U.S. Department of Labor

Office of Inspector General—Office of Audit

EMPLOYEE BENEFITS SECURITY ADMINISTRATION

EBSA NEEDS TO DO MORE TO PROTECT RETIREMENT PLAN ASSETS FROM CONFLICTS OF INTEREST

Date Issued: September 30, 2010
Report Number: 09-10-001-12-121

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

BRIEFLY…

Highlights of Report Number: 09-10-001-12-121, to the Assistant Secretary for the Employee Benefits Security Administration.

WHY READ THE REPORT

The report discusses EBSA's efforts to protect pension plan assets from conflicts of interest in pension plan service providers. Conflicts of interest affecting pension plans arise when a service provider has competing professional or personal interests. Such competing interests can hinder the service provider's and the plan fiduciary's ability to fulfill duties impartially and act solely in the interest of plan participants or beneficiaries.

Conflicts of interest are of concern in most ERISA covered pension plans. In 2005, the SEC examined 24 service providers who were registered investment advisers; and therefore, fiduciaries under SEC rules. The SEC found inadequate disclosure of continuing conflicts of interest in 13 of the 24 service providers (54 percent). These 13 service providers, as investment advisers, had more than $4.5 trillion in assets under advisement. Furthermore, these service providers had contracted with defined benefit plans that had total assets of $183.5 billion and average assets of $155.3 million per plan.

WHY OIG CONDUCTED THE AUDIT

The audit objective was to answer the question: Has EBSA taken action to evaluate and reduce risk of harm to plan participants from conflicts of interests in pension service providers?

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/2010/09-10-001-12-121.pdf.

September 30, 2010

EBSA NEEDS TO DO MORE TO PROTECT RETIREMENT PLAN ASSETS FROM CONFLICTS OF INTEREST

WHAT OIG FOUND

EBSA has taken several actions to evaluate and reduce risk of harm to plan participants and beneficiaries from conflicts of interest in service providers. For example, EBSA (1) developed two new regulations regarding fee determinations and disclosures and is requiring this information be reported to EBSA; (2) followed up on the 2005 SEC report on conflicts of interest and initiated 12 specific investigations; (3) worked with the SEC to develop guidelines for plan fiduciaries to use in selecting and monitoring specific service providers, and (4) implemented the Consultant Adviser Project, which concentrated resources on improper, undisclosed compensation by certain service providers.

While these actions go a long way toward creating transparency in plan activities and improving protections for plan assets and participant benefits, EBSA needs to do more to protect plan participants and beneficiaries from conflicts of interest in service providers. Specifically, EBSA needs to address other critical regulatory areas, such as broadening the definition of fiduciary status for investment advisers, requiring disclosure of all conflicts of interest and consideration of these conflicts of interest by plan fiduciaries when selecting service providers.

The narrow definition of a fiduciary and the lack of regulations dealing with conflicts of interest has hampered EBSA's enforcement program. For example, while the SEC reviewed 24 pension service providers and took action on 13 instances of inadequate disclosure of conflicts of interest, EBSA, using its regulations, could not take any enforcement action on the inadequate disclosure to pension plans.

WHAT OIG RECOMMENDED

The OIG recommended that EBSA: (1) broaden the definition of a fiduciary for investment advisers, and (2) develop regulations requiring disclosure of all conflicts of interest and consideration of conflicts of interest in selection of service providers.

The Assistant Secretary for the Employee Benefits Security Administration agreed with the finding and recommendations.

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Table of Contents

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U.S. Department of Labor

Office of Inspector General
Washington, D.C. 20210

September 30, 2010

Assistant Inspector General's Report

Phyllis C. Borzi
Assistant Secretary
for the Employee Benefits Security Administration
US Department of Labor
200 Constitution Avenue, NW
Washington, D.C. 20210

The Office of Inspector General (OIG) conducted a performance audit of the Department of Labor's (DOL) Employee Benefits Security Administration's (EBSA) oversight of pension plan service providers' conflicts of interest.

The private retirement system in the United States involves about $6 trillion of investments for more than 124 million Americans. There are about 708,000 retirement plans throughout the country.

