

June 2007

DEFINED BENEFIT PENSIONS

Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges





Highlights of [GAO-07-703](#), a report to congressional requesters

Why GAO Did This Study

To protect workers' retirement security, the requesters asked GAO to assess: 1) What is known about conflicts of interest affecting private sector defined benefit (DB) plans? 2) What procedures does PBGC have to identify and recover losses attributable to conflicts? 3) What procedures does Employee Benefits Security Administration (EBSA) have to detect conflicts among service providers and fiduciaries for PBGC-trusted plans? 4) To what extent do EBSA, PBGC, and SEC coordinate their activities to investigate conflicts? GAO interviewed experts, including agency officials, attorneys, financial industry representatives, and academics, and GAO reviewed PBGC documentation and EBSA enforcement materials. GAO analyzed Labor, SEC, PBGC, and private sector data, including data on pensions, pension consultants, and rates of return data, and conducted statistical and econometric analyses.

What GAO Recommends

GAO recommends that PBGC assess the risks from conflicts of interest; that EBSA expand enforcement to include a focus on PBGC-identified plans; and that each agency share data on conflicts. Congress should consider amending ERISA to expand Labor's authority to recover losses against non-fiduciaries. Each agency generally concurred with the report, although EBSA expressed some methodological concerns.

www.gao.gov/cgi-bin/getrpt?GAO-07-703.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or Bovbjerg@gao.gov.

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What GAO Found

A conflict of interest typically exists when someone in a position of trust, such as a pension consultant, has competing professional or personal interests. Though data are limited on the prevalence of conflicts involving plan fiduciaries and consultants, a 2005 SEC staff report examining 24 registered pension consultants identified 13 that failed to disclose significant conflicts. GAO's analysis found that, in 2006, these 13 consultants had over \$4.5 trillion in U.S. assets under advisement. GAO also analyzed a sample of ongoing DB plans associated with the 13 consultants that, as of year-end 2004, had total assets of \$183.5 billion and average assets of \$155.3 million. Additional sample analysis showed that the DB plans using these 13 consultants had annual returns generally 1.3 percent lower than those that did not. Because many factors can affect returns, and data as well as modeling limitations limit the ability to generalize and interpret the results, this finding should not be considered as proof of causality between consultants and lower rates of return, although it suggests the importance of detecting the presence of conflicts among pension plans. Whether specific financial harm was caused by a conflict of interest is difficult to determine without a detailed audit.

As a creditor and a trustee of terminated plans, PBGC's policies and procedures are oriented toward the likely recovery of assets, rather than explicitly focusing on losses associated with conflicts of interest involving service providers. Although PBGC has broad legal authority to recover losses attributable to conflicts of interest, PBGC officials told us that the agency limits its pursuit of cases to those in which the recovery will likely exceed the cost of bringing a case to court successfully. While monetary recoveries by PBGC may improve the agency's financial position, they generally have little effect on participant benefits because most affected participants already receive their full benefits promised by their plans. According to PBGC, more than 90 percent of all beneficiaries of PBGC trusted plans received their full promised plan benefit.

While EBSA's enforcement program is concerned with conflicts of interest affecting all private pension plans, it does not have specific procedures for plans trusted or likely to be trusted by PBGC. EBSA has recently initiated the Consultant/Advisor Project (CAP) to focus on conflicts among service providers, though it includes no specific focus on high risk or terminated plans. Moreover, existing law limits EBSA's efforts to pursue conflicts and redress for financial harm when certain service providers are either not fiduciaries under ERISA or did not knowingly act in concert with a fiduciary.

Coordination among EBSA, PBGC, and the SEC on conflicts of interest is primarily informal, in part because of agencies' different responsibilities. The agencies' investigative activities for conflicts of interest tend to operate independently. Differences in agency missions pose challenges to the three agencies' developing a coordinated focus to pursue conflicts of interest affecting individual pension plans.

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Abbreviations

CalPERS	California Public Employees' Retirement System
CAP	Consultant Advisor Program
DB	defined benefit
DC	defined contribution
DOL	Department of Labor
EBSA	Employment Benefits Security Administration
ERISA	Employee Retirement Income Security Act
GLS	generalized least squares
MOU	memorandum of understanding
OCIE	Office of Compliance Inspection and Examinations
OLS	ordinary least squares
PBGC	Pension Benefit Guaranty Corporation
SEC	Security and Exchange Commission
S&P	Standard and Poor's

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United States Government Accountability Office
Washington, DC 20548

June 28, 2007

The Honorable George Miller
Chairman
Committee on Education and Labor
House of Representatives

The Honorable Edward J. Markey
House of Representatives

The bankruptcies of United Airlines, Bethlehem Steel, and other firms since 2000 have resulted in the termination of a number of large underfunded pension plans and their becoming the responsibility of the Pension Benefit Guaranty Corporation (PBGC), the federal guarantor of private sector defined benefit (DB) plans. Since then, the number of pensioners who depend on the agency for their retirement benefits has almost tripled, and the agency's single employer insurance program has moved from a surplus of \$9.7 billion to an accumulated financial deficit in 2006 of more than \$18 billion. Recent experiences involving the termination of large DB plans have illustrated the weaknesses in funding rules.¹ Adding to concern over the health of DB plans have been recent reports about conflicts of interest among pension consultants – advisers who often play a major role in guiding plan investments. In June 2005, the Aircraft Mechanics Fraternal Association, which represents certain employee groups in terminated United and Northwest Airlines DB plans, expressed concern that conflicts of interest may have been present in the DB plans of employees the union represents. The union's concerns were raised as a result of a May 2005 study by Securities and Exchange Commission (SEC) staff on conflicts of interest among pension consultants. The SEC study revealed that many pension consultants have failed to adequately disclose conflicts of interest in the process of advising

¹The Pension Protection Act of 2006 revamped funding rules for defined benefit plans—generally effective in 2008—and makes changes to the PBGC insurance program. Also see, GAO, *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, [GAO-05-294](#) (Washington, D.C.: May 2005).

pension plans and their trustees, including DB plans.² A conflict of interest is typically a situation in which someone in a position of trust, such as a pension plan trustee or investment adviser, has competing professional or personal interests. Such competing interests can make it difficult for fiduciaries and others, in general, to fulfill their duties impartially and could cause them to breach their duty to act solely in the interest of investors, plan participants, or beneficiaries. Having a conflict in and of itself does not constitute a breach of fiduciary duty. However, given the potential of financial harm to plan sponsors and participants, concerns have been raised about the extent and nature of these conflicts of interest.

In view of the importance of protecting the retirement security of plan participants and bolstering the financial position of the PBGC, you asked us to pursue the following questions:

- What is known about conflicts of interest on the part of service providers and plan fiduciaries to single employer, private sector DB plans?
- What policies and procedures does the PBGC have in place to identify and recover losses attributable to conflicts of interest in plans it trustees?
- Does the Department of Labor's (Labor) Employee Benefits Security Administration (EBSA) have procedures in place to detect conflicts of interest among service providers and fiduciaries for plans now trusted by PBGC?
- To what extent do EBSA, PBGC, and SEC coordinate their activities to identify and investigate conflicts of interest?

To determine what is known about the existence of conflicts of interest in the context of single employer private sector DB plans, we interviewed a variety of professionals with expert knowledge of the issue, including agency officials, forensic auditors, accountants, attorneys, financial industry representatives, and academics. We also analyzed Form 5500 data, Nelson's Directory of Plan Sponsor data, Nelson's Directory of Pension Consultants data, SEC examination data, Pensions and Investments periodicals, and data received from the PBGC associated with

²See U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, *Staff Report Concerning Examination of Select Pension Consultants* (Washington, D.C.: May 16, 2005.) The report's findings were based on a 2002 to 2003 examination of 24 pension consultants. See <http://www.sec.gov/news/speech/spch120505lr.htm> (accessed 2007).

terminated DB plans. In addition, we analyzed Standard and Poors (S&P) rate of return and asset allocation data for ongoing and terminated plans. To determine the policies and procedures PBGC has in place on conflicts of interest, we interviewed PBGC and EBSA officials and reviewed PBGC documentation related to this issue. To determine the procedures EBSA has in place to detect and investigate conflicts of interest at service providers or plan fiduciaries, we reviewed EBSA's enforcement materials, our previously issued reports on EBSA's enforcement program, and interviewed EBSA officials. To determine EBSA's, PBGC's, and SEC's coordination efforts, we interviewed officials at all three agencies and reviewed previously issued reports that provided related information on this issue. We conducted our work between February 2006 and May 2007 in accordance with generally accepted government auditing standards. See appendix I and appendix II for more information on our scope and methodology.

Results in Brief

Although no complete information is available regarding the prevalence of conflicts of interest, pension plan consultants assisting significant numbers of pension plan sponsors may have conflicts of interest, as a result of their affiliations or business arrangements with other firms that could affect the advice they provide to these sponsors. A May 2005 SEC staff study of pension consultants registered as investment advisers found that 13 of the 24 consultants reviewed that had provided services to sponsors of pension plans, including ongoing DB and PBGC trustee DB plans, had failed to disclose significant ongoing conflicts of interest to their pension fund clients. Our analysis of data found that, in 2006, these 13 consultants had over \$4.5 trillion in U.S. assets under advisement, which included DB, DC, and other types of assets. We also analyzed a sample of ongoing DB plans associated with the 13 consultants that, as of year-end 2004, had assets of \$183.5 billion for these plans and average assets of \$155.3 million. Additional analysis found that the DB plans using these 13 consultants had annual returns generally 1.3 percent lower than those that did not. Because many factors can affect returns, and data and modeling limitations limit the ability to generalize and interpret the results, this finding, while suggestive, should not be considered as proof of causality between consultants and lower rates of return. Lack of data prevented a similar study of PBGC trustee plans or high risk plans likely to terminate. Although SEC staff have reported that some of the consultants examined in its study have since taken some corrective action, this finding nevertheless illustrates the importance of detecting the presence of undisclosed conflicts of interest among ongoing plans, and likely among terminated plans. However, independent experts, EBSA and

PBGC officials all concur that while analyzing rates of return is a useful first step, determining whether conflicts resulted in financial harm to individual plans and the magnitude of that harm is often extremely difficult without a detailed forensic audit.

As a creditor and a trustee of terminated plans, PBGC's policies and procedures are oriented toward the likely recovery of assets, rather than specifically focusing on losses associated with conflicts of interest involving service providers. When assuming responsibility for a terminated plan that is underfunded, PBGC takes steps to identify improper activities of the plan fiduciary, such as theft or improper loans of plan assets, but does not collect and evaluate service providers' records to identify their conflicts of interest and any associated losses to the plan. PBGC officials told us that, given the agency's mission, balancing scarce resources against the likelihood of recovering losses makes pursuing conflicts of interest cases particularly risky for PBGC. Although PBGC has broad legal authority to pursue and recover losses attributable to conflicts of interest, PBGC officials told us that the agency limits its pursuit of cases to those in which the recovery will likely exceed the cost of identifying and gathering evidence and bringing a case through the courts successfully. While monetary recoveries of missing assets by PBGC may improve the agency's financial position, they generally have little effect on participant benefits because most participants of PBGC trustee plans already receive their full plan benefits. According to a PBGC 2004 report, more than 90 percent of all beneficiaries of PBGC trustee plans received their full plan benefit.

EBSA's enforcement program is concerned with conflicts of interest affecting private-sector pension plans generally and does not have specific procedures for plans trustee by PBGC. EBSA officials told us they do not focus their enforcement efforts on PBGC-trustee plans and generally leave the responsibility of identifying potentially harmful conflicts of interest to PBGC for those plans under PBGC control. EBSA has recently expanded its enforcement activities to focus more heavily on conflicts of interest involving service providers through a new initiative known as the Consultant/Adviser Project (CAP). However, EBSA officials said there are no explicit procedures in the CAP that focus on service providers of plans that PBGC deems as likely to terminate or those plans now under PBGC's control. EBSA officials also noted that existing law limits their efforts to pursue conflicts involving those service providers that are not fiduciaries under ERISA or that did not knowingly participate in a breach by a fiduciary.

The current level of coordination among EBSA, PBGC, and the SEC regarding conflicts of interest is limited, largely because of the different authorities and missions of each agency. Exchanges of information are informal and have occurred both between staff at these agencies' headquarters and between their local offices. At the national level, for example, SEC has shared examination reports that it concluded would be helpful to EBSA and provided access to the non-public exam files related to its 2005 pension consultants study. Locally, information is generally exchanged when two or more local agency offices have good working relations. Differing agency responsibilities tend to reinforce limited collaboration among these agencies. For example, SEC is primarily concerned with regulating investment advisers to ensure compliance with securities laws, while EBSA is tasked with protecting participant benefits. PBGC, in contrast, provides an insurance program for plans in the event a plan is terminated without sufficient assets to cover promised benefits. However, more regularized coordination could improve agency efforts regarding conflicts of interest. Because of their different missions, these agencies have not established systematic procedures for regular sharing and coordinating on conflicts of interest.

We are making recommendations to Labor and PBGC that are intended to improve the detection and oversight of conflicts of interest, and strengthen EBSA's enforcement ability over non-fiduciaries and recovery of losses to PBGC-trusteed plans and to improve the collaboration among EBSA, PBGC, and SEC. We are also asking that Congress consider amending ERISA to give the Department of Labor greater authority to recover losses from non-fiduciaries. We provided a draft of this report to Labor, PBGC, and the SEC for their review and comment.

We obtained comments from the acting Assistant Secretary for the Employee Benefits Security Administration, the Deputy Director of the Pension Benefit Guaranty Corporation, and the Director of Compliance Inspections and Examinations for the Securities and Exchange Commission. Each of the agencies also provided technical comments, which were incorporated into the report as appropriate. EBSA, PBGC, and SEC generally agreed with the findings and conclusions of the report. PBGC noted that although it has no authority to take action against service providers with conflicts of interest involving ongoing plans, its recent initiative to enhance its procedures for identifying and pursuing fiduciary breach and other types of claims is fully consistent with our recommendation. In its comments, EBSA agreed to consider our recommendation to expand the focus of its CAP program to PBGC-identified pension plans that may be trusteed or are high risk as it reviews

the results of its initial efforts under CAP and gains additional experience through project investigations. EBSA also noted a number of concerns about our statistical analysis and in particular our econometric analysis that suggests a negative association between consultants with undisclosed conflicts of interest and rates of return on assets. In response to these concerns, we now discuss the limitations of the analysis more prominently and have added more information on our statistical analysis and data in appendix II. All three agencies acknowledge the importance of effective cooperation to facilitate their respective missions. EBSA's, PBGC's and SEC's comments are reproduced in appendix III, appendix IV and appendix V.

Background

ERISA is the primary federal law governing the sponsorship and operation of private sector employee pension plans, including DB plans.³ Title I of ERISA gives Labor the primary authority to enforce requirements governing the conduct of fiduciaries of pension and other employee benefit plans. EBSA is the Labor agency responsible for administering and enforcing Title I. ERISA has requirements relating to the standard of conduct of plan fiduciaries⁴ and also prohibits certain transactions⁵ between fiduciaries and parties in interest. Under Title IV of ERISA, PBGC was established to provide insurance to covered private-sector single-employer and multiemployer DB plans. The PBGC is not an enforcement agency and receives no funds from general tax revenues. When a bankrupt plan sponsor terminates an underfunded pension plan, PBGC assumes trusteeship of the assets and liabilities of the plan, pays participant and beneficiary benefits, and acts as a creditor of the bankrupt sponsor in the interest of the plan's participants and beneficiaries. As plan trustee, PBGC may file suit to recover missing assets of the plan as well as other assets of the bankrupt sponsor or to recover losses and debts owed to a plan,

³29 U.S.C. §§ 1001-1461.

