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PROTECTING AMERICA'S PENSION PLANS FROM FRAUD: WILL YOUR SAVINGS RETIRE BEFORE YOU DO?

HEARING

OF THE

COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINING PROTECTING AMERICA'S PENSION PLANS FROM FRAUD, FOCUSING ON THE DEPARTMENT OF LABOR'S EMPLOYEE BENEFITS SECURITY ADMINISTRATION'S ENFORCEMENT STRATEGY, EFFORTS TO ADDRESS WEAKNESS IN ITS ENFORCEMENT PROGRAM ALONG WITH THE CHALLENGES THAT REMAIN

JUNE 9, 2005

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C O N T E N T S

STATEMENTS

THURSDAY, JUNE 9, 2005

ADDITIONAL MATERIAL

PROTECTING AMERICA'S PENSION PLANS FROM FRAUD: WILL YOUR SAVINGS RETIRE BEFORE YOU DO?

THURSDAY, JUNE 9, 2005

U.S. SENATE,
COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS,
Washington, DC.

The committee met, pursuant to notice, at 9:58 a.m., in Room 430, Dirksen Senate Office Building, Hon. Mike Enzi, chairman of the committee, presiding.

Present: Senators Enzi, Kennedy, and Bingaman.

OPENING STATEMENT OF CHAIRMAN ENZI

The CHAIRMAN. We are a couple of minutes early, but we are here and ready to go, so we will go ahead and start the train.

Senator KENNEDY. This is the on-time chairman.

[Laughter.]

I was a little intimidated, even after 43 years, I still remember back in the 4th grade, getting to my teacher's classes—

[Laughter.]

The CHAIRMAN. I will go ahead and call the hearing to order. I want to thank you for coming to today's investigative hearing, our first investigative hearing.

Before we begin, I would like to thank the committee's ranking member, Senator Kennedy, for his support throughout the investigation of these issues and the other ones that we are working on.

I would also like to thank the witnesses who will testify before us today for taking time out of their schedules to be here. Your testimony will provide the committee with the direction, the detail, and the guidance that we need if we are to effectively address the vital issues that will be raised during this important hearing.

At present, approximately 90 million workers are enrolled in 700,000 pensions and retirement savings plans. In addition, there are 60 million workers who are part of a network of almost 6 million health and welfare plans. Many of these workers face some prospects of risk in their retirement and benefit funds from a host of potential predators. These threats arise from weaknesses in oversight by Federal Agencies, trustees who lack investment expertise and whose better judgment can be influenced by gifts and gratuities, and by administrators and other professional advisors who fail to perform their duties effectively.

Today, we will be considering these and other issues as we take a closer look at the largest pension fraud in U.S. history. It is a complicated story that involves the investment firm of Capital Consultants LLC and its efforts to elude the detection of the Department of Labor. It includes a cast of people across the country that had no idea that their pension funds were in jeopardy until it was too late. By then, through a complex Ponzi scheme, Capital Consultants defrauded approximately 300,000 pension plan participants and their families out of more than $500 million. Our witnesses will describe how the fraud was perpetrated, how the loss of these funded affected lives, and what the Federal Government is prepared to do to prevent these kinds of pension frauds in the future.

As we take a look at the details of the case, we will be looking to our witnesses for their insights on the following issues. Are the Department of Labor and other relevant agencies prepared to prevent future pension frauds so that workers will receive all of their vested benefits? Do employers and employees have the financial literacy to understand the pension system and to recognize the signs of pension fraud? Will the Federal Government use the successful recovery of more than 70 percent of the funds taken in this fraudulent scheme as a model that the Federal Government and the States can use to address future pension fraud cases? Finally, what can we in Congress legislatively, through our hearings and oversights, do that will aid in addressing and preventing pension fraud?

The Department of Labor and the Securities and Exchange Commission can be very proud of their participation in uncovering this scheme, the complexity of which underscores the difficulty of identifying pension fraud schemes in general. The size of the fraud in the Capital Consultants case highlights the importance of examining the lessons learned, and its potential to destroy the future earnings of our retirees makes it essential for the committee to determine the extent to which the Department of Labor is prepared to prevent future pension fraud.

