

U.S. Department of Labor

Office of Inspector General—Office of Audit

REPORT TO THE EMPLOYEE BENEFITS SECURITY ADMINISTRATION



LIMITED-SCOPE AUDITS PROVIDE INADEQUATE PROTECTIONS TO RETIREMENT PLAN PARTICIPANTS

Date Issued: September 30, 2014
Report Number: 05-14-005-12-121

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

BRIEFLY...

Highlights of Report Number 05-14-005-12-121, issued to the Assistant Secretary for Employee Benefits Security.

WHY READ THE REPORT

To ensure the integrity of retirement plan assets, most plans are required by federal law to arrange for annual independent audits. However, certain plans are not required to receive a full-scope audit because of an exemption in the law, putting more than \$1 trillion in complex trust arrangements and hard-to-value assets (HTV) at risk because limited-scope audits do not provide adequate assurance of assets' existence or value.

This report highlights changes EBSA needs to make to improve protections to plan participants for ERISA plans electing limited-scope audits for assets held and certified by trustee and custodians.

WHY OIG CONDUCTED THE AUDIT

Because these assets are at risk, we performed an audit to answer the following question: Has EBSA provided adequate oversight of employee benefit plans electing limited-scope audits for assets held and certified by custodians?

READ THE FULL REPORT

To view the report, including the scope, methodologies, and full agency response, go to:
<http://www.oig.dol.gov/public/reports/oa/2014/05-14-005-12-121.pdf>

September 2014

LIMITED SCOPE AUDITS PROVIDE INADEQUATE PROTECTIONS TO RETIREMENT PLAN PARTICIPANTS

WHAT OIG FOUND

Assurances to plan participants have been significantly eroded because EBSA has not provided the guidance and oversight needed to adequately protect more than \$1 trillion of plan assets invested in complex trust arrangements and HTV assets held and certified by custodians.

We found that custodians certifying ERISA plan assets under the limited-scope audit provision did not generally provide any valuations services; instead, their role was strictly limited to recordkeeping. We also found most plan administrators in our sample did not make a determination of fair value of plan assets by way of a prudent investigation.

EBSA has not consulted with federal or state regulators on this topic, nor has it conducted an assessment of regulators' examinations of custodians. EBSA has 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 subject.

WHAT OIG RECOMMENDED

We recommended EBSA continue to seek repeal of the limited-scope audit provision and work within its existing authority to increase protections to participants.

EBSA generally agreed with our findings and recommendations. EBSA stated it believes there are interpretive and regulatory steps that it can take with respect to the report recommendations. EBSA also stated it has formed an inter-office task group to evaluate the OIG and ERISA Council recommendations.

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U.S. Department of Labor

Office of Inspector General
Washington, D.C. 20210



September 30, 2104

Inspector General's Report

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Retirement plans in the United States hold more than \$6 trillion in assets and benefit more than 129 million individual participants.¹ The Employee Retirement Income Security Act of 1974 (ERISA) requires most large employee benefit plans to obtain annual audits of their financial statements by an independent qualified public accountant (IQPA). The Department of Labor's (DOL) Employee Benefits Security Administration (EBSA) has the responsibility to ensure these audits meet ERISA requirements. ERISA,² however, allows plan administrators to elect a limited-scope audit in which plan auditors do not audit plan assets held and certified by certain custodians.³ The intent of this provision was to exempt assets held by certain custodians from duplicative audits because these custodians were already regulated and supervised by a state or federal agency.

Limited-scope audits prevent plan auditors from providing assurances to plan participants and beneficiaries regarding their plan's financial statements. These limited-scope audits weaken assurances to participants and may put hard-to-value (HTV) assets of retirement plans at risk because they provide little to no assurance regarding the existence or value of those assets. This lack of audit assurance puts into question the financial health of more than \$1 trillion of plan assets invested in complex trust arrangements and HTV assets, a growing part of modern investment portfolios.

Due to these concerns, we performed an audit to answer the following question:

Has EBSA provided adequate oversight of employee benefit plans electing limited-scope audits for assets held and certified by custodians?

¹ The term "participant" is used throughout this report to include plan participants and beneficiaries.

² ERISA §103(a)(3)(C).

³ "Custodian" is used throughout this report to broadly encompass all of the types of institutions included in 29 USC 1023(a)(3)(C), specifically: "bank or similar institution or insurance carrier regulated and supervised and subject to periodic examination by a State or Federal agency."

