, comingled funds, hedge funds, real estate investments, 103-12 investments,⁶ and a pooled separate account, all considered alternative investments.

These plan administrators did not have an established process to evaluate the fair market value of hard-to-value assets. Such a process would include a complete understanding of the underlying investments and the fund’s investment strategy. In addition, plan administrators did not have a thorough knowledge of the investment

⁵ Hard-to-value investments as defined by FASB, and determined by the OIG to represent more than 5 percent of plan assets.

⁶ An entity whose underlying assets include “plan assets” of two or more plans that are not members of a “related group” of employee benefit plans.

entity's valuation methodology to ensure that they were presented at fair market value. A process that merely uses the investment entity's claimed value for all funds without additional analysis may not ensure that the alternative investments are valued at fair market value.

The Limited Scope Audit Exemption Increases the Risk of Loss to Plan Participants and Beneficiaries

In full scope audits, IQPAs ensure that plan administrators present assets at current value. Auditors test to verify that plan financial reports present plan assets at current value and attest to this via the auditor's opinion, thus providing some measure of assurance to plan participants.

However, ERISA allows plans to elect a "limited scope audit" in which IQPAs perform no auditing procedures to test for existence or valuation of plan assets held and "certified" by a qualifying financial institution. Most plan trustees and custodians are financial institutions that can avail themselves of the audit exemption. Financial institutions holding these plan assets need not certify that they are reporting them at fair market value, but only that their records are "complete and accurate." Lastly, these records could be nothing more than a pass through of estimated values directly from the alternative investment entity, which could give rise to a conflict of interest when it comes to reporting investment losses. This presents challenges for pension plan administrators and auditors in ensuring both the existence and valuation of alternative investment assets and ultimately, in reporting plan investments at fair market value.

In 2010, more than \$3 trillion in assets received only a "limited scope audit," up from just more than \$520 billion in 1989.

Consequently, a potentially unaudited investment entity – which may have an incentive to report gains and asset growth – can provide the values of alternative investments to a financial institution which, in turn, transmits these values to plan administrators without employing any audit procedures, analyses, or due diligence to verify the information provided by the investment entity. Participants and beneficiaries are at an increased risk for losses due to the lack of transparency and accountability from these types of investments.

EBSA has not provided guidance to plan administrators concerning the use of financial institution certifications of plan assets in limiting the scope of an audit and obtaining and supporting the current value for plan investments. In addition, while the 2010 ERISA Advisory Council studied the issue of limited scope audits and made recommendations, EBSA has not formally evaluated or taken action on those recommendations. As a result, plan administrators using limited scope audits are not consistently presenting plan assets at current value in their financial statements as required by ERISA. Instead, they are using asset values from asset certifications provided by qualified financial institutions even though these certifications may not always be an accurate reflection of current value.

Since 1984, the OIG has recommended repeal of the limited scope audit provision because we believe that this provision no longer serves the purpose intended and increases risk of loss to plan participants and beneficiaries. The OIG most recently reiterated this recommendation in September 2012.⁷ In that audit, we also recommended EBSA clarify the requirements needed to hold and certify plan assets and provide guidance to plan administrators to identify and adequately support the current value of plan assets in limited scope audits. EBSA has yet to take action on these important legislative and regulatory recommendations.

EBSA has agreed that Congress should repeal the limited scope audit exemption. In the past, EBSA has proposed changes to ERISA. However, Congress has not acted to make these changes and EBSA has not proposed eliminating the limited scope audit provision since 1997.

We found 46 percent of the plans in our plans sample received limited scope audits. When using limited scope audits, plan administrators need to understand the nature and scope of the certification the institution has provided before concluding that the certified information may be used to satisfy the administrator's obligation to report the fair value of the assets on the plan's annual report. If the certification does not fulfill ERISA requirements, plan administrators must perform sufficient due diligence to determine the fair value of the assets in question. We found that because plan management does not understand its responsibilities under limited scope audits, they have relied on trustee/custodial statements that did not certify to all the plans' assets or state them at fair market value and did not perform sufficient due diligence. For example:

- One sample plan that received a limited scope audit had approximately \$331 million, or 23 percent, of the plan's total assets invested in hard-to-value alternative investments not included in the trustee's certification. The estimated values for these investments were provided to the plan's management from its investment managers and did not demonstrate the underlying methodologies to support their valuation.
- For another sample plan, approximately \$290 million, or 47 percent, of the plan's total assets were invested in alternative investments not certified by the plan's trustee. These alternative investments were hedge funds and private equity assets whose values were reported by plan management based on information provided by the investment managers or general partners without the underlying methodologies to support their valuations.

Result: A Cascade of Circumstances

Each of the elements discussed in this section adds to the next. The inherent riskiness of alternative investments is compounded by the fact that they are difficult to value.

⁷ Changes Are Still Needed in the ERISA Audit Process to Increase Protections for Employee Benefit Plan Participants (Report No. 09-12-002-12-121).

Adding to the problem is the fact that, lacking concrete guidance by EBSA, plan administrators do not always understand their responsibilities to prudently invest, monitor, and value alternative investments by relying on trustee, custodial, and investment firm statements that do not provide assurances as to the fair market value of these investments. Finally, the limited scope audit exemption results in a lack of independent oversight by the IQPA community. This combination of elements creates an environment that places retirement dollars at risk.

Finding 2 — EBSA Needs to Improve Procedures in Enforcement Reviews of Plans' Valuations of Hard-To-Value Investments

As part of its regional enforcement project initiatives, EBSA's Office of Enforcement (OE) conducted investigations into plan valuations of hard-to-value investments. From FY 2008 to FY 2012, EBSA closed approximately 225 cases involving large plans with hard-to-value investments.