To assist in examining the Ponzi scheme, I asked my staff to prepare a chart that clearly illustrates how the pension funds were used to cover losses due to risky investments and conceal them through a complex web of corporations created for that purpose, and we have a chart over here that illustrates that.

In addition, the staff prepared a chart that lists some of the responsibilities of those entrusted with the fiduciary responsibility for the pension funds, and that chart is over there.

Before introducing the witnesses, I would like to introduce Senator Kennedy for any opening remarks he might have.

OPENING STATEMENT OF SENATOR KENNEDY

Senator KENNEDY. Thank you very much, Mr. Chairman. As we know, our committee and the Finance Committee have jurisdiction over these pension funds and we have all been enormously concerned by the headlines of recent times as well as long and continuing interest in the protection of pension funds. We recognize that we have some very, very important responsibilities in terms of oversight, in terms of legislating, and I commend the chair for the extensive series of hearings that he has had in terms of looking at all aspects of the pension issue and also for doing the oversight work that is so important for us as a committee and for us in the Senate.

He was talking about how he asked his staff to present these charts so it would clearly explain what happened. I am looking at that chart, and it is all so clear to me now.

[Laughter.]

We will come back to that.

The unethical practices of executives of Enron and Global Crossing and Tyco and Worldcom have undermined the financial security of tens of thousands of hard-working men and women and shattered the trust of millions of other Americans. Now, with this greedy, dishonest, and irresponsible handling of $1 billion in retirement and other funds, the executives of Capital Consultants have joined that shameful list.

Capital Consultants' record of mismanagement and lies is appalling. The company operated a private investment portfolio of risky loans that were inadequately underwritten and poorly documented, charged clients excessive fees. As long ago as 1995, the Department of Labor ordered the firm to repay $2 million in fees that it overcharged to a pension fund in Oregon.

Yet Capital Consultants continued to pull the wool over the eyes of its clients with a sophisticated scam. When one of its biggest debtors went bankrupt, Capital Consultants began a complex Ponzi scheme rather than disclosing the truth to its clients. The fraud involved placing the resources of employees' pension funds and health care funds into shell companies to pass the money back to Capital Consultants. Clients who asked questions were lied to and deceived and the devious practice continued until 2000.

This Congress has ushered in new tax cuts for the wealthy and has passed a bankruptcy bill that I believe caters to the credit companies and a class action reform measure that shields corporate defendants when the obvious need is for reform that will restore trust in our financial markets. We know that employees across the country are still overinvested in company stock and we need to deal with kickbacks and conflicts of interest by managers and financial service companies that oversee people's hard-earned pensions. We need to ensure that cases like Capital Consultants do not happen again.

I look forward to the testimony of our witnesses and to working with my colleagues in Congress to curb the abuses that have left far too many hard-working Americans without the financial security which they worked so hard for and rightfully deserve.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, and I appreciate the excellent explanation you did of the chart.

[Laughter.]

Your testimony covered that well.

Our first panel today on "Protecting America's Pension Plans from Fraud: Will Your Savings Retire Before You Do?" is the government panel, and the first witness on the panel is Alan Lebowitz, who is the Deputy Assistant Secretary for Program Operations at the Department of Labor. The second witness is Barbara Bovbjerg from the Government Accountability Office. We appreciate your being with us today.

Mr. Lebowitz?

Incidentally, your entire statement will be a part of the record, as well as any additional opening statements by members of the committee. So any effort you can make to condense the testimony so that we can do questions will be appreciated. Mr. Lebowitz?

STATEMENTS OF ALAN D. LEBOWITZ, DEPUTY ASSISTANT SECRETARY FOR PROGRAM OPERATIONS, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, U.S. DEPARTMENT OF LABOR, WASHINGTON, DC.; AND BARBARA D. BOVBJERG, DIRECTOR, EDUCATION, WORKFORCE, AND INCOME SECURITY ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC.