We concluded assurances to plan participants have been significantly eroded because EBSA has not provided the guidance and oversight needed to adequately protect the HTV assets in employee benefit plans electing limited-scope audits. Overall, we found only 9 percent of the plans electing limited-scope audits in our sample had a robust process to verify and value their plan assets, custodians exercised limited direct control and accountability over assets they held and certified, and little was publicly known about the oversight of state and federal regulators.

Despite EBSA's efforts, protections have decreased over time for plan participants. EBSA's improvement efforts have included working with the American Institute of Certified Public Accountants (AICPA) to establish an audit quality center that provides guidance and education, redesigning its targeting methods to identify and correct substandard plan audits, and providing training and outreach activities for plan auditors. However, these efforts have been offset by increased numbers of limited-scope audits and a continuing lack of legal authority over plan auditors and custodians.

Since 1984, we have recommended EBSA seek legislative repeal of limited-scope audits. EBSA has supported this recommendation and made several proposals to Congress to repeal the limited-scope audit provision. Despite these efforts, the provision has not been repealed. Also since 1984, we have recommended EBSA seek a legislative change to ERISA to allow EBSA to oversee IQPAs directly. With this authority, EBSA could better prevent IQPAs from performing audits that do not meet professional standards. EBSA has agreed with this recommendation and made several proposals to Congress to obtain this authority, none of which have been successful.

Despite its lack of legal authority over certain aspects of the process, EBSA can do more to protect plan participants from the lack of assurances resulting from limited-scope audits. We recommend EBSA: continue to seek repeal of the limited-scope audit provision, but until the provision is repealed, work within its existing authority to increase protections to participants by collaborating with federal and state regulators to determine the level of examination and supervision they exercise for ERISA plan assets certified and held by custodians; determine whether it can issue guidance on the level or form of supervision and examination by federal and state regulators needed to provide appropriate assurances for ERISA assets held in trust; and provide additional formal guidance to plan administrators to identify and adequately support the fair value of plan assets.

EBSA RESPONSE

In response, EBSA generally agreed with the findings and recommendations in the report. EBSA stated a more comprehensive legislative solution is needed to address the problems. EBSA also believed there are interpretive and regulatory steps that it can take with respect to the report recommendations and formed an inter-office task group to evaluate recommendations received in this area from the OIG and the ERISA Advisory Council. EBSA's full response appears in Appendix D.

RESULTS

Objective — Has EBSA provided adequate oversight of employee benefit plans electing limited-scope audits for assets held and certified by custodians?

EBSA has not provided the guidance and oversight needed to adequately protect more than \$1 trillion of plan assets invested in complex trust arrangements and HTV assets held and certified by custodians.

Plans may elect to perform only a limited-scope audit on their assets if the assets are held by a qualifying custodian, which under ERISA could be a “bank or similar institution or insurance carrier regulated and supervised and subject to periodic examination by a State or Federal agency.”⁴

We evaluated the path that plan administrators must navigate to elect limited-scope audits. This process, which we call the “chain of assurances,” relies on three parties: custodians, federal and state regulators, and plan administrators. Custodians must maintain proper accountability and controls over the assets they hold and certify; regulators must provide sufficient supervision over those custodians; and plan administrators must employ an adequate analytical process for the valuation of HTV assets certified by custodians. In order to maintain its integrity, every link in the chain of assurances must firmly connect to those on either side.

We found that the limited-scope audit provision has significantly weakened the chain of assurances for the 65,000 plans representing more than 49 million participants and approximately \$2.7 trillion in assets, which elect not to perform full audits of their assets.

Custodians Exercised Limited Direct Control and Accountability Over the Assets They Held and Certified

Although EBSA has limited control over their practices, custodians are, nonetheless, a key link in the chain of assurances. EBSA has the authority to prescribe regulations necessary to carry out its responsibilities under Title I of ERISA, but has not to date determined whether it can define the terms “plan assets held” and “regulated and supervised and subject to periodic examination by a State or Federal agency” for the limited-scope audit exemption. We reviewed custodians’ practices to determine if their internal control systems potentially mitigated some of the effects of the limited-scope audit exemption. We concluded they did not.

Overall, we found most custodians in our sample performed only pass-through recordkeeping services for assets they held. In our sample of 44 plans,⁵ we found

⁴ 29 USC 1023(a)(3)(C),

⁵ We drew a statistical sample of 44 defined-benefit plans holding HTV assets and electing a limited-scope audit. For our sample, we reviewed the underlying trust agreements between the plans and the custodians to determine if the custodians were responsible for providing valuation services or merely custodial, recordkeeping services.