Of the 225 hard-to-value investigative cases it closed from FY 2008 to FY 2012, EBSA issued only eight violations for failure to obtain proper valuations or appraisals. Furthermore, approximately 90 percent of the plans in our enforcement sample either did not obtain independent valuations or did not demonstrate an analytical process to determine the appropriate fair market value of all plan assets. EBSA investigators did not cite any of the plans in our enforcement sample for failure to obtain proper valuations or appraisals. Moreover, for 71 percent of the cases in our enforcement sample, EBSA investigators did not indicate on the reports of investigation that the areas examined and records reviewed for valuations were completed. The following examples illustrate plan failures to obtain independent valuations or have an established process to properly value plan assets.

- In one case, EBSA opened an investigation because a plan lost \$50 million due to investments in the Madoff scheme. Despite the investigation being initiated under the regional hard-to-value program initiative, which looked specifically at issues related to hard-to-value investments, EBSA's report made no mention of the plan's valuation of over \$150 million of other hard-to-value investments. We noted that plan management relied on client statements with "unaudited" values for alternative investments totaling \$148 million from its investment advisor, Ivy Asset Management. As a side note, nearly \$220 million was recovered for victims of Madoff by DOL, the Attorney General of NY, and certain private parties in a settlement with Ivy.⁸ Between 1998 and 2008, Ivy was paid over \$40 million to give advice and conduct due diligence for clients with large Madoff investments. Ivy's due diligence revealed that Madoff was not investing his funds as advertised. For example, Madoff's advertised strategy required him to buy and sell massive amounts of options in securities, but Ivy learned that there were insufficient options traded to support Madoff's purported trading strategy. When

⁸ <http://www.ag.ny.gov/press-release/ag-schneiderman-obtains-210-million-settlement-ivy-asset-management-connection-madoff> & <http://www.dol.gov/opa/media/press/ebsa/EBSA20122100.htm>

questioned, Madoff gave Ivy three vastly different explanations to explain the options problem, all of which Ivy knew to be false. Internal Ivy documents reveal the firm's deep but undisclosed reservations about Madoff. Despite its reservations, Ivy did not disclose its suspicions to clients for fear of losing the fees Ivy received through the Madoff investments.

- In another case, EBSA initiated an investigation after learning that a plan lost \$588 million, or 42 percent, of its total asset value of \$1.4 billion. While EBSA identified that the fund contained mostly hard-to-value investments, the case file did not contain documentation to demonstrate that plan management had obtained independent valuations or an established process to evaluate and determine the fair market value of its hard-to-value investments totaling approximately \$581 million. EBSA did not cite the plan with a failure to obtain proper valuation or appraisal. We also noted the underlying fund's auditors believed that "confirmation" of securities with the fund custodian, provided a reasonable basis for their audit opinion. However, professional auditing standards state simply receiving a confirmation from a third party, either in aggregate or on a security-by-security basis, does not in and of itself constitute adequate audit evidence with respect to the asset valuation or existence.

These are prime examples of why plan management need to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP. Without this process, the reliance on client statements for values that are estimated or unaudited provides no assurances for GAAP and ERISA reporting. Additionally, audited fund values reported by alternative investment entities may not translate into fair value for the plan invested because of complex factors such as illiquidity of ownership interests, possible sale restrictions, the quality of work of the entity's auditors, and other considerations.

In its response, EBSA stated that it provided the OIG documentation to substantiate enforcement reviews of plans' valuation of hard-to-value alternative investments. Based on this documentation, EBSA believed that its investigators properly examined all but 10% of the cases in our sample. However, after reviewing this documentation, the OIG still maintains that for approximately 90 percent of plans in our sample, plan management either did not obtain independent valuations or demonstrate an analytical process to determine the fair market value of all their hard-to-value investments.

We also found potential issues relating to IQPA audit quality in our enforcement sample. EBSA does not have specific procedures in its enforcement investigations to evaluate audit quality with respect to alternative investments, or procedures to refer cases in which EBSA finds potentially substandard audit work to its Office of Chief Accountant (OCA), who is tasked with reviewing audit quality issues. The fact that a plan received an unqualified audit opinion only provides assurances to participants that the audit was

performed according to professional standards. In our enforcement sample, we found poor valuation practices by plan management, which we believe plan IQPAs should have identified and performed additional audit procedures, yet no referrals were made by EBSA investigators to the OCA. IQPAs engaged on behalf of participants to plan audits play an important role in bringing questions, issues, and irregularities discovered during the course of their audit engagement to the attention of the plan administrator. In this regard, we believe, as part of the reviews of certifications, IQPAs should have identified potential problems when plan assets were not certified, or values were not reported at fair value. The limited scope audit exemption applies only to the investment information certified by the qualified trustee or custodian. The AICPA employee benefit plan audit and accounting guide noted that if the plan's auditor becomes aware that the certified information is incomplete, inaccurate, or otherwise unsatisfactory, further inquiry may be necessary which might result in additional testing or modification to the auditor's report. In certain instances, a limited scope audit may no longer be appropriate. In a full scope audit, we would expect to see the plan's auditors performing procedures to verify and test the value of all alternative investments.

The following cases, however, illustrate potential issues of substandard audit quality by plan IQPAs and OE's lack of specific procedures to evaluate audit quality with respect to alternative investments, and specific procedures to refer cases OCA to review further issues of audit quality:

- In a plan with a limited scope audit, the trustee agreement stated that the trustee would have no duty or responsibility to obtain valuations of any trust assets whose value is not readily determinable on an established market. The auditor's opinion report did not refer to additional audit procedures on the plan's hard-to-value investments. The hard-to-value investments reported on bank certification totaled \$1.5 million, representing 12 percent of the plan's assets.
- In another plan with a limited scope audit, the plan's trustee made reference to the need to modify the certification of plan assets as it was waiting for alternative investment entities to provide it with "updated" estimates of values totaling \$25.6 million, or 18 percent, of total plan assets.
- In another plan with a limited scope audit, the trustee certification did not extend to a limited partnership valued at \$10 million, or approximately 18 percent, of the total plan assets. Moreover, the plan administrator relied on the limited partnership's estimate for valuation with no additional support in the case file and the auditor's report did not refer to additional audit procedures on the limited partnership.
- In an example of a full scope audit, the plan administrator relied on a valuation for the alternative investment of \$1.3 million, or 39 percent, of the plan's \$3.3 million of total assets, stating that it was an estimate and provided no assurances for ERISA reporting.