Mr. LEBOWITZ. Good morning, Chairman Enzi, Senator Kennedy, and members of the committee. Thank you for inviting me here today to share information about the Department's enforcement role under the Employee Retirement Income Security Act, ERISA. I am Alan Lebowitz, Deputy Assistant Secretary for Program Operations at the Employee Benefit Security Administration at the Labor Department. My testimony will discuss EBSA's enforcement program and our investigation of Capital Consultants LLC, its principals, and numerous related investigations.

Under ERISA, the Secretary is responsible for protecting the rights and financial security of more than 730,000 private pension plans and 6 million private health and welfare plans, which together hold more than $4 trillion in assets and cover more than 150 million Americans. EBSA is responsible for administering and enforcing the fiduciary and reporting and disclosure provisions of Title I of ERISA. Our enforcement activities are conducted through 10 regional offices throughout the United States.

We have a total staff of 887, including 470 field investigators. The Office of the Solicitor, which estimates that it expends about 75 FTE annually on our behalf, provides legal support for us. Our investigative staff has varied professional backgrounds, including law, accounting, and business, which are complemented by our own specialized training programs.

We conduct a wide range of civil and criminal investigations to determine whether ERISA and the related Federal Criminal Code have been violated. Investigations are opened based on a variety of sources, including complaints from participants, referrals from the national office or other government agencies, and reviews of the annual report Form 5500.

We regularly work in coordination with other Federal and State enforcement agencies, including the Department's Office of the Inspector General, the Internal Revenue Service, the Securities and Exchange Commission, and the Justice Department, as well as Federal banking agencies.

The amount of time it takes to complete an investigation will, of course, vary, from a few weeks to several years, depending on its complexity, the cooperation of the parties, and whether the investigation is resolved through voluntary compliance or through contested litigation. Our goal in each investigation is to restore any money to the plan that was lost as a result of fiduciary breaches and to ensure the safety of the plan in the future.

In fiscal year 2004, EBSA closed 4,399 civil cases, over 60 percent of which found and corrected ERISA violations. Total monetary results from these cases exceeded $3 billion. In the criminal area, 152 cases were closed, 121 individuals were indicted, and 62 cases resulted in convictions or guilty pleas. We also have very active compliance assistance and educational programs designed to help plan officials understand their responsibilities and identify and correct problems.

We opened our first investigation of CCL in March 1992 based on information indicating that CCL engaged in prohibited transactions and self-dealing. The investigations were completed in March 1993 and revealed violations of ERISA, because under CCL's fee arrangement, it could use its investment discretion to increase its own compensation. Along with an annual management fee, an extra transaction-based fee was charged each time CCL made a real estate investment for a client plan.

The case was resolved with a complaint and consent order in December 1995, under which CCL paid $2 million to its plan client and a civil penalty to the Government of $182,000. The order also permanently enjoined CCL and Jeffrey Grayson from entering into fee arrangements of this type.

Our Seattle office opened its second investigation of CCL in October 1997, based upon the receipt of a complaint filed against Jeffrey Grayson and CCL by one of its plan clients. The investigation involved CCL's investment of plan assets in loans called collateralized notes, or loans for which the collateral consisted largely of the borrower's potential revenues.

A series of loans totaling $160 million of their clients' assets was made to Wilshire Credit Corporation from July 1995 to October 1998. When Wilshire defaulted on these loans, CCL did not report or acknowledge or the resulting losses to its clients. Instead, it engaged in a series of transactions with other entities to facilitate paper sales of all or a portion of the Wilshire loans at an artificially high price.

In reality, CCL carried out a Ponzi scheme under which it loaned an additional $72 million of plan funds during 1999 and 2000 to those entities that in turn used the funds to make purported interest payments on the original $160 million loans. Keep in mind that during this period, CCL continued to charge its clients a 3 percent annual management fee based on the full $160 million valuation.

In the summer of 2000, our investigative findings were shared with the SEC. The Commission and the Department decided to proceed jointly against CCL. The Department had an indepth knowledge of the underlying facts while the SEC could more readily have a receiver appointed over the entire business of CCL, which included nonERISA clients as well as ERISA plans.