⁴29 U.S.C. § 1104.

⁵29 U.S.C. § 1106. Although ERISA generally does not prohibit conflicts of interest, it establishes a number of prohibited transactions, such as sales or loans between fiduciaries and parties in interest, as well as any transaction between a plan and a fiduciary that's in the fiduciary's interest. ERISA also provides, however, a number of detailed exemptions to these prohibitions and permits Labor to establish additional ones. 29 U.S.C. § 1108.

including those resulting from the improper actions of anyone whether or not they are considered fiduciaries under ERISA.⁶

Among other things, ERISA provides that private sector employee pension plans, including DB plans, must have one or more named fiduciaries who have authority to control or manage the operation and administration of the plan.⁷ ERISA requires fiduciaries to discharge duties solely in the interest of the participants and beneficiaries with care, skill, prudence, and diligence. The law states that a person acts as a fiduciary when they 1) exercise any discretionary control or authority over plan management or any authority or control over plan assets; 2) render investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or property of a plan or has any authority or responsibility to do so;⁸ or 3) have any discretionary authority or responsibility in the administration of a plan.

Pension plans and their fiduciaries often rely on consultants and other service providers to assist them in plan administration and asset management, which include selecting money managers and monitoring money managers' performance and brokerage transactions. Not all of these consultants and service providers are at all times fiduciaries under ERISA. ERISA takes a functional approach to fiduciary status. Fiduciaries that breach their plan duties are personally liable for making up losses to the plan, restoring any profits made through the use of plan assets, and face removal as plan fiduciaries.⁹ To the extent that a service provider was not functioning as a fiduciary under ERISA; however, EBSA can seek recovery against that provider if it knowingly participated in a breach by a fiduciary. Any such recovery is limited to plan funds the service provider received (typically in the form of fees paid to it) and any proceeds derived from those funds to the extent that they remain in the service provider's possession.

⁶For more information on the financial risks facing PBGC, see GAO, *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks*, [GAO-04-90](#) (Washington, D.C: Oct. 29, 2003).

⁷29 U.S.C. § 1102.

⁸29 U.S.C. § 1002(21). EBSA officials explained that a consultant or other adviser fits within this element of the definition only to the extent that advice was provided (1) as to the purchase or sale of securities or other property of 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.

⁹29 U.S.C. § 1109.

SEC regulates certain money managers and pension consultants under the Investment Advisers Act of 1940 (Advisers Act), which requires those firms meeting certain criteria to register with the commission as investment advisers.¹⁰ SEC regulates potential conflicts of interests at registered investment advisers and requires that they disclose information about affiliations, business interests, and compensation arrangements to their advisory clients, primarily by providing Part II of SEC's Form ADV or a brochure containing the same information to clients at the beginning of a relationship and by offering to provide it annually thereafter.¹¹ According to SEC, investment advisers have a fiduciary obligation under the Advisers Act to provide disinterested advice and disclose any material conflicts of interest to their clients. When an adviser fails to disclose information regarding material conflicts of interest, clients are unable to make informed decisions about entering into or continuing the advisory relationship. Failure to act in accordance with requirements under the Advisers Act may constitute a violation. According to an SEC official, if SEC becomes aware of conflicts of interest that are inadequately disclosed or pose harm to investors, it can require a firm to remedy the deficiencies or take formal enforcement action against the firm. SEC also regulates broker-dealers under the Securities Exchange Act of 1934 (Exchange Act), which governs how they may engage in transactions in securities for their customers and make recommendations to their customers.¹²

The financial services industry and the DB pension system have changed significantly since the early 1970s. The globalization of financial markets, as well as technological and international regulatory changes, has facilitated the development of new financial instruments and the complexity of investment opportunities.¹³ Meanwhile, despite the long term decline in the number of plans and active participants, DB pension plans remain a major holder of financial assets. Consequently, the financial services industry has responded to the growing need for

¹⁰15 U.S.C. §§ 80b-1 et seq. Rules under the Advisers Act permit pension consultants to plans having an aggregate value of at least \$50,000,000 to register with the Commission (Rule 203A-2(b)).

¹¹Investment advisers use Form ADV to register with the SEC and state securities authorities or to amend those registrations and, among other things, to disclose their conflicts of interest to advisory clients.

¹²15 U.S.C. §§ 78a et seq.

¹³GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004).

assistance with managing, investing, transferring, settling, valuing, and holding pension assets. In 2005, over 81 percent of large public/government plans utilized a consultant and 42 percent of private pension plans did so.¹⁴ According to an SEC official, as of October 31, 2005, there were more than 1,800 SEC-registered investment advisers that indicated on their SEC registration forms that they provide pension consulting services.¹⁵ The official stated that these firms vary widely from small one-person operations to large organizations employing hundreds. Some firms only provide pension consulting, while others may have started as pension consultants, but then added additional business operations such as brokerage and money management. It has been reported by a financial newspaper that in order to remain competitive, some consulting firms are assuming the fiduciary responsibility of making investment decisions and have been expanding the range of services they offer.¹⁶

This trend toward diversification leads to the potential for conflicts of interest that could harm pension plans because of competing professional interests. While conflict of interest is a broad term that can encompass many specific arrangements, according to an SEC official, conflicts can occur in the case of money managers, broker-dealers, or pension consultants when business relationships, particularly those that involve business among each other, may make them vulnerable to breaching their fiduciary obligation or duty. Such competing interests can make it difficult for fiduciaries, in general, to fulfill their duties impartially and could cause them to breach their duty to act solely in the interest of investors, plan participants, and beneficiaries. According to Labor officials, having a conflict in and of itself does not constitute a breach of fiduciary duty. However, under securities law, acting on and benefiting from the existence of a conflict without making full and fair disclosure of all related issues to clients potentially affected by the conflict may very well constitute a breach. As ERISA fiduciaries, plan trustees also may face significant conflicts of interest as they may have allegiance both to the

¹⁴For consultant usage information, see Thomson Nelson, *Annual Report of Pension Fund Consultants 2006* (New York, N.Y.: 2006).

¹⁵For information on SEC's pension consultant examination, see SEC, *Speech by SEC Staff: Conflicts of Interest in Pension Consulting*, (Washington, D.C.: Dec. 5, 2005), <http://www.sec.gov/news/speech/spch1205051r.htm> (2007).

¹⁶See, Mark Bruno, "Consultants: Fighting for Revenue", *Pensions and Investments Online*, (October 30, 2006).

plan and its beneficiaries, as well as to the plan sponsor that appoints them, and they may receive economic benefits directly or indirectly from plan service providers.

Some Pension Plan Service Providers May Have Conflicts of Interest, but Determining Whether Harm Results Is Difficult

Although no complete information is available regarding the prevalence of conflicts of interests, pension plan consultants assisting significant numbers of pension plans sponsors may have conflicts of interest as a result of their affiliations or business arrangements with other firms that could affect the advice they provide to these plan sponsors. A May 2005 SEC staff study of pension consultants registered as investment advisers found that more than half (13 out of 24) of the 24 consultants examined had failed to disclose significant conflicts of interest to their pension fund clients, including ongoing and PBGC trustee DB plans.¹⁷ We determined that, in 2006, these 13 consultants had over \$4.5 trillion in U.S. assets under advisement, including private DB and defined contribution (DC) plan assets, as well as public pension plan and other types of assets. We also analyzed a sample of ongoing DB plans associated with the 13 consultants that, as of year-end 2004, had assets of \$183.5 billion for these plans, while average assets were \$155.3 million. Additional analysis found that the DB plans using these 13 consultants had annual returns that were generally 1.3 percent lower than those that did not. Because many factors can affect returns, and data and modeling limitations limit the ability to generalize and interpret the results, this finding, while suggestive, should not be considered as proof of causality between consultants and lower rates of return. Although SEC staff have reported that some of the consultants examined in their study have since taken corrective action, our analysis illustrates the importance of detecting the presence of undisclosed conflicts of interest among ongoing plans, and likely among terminated plans. However, independent experts, EBSA and PBGC officials all concur that while analyzing rates of return is a useful first step, determining whether conflicts resulted in financial harm to individual plans and the magnitude of that harm is often extremely difficult to detect without a detailed forensic audit.

¹⁷Most of the consultants examined in the SEC study had disclosures that SEC staff found inadequate; however, 13 of them were of particular concern for SEC because the nature of the conflicts of interest information is not disclosed.

Pension Plan Fiduciaries and Money Managers Can Have Conflicts of Interest, Although Little Information Is Available on Their Prevalence

According to experts we interviewed, fiduciaries of pension plans often have an inherent conflict of interest because they are frequently employees of the plan sponsor. As fiduciaries, they are charged by law to act solely in the interest of plan participants and beneficiaries, but they may also have loyalty to the plan sponsor. For example, in 2004, United Airlines, a plan sponsor, appointed itself fiduciary of its employee pension plans after all three members of its plan trustee board resigned during bankruptcy negotiations. A conflict of interest existed because the newly appointed fiduciaries would have reason to make decisions that would benefit the plan sponsor instead of the plan participants. In this instance, the fiduciaries of the United Airlines' plans faced the obligation to ensure that minimum funding standards explicitly set in ERISA were satisfied by the plan sponsor. United Airlines subsequently decided to stop making contributions to the pension plans it was attempting to terminate. Labor stated that United Airlines' decision to stop funding its pension plans made clear the need to appoint an independent fiduciary to represent the interest of workers and retirees and resolve this conflict of interest. Subsequently, Labor and United Airlines agreed that United Airlines would appoint an independent fiduciary.

Plan fiduciaries may also be more prone to conflicts of interest such as prohibited transactions involving improper loans or more serious actions such as taking money from the pension plan for personal or business use when the plan sponsor is financially unstable and may be heading toward bankruptcy. Experts told us that plan fiduciary conflicts of interest and other acts such as these are less likely to occur in larger plans since they often have many professionals to assist with a plan's administration and management of plan assets. Despite this potential, there is little information on the extent to which conflicts of interest occur among plan fiduciaries of DB plans.

Though no formal study has reported statistics quantifying the prevalence of conflicts of interest among money managers, SEC through its examination and enforcement efforts has also identified potential conflicts of interest at money managers that could result in harm to clients, including pension plans. Money managers may in some cases have incentives to allocate investment opportunities in a way that could be unfair to certain advisory clients. For example, an adviser might make more money in fees based on how it allocates an investment opportunity—such as an initial public offering—among its clients and steer that opportunity to the advisers' more lucrative clients. In deciding whether to allocate the opportunity among its clients, the adviser may have an incentive to unfairly allocate the investment to a client that pays higher

fees. For example, as between a hedge fund and a pension fund, the adviser could make more money in fees paid by the hedge fund (for which fees are generally calculated as a percentage of the fund's overall performance, which could increase significantly from the investment) than in fees paid by the pension plan (for which fees are generally calculated as a percentage of plan assets). Another form of this conflict of interest, referred to as "cherry picking," occurs when an adviser places a trade without immediately identifying the client the trade is associated with, and then allocates the investment after learning of its value. If the purchase appears valuable based on market conditions, the adviser might place it in its own portfolio or a more profitable portfolio, but if it appears less valuable, the advisor might instead place it in one of its client's portfolios.

Money managers, including those at pension plans, may also face conflicts of interest because of due to soft dollar payment arrangements. Under soft dollar arrangements, money managers use part of the brokerage commissions their clients pay to broker-dealers for executing trades to obtain research and other services.¹⁸ These arrangements can create a number of problems. They can create incentives for investment advisers to trade excessively to obtain more soft dollar services, thereby increasing costs to pension plan clients or other clients. They can also influence advisers to place trades with a broker-dealer that provides the adviser with soft-dollar services rather than another broker-dealer that might provide best execution.

¹⁸Some forms of soft dollar payment arrangements are considered legal under a "safe harbor" provision of the Exchange Act in section 28(e) of the Securities Exchange Act of 1934 that allows advisers to pay more than the lowest available commission rate for security transactions in return for research and brokerage services and not be in breach of their fiduciary duty. 11 U.S.C § 78bb(e). In order to be protected against a claim of breach of fiduciary duty under this safe harbor, the adviser must make a good faith determination that the amount of commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

Consultants Identified by SEC as Having Significant Ongoing Conflicts of Interest Provide Services to Many Pension Plans

No complete information exists about the presence of conflicts of interest at pension plan service providers. However, a 2005 SEC examination of the activities of 24 pension consultants from 2002 through 2003 revealed that 13 out of 24 of the firms examined failed to disclose significant ongoing conflicts of interest.¹⁹ These ongoing conflicts took a number of different forms. For example, SEC found that 13 pension consultants or their affiliates were found to have conflicts of interest because they provided products and services to both pension plan advisory clients and money managers and mutual funds on an ongoing basis without adequately disclosing these conflicts. Specifically, the study found that 10 pension consultants sold money managers analytical software packages, which they use to help analyze and improve the performance of clients' holdings. This creates a conflict of interest for the pension consultant that might be more inclined to recommend to pension plans the money managers that buy software because those business relationships are profitable for the consultant. Similarly, 13 pension consultants hosted conferences attended by pension plan advisory clients, who were typically invited to attend without charge, and money managers, who were often invited to attend for a fee. A consultant hosting such a conference has a conflict of interest because it might be more inclined to recommend to pension plans the money managers that pay fees to attend conferences as such fees are used to offset costs incurred in hosting the conference.

SEC staff also found that the majority of pension consultants examined had business relationships with broker-dealers that raised a number of concerns about potential harm to pension plans. For example, in certain directed brokerage arrangements, a pension consultant may convince a pension plan client to direct their money manager to place plan trades through a broker-dealer that was affiliated with the consultant as a means for paying advisor fees a plan owed to its consultant using a portion of the brokerage commission paid on such trades. These arrangements raised concerns that plans might not have received the best price for each trade—or “best execution”—because the directions given to a plan's money manager by the plan may have restricted the money manager's

¹⁹According to the SEC report, the pension consultants examined represented a cross section of the pension consultant community and varied in size (measured in terms of the number and size of their pension plan clients) and the type of products and services they offered. About half of the pension consultants examined was among the largest pension consulting firms, measured in terms of the assets of the plans they advise. The remainder of the sample consisted of medium and smaller consultants. Since the consultants were not selected randomly, this sample cannot be generalized to the population of pension consultants.

ability to select a broker-dealer that was the best able to execute a trade. These arrangements raised the additional concern that consultants might be overpaid because the plan did not always know when the fee had been paid in full because brokerage commissions were being used to pay the fee rather than checks drawn on the plan's checking account.

Following up on its examinations of 24 pension consultants, in late 2005, SEC staff subsequently sought to determine what steps these firms had taken to address the findings from the earlier examinations. According to SEC staff, in general, most pension consulting firms it had examined had taken positive steps to reevaluate, revise, and implement changes to their policies and procedures. Specifically, pension consultants implemented policies and procedures to insulate their advisory activities from other activities, including for example, creating separate reporting lines and firewalls between employees that perform these separate functions, and considering employee compensation and incentives. In addition, SEC staff said that most consultants they examined had updated their policies and procedures to improve their disclosure of material conflicts of interest to pension plan clients and potential clients. Many pension consultants the SEC staff examined also reviewed and improved their policies and procedures to prevent conflicts of interest with respect to brokerage commissions, gifts, gratuities, entertainment, contributions, and donations provided to clients or received by money managers. However, SEC staff noted that while the pension consultants it had examined had improved their practices, it was not able to conduct examinations of all 1,800 investment advisers that indicated that they provide pension consulting services.

