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.

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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

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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

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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.

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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.

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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.

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