In its response, EBSA takes the position that the fact that a portfolio is professionally managed should somehow affect the plan administrator's role and responsibilities, and appears to endorse the practice of plan administrators relying on values provided by the alternative investment itself ("the role of 'plan management' would be to monitor...these professional advisors"). We disagree. The responsibility for accurately reporting fair values cannot be outsourced or delegated to a party other than plan management. The potential conflict of interest that can arise when investment managers report asset values cannot be underestimated. As a result, plan administrators should not and cannot rely on values provided by investment managers without conducting their own, independent due diligence.

EBSA could take several steps toward improving its ability to detect deficiencies during enforcement reviews of plans with hard-to-value investments. For example, EBSA could design specific procedures to review valuations and determine whether plan management obtained independent valuations for all hard-to-value investments or had an established process to determine the valuation for these types of investments. EBSA could also develop formal procedures to determine the scope and nature of the IQPA's testing of plan assets as it can provide further insight as to the nature of plan asset valuations reported by plan management. OE could also establish specific procedures to make referrals to its Office of Chief Accountant when it finds potential issues of substandard audit quality. Finally, EBSA could share best practices used among regions. From the three EBSA regional offices in our sample, only Cincinnati used a specific questionnaire to inquire of plan management regarding additional information for the plan's hard-to-value investments. This best practice was not shared or used by the other two regions. Without these additional measures, EBSA may not be detecting all potential deficiencies in enforcement reviews for plans with hard-to-value investments.

Finding 3 — The Form 5500 Data Collection Process Does Not Provide Ready Access to Important Information

The Form 5500 is an important compliance, research, and disclosure tool for EBSA. The Form, however, has a limited ability to capture information on hard-to-value investments.

The FASB established a framework for measuring fair value. The framework provides a fair value hierarchy that ranks investments into three levels, level 1 being the most easily valued and level 3 being the most difficult.

Although plans are required by FASB to report levels 1 through 3 investments on their financial statements, and those statements are attached to the Form 5500, this information is not entered in a manner that is readily accessible using automated computer searches by EBSA. In order to determine which investments qualify as levels 2 and 3, EBSA would have to manually open and read the financial statement attached to each Form 5500, then manually tabulate the amounts contained in the notes to the financial statements. By contrast, other areas of the Form 5500 can be queried and

tabulated electronically. The IRS Emerging Issues Task Force recently determined that significant assets invested by plans in alternative investments may be a serious problem. Consequently, it submitted a proposal, on June 15, 2010, to DOL to add content regarding the value of alternative investments in Form 5500. This proposal was not approved. EBSA believed that neither “alternative investments” nor “derivative investments” have a settled meaning and putting such a question on the Form 5500 would likely have implications for the regulated community beyond the scope of the Form 5500.

Schedule H of the Form 5500 captures financial details about the plan’s assets, liabilities, and investments, among others. Question 4g on the Form asks plans if they hold any assets where the fair market value was not readily determinable on an established market and if so, the dollar amount involved. Almost 44 percent of the cases in our enforcement sample that were targeted by EBSA because of hard-to-value investments actually lacked any significant amount of this type of investment. Moreover, almost none of the plans in our plans sample accurately answered this question. In one case, a plan which held over a billion dollars in level 3 investments failed to report them. Because of the limitations in capturing and correlating hard-to-value investments from plan financial statements, EBSA was not able to analyze nor effectively determine plans’ compliance with the Schedule H reporting requirement.

For filing year 2010, less than 1 percent of the 88,000 plans with 100 or more participants and audited financial statements reported holding hard-to-value investments. Based on our audit sample results and the overall reporting rate of less than 1%, the OIG believes the number of plans holding such investments is significantly underreported. As a result, EBSA investigators cannot effectively target plans holding such investments for increased scrutiny.

EBSA officials stated that it uses many different methods of targeting, including information obtained from other investigations, referrals from other government agencies, media reports, and participant complaints. Using varied methods of targeting allows EBSA to identify issues that may not be readily available from the Form 5500. Nonetheless, EBSA officials stated that the agency had already initiated a project with the IRS and PBGC to evaluate changes to the Form 5500 series, including modernizing and improving the financial reporting requirements, in conjunction with evaluation of improvements in the EFAST filing and processing system as part of a future migration from EFAST2 to EFAST3. This change could be beneficial to assist EBSA in ensuring plans’ compliance with Form 5500 reporting and targeting plans with hard-to-value investments by specific asset class.

CONCLUSION

EBSA needs to provide additional oversight and guidance to ERISA plans that hold hard-to-value alternative investments. Without adequate assurances that plan management and fiduciaries prudently select, monitor, and value plan investments, ERISA plans invested in these types of assets can sustain losses from imprudent,

speculative, Ponzi, or other fraudulent schemes, which are prime examples of why assurances of existence and valuation matter. Participants and beneficiaries who are invested in plans to accrue retirement income are at an increasing risk of loss as assets invested in alternative, hard-to-value investments grow.