Our analysis of industry data regarding the 13 pension consultants that failed to disclose serious conflicts of interest found that these consultants provided services to a number of pension plans.²⁰ In particular, the 13 consultants:

²⁰The report did not seek to identify the financial harm to pension plans caused by these conflicts of interest, nor whether there were any violations of ERISA. U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations, *Staff Report Concerning Examination of Select Pension Consultants*, (Washington D.C.: May 16, 2005).

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- in 2006, had over \$4.5 trillion in U.S. assets under advisement, including private DB and defined contribution (DC) plan assets, as well as public pension plan and other types of assets;²¹
 - provided advisory services to 36 percent (9 out of 25) of the largest plan sponsors, in terms of claims, currently trustee by PBGC since 2000;²²
 - provided advisory services to 14 percent (12 out of 86) of the plan sponsors that were trustee by the PBGC in 2005; and
 - provided advisory services to 24 percent (1009 out of 4203) of the sponsors of ongoing DB plans between the years 2000 and 2004.

Our Analysis Shows an Association between Inadequate Disclosure of Conflicts and Lower Rates of Return, Although Proof of Financial Harm Requires a Detailed Audit

We conducted an analysis using ongoing DB plans that revealed a statistical association between inadequate disclosure and lower investment returns for ongoing plans, suggesting the possible adverse financial effect of such nondisclosure. Specifically, we conducted an econometric analysis using ongoing DB plans and SEC study data on pension consultants that either adequately disclosed their conflicts of interest and those who did not.²³ We found lower annual rates of return for those ongoing plans associated with consultants that had failed to disclose significant conflicts of interest, with lower rates generally ranging from a statistically significant 1.2 to 1.3 percentage points over the 2000 to 2004 period, depending on the different model specifications tested.²⁴ Since the average return for the ongoing plans that used consultants who did not

²¹*Pensions and Investments* periodical's list of Top 25 consultants ranked by U.S. institutional, tax exempt assets, 2006. 9 of the 13 consultants made the list of Top 25 consultants.

²²We constructed this analysis so that we looked at plans sponsors rather than plans. For example, PBGC's 25 largest trustee sponsors since fiscal year 2000 had a total of 67 plans and comprised 70 percent of the total claims against the agency between 1975 and 2006.

²³Our analysis is based on a data set we constructed by matching SEC consultant data with financial information compiled from the Form 5500 database on 1111 plans over 5 years. Of those, 983 were associated with the 13 consultants identified by the SEC as having provided services to DB plans that had serious disclosure problems, while 39 were associated with 11 consultants that either were in compliance or had minor inadequacies with disclosure and another 89 that were associated with both types of consultants. A complete discussion of our econometric approach, including model specification, variables used, data sources, estimation techniques and limitations is provided in appendix II.

²⁴These include an ordinary least squares specification with time-fixed effects and various random effect and fixed effect model specifications. "Fixed-effects" helps to control for the potentially large number of unmeasured forces that can explain the difference in plan returns. See appendix II.

have significant disclosure violations was about 4.5 percent, the model implies that the average returns for ongoing plans that used consultants who failed to disclose significant conflicts was 3.2 to 3.3 percent for the period. We did not find significant differences in returns for those plans that had associations with both types of consultants. As of year-end 2004, our sample of ongoing plans represented assets of \$183.5 billion for these plans, and average assets were \$155.3 million. We conducted our analysis using ongoing plans rather than terminated plans because the ongoing plans provided the necessary sample size to conduct our analysis, compared to a much smaller sample of terminated plans.

While, the results suggest a negative association between returns and plans that are associated exclusively with pension consultants that did not properly disclose significant conflicts of interest, the results should not be viewed necessarily as evidence of a causal relationship in light of modeling and data limitations. Although the analysis controlled for plan size, funding level, performance of asset markets, differences in plan fiscal years and other key variables, other unknown, omitted factors could have influenced the results of our analysis. While this result gives an indication of the potential harm conflicts of interest may cause in the aggregate, these results cannot be generalized to the population of pension consultants since the consultants examined by the SEC were not selected randomly. In addition, while these findings are consistent with the views of the experts we interviewed concerning the adverse effect that complex service provider related conflicts of interest can have on pension plans, we cannot rule out the possibility that some other differences between the plans could explained the differences in estimated returns. See appendix II for a fuller discussion of the limitations and caveats.

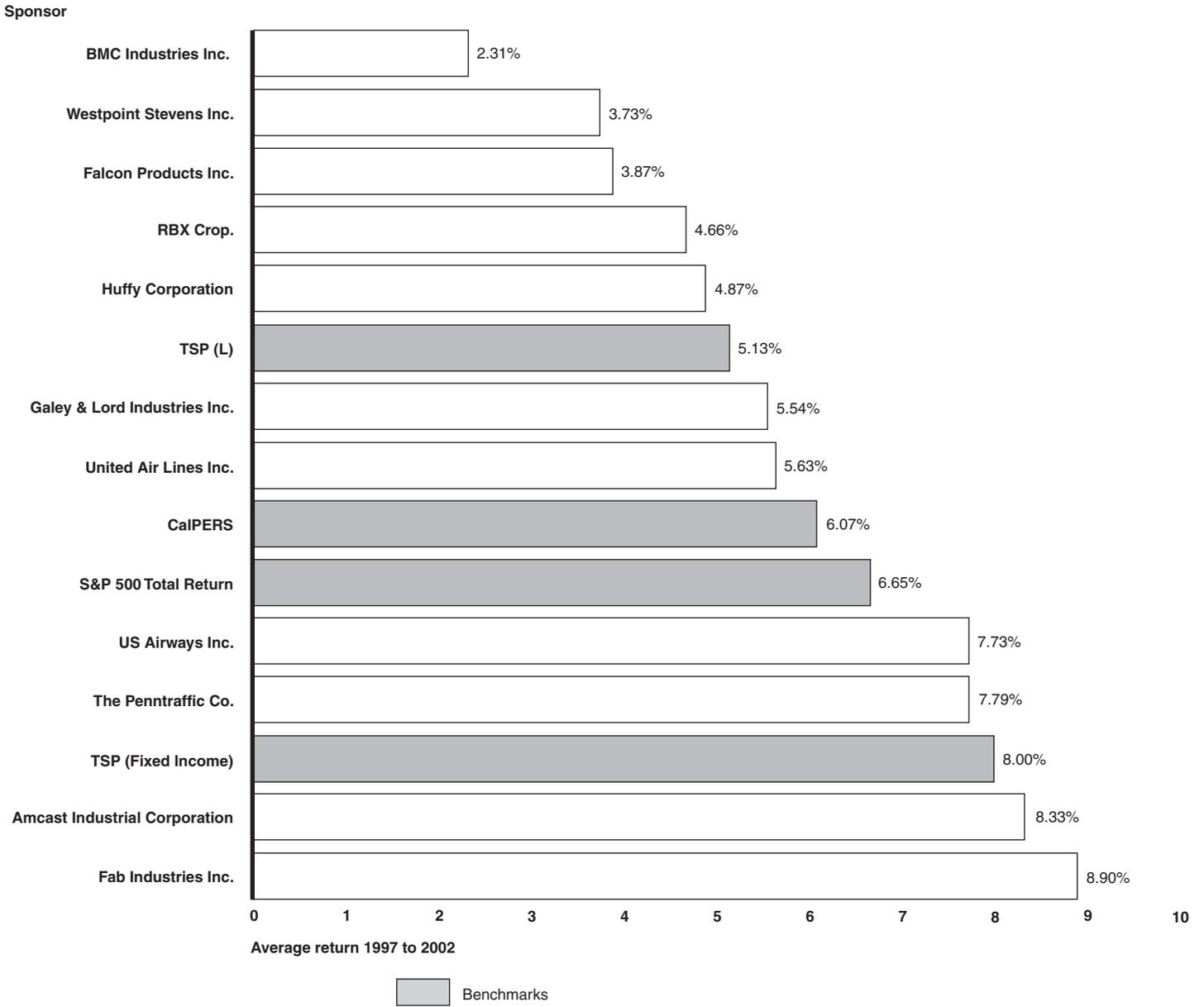
Although statistical analysis is useful, a detailed audit would be needed to uncover a conflict of interest in any one plan. Independent experts and officials stated that though a typical first step to identify harm related to a conflict of interest is to examine a plan's investment returns, determining whether any financial harm is caused to an individual pension plan by a conflict of interest requires a detailed forensic audit. A rate of return for any single plan is not necessarily a good litmus test for deciding whether to pursue an investigation. For example, two trustee sponsors of plans that had some history with consultants reported as having business arrangements that could pose conflicts of interest had very different rates of return for their plans. The U.S. Airways plans, which were trustee by PBGC in 2003 and 2005, had a rate of return that exceeded the average measured the benchmark returns earned by the Standard and Poors (S&P) 500, CalPERS (a major public plan) and the Thrift Savings Plan (the

defined contribution plan for federal employees). Yet, at some point from 2000 through 2005, the U.S. Airways plan used the services of consultants who had business arrangements that are of the form described in the SEC study that raise concerns regarding conflicts of interest. These business arrangements included directed brokerage arrangements and hosting conferences. (See figure 1.)

On the other hand, at some point during that time period United Airlines used a pension consultant who had been noted for engaging in business arrangements such as directed brokerage and commission recapture programs that are similar in form to the type that SEC concluded in their 2005 study posed a conflict of interest. During our analysis period, United Airlines showed a rate of return somewhat lower than three of the four benchmarks.²⁵ (See figure 1). For both cases, and very likely most cases, a detailed, forensic audit would be necessary to identify any accrued harm from a conflict of interest. Even then, the magnitude of the harm could be difficult to determine. Experts told us that determining harm often involves a resource-intensive audit of a plan's service provider's records and the investment performance of the plan's assets. To perform such an audit effectively, experts told us that they would need, at a minimum, 5 years worth of service provider specific documents, including contracts with the plan sponsor, fees charged, payments and other financial transactions between service providers and those involving plan fiduciaries. In addition, experts told us that it would be important to review the investigative files and complaint records of agencies like the SEC to determine if there is a history of problems at plans and service providers.

²⁵Many factors affect a plan's rate of return. At the individual plan level, the poor performance of a plan's investments might not reflect the harm of conflicts of interest but could reflect weakly performing asset markets, failure to manage these assets in a cost effective manner, misallocation of the plan assets, or some combination of the three. Lower returns could also signify more conservative investment strategies as a result of differences in the age profile of pensioners. As a result, the plan's rate of return received on its assets must be measured and isolated from the many other industry and firm specific factors which may have an impact on an investment's value.

Figure 1: Average Annual Rates of Return Achieved by Plans Terminated in 2005 Sponsored by Publicly Traded Companies Compared to CalPERS, TSP and the S&P 500 Benchmarks, 1997-2002



Source: GAO analysis based on, TSP, PBGC, CalPERS, and S&P 500 data.

Note: Analysis based on calculated average rate of returns for the publicly traded firms taken over by the PBGC in 2005. We selected a range of benchmarks beginning with a very conservative benchmark to an all stock investment portfolio, the S&P 500. The average return for the TSP is based on a conservative portfolio whose allocation mimics the conservative Lifecycle Fund 2010, as of April 6, 2007. The TSP 2020 fund, whose allocation mimics the less conservative Lifecycle Fund 2020, earned less than the 2010 fund during the period of analysis. As a result, we chose the 2010 fund as one of our benchmarks. S&P 500 returns are based on the actual S&P total return index and therefore do not consider the cost involved with maintaining a portfolio indexed to the S&P 500. The CalPERS benchmark was selected to provide a more realistic comparison given its asset mix of bonds and stock for a pension fund than the S&P 500 could.

PBGC's Current Policy and Procedures Are Not Focused on Detecting Conflicts of Interest among Service Providers

As a creditor and a trustee of a sponsor's terminated plan, PBGC's policies and procedures are designed to review a plan's assets and liabilities and recover any shortfall. Agency officials told us that such audits include identifying missing money and conflicts of interest involving improper activities by a fiduciary such as improper loans and other prohibited transactions or those that rise to the level of fraud and theft of fund assets.²⁶ However, there is no explicit focus on potential losses associated with conflicts of interest by service providers since these losses are likely to be found in service provider records and not in the plan's financial records. Agency officials told us that they currently do not collect the service provider's records to the extent needed to uncover conflicts. Although PBGC has authority to recover losses from a broad group of service providers and not merely ERISA fiduciaries, agency officials said it may not be cost effective to do so. Our own analysis also indicates that while recoveries could have a positive, but likely small effect on the agency's financial position, they would have little effect on benefits for the large majority of participants.

PBGC Policies and Procedures Are Focused on Recovering Plan Assets

As the insurer of private sector DB plans, PBGC has a primary responsibility to provide timely and uninterrupted payment of guaranteed pension benefits. Given that plans trustee by the PBGC have insufficient assets to pay all accrued benefits, the agency seeks to bridge that gap by reviewing the plan, in part, to help recover assets. Such recoveries include the difference between the plan's assets and liabilities and quarterly contributions that employers have failed to make. PBGC uses plan financial documents and a variety of procedures and processes to identify

²⁶PBGC officials explained that, in a majority of instances, missing money and improper loans by fiduciaries occur at small employers with small pension plans where the plan fiduciary may also be the owner of the company sponsoring the plan and has little or no professional assistance with plan administration or asset management.

and value plan assets and liabilities. The financial documents used also assist the PBGC in uncovering fiduciary breaches, including conflicts of interest such as prohibited transactions, improper loans and acts of theft and fraud. However, these financial documents do not provide financial information that would assist the PBGC in uncovering conflicts of interest associated with service providers. Agency officials told us that they currently do not collect such documents.²⁷ Experts told us that the agency would, in fact, need to collect and analyze 5 to 10 years worth of contracts between service providers and plan sponsors and documents that reveal fees charged, payments, and other financial transactions in order to conduct a forensic audit. The agency would also need to collect an historical list of investment advisers, pension consultants and broker dealers, the plan's investment strategy, the money managers' selection process, and the money managers' investment performance gross and net of fees.

According to PBGC officials, the only circumstances in which their agency would have examined records to detect potentially harmful conflicts by a service provider would be in the case of a complaint providing specific allegations of wrongdoing with a plan's assets. Agency officials told us that they had never received a complaint regarding conflicts of interest by a service provider. In 2005, they received a letter involving the underfunded United Airlines plans that had been trustee by PBGC. The letter was filed by union representatives of affected participants out of concern emerging from the findings of the SEC staff report on conflicts of interest among pension consultants. PBGC officials told us that one reason they did not conduct a forensic audit of the United Airlines plans under their control was that the letter did not direct them to specific violations that they should audit. Agency officials also told us that they did not find it necessary to conduct a detailed audit of any of the plans following the SEC study because: 1) the plan's investment performance did not appear out of line; and 2) after reviewing the fees charged, assets managed, and the type of disclosures implicated, PBGC concluded that it was unlikely that the conflicts could have had a material adverse affect on United's pension plans.²⁸

²⁷PBGC does collect some service provider contract and fee information when a plan fails, but only to assure that the provider is compensated as appropriate.

²⁸SEC officials told us that they did not review the consultants for ERISA violations. Based on PBGC's evaluation work, they also did not evaluate United Airline's service providers for possible ERISA violations.