The Employee Retirement Income Security Act of 1974 (ERISA) is the primary federal law governing the investment of these assets and private sector employee benefit plans in general. ERISA assigns DOL primary responsibility to enforce the fiduciary provisions of ERISA Title I. DOL administers this responsibility through EBSA.

ERISA relies heavily on the designation of fiduciaries and adherence to fiduciary standards of conduct to protect plan participants and beneficiaries. The plan document of an employee benefit plan identifies specific fiduciaries responsible for administering the plan. ERISA also defines other types of persons who may be a plan fiduciary and specifically states a person providing investment advice for a fee is a fiduciary to the plan.

Under ERISA's fiduciary standards, plan fiduciaries must act solely for the benefit of the participants and beneficiaries, and must act (1) exclusively for providing benefits and defraying expenses; (2) with skill, care, prudence, and diligence; (3) by diversifying investments; and (4) by following plan requirements.

To administer an employee benefit plan, plan fiduciaries often contract with service providers to provide professional services, such as assisting in determining the plans investment objectives and restrictions, allocating plan assets, selecting money managers, choosing mutual fund options, tracking investment performance, and selecting other service providers. Conflicts of interest affecting the plan arise when a

service provider has competing professional or personal interests. Such competing interests can hinder the service provider's and the plan fiduciary's ability to fulfill duties impartially and act solely in the interest of plan participants or beneficiaries. For example, a plan's investment adviser may receive compensation from a mutual fund company based on share purchases made by the plan's participants. This could sway the adviser's recommendations to buy that mutual fund company's shares.

Conflicts of interest are of concern in most ERISA covered pension plans. In 2005, the Securities and Exchange Commission (SEC) examined 24 service providers[1] who were registered investment advisers; and therefore, fiduciaries under SEC rules. The SEC found inadequate disclosure of continuing conflicts of interest in 13 of the 24 service providers (54 percent). These 13 service providers, as investment advisers, had more than $4.5 trillion in assets under advisement. Furthermore, these service providers had contracted with defined benefit plans that had total assets of $183.5 billion and average assets of $155.3 million per plan.

Furthermore, in 2007, the Government Accountability Office (GAO) also issued a report stating that conflicts of interest involving high-risk or terminated plans posed enforcement challenges to EBSA.

The audit objective was to answer the question: Has EBSA taken action to evaluate and reduce risk of harm to plan participants from conflicts of interests in pension service providers?

Our scope included all EBSA policies, procedures, and actions taken for identifying and evaluating conflicts of interest in service providers from October 1, 2006, through June 30, 2010.

We interviewed EBSA officials to obtain an understanding of the enforcement process relative to conflicts of interest, to follow up on the SEC and GAO reports, and to obtain information regarding proposed/final regulations relating to conflicts of interest. We obtained a list of EBSA's Consultant Adviser Project (CAP) cases as of June 30, 2010, and a watch list of potential CAP cases as of February 1, 2010, to understand how these cases were developed. We interviewed officials from the SEC to obtain an understanding of the process used in developing the SEC report and reviewed all 12 investigations initiated by EBSA because of the SEC report.

Finally, we reviewed a stratified random sample of 30 out of 2,455 fiduciary investigations EBSA closed during FY 2009 to understand the investigation process relative to conflicts of interest and interviewed the investigators for each case about the process used to evaluate service provider's conflicts of interest in the investigation.

[1] The 2005 SEC report uses the term "pension consultant" to refer to the persons/entities examined. The SEC examination covered persons/entities who were registered investment advisers under the Investment Advisers Act of 1940. These "pension consultants" fall under the broad term "service provider" used in EBSA regulations.

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

RESULTS IN BRIEF

EBSA has taken several actions to evaluate and reduce risk of harm to plan participants and beneficiaries from conflicts of interest in service providers. For example, EBSA (1) developed two new regulations designed to provide better information regarding fee determinations and disclosures and is requiring this information be reported to EBSA on the Form 5500[2]; (2) followed up on the 2005 SEC report on conflicts of interest by reviewing all 24 SEC cases and initiating 12 specific investigations; (3) worked with the SEC to develop guidelines for plan fiduciaries entitled "Selecting and Monitoring Pension Consultants - Tips For Plan Fiduciaries;" and (4) implemented the CAP, which concentrated resources on improper, undisclosed compensation by certain service providers.