Pursuant to complaints filed by us and the SEC on September 21, 2000, the U.S. District Court in Oregon entered court orders appointing the receiver to make an accounting, and to protect the interest of CCL's ERISA plan clients and other investors, the court froze the defendants' personal assets and enjoined them from doing business with ERISA plans. The receiver estimates that the total amount of litigation settlements and marshaled assets accumulated in the receivership to date is $291 million, of which $193 million has already been distributed to CCL's private placement clients, including ERISA plans.

In addition to the investigation of CCL, we opened 58 related investigations and filed 19 lawsuits against trustees of 34 plans in Oregon, Idaho, California, Nevada, Utah, Arizona, Colorado, Minnesota, and Ohio. In these lawsuits, the Department alleged that the trustees of those plans imprudently authorized CCL to invest in high-risk investments, failed to adequately investigate the merits of the investments, and failed to adequately monitor the investments. We also found that a number of trustees violated ERISA's self-dealing provisions by accepting gratuities from CCL, including free hunting trips, rifles, and tickets to football games.

The resolution of these cases resulted in the recovery of an additional $9.2 million, $1.8 million in civil penalties, and called for the retirement or resignation of 51 trustees and permanent injunctions barring 31 plan trustees and one investment advisor from serving as ERISA fiduciaries or service providers.

Just as important, the consent order imposed significant internal reforms on the affected employee benefit plans.

Our work on the task force that conducted related criminal investigations that included the FBI, the IRS, the Inspector General's office, and the Office of Labor Management Standards, resulted in the Justice Department indicting 11 individuals for various crimes for their participation in the CCL debacle. Seven of these individuals pleaded guilty. One was convicted and two were acquitted following a bench trial, and one case was dismissed. Four defendants served prison time, ranging from 15 to 24 months.

The scheme created by CCL and its principals was a very sophisticated fraud that had a veneer of respectability provided with the cooperation of its many professionals, including attorneys, accountants, and investment advisors. ERISA clearly places the ultimate responsibility for the governance of plans on individual plan fiduciaries. CCL was able to find fiduciaries who completely failed to responsibly oversee the assets of the plans for which they were responsible. These fiduciaries, in league with CCL, failed to live up to their solemn obligation to protect and preserve the hard-earned benefits of the workers in their plan.

All too often, these trustees, supported by their professional advisors, failed to understand the nature of CCL's investments, to review the investments, or even adhere to the plan's own investment guideline. Indeed, as late as June 2000, counsel for several plans was disputing that his clients had even experienced a loss.

Mr. Chairman, for some now who try to excuse their own illegal behavior by pointing fingers at others, including the Department, is to us incredible.

This concludes my testimony, Mr. Chairman, and I would be pleased to answer any questions that you may have.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Lebowitz follows:]

PREPARED STATEMENT OF ALAN D. LEBOWITZ

EXECUTIVE SUMMARY

Background

EBSA is responsible for administering and enforcing the fiduciary, reporting, and disclosure provisions of Title I of ERISA. EBSA conducts both civil and criminal investigations relating to employee benefit plans. Its enforcement activities are conducted through 10 regional and 5 district offices throughout the United States. The Agency's investigative staff has various backgrounds including law, business and accounting. EBSA also complements these backgrounds with specialized training.

Enforcement Results

In fiscal year 2004, EBSA closed 4,399 civil cases, achieving more than $3 billion in monetary results. In the criminal area, EBSA obtained 121 indictments during the fiscal year and closed 152 cases with 62 convictions and guilty pleas.

Capital Consultants Investigations

CCI (later renamed CCL) was an investment management firm located in Portland, Oregon, that managed more than $900 million for approximately 340 clients, many of which were employee benefit plans. The firm was owned and controlled by Jeffrey Grayson, who was its chief executive officer, and his son, Barclay Grayson, who was its president.

EBSA's first investigation of CCI was opened in March 1992, and completed in March 1993. The investigation disclosed that CCI and Jeffrey Grayson entered into prohibited fee arrangements with client plans that allowed them to increase their own compensation. This case was resolved by a consent order that required CCI to pay an ERISA plan $2 million along with other injunctive relief and penalties.