Although PBGC Has Authority to Recover Losses, Cost Benefit Considerations Shape the Agency's Actions

PBGC has the authority, as trustee, to recover losses from any party, including service providers that are not fiduciaries under ERISA.²⁹ Specifically, ERISA authorizes PBGC to recover from any entity that has caused a loss or liability to the plan utilizing any available federal or state cause of action. However, agency officials and experts explained that since PBGC is not an enforcement agency, their responsibility is to bring cases to recover losses to a plan, not to bring cases for ERISA violations. For example, a kickback arrangement—where an investor receives a financial benefit for choosing a particular investment—or other types of self-dealing constitute conflicts of interest that may violate ERISA's prohibited transaction rules. Although it is often difficult to determine whether a kickback causes a loss to a plan, under the prohibited transaction provision, the existence of a violation does not depend on whether any harm results from the transaction. Hence, identifying and bringing these types of cases would not necessarily be something that PBGC would pursue unless the violation caused a loss to the plan.³⁰

PBGC has pursued cases against plan fiduciaries in an effort to seek such recoveries. However, in many instances, according to PBGC officials, seeking recoveries from the plan fiduciary of a small plan to recover missing money or improper loans may prove fruitless since the plan fiduciary may have few assets to place a claim against. In fact, in some cases, a plan fiduciary's only asset from which to recover may be an accrued pension benefit.³¹ PBGC officials told us that the majority of their cases of fiduciary breach involve action by a fiduciary that adversely affected plan assets. The officials and outside experts told us that the majority of cases against fiduciaries to recover missing money or involving improper loans or prohibited transactions occur with small plans rather

²⁹29 U.S.C. § 1342(d)(1)(B)(iv). Under ERISA, PBGC generally has the later of 6 years after the cause of action arose or 3 years after trusteeing a plan to initiate a claim to recover the losses. 29 U.S.C. section § 1303(c)(6).

³⁰Some kickbacks involve pay-to-play schemes in which a money manager pays to gain access to pension plan sponsors, such as a pension consultant who only recommends to pension plans the money manager who pays the highest fees, while another form of kickback may involve the siphoning off of investment returns. In this example, kickbacks are siphoned off the investment returns of a client by the money manager after a marked-up trade. The siphoned returns may be paid to a plan trustee or fiduciary for their business, to pension consultants, or others.

³¹In such instances, spousal claims may prevent the attachment of or lessen the claim against a plan fiduciary's pension benefit.

than large plans since large plans typically have many professionals involved in the management and administration of the pension plan.

While identifying and pursuing cases against a small plan's fiduciary is typically not resource intensive, agency officials and experts have told us that identifying and pursuing harm related to conflicts of interest by service providers is a resource intensive effort that does not always result in the ability to quantify associated harm and make a recovery. Agency officials told us that, given their mission, measuring the investment of scarce resources against the likelihood of recovering losses makes pursuing conflicts of interest cases particularly risky for the PBGC. Further, officials explained that the agency must pursue cases where the recovery will likely exceed the cost of investing the agency's resources for identifying and gathering evidence and bringing a case through the courts successfully. If the agency does not believe that a recovery will exceed its costs, it would be imprudent for the agency to pursue that case. Nevertheless, as part of the agency's efforts to evaluate their exposure to certain risk factors, PBGC has undertaken two relevant studies, one of which includes an assessment of the risks that relate to the potential for unidentified claims against outside parties, which includes conflicts of interest³²

³²According to PBGC officials, the agency has very recently implemented new screening procedures to identify plans that would justify the significant expenditure of resources required to conduct an audit of a plan or service provider for conflicts of interest and other types of cases.

While Most of Its Pension Holders Would Not Likely Benefit, Additional Monetary Recoveries Could Potentially Reduce PBGC's Deficit

PBGC recoveries generally have little impact on participants in PBGC trustee plans because, as an insurer, the agency may pay benefits up to a guaranteed limit that is higher than the benefits promised to most participants of trustee plans.³³ According to a PBGC 2004 annual report, more than 90 percent of the participants and beneficiaries of single employer plans that were trustee by the agency received their full promised plan benefits.³⁴ Officials explained that many plans offer benefits that often fall under the guaranteed limits. The small percentage of participants and beneficiaries who currently could be helped by such monetary recoveries represents those that have lost promised plan benefits that were not guaranteed by PBGC and were not funded by the plan's assets.³⁵

PBGC is required by law to use a portion of its employer liability recoveries and remaining plan assets to cover the non-guaranteed benefits of pension holders after guaranteed benefits are funded and allocated.³⁶ An expert we interviewed explained that a portion of the recovered money goes toward assisting the agency in covering the guaranteed benefits it pays out. Agency officials told us that recoveries on claims for employer

³³PBGC pays vested accrued participant benefits as of the date of the plan's termination according to the provisions of each pension plan, subject to certain maximum guaranteed limits. Benefits guaranteed under section 4022 of ERISA (other than those under subsection (c)) are considered basic benefits. 29 U.S.C. § 1322. Some participants receive a small portion of non-basic benefits as outlined under section 4022(c) as well. For plans terminating in 2007, the PBGC maximum monthly annuity for an employee who retires at age 65 was \$4,125 per month or \$49,500 annually. The maximum guaranteed limit is dependent, in part, upon the age at which a pension holder begins receiving benefits and the type of benefits to be provided. The maximum benefit amount can be lower if benefits are received at an earlier age or the pension includes benefits for a survivor. However, if an individual is disabled, the maximum amount guaranteed is not reduced for age for those who begin receiving benefits from PBGC before reaching age 65.

³⁴See GAO See Pension Benefit Guaranty Corporation, *Pension Insurance Data Book* PBGC 2004 (Washington, D.C.: Spring 2005) p.25. Also note that participants of terminated pension plans lose future accrued benefits. See GAO, *Pension Plans: Benefits Lost When Plans Terminate*, T-HRD-92-58, (Washington, D.C.: September 24, 1992).

³⁵Generally, PBGC guarantees basic monthly benefits that provide income when participants retire, but does not guarantee basic benefits that exceed the ERISA specified maximum allowance per year and other non-basic benefits, such as special supplemental benefits that exceed the amount payable at normal retirement age, early retirement payments, and lump-sum death benefits. 29 U.S.C. § 1322. PBGC also pays only a portion of the benefit increases, the greatest of 20 percent per year or \$20 per month, in effect less than 5 years before plan termination. For those participants who own more than 10 percent of the business, stricter limits apply.

³⁶29 U.S.C. § 1322(c).

liability are distributed as prescribed by law and typically increases a participant's benefit payment less than \$20 per month. It is not clear whether recoveries related to conflicts of interest would provide significant additional benefits for participants since, according to experts we interviewed, recoveries for conflicts are likely to be small compared to represent a small fraction of a terminated plan's total underfunding.

Benefit recoveries may still help to reduce PBGC's accumulated deficit and support the agency's mission. PBGC's financial position declined dramatically for single-employer pension plans from fiscal year 2000 to 2005, with a four-fold increase in underfunding claims of \$25 billion. As of September 2006, the accumulated deficit for PBGC's single employer program was \$18.1 billion. Though recoveries from conflicts of interest are likely to be small compared with the agency's accumulated deficit, agency officials say that pursuing conflicts of interest would be beneficial as long as the costs do not outweigh the benefits obtained from the recovery.³⁷

EBSA's Enforcement Strategy Does Not Include Procedures That Focus on Conflicts of Interest Involving PBGC Trusteed Plans or High Risk Plans Likely to Terminate

Though EBSA's enforcement program is concerned with conflicts of interest affecting all private sector pension plans, the agency does not have a specific focus on plans that are trusteed by PBGC or ongoing high risk plans that PBGC identifies as most likely to terminate. Among EBSA's reasons for not having such a focus is the agency's view that the PBGC is in the best position to detect conflicts of interest at terminated plans and to refer cases to EBSA. Meanwhile, EBSA has recently expanded its ERISA enforcement effort by implementing its new Consultant/Adviser Project (CAP) to focus more heavily on conflicts of interest at all pension plans. EBSA officials also emphasized, however, that existing law presents a limitation to their pursuing conflicts on the part of several types of service providers.

³⁷ According to PBGC officials, these costs include direct costs of pursuing a case and opportunity costs of diverting PBGC staff from other mission critical work. Thus, a small net benefit based on direct costs could easily be outweighed by opportunity costs.

EBSA Has No Specific Enforcement Strategy for PBGC-Trusteed Plans or Plans that PBGC Deems Likely to Terminate

While EBSA's enforcement program does include a focus on conflicts of interest affecting all private sector pension plans, agency officials told us they have no specific procedures for detecting conflicts that may have involved plans that have been trustee'd by PBGC or may be trustee'd in the future.³⁸ There are several reasons for this, according to EBSA officials. First, they emphasized the view that it is primarily the failure of plan sponsors to adequately fund pension plans causing plan underfunding problems rather than poor investment advice from self-interested service providers. Second, officials told us that while they do have the responsibility to enforce fiduciary violations regardless of whether a plan has terminated, they do not focus their enforcement efforts on PBGC trustee'd plans and generally leave the responsibility of identifying potentially harmful conflicts of interest to PBGC for the plans under their control. EBSA officials also said, that while their agency has subpoena power, PBGC has the necessary authority and access to the many documents needed to pursue conflicts in the plans it trustee's. However, PBGC officials noted that while this may be true for terminated plans, it does not have jurisdiction to collect such documents for plans that have not yet terminated.

Finally, EBSA officials told us they had not had occasion to investigate any PBGC-trusteed plans for conflicts of interest insofar as PBGC had not made any investigative referral to EBSA concerning conflicts of interest. Further, EBSA officials said they had not received any complaints regarding service providers' conflicts of interests involving a terminated plan prior to a letter it, along with PBGC, received in 2005 from representatives of certain United Airlines employees. Agency officials told us that they responded to concerns raised in that letter by reviewing the plan performances and the portfolio distributions of United Airlines' plans and determined that they were in line with those demonstrated in the industry. In fact, in some discrete years, the performance for the United Airlines plans exceeded some industry benchmarks. Finally, EBSA used United's Form 5500 information to review the fees paid to service providers and found them to be comparable to other plans and reasonable. Thus, the agency did not believe that a forensic audit for service provider conflicts at United Airlines' plans was warranted.

³⁸A good identifier of high risk or future PBGC-trusteed plans is the PBGC list of probable claims. Historically, over 95 percent of claims classified as a probable claim on the PBGC's balance sheet do subsequently terminate in the future. See GAO, *Private Pensions: Questions Concerning the Pension Benefit Guaranty Corporation's Practices Regarding Single Employer Probable Claims*, GAO-05-991R (Washington, D.C.: Sept. 9, 2005).

EBSA Has a New Initiative to Focus on Conflicts of Interest among Service Providers

Despite the current lack of information about the extent of any harm that may have occurred as a result of conflicts of interest, EBSA officials acknowledged that such conflicts are a growing concern for their agency. In order to address these concerns, the agency has, therefore, undertaken a new national enforcement project, known as the Consultant/Adviser Project (CAP), which largely focuses on issues identified in the SEC's 2005 study of pension consultants.³⁹ In addition, with this project, EBSA hopes to identify other service providers that may be using or managing plan assets for personal benefit. Specifically the agency will look for improper, undisclosed compensation such as kickbacks, pay-to-play arrangements, and soft dollar arrangements. Further, to acquire more information about the fees charged by service providers, EBSA has proposed several revisions to the Form 5500, which plan sponsors are required to file annually. Among the many changes, the revised form would require increased disclosure regarding the types and amounts of payments made to service providers, including amounts paid via third-party arrangements, both direct and indirect.

Despite these changes, EBSA officials said the CAP will not have specific procedures focused on examining service providers of high risk and underfunded plans once they are trustee by PBGC. In addition, as we previously reported, challenges remain for pursuing more complicated conflicts of interest cases impacting plans in the context of EBSA's overall enforcement program.⁴⁰ For example, EBSA uses participant complaints and other agency referrals as sources of investigative leads and to detect violations. EBSA also identifies leads through informal targeting efforts by investigators primarily using data reported by plan sponsors on their Form 5500 annual returns. While these sources are important, such methods are generally reactive and may reveal only those violations that are sufficiently obvious for a plan participant to detect or those that are disclosed and not those violations that are more complex. Moreover, complaints have primarily originated from participants in defined contribution (DC) plans since certain problems (e.g., failure to credit participants' accounts with

³⁹As its investigations under the CAP are completed, EBSA may expand its scope to focus on additional pension consultants and advisers. Each of EBSA's 10 regional offices will be involved in identifying and investigating service provider activities related to conflicts of interest and prohibited transactions.

⁴⁰GAO has recently identified some steps that EBSA could implement that could enhance its enforcement effectiveness. GAO, *Employee Benefits Security Administration: Enforcement Improvements Made but Additional Actions Could Further Enhance Pension Plan Oversight*, [GAO-07-22](#) (Washington, D.C.: January 2007).

deposits) involving DC plans are often more apparent to participants. Requiring more information on the Form 5500 could, according to experts, uncover or discourage many abuses concerning conflicts of interest. However, the Form does not necessarily offer the agency timely or accurate information, because of the 285 days allowed for its completion and the possibility that errors may be present on the Form 5500 using the current paper-based filing system.⁴¹

It is also unclear how much time EBSA investigators, given their other duties, will be able to devote to the complex conflicts of interest cases similar to those targeted by the CAP. EBSA officials told us that they are addressing their resource constraints in the CAP by concentrating on a relatively small number of carefully targeted cases. They said they are undecided as to whether the agency will expand CAP beyond the cases identified as a result of the SEC study once these investigations are completed. We had previously reported that Labor's revised performance goals for EBSA enforcement may encourage a focus on cases that are more obvious and easily corrected, such as those involving delinquent employee contributions to DC plans, rather than on investigations of complex and emerging violations where the outcome is less certain and may take longer to attain. We had suggested changes to EBSA's approach to assessing performance to better promote industry compliance and address emerging violations although the agency has yet to make substantial changes to its performance measures.⁴²

Further, though fiduciaries are considered the first line of defense in avoiding conflicts of interest, EBSA does not conduct routine compliance examinations or routinely evaluate plan fiduciaries that are not part of an ongoing investigation to determine how well they select and monitor service providers. Agency officials and experts have stated that having a formal set of procedures and guidelines in place to guide the selection of service providers as well as a formal investment strategy to guide how assets are to be invested helps to mitigate conflicts of interest. EBSA officials said the agency lacks sufficient resources to conduct such general oversight and, instead, uses outreach programs to educate fiduciaries on

⁴¹GAO, *Private Pensions: Government Actions Could Improve the Timeliness and Content of Form 5500 Pension Information*, [GAO-05-491](#) (Washington, D.C.: June 2005).