While these actions go a long way toward creating transparency in plan activities and improving protections for plan assets and participant benefits, EBSA needs to do more to protect plan assets and plan participants from conflicts of interest in service providers. Specifically, EBSA needs to address other critical regulatory areas, such as broadening the definition of fiduciary status for investment advisers, requiring disclosure of all conflicts of interest and consideration of these conflicts of interest by plan fiduciaries when selecting service providers. The narrow definition of a fiduciary and the lack of regulations dealing with conflicts of interest has hampered EBSA's enforcement program. While the SEC/EBSA's guidelines are helpful in focusing attention on conflicts of interest, EBSA cannot incorporate the guidelines into its enforcement program because it cannot enforce compliance unless there are regulations. The results of this can be seen in that the SEC, in reviewing 24 pension service providers, found 13 instances of inadequate disclosure of conflicts of interest. EBSA, using its regulations, could not take any enforcement action on the inadequate disclosure to pension plans. EBSA did find two instances of prohibited transaction under ERISA in its review of the SEC cases.

We made the following two recommendations that would strengthen EBSA's enforcement program relative to conflicts of interest: (1) broaden the definition of a fiduciary for investment advisers, and (2) develop regulations requiring disclosure of all

[2] Each year, pension plans generally are required to file the Form 5500, Annual Return/Report of Employee Benefit Plan, regarding their financial condition, investments, and operations. The Department of Labor, Internal Revenue Service, and the Pension Benefit Guaranty Corporation jointly developed the Form 5500 series so employee benefit plans could utilize it to satisfy annual reporting requirements under Title I and Title IV of ERISA and under the Internal Revenue Code.

conflicts of interest and consideration of conflicts of interest in selection of service providers.

In response to our report, EBSA stated that they agreed with the report recommendations. Further, EBSA stated that the report reinforces EBSA's view that more can and should be done to address potential conflicts of interest and other issues arising in connection with the selection of service providers. Regarding the recommendations, EBSA indicated they had started over a year ago to broaden the definition of a fiduciary. EBSA also stated one of its highest priorities has been the adoption of a regulation that would ensure plan fiduciaries are furnished the information they need to make informed decisions about service providers.

EBSA's written response to the draft report is provided in its entirety in Appendix D.

RESULTS AND FINDING

Objective — Has EBSA taken action to evaluate and reduce risk of harm to plan participants from conflicts of interests in pension service providers?

EBSA has taken several actions to evaluate and reduce risk of harm to plan participants from conflicts of interest in service providers. However, to further increase protections for plan participants and beneficiaries, EBSA needs to develop additional regulations to broaden the definition of a fiduciary as it relates to investment advisers, require service providers to disclose all conflicts of interest, and clearly require plan fiduciaries to consider all conflicts of interest in selecting service providers.

Finding — EBSA Needs To Develop Additional Regulations To Protect Plan Participants And Beneficiaries From Conflicts Of Interest In Service Providers.

EBSA needs to develop additional regulations relating to conflicts of interest and incorporate these regulations into its enforcement program to better protect plan participants and beneficiaries. Specifically, EBSA needs to address the following critical regulatory areas: (1) broadening the definition of fiduciary status for investment advisers, (2) requiring disclosure of all conflicts of interest, and (3) requiring fiduciaries to consider conflicts of interest when selecting service providers. The narrow definition of a fiduciary and the lack of regulations dealing with conflicts of interest has hampered EBSA's enforcement program relative to conflicts of interest. As a result, EBSA has not been able to take enforcement action on lack of disclosure by service providers or ensure plans have appropriately considered conflicts of interest in selecting service providers.

Definition of a Fiduciary Needs to be Broadened — ERISA's protections for employee benefit plans are heavily dependent on the assignment of fiduciary duties and responsibilities to protect plan assets and plan participants and beneficiaries. ERISA Section 402(a)(1) requires that plans have at least one named fiduciary responsible for

administering the plan. ERISA Section 404(a)(1) further requires fiduciaries to be prudent and act only for the benefit of the plan participants and beneficiaries while diversifying assets and complying with plan documents.