82 percent of custodians certifying ERISA plan assets under the limited-scope audit exemption generally acted as directed custodians or non-discretionary trustees, which means their role was strictly limited to recordkeeping. Contractual arrangements between custodians and plan administrators often explicitly excluded valuation services. As a result, custodians did not provide independent statements of existence or value. Instead, custodians passed through reports of values for HTV assets, frequently directly from the investment vehicle itself. Custodians then certified the assets, adding little legitimacy to the reported figures, and then the same values passed on to plan administrators, who in most cases accepted them as reported and performed little or no further analysis or validation.

When ERISA was first enacted in 1974, plans invested mostly in traditional financial instruments, such as U.S. government securities and publicly traded stocks and bonds. These investments, printed on paper at the time, were physically held by a custodian in its vault. In 1974, plan auditors seeking to confirm the plan actually owned 100 shares of IBM stock could easily gain access to the custodian's vault and count the certificates. Later, plan auditors, having counted the paper stock certificates, could find that day's market price for the stock and calculate an exact value.⁶ As a result, the auditors' report gave assurances as to the existence of the stock certificates, and the financial markets provided an accurate current value for the stocks.

The basis for the limited-scope audit exemption was that plan assets were generally easy to verify and had readily available market values. Underpinning this assumption was the fact that only custodians regulated (and consequently, audited) by a state or federal regulator were authorized to certify plan assets. Moreover, an independent auditor audited those same custodians each year. In effect, ERISA presumed a chain of assurance, safeguarding plan assets, was present. For example, a bank trust department could take custody of a paper stock certificate on behalf of a plan. The bank's auditors would regularly verify the existence of this certificate by actually counting it. The bank's regulators would also audit the bank, and likewise potentially verify the existence of the stock certificate, or at the very least, prescribe certain protective measures ("internal controls") the bank had to put in place. Stocks could easily be valued by finding their current price on a stock exchange. As a result, ERISA presumed since there were sufficient safeguards in place in the custodian's environment, more auditing by the plan was not necessary.

Since 1974, the investment environment has radically changed. Stocks and bonds are no longer printed on paper. The vast majority of financial instruments exist only as a diffuse collection of bits and bytes in a vast array of computers around the world. Physical custody is no longer the model relied upon to prove existence. Even the bits and bytes do not truly reside, for the most part, on the custodian's own computer network. Instead, the custodian receives reports from various external parties who perform the computer processing necessary to effect trades and "hold" digital records of

⁶ On December 31, 1974, 100 shares of IBM stock were worth \$16,800. On August 15, 2014, those shares would be worth about \$299,800.

ownership. Plan auditors cannot walk into a computer room some place in the world and demand to count the number of bits and bytes that represent the plan’s assets; instead, the electronic reports that present the inventory of assets must act as evidence of their own existence.

Moreover, plans have increasingly shifted assets from traditional investments into hard-to-value (HTV) assets and non-traditional investments, such as hedge funds, private equity funds, and venture capital funds, among others. Certain types of investment vehicles add another layer of complexity; entities such as Master Trust Investment Accounts (MTIA), Common/Collective Trusts (CCT), and Pooled Separate Accounts (PSA) may not be required to receive an audit or even file an annual form 5500 with EBSA. These entities can also invest in other non-publicly traded entities. For example, a MTIA can invest in a CCT, which is further invested in hedge funds and limited

partnerships, further increasing the difficulty of valuing the investment. Table 1 provides a summary of the total dollars invested in these types of entities in filing year 2012. Of the \$2.7 trillion in ERISA plan assets eligible for the limited-scope audit exemption, approximately \$1.1 trillion were invested in complex arrangements in which an annual audit and/or a form 5500 filing were not required. Further illustrating the challenges in auditing these types of investments, GAO recently reported the complexity of large partnership structures, some of which are held by hedge funds and other HTV investments, such as those in table 1, makes it difficult for the Internal Revenue Service to audit them.⁷

Type of Entity	5500 Required?	Audit Required?	Dollars (Billions)
MTIA	Yes	No	\$731
PSA	No	No	\$128
CCT	No	No	\$281
Total			\$1,140

OIG’s September 2013 audit⁸ found EBSA needed to take further action to increase protections for participants and beneficiaries of plans investing in hard-to-value alternative investments. We found EBSA had not formalized into regulatory guidance a requirement that plan administrators identify and adequately support the fair value of HTV investments nor implemented the 2006, 2008, and 2011 ERISA council recommendations on the same subject.