⁴²GAO, *Employee Benefits Security Administration: Enforcement Improvements Made but Additional Actions Could Further Enhance Pension Plan Oversight*, [GAO-07-22](#) (Washington, D.C.: January 2007).

the importance of avoiding conflicts of interest. Other expert observers, however, commented that EBSA's education program only addresses abuses that occur as a result of ignorance or unintentional negligence, not those conflicts that are intentional. The experts emphasized that it is difficult to detect harmful conflicts of interest without some form of regularized or routine examinations. Although EBSA, in concert with the SEC, has issued a "tip list" of questions to help plan fiduciaries avoid conflicts among service providers, EBSA has no compliance procedures to determine whether fiduciaries are generally using this information.⁴³

EBSA Officials Cite ERISA as Constraint in Pursuing Conflicts of Interest

EBSA's ability to recover plan losses related to conflicts of interest by a service provider is largely limited by the extent to which the service provider was functioning as a fiduciary under ERISA. Additionally, for EBSA to take action against an individual or entity, there generally must be a breach of fiduciary duty. Many service providers carefully structure their contracts with plans in an attempt to avoid meeting the ERISA definition of a fiduciary, but whether or not they do depends on the facts and circumstances in each case. EBSA officials said that many service providers, such as accountants, auditors, and actuaries are seldom fiduciaries under ERISA even though they provide important consulting services to DB plans by evaluating plan assets, calculating required funding levels, and evaluating financial statements.⁴⁴ Experts told us that broker-dealers are a growing concern, for example, because they have been expanding their services to include both consulting and investment services—triggering conflicts of interest questions because offering both services raises concerns regarding the best execution of trades and introduces incentives that may not promote practices in the best interest

⁴³See U.S. Department of Labor, Employee Benefits Security Administration, *Selecting And Monitoring Pension Consultants - Tips For Plan Fiduciaries*, (Washington, DC.: May 2005).

⁴⁴Under ERISA, a person acts as a fiduciary when he or she 1) exercises any discretionary control or authority over plan management or any authority or control over plan assets; 2) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or property of a plan or has any authority or responsibility to do so; or 3) has any discretionary authority or responsibility in the administration of a plan. 29 U.S.C. § 1002(21). In addition, according to EBSA officials, a consultant or other adviser who renders advice for a fee or other compensation fits within the ERISA definition on that basis only to the extent that advice was provided (1) as to the purchase or sale of securities or other property of 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.

of plans and participants. Nevertheless, to the extent that a broker-dealer is not a fiduciary under ERISA, EBSA typically has no authority to take action against them for not acting solely in the interest of plans and participants.

To the extent that a service provider was functioning as a fiduciary under ERISA, in addition to recovering any funds taken from the plan and profits derived from them, EBSA can recover losses to the plan to the same extent that it can recover them from other fiduciaries. To the extent that a service provider was not functioning as a fiduciary under ERISA, however, EBSA cannot recover from them at all unless the service provider knowingly participated with a fiduciary under ERISA in a fiduciary breach. EBSA officials said that proving such knowing involvement is often quite difficult. Even in cases where EBSA can prove that a non-fiduciary knowingly participated in a fiduciary breach, however, EBSA is limited in its ability to obtain meaningful recoveries. Specifically, EBSA cannot recover plan losses but usually only amounts the plan paid to the non-fiduciary and any profits derived from those payments. Furthermore, courts have required proof that these amounts remain in the possession of the non-fiduciary plan in order for them to be recovered.

In addition to such monetary recoveries, EBSA can also obtain injunctions against fiduciaries initiating or continuing, and non-fiduciaries knowingly participating with fiduciaries in, activities constituting fiduciary breaches. Officials explained that, in theory, EBSA does not have to prove that an activity will cause financial harm to a plan before obtaining an injunction but as a practical matter it is very difficult to persuade a judge to grant one without being able to show such harm.

Different Authorities and Roles Have Limited Agency Collaboration

Currently, collaboration on the part of EBSA, PBGC, and SEC regarding service providers with conflicts of interest is largely informal. At the national level, SEC and EBSA have communicated about staff examinations related to the pension consultant study. At the local level, information about conflicts of interest involving pension plans has been exchanged between agencies where staffs have developed working relationships. For example, EBSA officials noted that two of its regional offices have been collaborating with regional SEC staff on some conflict of interest related cases. However, exchanges of information generally occur when local employees of different agency field offices have good working relations and decide that such contact is helpful. Differences in agency missions and responsibilities tend to reinforce such informal coordination.

Agency Collaboration on Conflicts of Interest Largely Informal

Collaboration on the part of EBSA, PBGC, and SEC that might facilitate identifying conflicts of interest is largely informal, particularly with regard to PBGC trustee plans. With respect to EBSA and PBGC, there is a memorandum of understanding (MOU) for sharing quarterly information on the financial status of plans, but it does not provide for collaborating over potential conflicts of interest. Moreover, EBSA and PBGC officials told us that the data currently shared would not likely reveal conflicts of interest. EBSA officials told us that their weekly discussions with PBGC representatives are related to financial matters of plans that may be experiencing financial trouble. With regard to the SEC, there is no formal agreement with the other two agencies to share information relevant to conflicts of interest. However, EBSA officials stated that there is some collaboration between EBSA and SEC both nationally and locally, generally occurring on an informal basis.

At the national level, SEC has shared examination reports that it concluded would be helpful to EBSA, including the non-public exam files related to the pension consultants study. At the local level, information about conflicts of interest involving pension plans has been exchanged between agencies where employees developed working relationships. For example, EBSA officials noted that two of its regional offices had been collaborating with regional SEC staff on some conflict-of-interest related cases.⁴⁵ However, under securities laws, SEC is subject to confidentiality restrictions with respect to information it can disclose to EBSA pertaining to an ongoing investigation, even if the information pertains to possible violations of ERISA. Likewise, EBSA investigators can alert SEC to information that is discovered during an ERISA investigation that might be of interest to SEC. However, unlike EBSA, SEC may not share documentation associated with its findings unless EBSA submits a written request for information which, if approved, allows access to any evidence that SEC has obtained during the course of its investigation.⁴⁶

⁴⁵In addition to the 2005 SEC study, these two regional projects also served as an impetus for EBSA's new CAP designed to address issues of whether plan service providers particularly pension consultants, may have potential conflicts of interest that could affect the objectivity of the advice they provide to their pension plan clients.

⁴⁶SEC personnel are generally prohibited from disclosing information obtained as a result of an examination or investigation. The Commission may provide such information, however, when those to receive it show that it is needed and provide acceptable assurances of confidentiality. 15 U.S.C. § 78x.

Nevertheless, there is no systematic procedure among the three agencies that would effectively target or monitor service providers engaged in conflicts of interest.⁴⁷ However, more regularized coordination could improve agency efforts regarding conflicts of interest. For example, during investigations and examinations, SEC and EBSA tend to collect documentation that is specific to their individual enforcement objectives. Experts told us that creating efficiencies through collaborative and supportive enforcement practices where both agencies collect and share information that both agencies would find useful would be a major improvement in collaboration.

Different Agency Responsibilities Tend to Reinforce Limited Collaboration among EBSA, SEC, and PBGC

To some extent, differences in each agency's roles and responsibilities affect the level of collaboration regarding conflicts of interest among the three agencies. First, EBSA is tasked with enforcing the fiduciary standards required under Title I of ERISA, which seeks to ensure that fiduciaries operate their plans in the best interest of plan participants. Second, SEC enforces securities law and is primarily concerned with regulating professional entities, such as pension consultants or investment advisers. Finally, PBGC insures benefits for the beneficiaries of private-sector DB pension plans.

Federal law and regulation across the agencies are not consistent on the treatment of conflicts of interest. For example, under securities law, a conflict of interest that is disclosed may not be a violation, and would not necessarily prompt investigation by the SEC, although it may prompt investigation by EBSA. However, Title I of ERISA applies only to those who have carried out or been associated with fiduciary responsibilities, which does not always include all types of service providers. In addition, differences in definitions and terminology create challenges for the agencies to gather useful information for collaborating on investigations. For example, all money managers and others that actively manage or invest pension assets have a fiduciary obligation under the Advisers Act. Money managers are generally considered fiduciaries under ERISA,

⁴⁷GAO has identified the need for greater coordination and made recommendations for greater and more formal coordination between EBSA and the SEC to improve enforcement efforts. See GAO, *Employee Benefits Security Administration: Enforcement Improvements Made but Additional Actions Could Further Enhance Pension Plan Oversight*, [GAO-07-22](#) (Washington, D.C.: January 2007) and GAO, *Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting*, [GAO-04-749](#) (Washington, D.C.: August 2004).

though broker-dealers are considered to be fiduciaries under ERISA only under certain circumstances. Pension consultants typically have a fiduciary obligation under the Advisers Act⁴⁸ but may not be fiduciaries under ERISA.

While PBGC has broad authority to recover losses, it is not an enforcement agency and therefore is not in the business of investigating conflicts of interest or other fiduciary violations without the intention of recovering meaningful losses. To the extent that there would be meaningful losses to recover, as trustee, PBGC has the ability to collect a range of service provider documents that might suggest a history of conflicts involving the pension plans it trustees. EBSA, which does have authority to investigate and bring conflict cases involving plan fiduciaries to court, does not have ready access to these documents without a subpoena. Although EBSA does have broad subpoena powers, the use of these subpoena powers and enforcing subpoenas can involve significant delays in enforcement and case resolution.

The lack of formal collaboration between the three agencies also reflects their differing missions. While the SEC and EBSA both have an enforcement role, their missions have different orientations. SEC enforces securities law and is primarily concerned with regulating professional entities, such as pension consultants or investment advisers, to the extent that all conflicts of interest are adequately disclosed and plan sponsors can make informed decisions about whom to hire. In most cases, the SEC is able to act administratively, in that it can levy fines and suspend registered advisers without having to use federal courts. Further, since advisers have a statutorily imposed fiduciary responsibility, investigators do not have the burden of proving a fiduciary status before taking action.

In contrast, EBSA is tasked with enforcing the fiduciary standards required under Title I of ERISA, which seeks to ensure that fiduciaries operate their plans in the best interest of plan participants. In most cases, EBSA must prove that each violation it pursues was caused by a plan fiduciary or a party carrying out a fiduciary function. EBSA officials told us that a consultant or other adviser is a fiduciary investment adviser only to the extent that advice was provided (1) on the purchase or sale of securities or other property of the plan, (2) on a regular basis, (3) pursuant

⁴⁸Rules under the Advisers Act require pension consultants to plans having an aggregate value of at least \$50 million to register with the Commission (Rule 203A-2(b)).

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. While the courts have ruled in some cases that EBSA can pursue non-fiduciaries that contribute to a fiduciary breach, EBSA officials stated that the remedies they have available to them under ERISA are limited when pursuing these entities. Moreover, EBSA officials told us that there can be situations where a pension consultant may not meet the conditions necessary to be considered a fiduciary under ERISA; in which case EBSA generally would not be able to take action against the consultant.

The role of PBGC, in turn, is not to regulate pension plan trustees and service providers, but to insure benefits for the beneficiaries of terminated pension plans. Therefore, PBGC's primary goal is to preserve plan assets to the degree possible in order to pay promised benefits and keep expenses to a minimum. Accordingly, PBGC generally does not undertake the cost of litigation without a clear opportunity to recover assets. PBGC officials stated that the recoveries are typically far smaller than their claims on assets, as the agency generally recovers at most 10 cents on the dollar. For plans terminating in fiscal 2005, for example, PBGC reported \$10.8 billion in claims but only \$170.7 million in recoveries.⁴⁹

Conclusions

The challenge to sound pension sponsorship posed by financial conflicts of interest is largely a consequence of the changes experienced by financial markets over the last 30 years. In fact, the pre-ERISA world of 1974 never anticipated the multiplicity and complexity of financial instruments that have expanded both investment opportunities and risks for plan fiduciaries. Index and hedge funds, the growth of complicated financial derivatives, and access to international financial markets represent only some of the extraordinary number of choices confronting today's pension plan fiduciaries.

Of necessity, DB pension plan fiduciaries must utilize the variety of service providers that have become available to help them assess choices. While conflicts of interest are not necessarily inherent in the provision of such financial services, the prevalence and the proliferation of consulting work and the complexity of business arrangements among investment advisers,

⁴⁹PBGC publishes detailed statistics regarding its program operations and benefit protections annually. For more information see, Pension Benefit Guarantee Corporation, *Pension Insurance Data Book*, PBGC 2005 (Washington, D.C.: Summer 2006).

plan consultants, and others have increased the likelihood. Our analysis of ongoing plans suggests that, in the aggregate, there may be some cause for concern. While many consultants have taken remedial action, there are pension plan consultants that advise on a sizeable portion of U.S. pension assets that did not fully disclose conflicts of interest in the past. Although not generalizable to all consultants and plans, our analysis cautiously suggests an association with such undisclosed conflicts and plan performance. However, assessing the extent and magnitude of the problem of conflicts of interest at an individual plan level, at the outset, may require a coordinated effort among the regulatory agencies because of the complexities involved and the significant resources associated with investigative audits. Regardless of the difficulty of finding a financial trail of damage, to the extent that financially harmful conflicts of interest exist, they pose a potential threat to the investment confidence of sponsors and participants. For this reason, alone, credible and visible enforcement is essential to prevent such erosion.

Yet our findings reveal that there is limited regulatory framework for deterrence in this area, particularly for terminated DB plans and those likely to terminate. EBSA's recent CAP initiative to target conflicts of interest among service providers may help, but it does not include any specific emphasis on service providers of plans either under PBGC's trusteeship or those considered likely to terminate. In addition, as EBSA officials have noted, ERISA's definition of fiduciary and associated remedies and penalties to correct potential breaches of fiduciary responsibility, conceived to address the pension issues of the 1970s, are less effective in combating conflicts of interest in the far more complex world of today. Further, the SEC concluded in its study that many pension consultants do not consider themselves to be fiduciaries to their clients. In fact, many pension consultants believe they have taken appropriate actions to insulate themselves from being considered a fiduciary under ERISA. As a result, it appears that many consultants believe they do not have any fiduciary relationships with their advisory clients and ignore or are not aware of their fiduciary obligations under the Advisers Act.

Meanwhile, PBGC's recent decision to conduct an overall risk assessment and implement new screening procedures acknowledges the need for improvement in PBGC's reviews for conflicts of interest and other risk factors. Without procedures to evaluate the effect of conflicts of interest on high risk and terminated plans, however, potential ERISA violations related to such conflicts of interest could possibly go undetected. Moreover, the current levels of collaboration among the three agencies most involved with DB pension plans – EBSA, PBGC, and the SEC – or

their service providers, present opportunities that could enhance enforcement. Because SEC conducts examinations of some registered advisers it oversees, consistent inquiry by EBSA and PBGC into SEC's inspection results would be a good first step toward bridging the information gap. In addition, in the spirit of creating efficiencies with overseeing service providers doing business with pension plans, EBSA and PBGC may greatly benefit from SEC's regular exams by giving some thought to what SEC could collect during its efforts that would be useful to the other two agencies.

Nevertheless, it would be prudent and responsible to carefully weigh the benefits of any new regulatory approaches against their potential effect on continued sponsorship of DB plans. Although the percentage of the private sector labor force covered by a pension plans has remained roughly constant over the last decade, the number of active DB plan participants has declined sharply. Nonetheless, given the important role that DB plans still play in the retirement security of millions of American workers and their families, it would be prudent to weigh any proposed regulatory options against the additional administrative costs they may generate on DB plans.

Matters for Congressional Consideration

Congress may wish to consider amending ERISA to allow EBSA to recover plan losses against certain types of service providers even if they are not currently considered fiduciaries under ERISA.

Recommendations for Executive Action

To enhance existing protections of plans and participants, and maintain participant and sponsor confidence in the private DB pension system, as part of its current risk assessment efforts, the Director of the PBGC should:

- Develop a pilot project to collect the necessary documents on a select group of trusteed plans to determine the extent to which conflicts of interest may have affected these plans. This pilot project should be undertaken with the assistance of EBSA and in consultation with the SEC. PBGC and EBSA should provide SEC with ideas that would be useful to them on the information SEC could gather during its adviser and broker-dealer examinations.