Section 3(21)(A) of ERISA provides that a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

EBSA has issued regulations specifying that to be considered as rendering investment advice and be considered a fiduciary under (ii) above, a person must 1) give advice regarding the purchase or sale of securities or other property of a plan; 2) on a regular basis; 3) pursuant to a mutual agreement, arrangement, or understanding; 4) as a primary basis for investment decisions; and 5) based on the particular needs of the plan. According to EBSA, investment advisers use these criteria to avoid meeting the definition of a fiduciary and therefore, are not liable for meeting fiduciary standards. This has been particularly true for investment advisers from large companies with the resources and sophistication to be aware of technicalities and approaches that can enable the investment adviser to avoid fiduciary status and liability.

Without this status, EBSA cannot enforce conflict of interest issues. For example, without fiduciary status EBSA cannot hold a service provider to a standard of prudent action or actions only for the benefit of the participants. This is required only of fiduciaries. Without fiduciary status, EBSA cannot hold a service provider liable for fiduciary breaches.

This was evident in EBSA's review of the results of the 2005 SEC study regarding conflicts of interest. For its study, the SEC used its own criteria: The Investment Advisers Act of 1940 and related interpretations. All advisers registered under this act, owe their clients a fiduciary duty. Using this criteria, the SEC considered all 24 service providers examined to be investment advisers and fiduciaries. Furthermore, 13 of the 24 investment advisers had not met their fiduciary duty to disclose all material conflicts of interest to pension plan clients.

When EBSA reviewed the 24 cases, it found 12 potential ERISA violations. When EBSA then applied its definition of a fiduciary, it did not consider 3 of the 12 investment advisers to be fiduciaries at all under its criteria, and did not consider 3 other investment advisers to be fiduciaries to all plans they served, which complicated enforcement. Overall EBSA's review of the investment advisers in the SEC study found two cases involving ERISA violations.

In these two cases, the investment advisers were fiduciaries under EBSA regulations and were engaged in prohibited transactions. In one case, the investment adviser, as a

fiduciary, received undisclosed and unauthorized compensation, and failed to provide timely promised commission rebates to certain ERISA plans. Since the investment adviser met EBSA's definition of a fiduciary to the plan, EBSA was able to hold the investment adviser to fiduciary standards and take strong enforcement. EBSA obtained restoration of more than $300,000 to the plan.

In some cases, the investment advisers essentially eliminated themselves from fiduciary status. They simply stated in their investment adviser contract that they were not fiduciaries. This put EBSA in a difficult enforcement position since one of the tests in their fiduciary criteria for investment advice was that there had to be mutual agreement between the plan and the investment adviser on the investment adviser's status. If the investment advisers stated in the contract that they were not fiduciaries, it would be difficult for EBSA to show they had agreed otherwise, no matter whether the plan had intended for the investment advisers to be fiduciaries.

EBSA wrote the fiduciary definition in 1974 and has not updated it. Financial and business relationships have changed significantly since that time and the definition of a fiduciary has not been kept current. As a result, EBSA frequently cannot effectively address conflict of interest situations. Recognizing the new challenges and environment in investments, EBSA had placed examining its definition of a fiduciary on its regulatory agenda for 2010. Completing this regulation and broadening the definition of a fiduciary, especially as it relates to investment advisers, is necessary to provide improved protections for plan participants and beneficiaries.

EBSA Needs To Require Disclosure Of All Conflicts Of Interest — There is no regulatory requirement for service providers to disclose all conflicts of interest to plan fiduciaries. While it may be considered part of a fiduciary's duty, EBSA has not had a regulatory requirement in place requiring service providers to disclose all conflicts of interest to plan fiduciaries. Therefore, it has been difficult for EBSA to take action when service providers do not disclose all conflicts of interest. Disclosure of all conflicts of interest is important because it is critical for plan fiduciaries to understand a service provider's business relationships and arrangements with others in order to evaluate whether these relationships may influence the service provider in its services to the plan.