RECOMMENDATIONS

We recommend the Assistant Secretary for Employee Benefits Security:

1. Improve current protections under current authority to:
 - a. Provide guidance to plan administrators to identify and adequately support the fair market value of hard-to-value plan assets.
 - b. Evaluate and determine the feasibility of ERISA Advisory Council recommendations on hard-to-value alternative investments.
2. Improve enforcement case file reviews by adding procedures to:
 - a. Ensure that plan administrators obtain independent valuations or use an analytical process to determine their fair market value of hard-to-value plan assets.
 - b. Evaluate the type of audit performed, testing of valuation by plans' IQPAs for hard-to-value investments, and make referrals to the Office of Chief Accountant when issues arise regarding potential substandard audit quality.
 - c. Ensure regions share best practices as a result of their regional enforcement initiatives for hard-to-value investments.
3. Improve Form 5500 data collection, analysis, and targeting of plans with hard-to-value investments.

We appreciate the cooperation and courtesies EBSA personnel extended to the Office of Inspector General during this audit. OIG personnel who made major contributions to this report are listed in Appendix E.



Elliot P. Lewis
Assistant Inspector General for Audit

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Appendices

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Appendix A**Background**

The Employee Retirement Income Security Act of 1974 (ERISA) governs the investment of assets in private sector employee benefit plans. ERISA gave oversight to the Department of Labor (DOL) and DOL administers this oversight through its Employee Benefit Security Administration (EBSA). In the context of our report, the terms “fiduciary” and “plan administrator” refer to a person or entity who has control over plan assets, gives investment advice, or has responsibility for plan administration. ERISA requires that plan fiduciaries: 1) carry out their duties with care, skill, prudence, and diligence; and 2) use independent qualified public accountants (IQPA) to audit employee benefit plan financial statements. ERISA also requires that plan administrators report the fair market value of plan assets annually. An accurate fair market valuation of plan assets plays a critical role in determining plan funding levels and payments to participants and beneficiaries. Since 1984, the OIG has reported that legislation aimed at strengthening the quality of plan audits was needed. Audits that meet professional standards are needed to ensure plan management meets its responsibility for proper valuation and reporting of plan assets.

As of 2010, the latest year for which data is available, retirement plans had amassed almost \$3 trillion in alternative investments, of which EBSA estimated anywhere between \$800 billion and \$1.1 trillion were hard-to-value. Estimates of the total dollars invested in retirement plans vary, but are generally thought to be around \$6.5 trillion. In 2010, Internal Revenue Service (IRS) Emerging Issues Task Force determined and reported to EBSA that significant assets invested by plans in alternative investments may be a serious problem.

Plan administrators cannot easily determine the fair market value of alternative investments. Alternative investment entities may be unaudited, not listed on any national exchange, and not subject to state or federal regulation. Plans are also not required to obtain an independent valuation to demonstrate the fair market value of these types of investments. Moreover, ERISA allows plans to elect a “limited scope audit” in which IQPAs perform no auditing procedures to test for existence or valuation of plan assets held and “certified” by a qualifying financial institution. Financial institutions holding these plan assets also need not certify that they are reporting them at fair market value, but only that their records are “complete and accurate.” Lastly, these records could be nothing more than a pass through of estimated values directly from the alternative investment entity, which gives rise to a conflict of interest when it comes to reporting investment losses.

As a result, a potentially unaudited investment entity – which may have an incentive to report gains and asset growth – can provide the values of alternative investments to a financial institution which, in turn, transmits these values to plan administrators without employing any audit procedures, analyses, or due diligence to verify the information provided by the investment entity. Participants and beneficiaries are at an increased risk

for losses due to the lack of transparency and accountability from these types of investments.

In 2010, approximately 70 percent of plans used limited scope audits, up from 46 percent in 1987. The OIG recently reported that EBSA needed to clarify and strengthen limited scope audit regulations.⁹ The ultimate responsibility for accurately reporting the fair market value of plan assets, however, lies with plan administrators.

In a March 21, 1996, Information Letter to the Comptroller of the Currency, Eugene Ludwig, (the “Ludwig Letter”) regarding the investment of ERISA plan assets in derivatives, the DOL indicated that the same fiduciary standards would apply when plan assets are invested in derivatives as when the assets are invested in other investments. This effort would include understanding how the investment fits within the plan’s investment policy, the plan’s potential for losses and an evaluation at the time of initial investment and, as appropriate, on an ongoing basis, of market, credit, legal and operational risks. Fiduciaries should have the requisite expertise to understand the investment, as well as the personnel, control and resources to perform the appropriate analysis, or in the alternative, engage outside experts for such purposes.

The American Institute of Certified Public Accountants (AICPA) Position

The AICPA's position on the valuation of alternative investments, such as hedge funds, real estate, limited partnerships, private equity funds, and other difficult to value investments, was that valuation was problematic. Determining the value of alternative investments, which can fluctuate substantially and may not have readily available market value, and can be extremely difficult. The AICPA noted valuations were subjective, often required the assistance of third party specialists, and were complicated by limited transparency. Many times the valuations of the alternative investments on the books were the “pass through” of the values provided by the fund companies or limited partnerships for commingled funds.

EBSA Regional Office Initiatives

EBSA’s Office of Enforcement (OE) established regional enforcement projects to investigate alternative investments. From Fiscal Years 2008 through 2012, EBSA regional offices closed 225 investigations to target large plans with hard-to-value investments. Over 90 percent of these investigations were closed by the following 4 of the 10 EBSA Regional Offices:

1. Atlanta
2. Cincinnati
3. Boston
4. Los Angeles

⁹ Report Number 09-12-002-12-12.

Appendix B

Objective, Scope, Methodology, and Criteria

Objective

We conducted an audit to answer the following question:

Is EBSA providing adequate oversight of employee benefit plans investing in alternative investments?

The relevant sub-objectives were:

1. To what extent are plan management and fiduciaries demonstrating the prudence of alternative investments?
2. Has EBSA formally evaluated and taken appropriate actions on the ERISA Council's, and other authoritative sources' recommendations to provide guidance for ERISA plans concerning alternative investment practices?
3. Does EBSA enforcement strategy adequately identify and target plans with alternative investments using Form 5500?