The Secretary of Labor should direct the Assistant Secretary for EBSA:

- to enhance current enforcement by expanding the scope of the new CAP program to include some emphasis on service providers of those high risk plans PBGC deems likely to terminate in the future and plans PBGC-trusted.

Building on the existing memorandum of understanding (MOU) between EBSA and PBGC and a recommendation made in our earlier work, the Assistant Secretary of EBSA, the Director of the PBGC, and the Chairman of the SEC should:

- Enter into an MOU to facilitate information sharing on conflicts of interest among service providers that either consult or that provide money management services to PBGC-trusted plans and those likely to terminate in the future.

Agency Comments and Our Evaluation

We obtained comments from the acting Assistant Secretary for the Employee Benefits Security Administration, the Deputy Director of the Pension Benefit Guaranty Corporation, and the Director of Compliance Inspections and Examinations for the Securities and Exchange Commission. PBGC's, EBSA's, and SEC's comments are reproduced in appendix III, appendix IV, and appendix V. Each of the agencies also provided technical comments, which were incorporated into the report as appropriate.

EBSA, PBGC and SEC generally agreed with the findings and conclusions of the report. PBGC noted that although it has no authority to take action against service providers with conflicts of interest involving ongoing plans, its recent initiative to enhance its procedures for identifying and pursuing fiduciary breach and other types of claims is fully consistent with our recommendations. In comments, EBSA agreed to consider our recommendation to expand the focus of its CAP program to PBGC-identified pension plans that may be trusted or are high risk as it reviews the results of its initial efforts under CAP and gain additional experience through project investigations.

All three agencies acknowledge the importance of effective cooperation to facilitate their respective missions. SEC notes that it looks forward to further developing its currently cooperative relationship with EBSA and PBGC through discussion on our recommendations. PBGC pointed to the existing information sharing arrangement that it has with EBSA and the

Internal Revenue Service that it believes could serve as a useful model to coordinate with EBSA and SEC, and pledges to work with EBSA and SEC to more closely coordinate agency action on PBGC-trusted plans and plans likely to terminate in the near future. EBSA also notes both the importance of establishing and maintaining effective working relations with other agencies to maximize enforcement effectiveness, and has stated that it is prepared to work with PBGC and SEC to facilitate information sharing.

EBSA noted a number of concerns about our statistical analysis and in particular our econometric analysis that suggests a negative association between consultants with undisclosed conflicts of interest and rates of return on assets. EBSA expressed important cautions that should be considered when interpreting our results, including some data limitations and our use of an estimate for our investment returns variable. We agree that our econometric study, while suggestive, should not be considered definitive, or a proof of causality, especially in light of the data and modeling limitations constraining the analysis. The goal of this analysis was to shed some light on a critical public policy issue—understanding the relationship between rates of return and consultants that have been found to have undisclosed conflicts of interest—given the current state of econometric techniques and limited real world data. We view our findings as an indicator of the potential effects that conflicts of interest can have on returns and as a catalyst for further analysis rather than evidence of a causal relationship. In response to EBSA's concerns, we now discuss the limitations of the analysis more prominently and have added more information on our statistical analysis and our data in appendix II.

We are sending copies of this report to the Director of the PBGC, the Secretary of Labor, the Chairman of the SEC, and other interested parties. We will also make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff has any questions concerning this report, please call me at (202) 512-7215. Key contributors are listed in appendix VI.

A handwritten signature in black ink that reads "Barbara D. Bovbjerg". The signature is written in a cursive style with a large, stylized initial 'B'.

Barbara D. Bovbjerg
Director, Education, Workforce, and
Income Security Issues

Appendix I: Scope and Methodology

To conduct our review of the procedures the PBGC, SEC and EBSA have in place to detect and coordinate on conflicts of interest that may impact the entities they oversee, we interviewed officials from key agencies as well as independent outside experts, lawyers and forensic auditors knowledgeable about conflict of interest issues. We conducted interviews with officials from SEC's Office of Compliance Inspections and Examinations (OCIE) and SEC's Division of Enforcement regarding their 2005 staff report concerning examinations of selected pension consultants and the agency's general enforcement practices. We interviewed various PBGC officials, including staff attorneys and accountants, on their departmental procedures policies regarding the pursuit of financial recoveries regarding underfunded terminated plans, as well as other related issues. We interviewed various EBSA officials, including those from EBSA's Office of Enforcement and the Solicitors office. We interviewed a number of experts on conflict of interest issues, including lawyers and auditing professionals knowledgeable about conducting audits related to conflicts of interest, and those with expert knowledge on EBSA and PBGC's policies and procedures. We also interviewed legal experts on ERISA and securities laws.

To obtain information about agency procedures, we collected and reviewed PBGC's operations and policy manual, and reviewed PBGC court cases. We collected data provided by EBSA's Office of Enforcement pertaining to the investigation of cases related to conflicts of interest and prohibited transaction violations and reviewed EBSA's enforcement manual. We reviewed the relevant section of ERISA and securities laws in consultation with GAO's legal staff. Finally, we reviewed past GAO work on SEC, PBGC and EBSA enforcement efforts with respect to conflicts of interest, as well as agencies' general enforcement efforts and we consulted the teams within GAO that regularly review SEC, PBGC and EBSA operations.

To conduct our statistical analysis on the 24 pension consultants included in the SEC study, we obtained details regarding the type of conflicts found and the disclosure issues involving the 24 pension consultants from SEC officials. We obtained specific information regarding certain finding statements made in the SEC's 2005 staff report and reviewed this information at SEC headquarters under their oversight. To protect the confidentiality of SEC's exam practice, our data analysis was mostly conducted at SEC headquarters. Any additional analysis conducted by us at GAO headquarters which could reveal information that could identify the consultants reviewed in the SEC's 2005 staff report has been destroyed.

Working with the SEC study data, we compiled a list of clients associated with the 13 consultants identified by the SEC staff report as having undisclosed conflicts of interest using the Form 5500 and Thomson Nelson's database of pension consultants and plan sponsors. ERISA and the IRC require administrators of pension plans to file annual Form 5500 reports concerning, among other things, the financial condition and operation of plans. Form 5500 Reports are shared among Labor's Employee Benefits Security Administration, IRS, PBGC, and the Social Security Administration, and each agency uses the Form 5500 to meet its statutory obligations. Plan year 2004 was the most recent year for which plan-specific Form 5500 data were available for our review. The Form 5500 data presents a number of data limitations. These limitations have been well documented in other reports issued by us.¹

We then supplemented our Form 5500 data with information we purchased from Thomson Nelson (Nelson). We used the Nelson databases and the Thomson Nelson Annual Report of Pension Fund Consultants 2006. The Nelson database contains detailed information on various aspects of 20,000 single employer DB and DC pension plans and on 350 pension consultants and other service providers who service those plans. With the Form 5500 and Nelson data, we developed a client list for the 13 pension consultants examined in the SEC study. We regard our client list to be a partial list since the sources contained incomplete information and no complete source of information was available to us. Since creating a complete client list for the 13 consultants identified by the SEC staff report as having undisclosed conflicts of interest was not possible, we consider our counts of the clients of these consultants to be conservative.

To determine the relationship between the consultants identified by the SEC with PBGC trustee plans and ongoing plans we conducted three matches:

- 24 SEC identified consultants with PBGC's list of the trustee plans of the 25 largest companies in terms of claims since the beginning of fiscal

¹See GAO, *Private Pensions: Participants Need Information on the Risks of Investing in Employer Securities and the Benefits of Diversification*, [GAO-02-943](#) (Washington, D.C.: Sept. 6, 2002); *Retirement Income Data: Improvements Could Better Support Analysis of Future Retirees' Prospects*, [GAO-03-337](#) (Washington, D.C.: Mar. 21, 2003); *Private Pensions: Multiemployer Plans Face Short- and Long-Term Challenges*, [GAO-04-423](#) (Washington, D.C.: Mar. 26, 2004); and *Private Pensions: Publicly Available Reports Provide Useful but Limited Information on Plans' Financial Condition*, [GAO-04-395](#) (Washington, D.C.: Mar. 31, 2004).

year 2000.² We constructed each match so that we looked at plan sponsors rather than plans. PBGC's 25 largest trustee companies since the year 2000 had a total of 67 plans.

- 24 SEC-identified consultants and our client list with PBGC's list of plans that underwent PBGC trusteeship in 2005. The total number of plans was 118.
- 24 SEC-identified consultants and our client list with plans that were non-terminated and ongoing between 2000 and 2004. The total number of plans was 4832.

The compilation and matching of our data sources provide the following information is illustrated in the table 1:

Table 1: Pension Plan Sponsors Employing 13 Consultants of Concern to the SEC Regarding Inadequately Disclosed Conflicts of Interest.

	25 largest PBGC trusteehips since 2000	Sponsors of plans trusteeed by PBGC in 2005	Sponsors of ongoing defined benefit plans 2000-2004
Sponsors employing 1 or more consultants with undisclosed conflicts	9	12	1,009
Total number of sponsors	25	86	4,203
Percentage	36%	14%	24%

Source: GAO Analysis of data from PBGC, SEC, Nelson Information, and Form 5500 filings.

Of the remaining 11 consultants that were of less concern to the SEC:

- Six were ranked as some of the largest pension consultant firms in the U.S. with pension assets under advisement totaling over 1.5 trillion dollars.³
- One of the 11 had an advisory relationship with one of the 25 largest PBGC trusteehips at some point during the years they were ongoing, although at least one or more of the 13 consultants of concern also provided services to this plan sponsor during that same period.

²These 25 companies' plans with the largest claims against the PBGC comprised 70 percent of the total claims against the agency, to date.

³According to Pensions and Investments periodical list of Top 25 consultants ranked by U.S. institutional, tax exempt assets, 2006. 6 of the 11 consultants made the list of Top 25 consultants.

- One of the 11 had an advisory relationship at some point during the 5 year period between 2000 through 2004 with one of the sponsors with plans that terminated in 2005 and was trustee by PBGC, although at least one of the 13 consultants of concern also provided services to this plan sponsor during that same period.
- One or more of the 11 had an advisory relationship with 167 of the ongoing defined benefit plan sponsors from 2000-2004, although at least one or more of the 13 consultants of concern also provided services to 99 of these plan sponsors during that same period.

To match the 13 consultants identified by the SEC with non-terminated/ongoing DB plans, we analyzed Form 5500 information from filing years 2000 to 2004 to identify the sponsors of DB plans we categorized as ongoing. We selected only single employer or multiple employer DB plans that filed Form 5500 in 2004 and were not on the PBGC list of plans that terminated in 2005. From these we selected plans whose filings were not partial year and were not final plan filings. Additionally, we selected those plans with at least one other full year filing for the period 2000 to 2003. Additionally, we chose only plans with information on both beginning and end of year assets reported on Schedule H. This resulted in a list of 4,203 sponsors of 4,832 plans.

To determine the consultants that worked directly for a plan or indirectly for a plan through a plans holdings in master trusts accounts and other such arrangements, we compiled information on service providers reported on the plans Form 5500 schedule C and also on service providers reported on the filings of master trust accounts and other such plan holdings. We compiled a working list of consultants whose service was reported with the codes 17 (Consulting), 20 (Investment advisory), and 21 (Investment management). We matched this list to the list of consultants investigated by the SEC to determine which plans used the services of one or more of the consultants that were investigated. We augmented this list using consultant and client list information available from Nelson.

Finally, we conducted an econometric analysis to determine whether there was a correlation between undisclosed conflicts of interest and rates of return for the ongoing DB plans identified as employing the services of one or more of the consultants listed in the SEC study. We included only the plans that we could link to the 24 consultants either directly on the basis of plan form 5500 filings or indirectly based on a plans holdings in master trusts accounts and other such arrangements. For details of this analysis please see appendix II.

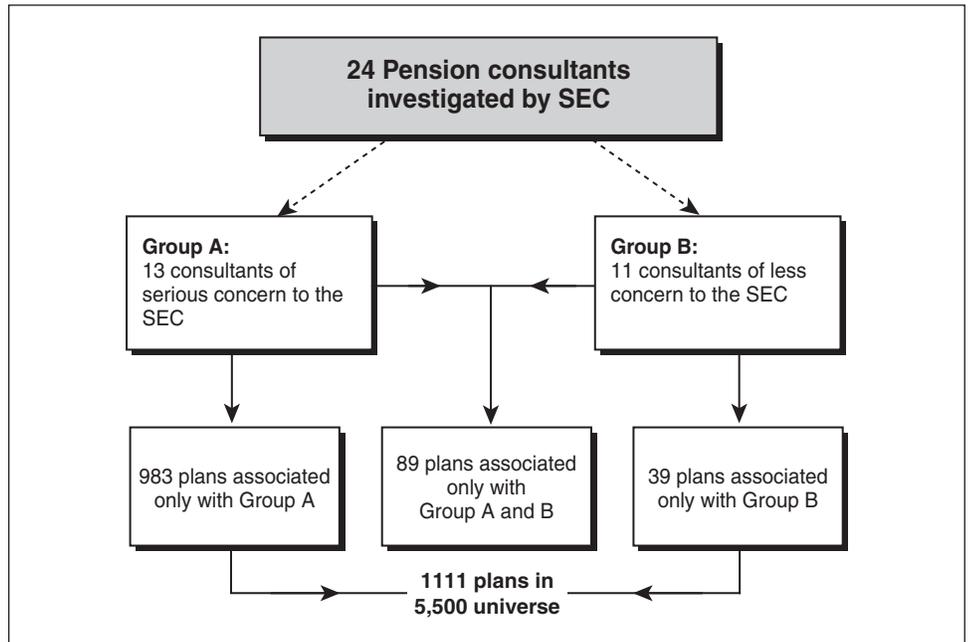
Appendix II: Econometric Analysis of the Effect of Inadequately or Undisclosed Conflicts of Interest on Pension Plan Rates of Return

The SEC has stated that disclosure helps to mitigate the effects of conflicts of interest. There is concern that plans that use pension consultants who have not properly disclosed conflicts of interest may achieve lower net returns on plan assets either because of higher administrative costs or due to poor money manager selection, among other reasons. To investigate the relationship between returns and improperly disclosed conflicts of interest, GAO compiled a database using SEC data on pension consultants and the Department of Labor's 5500 data (as well as some auxiliary data sources to create additional control variables). The data contains observations on 1111 pension plans over a 5-year period, 2000 to 2004. To analyze the relationship, GAO employed various multivariate econometric models using the panel data. While, the results suggest a negative correlation between returns and plans that are associated exclusively with pension consultants that have not properly disclosed conflicts of interest, the results should not be viewed necessarily as evidence of a causal relationship in light of the modeling and data limitations. This appendix provides additional information on the construction of GAO's database, the econometric model, additional descriptive statistics, and the limitations of the analysis.

GAO Panel Data Sample Constructed from Two Primary Data Sources

To explore the risk areas relating to pension consulting, SEC's Office of Compliance Inspections and Examinations (OCIE) conducted focused examinations of 24 pension consultants who were registered investment advisers, some of whom were considered at high risk for undisclosed conflicts. These consultants examined ranged in size and by the types of products and services offered. SEC chose its sample in part based on geographical dispersion and judgmentally selected the consultants. SEC found that 13 of these 24 pension consultants failed to disclose significant conflicts of interest while the remaining 11 were found to have less significant disclosure issues. Using the Labor's 5500 data, GAO used the SEC information to identify 983 pension plans associated with these 13 pension consultants and 39 pension plans associated with the 11 pension consultants found to have less significant disclosure issues. We were also able to identify 89 plans in the 5500 database that were associated with both types of pension consultants (see figure 2). Given the nature of the SEC selection process (it was not selected randomly) and the small number of pension consultants, the plans included in the analysis should not be considered as representative of the population of defined benefit pension plans and the results may not be generalizable.