In recent years, there have been a number of changes in the way many service providers assist in administering pension plans, the way clients compensate service providers, and how service providers operate in relation to other businesses. The complexity of these changes, particularly in the investment environment, has made it more difficult for plan fiduciaries to understand what the plan actually pays for the specific services rendered and the extent to which business relationships among service providers present potential conflicts of interest that may affect the costs and quality of services provided.

Section 404(a)(1) of ERISA requires plan fiduciaries, when selecting service providers, to act prudently and solely in the interest of the plan's participants and beneficiaries and

for the exclusive purposes of providing benefits and defraying reasonable expenses of administering the plan. Fundamental to a fiduciary's ability to discharge these obligations properly is the availability of information, such as conflicts of interest, sufficient to enable the fiduciary to make informed decisions about the services, the costs, and the service provider itself.

In this regard, EBSA has published regulations concerning the disclosure and other obligations of plan fiduciaries and service providers under ERISA. However, EBSA's regulations have not included a requirement that plan service providers disclose all conflicts of interest, financial or otherwise. EBSA's recently issued regulation (29 CFR 2550-408b-2) describes what constitutes a reasonable contract under ERISA, but does not specifically require disclosure of all conflicts of interest, even if unrelated to compensation for plan services. Until recently, it was possible to have a reasonable contract or arrangement without disclosing any conflicts of interest, including financial conflicts.

Recently, EBSA has developed several regulations including new disclosure requirements of a reasonable contract for service providers, including investment advisers, to the pension plans. For example, a new requirement in Form 5500, Schedule C became effective on January 1, 2009. It requires the identification of any person who rendered services to, or who had transactions with, the pension plan during the reporting year if the person received, directly or indirectly, $5,000 or more in reportable compensation in connection with services rendered to the plan.

Furthermore, in July 2010, EBSA finalized an interim-final regulation that will require certain covered service providers to disclose the compensation they will receive, directly or indirectly, in connection with its services to the plan. This is the first time for a regulatory disclosure requirement for a service provider designed to ensure the service provider provides ERISA plan fiduciaries the information they need to make better decisions when selecting service providers for their plans. The final regulation will be effective for contracts or arrangements between plans and service providers on July 16, 2011.

However, EBSA still does not require disclosure of all conflicts of interest. Specifically, service providers do not have to disclose business or personal relationships not involving compensation. For example, in one case the SEC found, a service provider had not disclosed that financial institutions paid the service provider to attend a conference the service provider provided for its clients. Specifically, to help defray the costs of the conference, plan sponsor attendees paid a registration fee of $850 while the financial institution paid a subsidy fee of $20,000. Since the service provider could potentially evaluate some of the financial institutions, or their affiliates, as part of its services to plan fiduciaries, this constituted a material conflict of interest to the SEC. EBSA's new regulations do not require this type of conflict to be disclosed.

In another case, the SEC found the majority of money managers recommended by a specific service provider also purchased other products/services from the service

provider or its affiliates. Furthermore, according to the SEC, those money managers who purchased one or more products or services from the company had a greater chance of being recommended than those who did not purchase any such products or services. The company failed to provide full disclosure that a material conflict of interest existed when recommending money managers who provided it with compensation. This arrangement would not be required to be disclosed under current EBSA regulations.

These cases show how conflicts of interest can go undisclosed under EBSA regulations. During the audit, EBSA stated that the interim-final regulation might already provide the requirement for the disclosure of all conflicts of interest and they are in the process of providing clarifying interpretations. However, we do not believe the regulation clearly requires disclosure of all conflicts of interest. EBSA needs to develop regulations to require these conflicts of interest to be disclosed to plan fiduciaries.

EBSA Needs To Require Plans To Consider Conflicts Of Interest In Selecting Service Providers — At the present time, EBSA regulations do not require plan fiduciaries to consider conflicts of interest in selecting service providers. EBSA must show damage to plan participants before it can take any action. As a result, plans may not be considering conflicts of interest in selecting service providers.