The result of this change in the investment environment is that custodians no longer hold physical proof of ownership in their vault, relying instead on reports transmitted to them by third parties. Instead of maintaining custody of plan assets in the traditional physical sense as envisioned by ERISA, custodians have now adopted the role of the record keeper. Custodians, in their certifications, do not vouch for the existence or value

⁷ *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency* (GAO, September 2014).

⁸ *EBSA Needs to Provide Additional Guidance and Oversight to ERISA Plans Holding Hard-to-Value Alternative Investments* (Report No. 09-13-001-12-121, September 30, 2013).

of assets they hold, but instead, act as pass-throughs. Assets held in electronic form by a third party clearinghouse, such as the Depository Trust Company, are reported to the custodian electronically, and the custodian, in turn, certifies the same data to the plan administrator. The custodian merely passes along data it received and recorded in its books and records from an external source, while certifying to plan administrators only that its records are complete and accurate.

The 2010 ERISA Advisory Council recommended that the Secretary of Labor use regulatory authority to clarify the limited-scope audit exemption requirements. EBSA however, has not yet formally evaluated the feasibility of implementing the ERISA Advisory Council or the OIG's 2012⁹ recommendations to clarify the requirements needed to hold and certify plan assets. In 2014, however, EBSA formed a working group to evaluate possible regulatory or interpretive guidance options for clarifying regulations interpreting the limited-scope audit exemption. The group plans to forward its recommendations to the Assistant Secretary by December 31, 2014.

The oversight by federal and state regulators of HTV assets held on behalf of plans may not provide sufficient assurance to allow plans to elect limited-scope audits

It is unclear whether regulation and examination by state and federal agencies charged with bank and insurance company supervision provide assurance to participants because regulators, at least at the federal level, do not make public the results of their examination. This leaves EBSA and the public with no way of knowing when examinations reveal problems with custodians. EBSA has not consulted with federal or state regulators on this topic, nor has it conducted an assessment of regulators' examinations of custodians.

ERISA allows the limited-scope audit exemption for assets held by a "*bank or similar institution or insurance carrier which is regulated and supervised, and subject to periodic examination by a State or Federal agency.*"¹⁰ The intent of this provision was to exempt assets held by custodians regulated by federal or state agencies from duplicative detailed audits. The intent of the limited-scope audit provision of ERISA appears to be that the regulation and examination of custodians by a federal or state regulator provide a set of controls sufficient to make additional auditing redundant. However, given the change in the investment environment described earlier in our report, two factors act together to undermine this intention:

- The lack of transparency and communication by regulators undermines assurances their supervision might otherwise provide, and
- EBSA has not collaborated with state and federal regulators to determine the nature of their oversight over ERISA plan assets nor does it have authority to access results of the federal examinations of these

⁹ *Changes are Still Needed in the ERISA Audit Process* (Report No. 09-12-002-12-121, September 2012).

¹⁰ 29 USC 1023(a)(3)(C)

custodians. In a report issued in 1989,¹¹ we recommended EBSA work with regulators to determine how annual audit coverage could be provided to employee plan assets held in trust.

We interviewed officials from all three major federal bank regulators – the Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), as well as state banking and insurance regulators covering 73 percent of the HTV assets in our sample. Our review of regulators' practices found:

- Regulators employ inconsistent degrees of compliance review of custodians certifying ERISA plan assets;
- The ERISA trust departments of custodians and the plan assets they hold are not always audited on an annual basis;
- Testing might not extend to all ERISA plans or all plan assets held and certified by custodians, and even though some regulators may test ERISA assets on a sample basis, the sample may not be statistically representative of the overall population of assets, and therefore may not provide the level of assurance that a statistical sample would;
- Regulators, such as the OCC, FDIC, and FRB, do not review the valuation procedures of custodians when those institutions have no contractual obligation to determine the fair value of plan assets. In our sample of 44 plans, regulators could have reviewed the valuation procedures of only 18 percent of custodians they examined; and
- Professional industry guidance for internal audits of these custodians does not consider ERISA requirements.

Notably, one of the state banking regulators the OIG interviewed stated its examinations were not a substitute for a plan's annual audit by an independent auditor, and that the regulator did not typically examine ERISA plan assets held by banks unless they were aware of an issue with those assets.