Figure 2: Identifying Plans for GAO's Pension Plan Sample



Source: GAO analysis.

To construct the database used to estimate the econometric model, we compiled financial information from the 5500 database on these 1111 plans over 5 years and added additional data on the performance of the S&P 500 over various fiscal year end dates taken from Robert Shiller's Web site and market performance indicators from Credit Suisse and the Federal Reserve Board. As a panel data set, data pooled across all plans matched to the 24 consultants reviewed by SEC over the 2000 to 2004 period, we were able to account for variances in returns across plans and over a short period of time and utilizes techniques that enhance the validity of the parameter estimates. Because some of the plans did not have the requisite data for each year, the panel is unbalanced. While this requires minor modifications in the computation of the related statistics, it does not preclude the estimation of the model. Nevertheless, this panel of 1111 plans was used to empirically evaluate the relationship between returns and undisclosed conflicts of interest. Table 2 reports some descriptive statistics on the plans included in the analysis.

**Appendix II: Econometric Analysis of the
Effect of Inadequately or Undisclosed
Conflicts of Interest on Pension Plan Rates of
Return**

Table 2: Selected Descriptive Statistics for Plans included in the Econometric Model

	Return (average, 2000-2004)	Return (standard deviation, 2000-2004)	Assets per plan (average, 2004)	Sum of assets in 2004	Assets per plan (average, 2000-2004)
Plans associated with Group A	3.2%	11.5%	186,708,455	183,534,411,177	155,371,479
Plans associated with Group B	4.5%	12.7%	253,121,820	9,871,750,992	214,063,302
Plans associated with Group A and B	4.2%	12.4%	363,821,650	32,380,126,875	317,061,230
All plans	3.4%	11.6%	203,227,983	225,786,289,044	170,426,326

Source: GAO Analysis.

Note: The groups reflected in the table are as follows: Group A consists of those consultants that had failed to disclose significant conflicts of interest, Group B consists of those consultants that failed to disclose less significant conflicts of interest or that had no conflicts of interest, and Group A and B consists of members of group A and B.

**Standard Econometric
Modeling Procedures for
Handling Panel Data:
Random and Fixed-Effects
Model**

Panel data provides potential advantages over pure cross sectional and pure time series designs as it allows us to factor out the time- and space-invariant components of the data. As a result, panel data are able to identify and measure effects that are not detectable in other designs. There are two commonly accepted approaches to estimating panel data, the “random-effects” model and the “fixed-effects” model. In a “fixed-effects” model individual effects are estimated in this case for each plan to reflect the assumption that special features specific to each plan such as investment style or skill can be captured best with a different, time-invariant intercept for each plan. In a “random-effects” model, in this context, these individual effects are captured through treating the intercept as a random variable with a unique error term for each plan. While each model has its advantages and disadvantages, the random effects model is appropriate when we can plausibly assume that the individual effects (which are unobserved and unmeasured in the model) are uncorrelated with the explanatory variables that are measured and included in the model. If this assumption holds, the random-effects model is especially attractive if the cross-sectional units (pension plans) are drawn randomly from a common population or alternatively when the number of cross-sectional units is large and the time period is small. Otherwise, the fixed-effects model is preferred, especially as a control for omitted variables bias.

Using panel data as stated above, basic model takes the form:

$$(1) y_{it} = \theta + X_{it}\beta + Z_i\delta + \varepsilon_{it}$$

where y = the dependent variable (plan returns).

X = a matrix of explanatory variables that varies across time and individual plans. These variables are control variables that help explain the variation in returns across plans such as the performance of various markets over a plan's fiscal year, the size of a plan and its funding status.

Z = a matrix of variables that vary across individuals plans but for each individual plan are constant across the 5 years. The variables are essentially the dummy variables that indicate whether a plan is associated with the various types of pension consultants outlined above.

θ = constant term.

$i = 1, 2, \dots, 1111$ and represents the individual pension plans in the panel data.

$t = 1, 2, \dots, 5$ and represents the number of years (2000 to 2004).

As is the typical case with panel data, we have a large number of cross-sections (pension plans) and a relatively small number of time periods. Therefore we specify the composite error structure for the disturbance term as follows:

$$(2) \varepsilon_{it} = \alpha_i + \eta_{it}$$

where α_i = plan-specific error component which captures the unobserved heterogeneity across plans (either as a fixed- or random-effect).

$E(X_{it}\eta_{it}) = 0$ (there is no correlation between η_{it} and X_{it}).

The α_i is the individual effect which can be treated as either fixed or random. The fixed- and random-effect models which take account of the repetition inherent in the data and allow us to use the individual differences effectively. Correspondingly, if we treat the individual effect as zero we can estimate the model using the simple ordinary least squares

(OLS) procedure. Essentially, this is a pooled regression model where we assume the intercept and slope coefficients are constant across time and space and the normal error term (η_{it}) captures differences over time and individual plans. However, when the true model is a random-effects model, pooling the observations in this manner using OLS produces biased estimates that are also not efficient when compared to the more complex GLS procedure (outlined hereafter). The pooled OLS model is also susceptible to omitted-variables bias.

The random-effects technique proceeds under the premise that the ignorance about the unobserved differences in returns across plans is better captured through the disturbance term rather than the intercept. The random-effects model basically maintains that the 1,111 pension plans in the sample are a drawing from a much larger universe of such plans and that they have a common mean value for plan returns (represented by the constant term, θ) and that the individual differences in the intercept values of each plan are captured in the error term ε_{it} .¹ Given the composite nature of the new disturbance term that incorporates the individual random effect of each plan, the appropriate method for producing estimates is generalized least squares (GLS).² Feasible GLS derives an estimate of the covariance matrix of the error term and uses the information (heteroscedasticity from repeated observations of the same cross-section unit) to estimate the coefficients in the model.

Note that the random-effects model uses the heterogeneity across units to produce more efficient estimates.³ However, the drawback to this approach is that it forces one to make the strong assumption that the unobserved random-effects are uncorrelated with the explanatory variables in the model ($E(X_{it}\alpha_i) = 0$ in addition to the standard assumption $E(X_{it}\eta_{it}) = 0$). As a result the random effect treatment of the panel data may also produce estimates that suffer from the inconsistency because of omitted variables. Therefore, the validity of the results in the case would

¹The random effects model can be thought of as a regression with a random constant term. In other words, it is assumed that the intercept is a random outcome variable that is a function of a mean value plus a random error.

²Because α_i is in the composite error for each time period t , the error term ($\varepsilon_{it} = \alpha_i + \eta_{it}$) is serially correlated across time, invalidating OLS estimates.

³The technique uses the additional information (heterogeneity) to achieve potential efficiency gains, meaning the standard errors on the estimator can have minimum variance. These efficiency gains come at the risk of biased estimates when compared to the fixed effects model.

depend more heavily on the control variables included in the model to capture differences across plans, unless the omitted variables (unobserved heterogeneity across plan) are uncorrelated with the conflict dummy variable. If this is the case, the random-effect model may produce more appropriate estimates than the fixed-effects model. In our case, the unobserved effects, α_i , were found to be unimportant (relative to the variance of η_i) as the random-effect estimates approximated the pooled OLS results. This made the choice between random and pooled OLS a moot point (see below).

Fixed-Effect Model

When there is heterogeneity that cannot readily be explained, another analytical approach is to incorporate it into a fixed-effects model. In the case of the fixed-effects model, α_{it} is estimated uniquely for each plan as a fixed coefficient to be added to the intercept term. In this way, we take into the account the individuality of each plan (each cross-sectional unit) by letting the intercept vary by a fixed amount for each plan. The benefit of the fixed-effects estimator is that it is consistent in the presence of omitted variables. Because many variables that impact returns across plans are difficult to measure or could not be obtained this omission could bias the parameter estimates. With panel data and a fixed-effect specification it is possible to obtain consistent estimates of the impact of undisclosed conflicts of interest even when there are correlated omitted effects. The differences that exist across plan are essentially pulled out and accounted for explicitly, allowing for a more valid estimation of the impact of conflicts of interest on plan returns. Moreover, in many cases the fixed-effects estimates will still produce consistent estimates even when the random effects model is valid.

While the easiest way to implement the fixed-effects estimator is to include a dummy variable for each plan, we could not run a fixed-effect model directly due to the nature of our primary regressor of interest. Since the fixed-effects are time-invariant and the conflict variable in our model is a qualitative variable (dummy) that does not change over the 2000 to 2004 period either, the fixed effects model is not able to identify the impact of the variable. Essentially the variable is collinear with the fixed effect intercepts. Therefore we used an alternative procedure to achieve the same effect. To produce the fixed-effects estimator we used the fixed-

effects vector decomposition approach.⁴ The technique estimates the fixed-effects estimator in three stages: the first stage runs a fixed-effect model without the time invariant variables (Z_i). We then decompose the fixed-effects estimator into a portion explained by the time invariant variables (Z_i) and an error term. The final stage re-estimates the first stage with the time invariant and time variant variables and the error term from the stage two. In the third stage, estimated by pooled regression, we used robust standard errors adjusted for the degrees of freedom. In this manner we were able to approximate the unbiased, consistent estimator in the presence of time-invariant omitted variables.⁵ While some researchers have found that this procedure has better finite sample properties than the alternative approaches for estimating the effect of time-invariant variables using panel data, it should be noted that this is a recently applied econometric technique.

Variables Included in the Model

The dependent variable in all of our econometric models is plan returns. Returns were calculated two ways using the Form 5550 data. The first return measure calculates plan returns relating the change in plan assets ($A_t - A_{t-1}$) over the year, netting out the impact of benefits payments from the plan (B) and contributions to the plan (C) and also accounts for net transfers (T) into the plan. The formula can be written:

$$(3) \text{ROR}_1 = [(A_t - A_{t-1}) + B - C - T] / [(A_{t-1}) + \frac{1}{2}(C - B + T)].$$

As an alternative we slightly amend this calculation to account for administrative expenses (E) paid by the plan in a different manner. This alternative formula can be written:

$$(4) \text{ROR}_2 = [(A_t - A_{t-1}) + B + E - C - T] / [(A_{t-1}) + \frac{1}{2}(C - B - E + T)].$$

The results we report below use this measure of returns but we obtained similar results using the first estimate of returns.

⁴See for example T. Plumper and V. Troeger, "Efficient Estimation of Time-Invariant and Rarely Changing Variables in Finite Sample Panel Analysis with Unit Fixed Effects." *Political Analysis*, Vol. 15, 2007.

⁵Because of the need to estimate the model in steps, the estimator is consistent if the assumption underlying our estimator is correct the time-invariant variable is uncorrelated with the unobserved unit effects. Otherwise, the estimates may be inconsistent.

The primary variables of interest are the time invariant variables (Z), namely a dummy variable (conflict) that equal 1 if the plan is associated exclusively with pension consultants found to have undisclosed conflicts of interest and 0 otherwise. In many specifications we also include a dummy variable (mixed) that equals 1 if the plan is associated with both types of consultants – pension consultants found to have undisclosed conflicts of interest and pension consultants that have no conflicts or disclosed conflicts properly and 0 otherwise.

Although, the fixed effect model guards against time invariant omitted variables bias, it is always advisable to explore possible causes of heterogeneity. We included a number of control variables in attempt to capture the variation in plan return across plans although time constraints restricted the variables we could include. Because different plans may allocate assets differently because of investment style or age composition of plan participants, some plans may track more conservative or aggressive benchmarks rather than the overall market. As a result in addition to a general market indicator, the S&P 500, we also include a measure of hedge fund performance as well as a fixed income measure. The broad market measure the performance of the S&P 500 over plan i 's fiscal year for year t .⁶ Our measure of hedge fund performance is the Credit Suisse/Tremont hedge fund index.⁷ The fixed-income measure is the Moody's yield on corporate seasoned Aaa bonds taken from the Federal Reserve Board. These variables were constructed in a manner that also accounts for the varied fiscal year end dates across plans. Moreover, since the size and the funding level of the plan may influence asset allocation and investment strategy, we included assets at the beginning of the fiscal year and the degree of under-funding as explanatory variables as well. Including funding status creates potential simultaneous equations bias since the funding ratio is most likely dependent on plan returns. Since lagging the variable resulted in a loss of both a year's data and large number of observations as well as severe autocorrelation, we included the contemporaneous funding ratio but did not include the variable all

⁶<http://www.econ.yale.edu/~shiller/data.htm> (2007).

⁷Credit Suisse/Tremont Hedge Fund Index is compiled by Credit Suisse Tremont Index LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The Index uses the Credit Suisse/Tremont database, which track over 4500 funds, and consists only of funds with a minimum of US\$50 million under management, a 12-month track record, and audited financial statements. It is calculated and rebalanced on a monthly basis, and shown net of all performance fees and expenses. It is the exclusive property of Credit Suisse Tremont Index LLC.

specifications. The asset variable was substantively and/or statistically insignificant across multiple specifications and therefore it was not included in some instances.

We also included time period effects whenever possible. This amounts to creating a dummy variable for 4 of the 5 time periods covered in the database. While, this is straightforward in the OLS and fixed-effects models, two way random effects or random effects with a time period fixed effect is only possible for balanced panel in the econometric software used for the modeling procedure. When we included time period fixed effects in the fixed-effects model some of the explanatory variables became redundant and added no explanatory power to the models. In our case, we did not reproduce the random-effects model on the balanced panel in this appendix, since the only variation across units were the fixed effects, and the random effects model was equivalent to the pooled OLS results.

Results: Ordinary Least Squares (OLS) and Random-Effects Models

The simple econometric model (OLS), suggests that plans associated with undisclosed conflicts of interest achieve returns roughly 1.2 to 1.7 percentage points lower. The results are all significant at the 5 percent level (table 3). However, this model disregards the space and time dimensions of the pooled data and is plagued with a number of issues including omitted variables bias, which can impact the parameter estimates, as potentially evidenced by the somewhat low Durbin-Watson statistic. The random-effect model, which assumes that there are differences between the plans and that these differences are random, did not produce results distinct from the OLS model. When the unobserved effects, α_i , are unimportant (relative to the variance of η_{it}), the random-effects estimates will be closer to a pooled OLS model. Our estimation found that the random-effects were unimportant and there were no efficiencies to estimating the model via GLS. Nevertheless, the relationship between undisclosed conflicts and returns estimated by the OLS and random-effects models remained robust even when additional control variables were included and, in the case of OLS, when time fixed-effects were added to the model.⁸

⁸Time period fixed effects were included in the OLS model only since two-way random effects or mixed random effects and fixed-time effects cannot be estimated for an unbalanced panel.

Appendix II: Econometric Analysis of the Effect of Inadequately or Undisclosed Conflicts of Interest on Pension Plan Rates of Return

Table 3: Econometric Estimates of the Relationship between Undisclosed Conflicts of Interest and Plan Returns (OLS and Random Effects)

Independent variable	OLS/Random Effects I	OLS/Random Effects II	OLS III	OLS IV	OLS V	OLS VI
Conflict	-0.012^a	-0.014^a	-0.014^a	-0.013^a	-0.014^a	-0.017^b
Mixed						-0.006
SP500	0.600 ^a	0.676 ^a	-0.090 ^a	0.050	0.053	0.050
Hedge		-0.575 ^a		-0.252 ^a	-0.263 ^a	-0.253 ^a
Bond yield		-0.023 ^a		0.062 ^a	0.062 ^a	0.0612 ^a
Assets		-0.000		0.000		
Funding ratio					-0.000	
Constant	0.062 ^a	0.252 ^a	0.043 ^a	-0.341 ^a	-0.336 ^a	-0.330 ^a
Time period fixed-effects	No	No	Yes	Yes	Yes	Yes
R-square	0.5276	0.5584	0.6388	0.6430	0.6411	0.6423
Durbin-Watson	1.86	1.95	1.61	1.61	1.61	1.61
Sample size	4,170	4,170	4,170	4,170	4,170	4,170

Source: GAO analysis.