Scope

Our scope included all EBSA policies and procedures pertaining to EBSA enforcement reviews of plans with hard-to-value investments for January 1, 2008, through December 31, 2012. Additionally, for plan Filing Year 2010, we reviewed responses for investment information from 45 employee benefit plans with assets in with 20 percent or more of plan assets invested in Alternative Investments. We reviewed prior EBSA and GAO studies on alternative investments. Fieldwork was conducted at EBSA headquarters in Washington, DC, and the Cincinnati, Los Angeles, and Boston Field Offices.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Methodology

To accomplish our audit, we reviewed professional standards, applicable regulations, and EBSA policies and procedures. We also interviewed officials from EBSA, the American Institute of Certified Public Accountants (AICPA), the Pension

Benefit Guarantee Corporation, and reviewed prior ERISA Advisory Council reports to gain an understanding of standards for plans investing in alternative investments.

In planning and performing our audit, we considered EBSA's internal controls that were relevant to our audit objective. We confirmed our understanding of these controls through interviews, obtaining, and reviewing EBSA reviews, policies, procedures, and enforcement actions. Our consideration of internal controls relevant to our audit objective would not necessarily disclose all matters that might be significant deficiencies. Because of inherent limitations in internal controls, misstatements or noncompliance may nevertheless occur and not be detected.

To determine whether EBSA provided adequate oversight of employee benefit plans investing in alternative investments, we reviewed a sample of closed EBSA enforcement cases files for FYs 2008 and 2012 of plans hard-to-value investments. We selected a random sample of 46 case files from the Boston, Cincinnati, and Los Angeles Regional Offices. These 3 regions comprised approximately 54 percent of the 225 closed enforcement cases from FY 2008 through FY 2012. These 46 sampled plans had end-of-year total alternative investments of \$1.6 billion. Of the 46 sampled case files, 21 received limited scope audits and 25 plans received full scope audits.

We also selected and reviewed a stratified random sample of 45 out of 1380 Defined Benefit plans with 20 percent or more of plan assets invested in alternative investments. These 45 sampled plans had end-of-year total alternative investments of \$22 billion. Of the 45 sampled plans, 18 received limited scope audits and 27 plans received full scope audits. For these plans, we contacted plan management to obtain documentation to support the prudence and fair value assumptions of the plan's alternative investments.

For both samples, we reviewed hard-to-value investments as defined by FASB, and determined by the OIG to total more than 5 percent of plan assets. For these investments we reviewed documentation to determine plan management's process for determining the fair market value of these investments, and where applicable, EBSA's evaluation of this process. Since EBSA's enforcement case files of plans with hard-to-value investments were non-statistical, we did not extrapolate our sampled testing to the employee benefit plan filing universe. Similarly, we did not extrapolate our second sampled testing of plans with alternative investments due to limitations in Form 5500 in capturing information on hard-to-value investment reporting.

To achieve the audit's objective, we relied on computer-processed data from the ERISA Filing Acceptance System II (EFAST2) Form 5500 Series plan filings. We assessed the reliability of this data by: (1) performing analytical tests of data elements, (2) reviewing prior OIG and GAO reports on the EFAST2 system, and (3) tracing selected data elements from Form 5500 filings to plan documents.

Based on these tests and assessments, we concluded the data was sufficiently reliable for us to use in meeting the audit's objective.

Criteria

We used the following criteria to accomplish our audit:

- Title I of the Employee Retirement Income Security Act of 1974
- The Pension Protection Act of 2006
- 29 C.F.R. § 2550.404a- Prudent Man Standard for fiduciaries managing plan investments
- 1996 Ludwig Letter- regarding the investment of ERISA plan assets in derivatives
- The Financial Accounting Standards Board Statement No. 157, *Fair Value Measurements* (FASB Statement No. 157)

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Appendix C**Acronyms and Abbreviations**

AICPA	American Institute of Certified Public Accountants
FY	Fiscal Year
DOL	Department of Labor
EBSA	Employee Benefits Security Administration
EFAST	ERISA Filing Acceptance System
ERISA	Employee Retirement Income Security Act of 1974
GAO	Government Accountability Office
GAAP	Generally Accepted Accounting Principles
FASB	Financial Accounting Standards Board
IQPA	Independent Qualified Public Accountant
IRS	Internal Revenue Service
OCA	EBSA's Office of Chief Accountant
OE	EBSA's Office of Enforcement
OIG	Office of Inspector General
SEC	Securities Exchange Commission

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Appendix D

EBSA Response to Draft Report

U.S. Department of Labor

Assistant Secretary for
Employee Benefits Security Administration
Washington, D.C. 20210



SEP 27 2013

DATE:

MEMORANDUM FOR: ELLIOT P. LEWIS
Assistant Inspector General for Audit

FROM: PHYLLIS C. BORZI *Phyllis C. Borzi*
Assistant Secretary of Labor for Employee Benefits
Security

SUBJECT: EBSA Response to OIG Performance Audit
Report No. 09-13-001-12-121

This is in response to the recommendations in your September, 2013 audit report regarding the Employee Benefits Security Administration's (EBSA) oversight, guidance, enforcement, and data collection in connection with the use of hard to value alternative investments by employee benefit plans.

We are concerned that your report overstates the exposure of ERISA-covered employee benefit plans to hard to value investments. For example, your report states:

"EBSA faces challenges meeting its mission because some plans have increasingly shifted assets from traditional investments such as stocks and bonds into an array of complex, hard to define alternative investments such as common collective trusts, private equity funds, limited partnerships, hedge funds, and real estate. As of 2010, the latest year for which data is available, employee benefit plans had amassed almost \$3 trillion in these alternative investments. Of this amount, EBSA estimated that \$1 trillion should be considered hard to value as approximately \$2 trillion can be traced to other line items that generally would not include hard to value assets."