Although it has no direct control over regulators, EBSA has the authority under ERISA §505 to prescribe regulations the Secretary finds necessary or appropriate to carry out the provisions of Title I of the statute, including defining accounting, technical, and trade terms. EBSA has not, to date, determined whether it can define the terms "plan assets held" and "regulated and supervised and subject to periodic examination by a State or Federal agency" for the limited-scope audit exemption.

¹¹ *Changes are Needed in the ERISA Audit Process to Increase Protections for Employee Benefit Plan Participants* (Report No. 09-90-001-12-001, November 1989).

To require audit coverage of these assets in banks or other institutions would not be duplicative and would provide increased scrutiny and additional protection of plan assets. Moreover, EBSA has not established channels of communication with regulators so as to be better aware of their examination processes and how their findings could be used by EBSA in its oversight role.

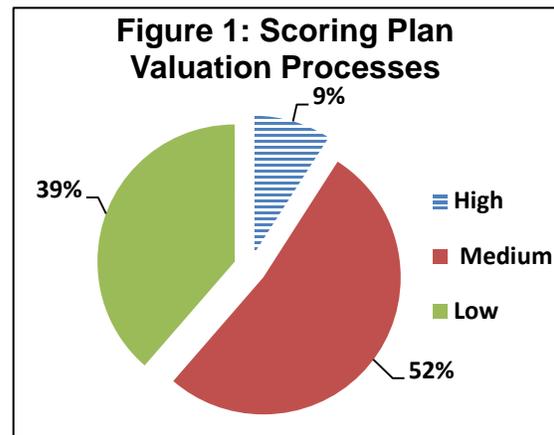
As a result, audit coverage of more than \$1 trillion invested in complex trust arrangements and HTV ERISA plan assets held in trust by custodians may be inadequate because very little is known about the supervision of – and consequently assurances provided by – federal and state regulators over assets held and certified by custodians.

Most plan administrators relying on certifications lacked a robust analytical process to determine the fair market value of plan assets

We found 84 percent of plan administrators in our sample either failed to obtain an independent valuation of their HTV assets and/or did not have a robust analytical process to arrive at the fair market value of those assets. In 20 percent of cases in our sample, plan administrators accepted HTV investment statements clearly marked “unaudited” and reported those values as fair market without performing any further analysis.

We also analyzed our sample of 44 plans to score their processes for determining the fair value of HTV assets. We scored plans as follows:

- Low: plan lacked an analytical process for determining the fair value of HTV assets, and or relied on estimated or unaudited client or financial statements.
- Medium: plan had an established process for evaluating HTV assets, but the process was not always followed or the plan relied on estimated or unaudited client or financial statements.
- High: plan demonstrated an analytical process for determining the fair value of plan investments, received an independent appraisal or valuation, or provided audited investment statements at fair value for hard-to-value plan assets.



ERISA requires plan administrators to present plan assets at fair value in their annual report and financial statements. The U.S. Court of Appeals for the 5th Circuit, interpreting ERISA, has opined that when reporting on fair value:

“A pure heart and an empty head are not enough...fiduciaries will carry their burden to prove that adequate consideration was paid by showing that they arrived at their determination of (FMV) by way of a prudent investigation in the circumstances then prevailing.”¹²

EBSA has provided some guidance interpreting administrators’ responsibility to value plan assets, but this guidance is insufficient, as evidenced by the fact that only 9 percent of the plans in our sample had a “prudent investigation” process (see Figure 1).

The OIG, ERISA Advisory Council, GAO, and AICPA have all recommended EBSA provide guidance to fiduciaries of employee benefit plans for valuing HTV investments. EBSA has not yet implemented these recommendations. As a result, a significant proportion of plans holding HTV assets have no authoritative independent assurances of existence and may not be reported at an accurate fair value, potentially undermining the value of assets available to pay future pension benefits.

CONCLUSION

Auditors and federal and state regulators continue to audit banks and other custodians and as a result, custodians continue to certify plan assets, but the chain of assurance in the case of more than \$1 trillion in assets¹³ invested in complex trust arrangements and other HTV assets has been broken. By definition, these investments are hard to value. Furthermore, there is no longer a clear definition of the term “holding an asset.” Consequently, certification no longer carries with it the power of physical custody and thorough audit and oversight. A custodian’s certification may be nothing more than a pass-through electronic report from a third party of asset inventories and values over which the custodian has no real control. That said, a certification by a custodian may act as a stamp of validation to plan administrators, who are not aware of the true nature of the certification in this situation.