^adenotes significance at the .01 level.

^bdenotes significance at the .05 level.

Notes: Conflict indicates a plan that is associated with one of the pension consultants identified as having undisclosed conflicts of interest. Mixed indicates a plan that is associated with a pension consultant with undisclosed conflicts but also a pension consultant found to be free of conflict or having disclosed them properly.

Bond Yield, SP500, and Hedge are: Moody's average yield on corporate Aaa bonds, the change in the S&P 500, and the change in the Credit Suisse/Tremont hedge fund index return over a plan's fiscal year, respectively. Assets denote plan assets at the beginning of the year (squared). The funding ratio is the ratio of assets to liabilities.

Results: Fixed-Effects Models

The fixed-effect model, which helps guard against omitted variable bias, supports the results from the pooled OLS model. The R-square from the fixed-effect regression suggest that the models explain roughly 75 percent of the variation in plan returns. Again, the results are highly significant as the probability of an erroneous statistical conclusion in most models is substantially lower than what is commonly accepted as significant in hypothesis testing (5 percent or a p-value of .05). There is one exception to be noted, when the dummy variable is included for those plans associated with both conflicted and non-conflicted pension consultants, the significance of the conflict variable falls to the 10 percent level (p-value is

**Appendix II: Econometric Analysis of the
Effect of Inadequately or Undisclosed
Conflicts of Interest on Pension Plan Rates of
Return**

roughly 6 percent). This implies the probability of concluding a negative relationship when none is present has increased to about 6 percent. Moreover, when we drop those observations associated with both types of pension consultants, the conflicted variable was again significant only at the 10 percent level (p-value on roughly 6.7 percent). However, when we used the return calculation expressed in equation (3) the conflict dummy remains significant at the 5 percent level (p-value of roughly 3%) even when an independent dummy variable is included for the plans associated with both conflicted and non-conflicted pension consultants. It should be noted that, against the one-sided alternative, returns are lower for conflicted plans (H1: Conflict<0) and the results remain highly significant at the 5 percent level or lower. Otherwise, the conflict variable is robust to the inclusion of any of the additional control variables discussed above and the two measures of returns. We generally find that an exclusive association with one of the pension consultants identified as having conflicts of interest is associated with a lower return by about 1.2 to 1.3 percentage points, and higher in one case.

**Appendix II: Econometric Analysis of the
Effect of Inadequately or Undisclosed
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Return**

Table 4: Econometric Estimates of the Relationship between Undisclosed Conflicts of Interest and Plan Returns (Fixed-Effects)

	Model I	Model II	Model III	Model IV	Model V (no mixed plans)	Model VI
Independent variable						
Conflict	-0.013^a	-0.012^a	-0.025^a	-0.013^c	-0.013^c	-0.013^a
Mixed				-0.001		
SP500	0.103 ^a	0.051	0.053 ^a	0.051	0.036	0.054 ^c
Hedge		-0.115 ^b	-0.125 ^c	-0.115 ^b	-0.063	-0.129 ^b
Bond Yield		0.108 ^a	0.106 ^a	0.108 ^a	0.113 ^a	0.107 ^a
Assets			-0.000 ^a			
Funding ratio						-0.000
Constant	0.042 ^a	-0.648 ^a	-0.594 ^a	-0.647	-0.687	-0.637
Time period fixed-effects	Yes	Yes	Yes	Yes	Yes	Yes
R-square	0.742	0.746	0.747	0.746	0.753	0.745
Durbin-Watson	1.94	1.94	1.93	1.94	1.91	1.94
Sample Size	4,170	4,170	4,170	4,170	3,385	4,170

Source: GAO Analysis.

^aDenotes significance at the .01 level.

^bDenotes significance at the .05 level.

^cDenotes significance at the .10 level. Standard errors (not reported) were adjusted for heteroscedasticity using White's procedure.

Notes: Conflict indicates a plan that is associated with one of the pension consultants identified as having undisclosed conflicts of interest. Mixed indicates a plan that is associated with a pension consultant with undisclosed conflicts, but also a pension consult found to be free of conflict or having disclosed them properly.

Bond Yield, SP500, and Hedge are: Moody's average yield on corporate Aaa bonds, the change in the S&P 500, and the change in the Credit Suisse/Tremont hedge fund index return over plan i's fiscal year, respectively. Assets denote plan assets at the beginning of the year (squared). The funding ratio is the ratio of assets to liabilities.

**Limitations of Our
Econometric Model**

Like many statistical analyses, the results should be interpreted with care. Although the panel data provides many advantages and can produce more valid and efficient estimates, drawing causal inferences is still difficult. Even with control variables and the fixed-effects models there are a number of threats to the validity of our results. First, although the fixed-effects estimator is robust to the omission of any relevant time-invariant variables, if there are time-varying differences that have been omitted the result could be biased. Although the analysis controlled for plan size, funding level, the performance of asset markets and other key variables,

**Appendix II: Econometric Analysis of the
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other unknown, omitted factors could still influence the results of our analysis or account for the differences in estimated returns. There may be additional biases resulting from the vector decomposition procedure used to obtain the fixed-effect estimates. Second, the existence of statistical relationship is not in and of itself, enough to assert causality. Fixed-effects, while strengthening the validity of model's parameters, do not completely solve the problem of drawing causal inferences. Third, the use of the 5500 data could lead to measurement error in the dependent variable (plan returns). We assume that any errors are random and therefore do not impact the validity of the parameter estimates. Similarly, although we were careful in identifying and reviewing the plans associated with the two types of pension consultants any error, random or non-random, would impact the parameter estimates. Moreover, we used a potentially unrepresentative sample of pension consultants to identify the pension plans included in our investigation that therefore limits the ability to generalize the results. A few pension consultants that had significant conflicts of interest that impacted their activity could very well drive the observed negative relationship. Further, the imbalance between the large number of plans associated exclusively with conflicted consultants and the small number of those that were not raise additional statistical issues and limits the ability to generalize the results. Lastly, given the short time period analyzed, it could be possible that some plans' return were abnormally low due to their investment strategies, and would have higher returns had the time period analyzed been lengthened.

Appendix III: Comments from the Pension Benefit Guaranty Corporation



June 18, 2007

Barbara D. Bovbjerg, Director
Education, Workforce, and Income Security Issues
U.S. Government Accountability Office
Washington, D.C. 20548

Dear Ms. Bovbjerg:

Thank you for the opportunity to comment on the draft version of your report entitled, "Conflicts of Interest Involving High Risk or Terminated Pension Plans Pose Enforcement Challenges."

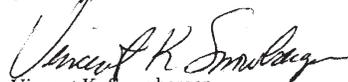
Under ERISA, when a plan is ongoing, PBGC has no authority to take action against service providers with conflicts of interest. However, upon termination and trusteeship of plan, PBGC seeks to obtain recoveries to cover unfunded benefits. One avenue to obtain recoveries relates to fiduciary breach claims, including those relating to service providers with conflicts of interest. PBGC takes its obligations in this area very seriously and appreciates GAO's work on this important issue.

We believe that our recent initiative to enhance our procedures for identifying and pursuing fiduciary breach and other types of claims is fully consistent with GAO's recommendation to include as part of our plan intake process an assessment of whether there exist conflicts of interest with service providers that would support potential claims to recover unfunded benefits. We intend to pursue such claims when we can achieve beneficial recoveries in a cost-effective manner.

We will also work with the Department of Labor's Employee Benefit Security Administration (EBSA) and the Securities Exchange Commission to more closely coordinate regarding such conflicts of interest for plans already trusted by PBGC and those likely to terminate in the near future. The current information-sharing arrangements among PBGC, EBSA and the Internal Revenue Service will serve as a useful model for such coordination.

This report highlights the importance of PBGC's mission and our efforts to safeguard America's pension insurance program. Again, thank you for the opportunity to comment.

Sincerely,


Vincent K. Snowbarger
Deputy Director

Appendix IV: Comments from the Department of Labor

U.S. Department of Labor

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



June 25, 2007

Ms. Barbara D. Bovbjerg
Director, Education, Workforce, and Income Security Issues
United States Government Accountability Office
Washington, DC 20548

Dear Ms. Bovbjerg:

We have reviewed the Government Accountability Office's (GAO) draft report entitled "Defined Benefit Pensions: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges" (GAO-07-703). This letter provides our general comments concerning the draft report and responses to recommendations; we already have provided technical comments directly to your staff.

The Department is committed to protecting the retirement security of American workers, retirees and their families. We agree that undisclosed conflicts of interest by pension consultants and others who provide services to pension plans could constitute violations of ERISA, potentially resulting in losses to plans, particularly where the pension consultant or adviser uses its position with the plan to generate additional fees for itself or its affiliates. It is for this reason that we began a national enforcement project, the Consultant/Adviser Project (CAP), on October 1, 2006. The CAP investigations are aimed at identifying those potential conflicts of interest that not only may affect a plan's financial health but also may erode the confidence of plan fiduciaries that rely on consultants and advisers to assist them in carrying out their fiduciary duties. It is through the CAP that we expect to determine whether these undisclosed conflicts of interest are indeed a problem of the magnitude suggested by the GAO in its report.

In addition to our enforcement efforts, the Employee Benefits Security Administration (EBSA) is pursuing a regulatory initiative addressing the disclosure of conflicts. We will soon publish a proposed regulation requiring service providers, including pension consultants, to disclose to plan fiduciaries information concerning the providers' direct and indirect compensation, fees, and other financial arrangements. This will ensure fiduciaries have the information needed to assess both the reasonableness of the fees and potential conflicts of interest by service providers, including pension consultants.

Recommendation: The Secretary of Labor should direct the Assistant Secretary for EBSA to expand the scope of the new CAP program to include some emphasis on high risk plans PBGC deems as likely to terminate in the future and PBGC-trusteed plans.

The CAP is designed to target pension consultants and other investment advisers who receive indirect, undisclosed compensation. The agency has concentrated its initial

review on carefully targeted cases, many of which were opened as a result of information obtained from the SEC in connection with that agency's review of pension consultants. As these investigations are completed, the agency may expand its targeting of high risk profile consultants and advisers. We will consider the GAO's recommendation to shift the focus of the project from pension consultants to PBGC-identified, underfunded pension plans as we review the results of these initial investigations and make decisions about the future course of the project. However, we will, as always, provide appropriate enforcement support to the PBGC in connection with the plans it trustees.

CAP is focused on the potential civil and criminal violations arising from the receipt of indirect, undisclosed compensation by pension consultants and advisers. In addition to investigating the conduct of the consultants, we also examine the conduct of the fiduciaries hiring the consultants and following their advice to determine if any conflict was compounded by a failure in fiduciary duty by the plan, such as not abiding by the plan's investment guidelines, or by failing to understand the compensation and fee arrangements and to prudently select and monitor the consultants. CAP is a well-structured and well-designed enforcement project, but as we gain experience through investigations under the project, we expect to make adjustments in our investigative approaches as necessary.

Recommendation: Building on the existing Memorandum of Understanding (MOU) between EBSA and PBGC and a recommendation made in our earlier work, the Assistant Secretary of EBSA, the Executive Director of the PBGC and the Chairman of the SEC should enter into an MOU to facilitate information sharing regarding conflicts of interest at PBGC trustee plans and those likely to terminate in the future.

EBSA fully recognizes the importance of establishing and maintaining effective working relationships with other agencies. That is why we have developed successful relationships with both the PBGC and SEC, and we are prepared to work with PBGC and the SEC to develop an MOU if the agencies agree that one is necessary to facilitate information sharing.

Concerns about the GAO's Econometric Analysis:

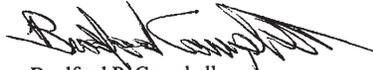
Due to the unusually short review period for the draft report, we have been unable to confirm the validity of the GAO's novel methodology. The results are provocative, as they suggest that the exclusive use of "conflicted" consultants may lead to substantially lower returns on a plan's investments. However, because of our concerns regarding the novelty of the methods and the potential weaknesses in the data (some of which are cited by GAO statisticians in the draft report), the Department feels that peer review of this analysis would have been useful in evaluating these concerns. As GAO notes, the non-random data sample used "limits the ability to generalize the results." Our additional statistical concerns include the rather skewed data sets (described in the report as "the imbalance between the large number of plans associated exclusively with conflicted consultants and the small number of those that were not"), the mixing of "conflicted" and

“non-conflicted” consultants in groups labeled “non-conflicted,” and the use of an estimate for the critical variable of investment returns. Statistical descriptions of all the variables, by consultant type, would help facilitate a better assessment of the validity and implications of the report’s findings.

Conclusion

EBSA is dedicated to protecting the employer-provided benefits of American workers, retirees, and their families, and continues to strive to improve our enforcement program to deter, detect, and correct violations of ERISA. We appreciate having had the opportunity to review and comment on the draft report. Please do not hesitate to contact us if you have questions concerning this response or if we can be of further assistance.

Sincerely,



Bradford P. Campbell
Acting Assistant Secretary

Appendix V: Comments from the Securities and Exchange Commission



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF COMPLIANCE
INSPECTIONS AND
EXAMINATIONS

June 21, 2007

Barbara D. Bovbjerg
Director
Education, Workforce, and Income Security Issues
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Re: GAO Report Entitled "*Defined Benefit Pensions: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges*" (GAO-07-703), dated June 2007

Dear Ms. Bovbjerg:

Thank you for sharing with us a copy of the Government Accountability Office's report entitled "*Defined Benefit Pensions: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges*" (GAO-07-703), dated June 2007. We were glad to assist GAO by meeting with your staff and providing information in connection with the preparation of the report.

While the recommendations in the report are addressed primarily to the Director of the Pension Benefit Guaranty Corporation and to the Secretary of Labor, the report suggests that certain actions be taken in consultation with the SEC. The report also recommends that the Assistant Secretary of EBSA, the Executive Director of the PBGC and the Chairman of the SEC should enter into a MOU to facilitate sharing of certain information regarding conflicts of interest. We have enjoyed a collegial and cooperative relationship with EBSA and PBGC concerning issues of common interest, and look forward to continuing and developing that relationship through future discussions regarding the recommendations in the report.

If I can be of any further assistance, please contact me or have your staff contact me at (202) 551-6200, or Gene Gohlke, Associate Director, at 202-551-6375. Additional contacts at the SEC are Robert Plaze, Division of Investment Management, at 202-551-6702, and Sarah Bessin, Division of Enforcement, at 202-551-4593.

Sincerely,

Lori Richards
Director
Office of Compliance Inspections and Examinations

Appendix VI: GAO Contact and Staff Acknowledgments

Contact

Barbara Bovbjerg (202)512-7215

Staff Acknowledgments

In addition to the above, Charles A. Jeszeck, Kimberley M. Granger, Joseph Applebaum, Susan Bernstein, Megan Birney, Richard Burkard, Julie DeVault, Lawrance Evans Jr., Randall Fasnacht, Cody Goebel, Gene Kuehneman, Michael Morris, Walter Vance, and Craig Winslow made important contributions to this report.

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