It should be pointed out that the \$3 trillion figure in your report includes \$1.6 trillion invested through master trusts. Master trusts, which pool investments of two or more related benefit plans, are invested mostly in traditional investments such as stocks and bonds. Another \$600 billion of the \$3 trillion consists of interest in common collective trusts, bank-maintained funds that invest mostly in stocks and bonds.

Regarding the estimated \$1 trillion in hard to value assets, we advised that \$798 billion would be a better figure, and even that does not take into account the wide differences in valuation issues among the asset classes reported on the Form 5500, which are included in that estimate. Some, such as "partnership/joint venture interests" are likely to be hard to value. But others are less likely to raise valuation concerns. For example, "assets in insurance company general accounts" includes products such as GICs that guarantee a rate of return and return of principal, which do

not raise similar valuation concerns. “Other general investments” in DC plans includes assets such as publicly traded mutual funds and stocks when they are held through brokerage windows. “Other general investments” in DB plans may be managed by a fiduciary investment manager as defined under ERISA section 3(38), who has a separate responsibility from the plan auditor to ensure proper valuation of assets and who may report asset values to the plan administrator. The ERISA oversight and enforcement issues in such cases would be different from what we would anticipate if a small employer 401(k) plan concentrated its investments in hard to value assets. Thus, the true amount of assets likely to raise meaningful valuation concerns is likely to be a fraction of the \$798 billion, possibly a small fraction.

Your report also asserts that “some plans have increasingly shifted assets from traditional investments such as stocks and bonds into an array of complex, hard to define alternative investments.” Although some plans no doubt made such shifts, by linking this statement with aggregate statistics, your report appears to suggest that this shift has occurred on aggregate. It is possible that any apparent shift toward alternatives might in fact be a shift toward holding traditional assets through intermediary funds rather than directly, and not a trend toward alternatives.

EBSA agrees that additional Form 5500 reporting requirements would be necessary to verify a precise figure for hard to value assets held by ERISA plans. Currently, using Form 5500 data to identify assets that may be “hard to value,” or consist of “alternative investments,” generally requires close manual examination of individual filings. Statistical tabulations of available data elements drawn from line items on Form 5500 can provide estimates of certain categories of assets that may include “hard to value” assets or “alternative investments.” But the total amounts held in these certain categories will be larger than the actual amount of assets that are “hard to value” or consist of “alternative investments.” EBSA is already undertaking an effort to improve reporting requirements.

Overall, the essential message of your report appears to be the statement on page 14 that: “The combination of each of these elements creates an unregulated environment that needlessly places trillions of retirement dollars at risk.” For the reasons set forth in this response, we do not believe that statement is factually or legally accurate, and it is not, in our view, an objective, substantiated observation.

OIG’s RECOMMENDATIONS

Recommendation 1: Improve current protections under current authority to: (a) Provide guidance to plan administrators to identify and adequately support the fair market value of hard to value plan assets; and (b) Evaluate and determine the feasibility of ERISA Advisory Council recommendations on hard to value alternative investments.

EBSA Response: In the Department’s view, investments in alternative investments that are hard to value are subject to the fiduciary responsibility rules in the same manner as are any other plan investments. Those responsibilities derive primarily from the section 404(a) requirements that a plan fiduciary must carry out his/her duties with the care, skill, prudence and diligence of a knowledgeable person under similar circumstances, including the duty of investing plan assets.

Plan fiduciaries, in determining whether to invest in alternative investments, including those that may be hard to value, are required to engage in the same general procedures and undertake the same type of analysis that they would in making any other investment decision. This process would include, but not be limited to, consideration of how the investment fits in the plan's investment policy; the role of the investment in the plan's portfolio, taking into account the risk of loss and the opportunity for gain or other return associated with the investment. Plan fiduciaries also need to consider how the investment will affect diversification, liquidity, and the projected returns relative to the funding objectives of the plan. The analysis should further include a review of the methodology for valuing changes in the value of the investment; and if investing in a pooled fund, whether the managers are qualified to manage the asset, and whether the managers of the fund are ERISA fiduciaries. This issue generally turns on whether the fund/investment is determined to be holding "plan assets" within the meaning of ERISA. Fiduciaries that lack the knowledge to perform this analysis for a particular investment would need to consult with someone who has the requisite expertise.

As pointed out in your report, EBSA issued a regulation addressing when a fiduciary would be treated as having satisfied his or her duties under ERISA to act in connection with an investment or investment course of action with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man 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. The most comprehensive discussion of these principles in the context of hard to value type assets appears in a March 21, 1996 letter from the DOL Assistant Secretary for Pension and Welfare Benefits to the Comptroller of the Currency dealing with investments and derivatives. Although the letter is focused on derivatives, EBSA officials have said, including in testimony before the ERISA Advisory Council, that the Ludwig letter made salient points which would be equally applicable with respect to other non-traditional investments, including hard to value alternative investments.

The specific analysis required of a fiduciary, however, will vary depending on the individual facts and circumstances. For example, the type of plan would be a relevant fact, that is, the role of a hard to value or alternative investment might be different depending on whether it is an asset of a defined benefit plan, or an investment option under a defined contribution plan. The so-called "Benages Letter" cited in your report was case specific, and was not issued as generally applicable guidance under section 404 for all plans under all circumstances. As your report points out, in 1988 EBSA issued a proposed regulation on the term "adequate consideration" in ERISA. At a minimum, in light of the passage of time and changes in the pension marketplace, EBSA would need to re-propose the regulation before completing this rulemaking. That decision would have to be considered in the context of EBSA's other regulatory priorities (most importantly our conflict of interest rule for investment advice) and resource constraints.