The second investigation was opened in October 1997 and disclosed that CCL placed its clients' funds into high-risk private loans and equities, including a $160 million loan to Wilshire Credit Corp. When this loan failed, CCL carried out a complex ponzi-like scheme to hide the default by agreeing to loan an additional $100 million of clients' funds during 1999 and 2000 to shell entities to make the purported interest payments on the Wilshire loan.

Government Legal Actions

On September 21, 2000, the Department and the SEC filed simultaneous complaints and consent orders against CCL, shutting it down and placing it into receivership. The Receiver estimates that the total amount of settlements and marshaled assets accumulated in the receivership to date is $291 million of which about $193 million was already distributed to CCL's private placement clients, including the ERISA plans.

The Department filed 19 additional lawsuits against fiduciaries of 34 employee benefit plans. In addition to money collected by the Receiver and through the mediation in third party litigation, the Department obtained substantial restitution, civil penalties and other injunctive relief. Criminally, the Department of Justice charged 11 individuals with various criminal counts, of which eight were convicted or pled guilty.

INTRODUCTORY REMARKS

Good morning, Chairman Enzi and members of the committee. Thank you for inviting me here today to share information about the Department's role in enforcing the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). I am Alan D. Lebowitz, the Deputy Assistant Secretary for Program Operations of the Employee Benefits Security Administration. I am here today representing the Employee Benefits Security Administration (EBSA),[1] and its employees, who work diligently to protect the interests of plan participants and support the growth of our private benefits system.

My testimony will discuss EBSA's investigation of Capital Consultants, LLC, its principals, Jeffrey and Barclay Grayson, and numerous related investigations. Additionally, I will describe the structure of EBSA's enforcement program and the process we follow to conduct investigations of potential pension fraud.

[1] Prior to its name change in February 2003, EBSA was known as the Pension and Welfare Benefits Administration.

Background

EBSA is responsible for administering and enforcing the fiduciary, reporting and disclosure provisions of Title I of ERISA. Under ERISA, the Secretary of Labor is responsible for protecting the rights and financial security of more than 730,000 private pension plans and 6 million private health and welfare plans, which together hold approximately $4.5 trillion in assets and cover more than 150 million Americans.

EBSA headquarters are located in Washington, D.C., and its enforcement activities are conducted in 10 regional offices and 5 district offices throughout the United States. EBSA's staff has the highest average educational attainment of any agency in the Department of Labor. EBSA has a total authorized staff of 887, including the 470 investigative staff members that work out of the field offices.

Our investigators have expertise in a wide variety of fields including law, accounting, banking, securities, and business. We recruit entry-level investigators and auditors who have specialized experience in such areas as accounting, finance, economics, business, insurance, securities, and banking, or who have graduated with advanced degrees. For other than entry-level investigative positions, EBSA requires specialized experience relevant to conducting complex financial investigations, such as past work experience in government, a law firm, a pension plan administration firm, or a bank trust department.

Our Agency has an active training program for its employees. EBSA provides a basic training course on the fiduciary provisions of ERISA, as well as courses on investigative techniques, and criminal enforcement to all investigative staff. Individuals without an accounting background attend EBSA's Employee Benefit Plan Accounting training. These courses are all residential programs of at least 2 weeks in length, and offer academic and practical instruction led by EBSA staff and guests from government and the benefits field. In addition, EBSA's Office of Enforcement provides annual field office training on topics determined by enforcement priorities, regulatory and legal developments, and industry trends. Also, some of our investigators attend such courses as Financial Forensic Techniques at the Federal Law Enforcement Training Center when training slots are available. EBSA encourages onboard staff to acquire additional training, and agency funding has enabled individuals to attain the Certified Employee Benefits Specialist designation and other credentials.

DOL shares responsibility and closely coordinates with the Internal Revenue Service and the Pension Benefit Guaranty Corporation in its administration and enforcement of the provisions of ERISA, which are designed to protect participants and beneficiaries in employee benefit plans sponsored by private-sector employers.