The net result of these changes has been decreased transparency and accountability over plan assets and, ultimately, decreased assurances about the financial health of retirement plans to their participants. As the Assistant Secretary for Employee Benefit Security succinctly put it in a 2012 speech, “the limited-scope audit is practically useless.”

RECOMMENDATIONS

We recommend the Assistant Secretary for Employee Benefits Security:

1. Seek repeal of the limited-scope audit provision.

¹² *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983).

¹³ As of filing year 2012, the latest for which figures are available.

2. Provide additional formal guidance to plan administrators to identify and adequately support the fair value of plan assets.
3. Establish a timetable to evaluate the feasibility of ERISA Advisory Council recommendations on limited scope audits.
4. Collaborate with federal and state regulators to determine the level of examination and supervision they exercise for ERISA plans assets certified and held by custodians by:
 - a. Establishing memoranda of understanding with, at minimum, federal regulators to share information on regulatory and examination practices and evaluating those practices; and
 - b. Obtaining access to reports of examination by federal and state regulators to evaluate audit assurances and identify areas of concern for ERISA plan assets held and certified by qualified custodians.
5. Determine whether EBSA can issue guidance on the level or form of supervision and examination by federal and state regulators needed to provide appropriate assurances for ERISA assets held in trust.

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



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Assistant Inspector General
For Audit

Appendices

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Appendix A

Recommendations to EBSA on the Limited Scope Audit Provision and HTV Investments

Recommendations to EBSA on the Limited Scope Provision and HTV Investments				
Agency	Date	Report	Recommendation	EBSA Actions
OIG	September 2013	Report Number: 09-13-001-12-121 http://www.oig.dol.gov/public/reports/oa/2013/09-13-001-12-121.pdf	<p>Improve current protections under current authority by:</p> <p>Providing guidance to plan administrators to identify and adequately support the fair market value of hard-to-value plan assets.</p> <p>Evaluating and determining the feasibility of ERISA Advisory Council recommendations on hard-to-value alternative investments.</p>	In 2014, EBSA formed an inter-office working group to evaluate possible regulatory or interpretive guidance options for clarifying the limited scope audit regulation at 29 CFR 2520.103-8 and forward its recommendations to the Assistant Secretary by December 31, 2014.
OIG	September 2012	Report Number: 09-12-002-12-121 http://www.oig.dol.gov/public/reports/oa/2012/09-12-002-12-121.pdf	Renew efforts to seek repeal of limited-scope audit exemption.	EBSA has made multiple efforts, however Congress has not acted upon recommended legislation.
OIG	September 2012	Report Number: 09-12-002-12-121 http://www.oig.dol.gov/public/reports/oa/2012/09-12-002-12-121.pdf	<p>Improve current protections under current authority to:</p> <ol style="list-style-type: none"> a. Clarify the requirements needed to hold and certify plan assets for limited scope audits. b. Provide guidance to plan administrators to identify and adequately support current value of plan assets in limited-scope audits. 	In 2014, EBSA formed an inter-office working group to evaluate possible regulatory or interpretive guidance options for clarifying the limited scope audit regulation at 29 CFR 2520.103-8 and forward its recommendations to the Assistant Secretary by December 31, 2014.

			c. Evaluate the recommendations from the ERISA Advisory Council on limited scope audits.	
OIG	September 2013	Report Number: 09-13-001-12-121 http://www.oig.dol.gov/public/reports/oa/2012/09-12-002-12-121.pdf	Improve Form 5500 data collection, analysis, and targeting of plans with hard-to-value investments.	EBSA has initiated a strategic project with the Internal Revenue Service and the Pension Benefit Guaranty Corporation to revise the tri-agency Form 5500 Annual Return/Report. This milestone has been added to the Spring 2014 Semi-Annual Regulatory Agenda as a Long-term Action. The anticipated next action is publication of a Notice of Proposed Form Changes and NPRM by approximately July 2015.
2010 ERISA Advisory Council	2010	http://www.dol.gov/ebsa/publications/2010ACreport2.html	The Department should clarify the kinds of entities that are qualified to issue certifications under existing regulations and guidance and reiterate that only qualified entities may issue certifications.	In February of 2014, EBSA formed an inter-office task group to evaluate recommendations from the OIG and from the ERISA Advisory Council in response to the September 2012 and September 2013 audit report on EBSA oversight of ERISA plan audits and plans holding hard-to-value alternative investments.
2010 ERISA Advisory Council	2010	http://www.dol.gov/ebsa/publications/2010ACreport2.html	The Department should amend the limited-scope audit regulations to require that the certification of investment information include a disclaimer that investment values may not have been subject to independent verification of fair value by the certifier.	In February of 2014, EBSA formed an inter-office task group to evaluate recommendations from the OIG and the ERISA Advisory Council in response to the September 2012 and September 2013 audit report on EBSA oversight of ERISA plan audits and plans holding hard-to-value alternative investments.
2010 ERISA Advisory Council	2010	http://www.dol.gov/ebsa/publications/2010ACreport2.html	The Department should require Plan administrators to include any certification issued in connection with a limited scope audit in the Plan's Form 5500 filing or other annual report.	In February of 2014, EBSA formed an inter-office task group to evaluate recommendations from the OIG and the ERISA Advisory Council in response to the September 2012 and September 2013 audit report on EBSA oversight of ERISA plan audits and plans holding hard-to-