Historically, the Department has advocated for statutory amendments to ERISA that would repeal the limited scope audit exemption and provide EBSA with more effective regulatory authority over ERISA plan auditors. Congress, however, has not enacted any legislation in this area. As stated in our response to the OIG report on this topic last year, we appreciate the OIG's continued attention to this audit quality issue, and have used the OIG report as an opportunity to

advocate for legislative change. Notwithstanding our support for repeal of the limited scope audit provisions in ERISA, we do not believe the current statutory provisions permit or result in an “unregulated environment that needlessly places trillions of retirement dollars at risk.” Rather, under 29 C.F.R. § 2520.103-8, which interprets and implements section 103(a)(3)(C) of ERISA, the examination and report of an independent qualified public accountant need not address any statements or information regarding plan assets held by a bank, similar institution or insurance carrier, which is regulated and supervised and subject to periodic examination by a State or Federal agency, provided that the statements or information regarding assets so held are prepared and certified to by the bank or insurance carrier in accordance with 29 C.F.R. § 2520.103-5. Paragraph (d)(1) of § 2520.103-5 provides, in part, that: “An insurance carrier or other organization, a bank, trust company, or similar institution, . . . shall certify to the accuracy and completeness of the information described in paragraph (c) of this section by a written declaration which is signed by a person authorized to represent the insurance carrier, bank, Such certification will serve as a written assurance of the truth of the facts stated therein.”

With respect to recommendation 1(b), we previously advised the Government Accountability Office that we plan to consult with other federal agencies with regulatory or enforcement responsibilities for alternative investments such as hedge funds and private equity investments to discuss whether and how to develop useful investor guidance regarding hard to value, alternative investments and investment strategies. We have consistently pointed out that the great variety of alternative investments could make development of comprehensive and useful guidance difficult. Moreover, to the extent that alternative investments are held by large defined benefit plans or otherwise in professionally managed accounts, we would need to consider whether EBSA’s limited resources should be dedicated to providing investment guidance to such sophisticated fiduciaries.

Recommendation 2. Improve enforcement case file reviews by adding procedures to: (a) Ensure that plan administrators obtain independent valuations or use an analytical process to determine their fair market value of hard to value plan assets; (b) Evaluate the type of audit performed, testing of valuation by plans’ IQPAs for the hard to value investments, and make referrals to the Office of Chief Accountant when issues arise regarding substandard audit quality; and (c) Ensure regions share best practices as a result of their regional enforcement initiatives for hard to value investments.

EBSA Response: With respect to recommendation 2(a), plans are required to report the value of assets at their “current value,” which—with respect to assets that do not have a market value—is defined under ERISA Section 3(26) to mean their fair value as determined in good faith by a trustee or named fiduciary in accordance with regulations of the Secretary. There is no explicit requirement in ERISA or the Department’s regulations that requires plans to obtain independent valuations of hard to value assets. However, plan fiduciaries in all their activities, including reviewing and reporting on valuations must act prudently and solely in the interests of plan participants and beneficiaries. As pointed out in your report, our 1988 proposed regulation on “adequate consideration” was not finalized. As noted in your report, one of our Regional Offices noted that most valuation practitioners do consider the Department’s proposed regulation in discharging their responsibilities. Thus, some plan fiduciaries in fact rely on that proposed regulation in managing plan assets notwithstanding the fact that the proposed regulation has not

been adopted as a final rule. Nonetheless, for EBSA to adopt a specific “independent valuation” requirement for plan administrators or other fiduciaries to obtain valuations of hard to value assets would require EBSA to engage in notice and public comment rulemaking.

EBSA investigators currently evaluate plan fiduciaries’ processes in the selection, monitoring, and valuation of hard to value investments. For example, the Cincinnati Regional Office (CinRO), as part of its standard procedures in connection with alternative investment cases, reviews plan level due diligence efforts both in the initial selection and the monitoring of such investments. The details of these efforts are generally captured through interviews of plan fiduciaries, including but not limited to plan trustees, investment advisors, and investment managers. EBSA investigators also review the process that plan administrators use to evaluate and report the value of hard to value assets. Investigators review documents and conduct on-site interviews with plan fiduciaries to uncover the nature of their procedures with respect to evaluating the current value of hard to value investments. This EBSA review process is important because of potential fiduciary breaches that could occur as a result of improperly valuing assets, including paying too much for an investment, failing to appropriately diversify a plan’s investments, or paying incorrect performance-based fees to service providers. If an investigation concludes that the plan fiduciaries failed to prudently select, monitor and value investments, EBSA would pursue correction of process deficiencies as well as any losses as a result of these fiduciary breaches. Therefore, OIG’s finding that 71% of the enforcement cases in the sample did not indicate on the reports of investigation that the areas examined and records reviewed for valuations were completed is misleading.

EBSA’s Office of Enforcement reviewed the underlying documents received in the enforcement sample of 46 plans, including documents pertaining to the investments themselves (including audited financial statements prepared for the asset managers) and reports of interviews. After reviewing the totality of investigative documents, we determined that in five of the investigations, the plan did not hold alternative investments. These plans either mischaracterized the investments, or improperly reported them on the Form 5500. Three of the cases involved participant directed accounts which had invested in the alternative investment. Two of the plans had sold the alternative investments. Of the remaining 36 cases, EBSA investigators reviewed the valuation of alternative investments, either in whole or in part, in 33 of them. In only three (3) investigations was there no indication that valuations were reviewed. Therefore, EBSA believes that at least 90 percent of the investigations in the OIG enforcement sample involving plans which currently hold alternative investments included a review of alternative investment valuations. We have provided OIG with the supporting documents.

Finally, we believe the report should consider the role of professional investment managers and consultants in the selection and monitoring of hard to value assets. EBSA believes that many plans invested in hard to value assets are professionally managed. In such cases, the role of “plan management” would be to monitor the activities of these professional advisors; normally with the help of outside consultants. Whether a plan’s investments are professionally managed does affect the manner in which investigators conduct the evaluation of the selection and monitoring of investments.