As a result of the SEC report, EBSA and the SEC worked together to produce a document titled “Selecting and Monitoring Pension Consultants – Tips for Plan Fiduciaries.” It is a set of questions to assist plan fiduciaries in evaluating the objectivity of the recommendations provided, or to be provided, by a pension consultant, one type of service provider. The document specifically states:

> To encourage the disclosure and review of more and better information about potential conflicts of interest, the Department of Labor and the SEC has developed . . . {a} set of questions to assist plan fiduciaries in evaluating the objectivity of the recommendations provided, or to be provided, by a pension consultant.

The document has seven questions plan fiduciaries are encouraged to ask their pension consultants to identify conflicts of interest and to encourage plan fiduciaries to assess the potential impact of conflicts of interest.

However, the use of this document and the questions is not mandatory. Furthermore, EBSA developed it for fiduciaries use in selecting pension consultants, which, according to EBSA, does not include all service providers. There also is no requirement to establish a process, which accomplishes the same purpose in performing the plan fiduciary’s duty. EBSA has no means to enforce the guidance and does not formally incorporate it into their enforcement program.

As a result, EBSA has not had any specific regulatory criteria to incorporate into its enforcement program and no benchmark against which to measure the effectiveness of

plans selection of service providers. The lack of a requirement for plans to consider service providers conflicts of interest has hampered EBSA's enforcement process.

We reviewed a stratified random sample of 30 out of 2,455 fiduciary investigations that EBSA closed in fiscal year 2009 in 6 out of 14 EBSA field offices. Of these 30 cases, we identified 10 that had used investment related service providers. For these 10 cases we reviewed the case file and the work done, and interviewed the case investigator. In these 10 cases, due to the lack of enforceable regulations, EBSA did not determine if the plan fiduciary had appropriately considered conflicts of interest in selecting their service providers. While EBSA did review for evidence of conflicts of interest through reviewing fees, there was no indication EBSA ensured plan fiduciaries considered conflicts of interest in meeting their fiduciary duties in selecting service providers.

For example, in one case, a plan with more than $106 million in assets had hired an investment adviser who advised using a specific mutual fund company for participant investments. The adviser continued recommending this mutual fund company although returns declined and the company was the subject of SEC investigations. The plan finally hired another investment adviser to evaluate the investment performance and this adviser recommended switching to another mutual fund company. There were no regulatory conflict of interest requirements that the plan or its advisers had to meet in selecting these service providers and, as a result, there was no evidence of investigative work relative to whether the plan had appropriately considered conflicts of interest in selecting these service providers.

Without a regulatory requirement for plan fiduciaries to specifically consider conflicts of interest in selecting service providers, it is difficult for EBSA to hold plan fiduciaries accountable for considering conflicts of interest. Rather, EBSA focuses on improper and undisclosed compensation which has caused harm to participants and beneficiaries. While this is also necessary and restores funds to plans when detected, additional regulations requiring specific consideration of conflicts of interest in selecting service providers would reduce the risk and provide EBSA an additional enforcement tool.

Overall, EBSA conducts more than 2000 fiduciary investigations each year. With a broader definition of a fiduciary, requirements for disclosure of all conflicts of interest and consideration of conflicts of interest in selecting service providers, EBSA would incorporate these items into their investigative process and be able to ensure plans have disclosure and consideration of all conflicts of interest in selecting service providers. Furthermore, EBSA would have better enforcement tools to take action against plans or service providers who do not disclose or appropriately consider conflicts of interest.

RECOMMENDATIONS

We recommend that the EBSA:

1. Broaden the definition of a fiduciary to align the definition with the current environment of investment financial services.

2. Develop regulations requiring disclosure of all conflicts of interest by service providers to create transparency and accountability in plan activities for plan assets and participant benefits.

We appreciate the cooperation and courtesies that 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

Appendices

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Appendix A

Background

The private retirement system in the United States involves about $6 trillion of investments for more than 124 million Americans. There are about 708,000 retirement plans throughout the country.

ERISA is the primary federal law governing the investment of these assets and private sector employee benefit plans in general. ERISA assigns responsibility for employee benefit plan oversight to DOL, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation. DOL, through EBSA, administers the fiduciary provisions of ERISA governing plans actions regarding conflicts of interest.