				value alternative investments.
2010 ERISA Advisory Council	2010	http://www.dol.gov/ebsa/publications/2010ACreport2.html	The Department should issue informal education materials targeted to Plan sponsors and Plan auditors that would assist them in understanding their respective obligations with respect to limited scope audits.	In February of 2014, EBSA formed an inter-office task group to evaluate recommendations from the OIG and the ERISA Advisory Council in response to the September 2012 and September 2013 audit report on EBSA oversight of ERISA plan audits and plans holding hard-to-value alternative investments.
2008 ERISA Advisory Council	2008	http://www.dol.gov/ebsa/publications/2008ACreport1.html	The Department should issue guidance to a plan fiduciary's responsibility to evaluate alternative investments as an investment vehicle and the fiduciary's responsibility for valuing such investment assets	In February of 2014, EBSA formed an inter-office task group to evaluate recommendations from the OIG and the ERISA Advisory Council in response to the September 2012 and September 2013 audit report on EBSA oversight of ERISA plan audits and plans holding hard-to-value alternative investments.
2006 ERISA Advisory Council	2006	http://www.dol.gov/ebsa/publications/AC_1106A_report.html	The Department of Labor should publish guidance which expresses the unique features of hedge funds and matters for consideration in their adoption for use by qualified plans as a matter of procedural prudence	In February of 2014, EBSA formed an inter-office task group to evaluate recommendations from the OIG and the ERISA Advisory Council in response to the September 2012 and September 2013 audit report on EBSA oversight of ERISA plan audits and plans holding hard-to-value alternative investments.

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Appendix B

Objective, Scope, Methodology, and Criteria

Objective

We conducted an audit to answer the following question:

Has EBSA provided adequate oversight of employee benefit plans electing limited-scope audits for assets held and certified by financial institutions? Specifically we sought to determine:

1. To what extent did qualifying custodians exert accountability and control over the assets they certify?
2. What is known about the supervision and examinations conducted by State or Federal agencies as it pertains to these hard-to-value alternative assets held on behalf of employee benefit plans?
3. What process did plan administrators use when relying on custodians' certifications and determining that the information could be used to satisfy the administrator's obligation to report the fair value of the assets on the plan's annual report?

To answer these questions, we reviewed accounting and pension industry professional standards, applicable regulations, and EBSA policies and procedures. We also reviewed a sample of ERISA plans with HTV investments from the 2011 Form 5500 filing year.

Scope

Our scope included all EBSA policies and procedures pertaining to audit quality reviews and trustee and custodial holding of ERISA plan assets for limited-scope audits. Additionally, for plan Filing Year 2011, we reviewed responses for investment information from 44 employee benefit plans with assets with 20 percent or more of plan assets invested in HTV alternative investments. We reviewed prior EBSA and GAO studies on alternative investments. Fieldwork was conducted at EBSA headquarters in Washington, DC.

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 banking regulations, and EBSA policies and procedures. We also interviewed officials from EBSA, the AICPA, Federal and State Banking Regulators, and reviewed prior ERISA Advisory Council reports to gain an understanding of standards for the supervision and examination of ERISA assets certified and held in trust by qualifying custodians.

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.

We selected a stratified random sample of 55 (we received responses from 44 plans) out of 2,617 Defined Benefit plans with 20 percent or more of plan assets invested in HTV alternative investments. These 44 sampled plans had end-of-year total HTV alternative investments of \$87.5 billion. For these plans, we contacted plan management to obtain documentation to support the prudence and fair value assumptions of the plan's HTV alternative investments. We also reviewed trustee and custodial service agreements to determine what role the qualified custodian played in determining the value of plan assets held for certification purposes under the limited scope audit provisions.