Although plan fiduciaries may in appropriate cases rely on the values reported by the management of the hard to value assets, our investigations have shown that these reported values

are often based on described and justifiable methodologies. In addition, some of these assets are independently audited. Hard to value assets may represent a non-material percentage of plans' overall investment portfolio. If that is the case, especially if the plan is a fully-funded or over-funded defined benefit plan, investigators may decide not to expend their limited resources on evaluating the process used by plan administrators in reporting these plan assets.

With respect to recommendation 2(b), cases are referred to the Office of the Chief Accountant (OCA) if the investigator finds the audited financial statements are deficient, or if there are no audited financial statements when required. EBSA has a procedure to refer such cases to OCA on a specific referral form. Although EBSA agrees that the referral form does not have a specific checkbox for OCA referral based on a deficient audit, the form has a "Reason for Referral" section that allows the investigator to note the reason. Instructions clearly state the referrals should be made when there are "auditor or accountant breaches of professional responsibilities".

The Regional Offices have developed strategies for evaluating fair value measurements and disclosures. For example, the CinRO specifically reviews alternative investments to ensure that valuations of a fund and/or of underlying funds are performed regularly, using standard valuation practices, and that the fund is audited by an independent, reputable third party. These details, including the identity of the independent, reputable third party auditing the fund's financial statements, are included in the memo the CinRO prepares with respect to alternative investment cases. Furthermore, the CinRO also has a list of questions that it utilizes in its alternative investment cases, which the OIG referenced as a best practice in its findings. Although an investigator might not ask any single fiduciary all the questions on this list, the salient points are generally covered during interviews and subsequently documented in the alternative investment memo prepared for the case file.

We provided two EBSA guidance memos issued to the field describing the role of an Independent Qualified Public Accountant (IQPA). These memos indicate that the IQPA's failure to identify and report plan assets at fair value could result in the IQPA becoming a knowing participant in a fiduciary breach. If investigative results indicate that the conduct of the IQPA has risen to the level of possible knowing participation, it may indicate a breach of professional responsibilities and should be referred to OCA.

In response to Recommendation 2(c), EBSA agrees that investigating alternative or hard to value investments is a complex subject. To address this, EBSA in FY 2013 provided training to its investigators on alternative investments conducted by the New York Institute of Finance. A significant portion of EBSA's new internal Advanced Issues Training course is devoted to alternative investments and valuations. Three regions have regional projects on alternative investments, and the other remaining regions conduct investigations involving such assets. Our Los Angeles Regional Office has initiated an OCA Alternative Investment Valuation Project as a sub-project under its ongoing Alternative Investment Project. We have an established, internal web site which includes best practices incorporating CinRO's questionnaire and other investigative resources. We will also consider the feasibility in developing an asset valuation guideline for investigators.

Recommendation 3. Improve Form 5500 data collection, analysis and targeting of plans with hard to value investments.

EBSA Response: The Form 5500 report already focuses on asset valuation issues in several ways. As to the annual reporting requirement, administrators of employee pension benefit plans are normally required to file an annual report – Form 5500 Series - with the DOL under Sections 101 and 103 of ERISA. The Form 5500 requires a “current value” basis for reporting the plan’s assets, as defined in Section 3(26) of ERISA. Large plans that file the Form 5500 must break their investments into specific asset classes and include a schedule that individually lists each investment held by the plan at the end of the plan year, including cost and current value information. Large plans are also required to answer a specific question on Schedule H of the Form 5500 that asks whether the plan holds any investments that do not have readily determinable market value or that were not valued by an independent third party appraiser. If they hold such investments, they must provide a total value for those holdings.

Small plans do not have to include as much detail regarding their investment portfolios, but they must separately identify several investment classes that are generally viewed as hard to value, such as real estate, partnership/joint venture interests, and employer securities. Those small plans must also answer the specific question on Schedule I of the Form 5500 on whether they hold hard to value investments. In the case of assets for which there is no readily ascertainable value, a plan fiduciary thus must make a good faith determination of the value of the asset. This obligation even applies in the case where the plan is subject to an annual audit requirement and avails itself of the limited scope audit option permitted by ERISA. EBSA issued guidance on this point in a May 2002 letter to Richard M. Steinberg, Chair of the Employee Benefits Expert Panel, Department of Labor Liaison Taskforce of the American Institute of Certified Public Accountants.

The largest number of ERISA pension plans are small plans that are eligible to file the Form 5500-SF, which requires, among other things, that the plan meet the conditions for being exempt from the requirement that the plan’s books and records be audited by an independent qualified public accountant (IQPA) and have 100% of its assets invested in certain secure investments with a readily determinable fair value. For that purpose, secure assets with a readily determinable fair value include assets that your report classifies as alternative investments, i.e., investment contracts with insurance companies or banks that provide the plan with valuation information at least annually.

We understand that your audit led you to conclude that plan administrators are not correctly answering the specific question of whether the plan holds any hard to value assets. We agree that your audit conclusions merit further examination by EBSA to determine whether there is a general reporting compliance problem in this area. Nonetheless, we think your report failed to properly distinguish the types of employee benefit plans holding hard-to-value assets, and the types of hard to value assets held by those different types of plans. Basing your conclusions on investment practices of large defined benefit pension plans together with small employer 401(k) plans, for example, may not properly present the nature of the hard to value asset issues that exist in pension plan portfolios.

We also think it is important to note that EBSA uses many different methods of targeting, including information obtained from other investigations, referrals from other government agencies, media reports, and participant complaints. Using varied methods of targeting allows EBSA to identify issues which may not be readily available from the Form 5500. Nonetheless, as you note in your report, EBSA already initiated a project with the IRS and PBGC to evaluate changes to the Form 5500 series in conjunction with evaluation of improvements in the EFAST filing and processing system as part of a future migration from EFAST2 to EFAST3. Modernizing the financial reporting requirements on the Form 5500 and making investment information more data mineable are part of that evaluation.

We appreciate the opportunity to provide our comments.

Appendix E

Acknowledgements

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