ERISA relies heavily on the designation of fiduciaries and adherence to fiduciary standards of conduct to protect plan participants and beneficiaries. The plan document of an employee benefit plan identifies specific fiduciaries responsible for administering the plan. ERISA also defines other types of persons who may be a plan fiduciary and specifically states a person providing investment advice for a fee is a fiduciary to the plan.

Employee benefit plans have named fiduciaries responsible for operating the plan solely for the benefit of the participants and beneficiaries. Under ERISA's fiduciary standards, plan fiduciaries must act solely for the benefit of the participants and beneficiaries, and must act (1) exclusively for providing benefits and defraying expenses; (2) with skill, care, prudence, and diligence; (3) by diversifying investments; and (4) by following plan requirements.

To administer an employee benefit plan, fiduciaries contract with service providers to provide professional services, such as assisting in determining the plans investment objectives and restrictions, allocating plan assets, selecting money managers, choosing mutual fund options, tracking investment performance, and selecting other service providers. Conflicts of interest affecting the plan arise when the service provider has competing professional or personal interests. Such competing interests can hinder the service provider's ability to (a) fulfill their duties impartially and (b) act solely in the interest of plan participants or beneficiaries. For example, a plan's investment adviser may receive compensation from a mutual fund company based on share purchases made by the plan's participants. This could sway the adviser's recommendations to buy that mutual fund company's shares.

Conflicts of interest are of concern in most ERISA covered pension plans. In 2005, the SEC examined 24 service providers who were registered investment advisers; and therefore, fiduciaries under SEC rules. The SEC found inadequate disclosure of continuing conflicts of interest in 13 of the 24 service providers (54 percent). These 13 service providers, as investment adviser, had more than $4.5 trillion in assets under advisement. Furthermore, these service providers had contracted with defined benefit

plans that had total assets of $183.5 billion and average assets of $155.3 million per plan.

In 2007, the GAO also issued a report concerning the conflicts of interest involving high-risk or terminated plans. In the report, GAO concluded that conflicts of interest in these plans present enforcement challenges to EBSA. Further, GAO indicated that existing laws limits EBSA's efforts to pursue conflicts and redress for financial harm when certain service providers were either not fiduciaries under ERISA or did not knowingly act in concert with fiduciaries. GAO recommended that Congress should consider amending ERISA to expand DOL's authority to recover losses against non-fiduciaries.

Appendix B

Objectives, Scope, Methodology, and Criteria

Objective

The audit objective was to answer the question: Has EBSA taken action to evaluate and reduce risk of harm to plan participants from conflicts of interests in pension service providers?

Scope

Our scope included all EBSA policies, procedures, and actions taken for identifying and evaluating conflicts of interest in service providers from October 1, 2006 through June 30, 2010.

We conducted our fieldwork at EBSA's headquarters in Washington, DC and the following EBSA field offices:

Atlanta, Georgia
Boston, Massachusetts
Detroit, Michigan
Miami, Florida
San Francisco, California
Seattle, Washington

Methodology

In performing our audit, we conducted interviews, researched applicable laws, reviewed EBSA's policies and procedures, and studied similar entities. Further, in our analysis of EBSA's oversight process, we examined a stratified random sample. Specifically, we performed the following audit procedures:

- We interviewed EBSA, Office of Enforcement (OE) officials to obtain an understanding of the enforcement process used relative to conflicts of interest in plan service providers.

- We interviewed EBSA officials specifically about EBSA follow up on the SEC report on service providers.

- We interviewed officials from the SEC to understand the process and methodology used in the SEC report on service providers.

- We interviewed officials from the GAO to obtain information regarding the 2007 GAO Report entitled "Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges."

- We reviewed all 12 investigations initiated by EBSA because of potential violations of ERISA identified in SEC report.

- We interviewed EBSA, Office of Regulations and Interpretations officials to obtain information regarding proposed/final regulations issued relative to conflicts of interest in plan service providers

- We interviewed EBSA, OE officials to obtain an understanding of the process, which developed the CAP.

- We obtained a list of all CAP cases as June 30, 2010 as well as a watch list of potential CAP cases as of February 1, 2010 to understand how these cases were developed.