For sampled plans, we reviewed HTV investments as defined by the Financial Accounting Standards Board (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, the certifying custodian's service agreements for the evaluation of this process. We did not extrapolate our sampled testing of plans with HTV alternative investments due to limitations in Form 5500 in capturing information on HTV 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 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
- 29 C.F.R § 2510.3-21- Definition of a Fiduciary
- 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
CCT	Common Collective Trust
DOL	Department of Labor
EBSA	Employee Benefits Security Administration
EFAST2	ERISA Filing Acceptance System II
ERISA	Employee Retirement Income Security Act of 1974
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Bank
GAO	Government Accountability Office
HTV	Hard-to-value
IQPA	Independent qualified public accountant
MTIA	Master Trust Investment Account
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
PSA	Pooled Separate Account

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EBSA Response to Draft Report

U.S. Department of Labor

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



DATE: **SEP 29 2014**

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. 05-14-005-12-121

This is in response to the recommendations in your September, 2014 audit report regarding the Employee Benefits Security Administration's (EBSA) oversight of employee benefit plans electing limited scope audits under ERISA section 103(a)(3)(C) and the 29 CFR § 2520.103.8 for assets held by a bank or similar institution or insurance carrier which is regulated and supervised and subject to period examination by a State or Federal Agency.

Your current Audit Report reiterates several conclusions contained in earlier audit reports you have issued in this area with which we generally agree. To simplify our response, I refer you, and others that may read your report, to our earlier responses that you kindly included in your earlier reports.

OIG's RECOMMENDATIONS

A. Recommendation for Legislative Action

Your first recommendation was that EBSA should continue to seek statutory amendments of ERISA to repeal the limited scope audit exemption in ERISA section 103(a)(3)(C), and provide EBSA with direct oversight authority over plan auditors. This same recommendation was made in your September 2012 audit report (No. 09-12-002-12-121) regarding EBSA's oversight of annual financial audits of employee benefit plans under ERISA. As you know, 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. We appreciate the OIG's continued attention to this issue, and we will continue to use the OIG reports on this topic to advocate for legislative change.

B. Recommendations for Administrative Action

You made the following recommendations for regulatory and interpretive actions that EBSA should take with respect to limited scope audits:

2. Work within its existing authority to mitigate the risks created by the limited-scope audit provision.

3. Provide additional formal guidance to plan administrators to identify and adequately support the fair value of plan assets.
4. Establish a timetable to evaluate the feasibility of ERISA Advisory Council recommendations on limited scope audits.
5. Collaborate with federal and state regulators to determine the level of examination and supervision they exercise for ERISA plans assets certified and held by custodians by:
 - a. Establishing memoranda of understanding with, at minimum, federal regulators to share information on regulatory and examination practices and evaluating those practices; and
 - b. Obtaining access to reports of examination by federal and state regulators to evaluate audit assurances and identify areas of concern for ERISA plan assets held and certified by qualified custodians.
6. Determine whether EBSA can issue guidance on the level or form of supervision and examination by federal and state regulators needed to provide appropriate assurances for ERISA assets held in trust.

As we noted in response to earlier audit reports, a more comprehensive legislative solution is needed to address the problems at the heart of your report. We also believe there are interpretive and regulatory steps that we can take with respect to your above recommendations. In fact, in response to your September 2012 and September 2013 audit reports on EBSA oversight of ERISA plan audits and plans holding hard-to-value alternative investments, EBSA formed an inter-office task group to evaluate recommendations we have received in this area from your office and from the ERISA Advisory Council. We advised you of that task group in our February 2014 report on open OIG recommendations. The inter-office task group is comprised of staff from EBSA's Office of Regulations and Interpretations and Office of the Chief Accountant. I have directed them, to include your most recent recommendations in the evaluation they are conducting. The current target is for the task group to identify options for possible interpretive and regulatory actions by the end of this year. Before taking formal action, I will certainly seek the views of your staff regarding any interpretive or regulatory steps that we propose to take.

Appendix E

Acknowledgements

Key contributors to this report were Nicholas Christopher (Audit Director), Jason Jelen (Audit Manager), Richard Donna Jr., Lewis Leung, Patrick Trager, Steve Chiang, Tim Kerschen, Elizabeth Garcia, Steve Witherspoon, and Mary Lou Casazza.

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