Investigative authority is vested in the Secretary of Labor by Section 504 of ERISA, 29 U.S.C. § 1134, which states in part:

> "The Secretary shall have the power, in order to determine whether any person has violated or is about to violate any provision of this title or any regulation or order thereunder . . . to make an investigation, and in connection therewith to require the submission of reports, books, and records, and the filing of data in support of any information required to be filed with the Secretary under this title . . ."

In addition, the Comprehensive Crime Control Act of 1984 amended ERISA Section 506(b) to give the Secretary explicit authority to investigate criminal violations of Title 18 of the United States Code insofar as they relate to employee benefit plans.

The broad provisions in Title I protect not only retirement and health benefits, but other employee benefits as well. The core of Title I of ERISA consists of provisions that address the conduct of persons (fiduciaries) who are responsible for operating pension and welfare benefit plans (including group health plans, life insurance, disability, dental plans, etc.). Fiduciaries are required to discharge their duties solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits and defraying reasonable expenses of plan administration. In discharging their duties, fiduciaries must act prudently and in accordance with the documents governing the plan, to the extent such documents are consistent with ERISA. Certain transactions between an employee benefit plan and "parties in interest," including fiduciaries and others who may be in a position to exercise improper influence over the plan, are prohibited by ERISA. If a fiduciary's conduct fails to meet ERISA's standards, the fiduciary is personally liable for any resulting losses to the plan.

Subpoena Authority

Under section 504 of ERISA, the Secretary of Labor has authority to issue administrative subpoenas for testimony and for the production of documents. The Secretary does not need to show reasonable cause to believe that a violation may exist unless the Secretary is seeking to require a plan to submit books and records more than once in a 12-month period or unless the Secretary is seeking to enter a place and inspect books and records and question persons.

Typically, the subject of an EBSA subpoena complies by submitting the requested documents or testimony. In cases where the subject fails to respond adequately to the subpoena, the Department may enforce the subpoena by bringing an enforcement action in Federal District Court. The court may compel compliance with the subpoena by imposing appropriate sanctions, including incarceration in cases of civil contempt.

Investigative Process

Under the leadership of its Regional Director, the investigative staff in each of EBSA's field offices conducts investigations to detect and correct violations of Title I of ERISA and related criminal laws. The Regional Directors report to EBSA's Deputy Assistant Secretary for Program Operations through the Office of Enforcement in Washington, which is responsible for coordinating the Agency's enforcement activities. The Solicitor's Office, a separate Agency within the Department of Labor that provides legal representation for the entire Department, provides litigation and other legal support through their National and Regional offices. The Solicitor's Office has about 75 attorneys devoted to ERISA in the National Office and the Regions at this time.

In carrying out its enforcement responsibilities, EBSA conducts a wide range of activities, including civil and criminal investigations, to determine whether the provisions of ERISA and sections of Title 18 of the United States Code, as they relate to employee benefit plans, have been violated. EBSA regularly works in coordination with other Federal and State enforcement agencies, including the Department's Office of Inspector General, the Internal Revenue Service, the Department of Justice, the Federal Bureau of Investigation, the Securities and Exchange Commission, the PBGC, the Federal banking agencies, State insurance commissioners, and State attorneys general.

EBSA field offices manage their investigative activity within broad guidelines identified by the Agency's long-term Strategic Enforcement Plan (StEP), which was published in the Federal Register on April 6, 2000. The StEP establishes a general framework by which EBSA's enforcement resources are focused to achieve the Agency's policy and operational objectives as established by the Secretary and Assistant Secretary. Short-term enforcement priorities are established annually, through the Program Operating Plan (POP) Guidance issued by the national office. Preparation of the POP Guidance begins with the identification of recent enforcement trends, an analysis of particular areas of noncompliance, and a review of current policy considerations. In this manner EBSA shifts its enforcement resources to respond quickly when new and emerging issues are spotted while staying within the long-term framework established by the StEP.