- We reviewed a stratified random sample of 30 out of 2,455 fiduciary investigations closed by EBSA during FY 2009 to test various investigation attributes. We also interviewed the investigators for each case selected to determine if EBSA had a process in place to detect and evaluate conflicts of interest during their fiduciary investigations.

A performance audit includes obtaining an understanding of internal controls considered significant to the audit objectives and testing compliance with significant laws, regulations, and other requirements. Our work on internal controls included obtaining and reviewing policies and procedures and interviewing key personnel. We gained an understanding of the EBSA's processes relative to our audit objectives and documented a description of the controls. Our testing of internal controls focused only on the controls related to our objectives of assessing compliance with significant laws, regulations, and policies and procedures. We did not intend to form an opinion on the adequacy of internal controls overall, and we do not render such an opinion.

Criteria

We used the following criteria to accomplish our audit:

- Employee Retirement Income Security Act of 1974

- Title 29 (Labor) - Code of Federal Regulation, Parts 2500 to 2599

Appendix C

Acronyms and Abbreviations

CAP	Consultant Adviser Project
DOL	Department of Labor
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act of 1974
GAO	Government Accountability Office
OIG	Office of Inspector General
OE	Office of Enforcement
SEC	Securities and 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

DATE: September 29, 2010

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

FROM: PHYLLIS C. BORZI
Assistant Secretary of Labor

SUBJECT: EBSA Response to OIG Draft Audit
Report No. 09-10-001-12-121

Thank you for the opportunity to review and comment on the subject draft audit report.

At the outset, we would like to commend the OIG staff for their work on the report. In brief, we believe that, contrary to the title of the draft, the subject report not only supports, but confirms and endorses, the important work that EBSA has been pursuing for a number of years in both the enforcement and regulatory areas with respect to conflicts of interest and protecting the retirement security of millions of America's workers.

As recognized in your report, section 404(a)(1) of the Employee Retirement Income Security Act (ERISA) clearly requires plan fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries when discharging their responsibilities with respect to an employee benefit plan, including the selection of service providers. EBSA has long held the view that satisfaction of these standards requires fiduciaries to understand and consider those conflicts of interest on the part of a service provider that may affect the quality of the services to plan. As also recognized by the report, EBSA has successfully relied on these standards in pursuing a number of cases involving conflicts of interest, notably EBSA's Consultant/Adviser Project.

Most importantly, however, the report reinforces EBSA's view that more can and should be done to address potential conflicts of interest and other issues arising in connection with the selection of service providers. Specifically, the report recommends that EBSA broaden the definition of fiduciary to align the definition with the current environment of investment financial services. EBSA could not agree more. In this regard, EBSA started work over a year ago to update the regulation that defines when parties become fiduciaries by virtue of rendering investment advice under section 3(21) of ERISA (§ 2510.3-21(c)) to take into account not only changes in the financial services industry, but many years of investigative experience involving conflicts, self-dealing and other breaches of fiduciary responsibility. A proposed regulation encompassing those changes has been drafted and is expected to be published shortly.

The report further recommends requiring full disclosure of all conflicts of interest by service providers to create transparency and accountability in plan activities for plan assets and participant benefits. Again, EBSA agrees with OIG that identifying conflicts of interest by service providers is an important issue and is currently engaged in rulemaking to address this problem. One of EBSA's highest priorities has been the adoption of a regulation that would ensure that plan fiduciaries, when entering into arrangements with service providers to their plan, are furnished the information they need to make informed decisions about both the reasonableness of the compensation to be paid for services and potential conflicts of interest that may affect the quality of the services to be provided. On July 16, 2010, EBSA published an interim final regulation (§ 2550.408b-2) representing a major step forward in the ability of pension plan fiduciaries to assess the impact of potential conflicts on the provision of services by their providers.

In summary, EBSA not only agrees with the recommendations included in the report, we are committed to completing work on both recommendations on the earliest possible date. Again, we thank you the opportunity to comment on the report and for the support of the OIG staff in EBSA's pursuit of initiatives critical to the retirement security and savings of America's workers.

2

Appendix E

Acknowledgements

Key contributors to this report were Ralph McClane (Audit Director), Steve Chiang, Richard Bryan, Tim Kerschen, Cassie Galang and Mary Lou Casazza.

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