It is through the POP Guidance that EBSA establishes each fiscal year's national enforcement projects, provides guidance for choosing regional enforcement projects, identifies any other specific policy priorities that will require investigative resources, integrates the Agency's GPRA goals into the planning process, and provides general guidance with regard to the selection of investigations. EBSA has currently identified five national enforcement projects. Each region is required to make sufficient investigative resources available to perform necessary investigative functions in connection with these designated national projects. The national enforcement initiatives are Health Fraud/Multiple Employer Welfare Arrangements (MEWAs), Employee Contributions Project, Rapid ERISA Action Team (REACT), Orphan Plan Project, and Employee Stock Ownership Plans (ESOPs). In addition, each region is encouraged to develop regional enforcement projects to target issues within its geographic jurisdiction.

EBSA field offices open investigations based on a variety of considerations, including complaints from participants or other people, referrals from the National Office or other government agencies, computer targeting, and Form 5500 reviews (annual reports which contain detailed information on the financial condition of plans). Our goal in each investigation is to restore any money to the plan that was lost as a result of fiduciary breaches, and ensure the safety of the plan in the future.

Generally, a field investigator examines a plan to determine whether it is operated in accordance with its terms and the rules set forth in Title I of ERISA. The ERISA Enforcement Manual guides the conduct of EBSA investigations. Of particular concern in most investigations is whether the fiduciaries are carrying out their fiduciary duties appropriately, especially with regard to monitoring service providers; prudent investment of plan assets; the payment of plan expenses; proper diversification of investments; avoidance of self-dealing and prohibited transactions; the timely collection of contributions; and adherence to required claims procedures.

The type of records examined during the investigation varies depending on the nature of the case and the issues identified. Records are requested at the outset of the investigation and are generally identified in a letter sent to the Plan Administrator. All plan records relating to the maintenance of the plan are reviewed, including the plan document, trust agreement, collective bargaining agreement (if any), summary plan description, summary annual report, Form 5500, fidelity bond, and plan financial records. In addition, depending on the type of plan and the reason for the case opening, written and electronic records specific to a particular issue are requested. EBSA has broad authority to issue administrative subpoenas to compel the production of documents or testimony.

The amount of time it takes to complete an investigation varies from a few weeks to several years depending on the complexity of the issues involved, the cooperation of the parties in complying with document requests and subpoenas, and whether the investigation is resolved through voluntary compliance or through contested litigation. Procedurally, an investigation is closed when no violations are found and the Regional Director issues a no action letter. When violations are detected, the Regional Director will determine whether to pursue corrective action through voluntary compliance (VC). If so, the Regional Director will issue a VC notice letter which advises plan fiduciaries or other responsible parties of the results of the investigation and the sections of ERISA violated and invites the recipients to discuss how the violation(s) will be corrected and losses restored to the plan. In cases where VC efforts failed or that involve issues for which VC is not appropriate, the investigation may be referred to the local Regional Solicitor's Office or the Plan Benefits Security Division of the Solicitor's Office (SOL) in Washington, DC, with a recommendation that litigation be initiated. If criminal violations are found, the case is referred to the U.S. Attorney's Office for consideration of prosecution.

Compliance and Participant Assistance

EBSA conducts numerous educational and outreach activities to ensure fiduciaries understand and comply with their responsibilities under the law. Our newest Campaign, "Getting It Right—Know Your Fiduciary Responsibilities," includes nationwide educational seminars to help plan sponsors understand the law. The program teaches plan sponsors steps for avoiding the most common problems EBSA encounters in its enforcement activities, emphasizing the obligation of fiduciaries to:

- Understand the terms of their plans;
- Select and monitor service providers carefully;
- Make timely contributions to fund benefits;
- Avoid prohibited transactions; and
- Make timely disclosures to workers and reports to the Government.

Nine seminars have been held to date and two more have been scheduled.

EBSA has established the Voluntary Fiduciary Correction Program (VFCP). The VFCP is a voluntary enforcement program that encourages plan sponsors and their advisors to self-identify and correct many types of violations of Title I of ERISA. The program allows plan officials to identify and fully correct certain transactions such as prohibited purchases, sales and exchanges, improper loans, delinquent participant contributions, and improper plan expenses. The program includes 18 specific transactions and their acceptable means of correction, eligibility requirements, and application procedures. If an eligible party documents the acceptable correction of a specified transaction, EBSA will issue a no-action letter.

EBSA also provides assistance to plan participants and beneficiaries regarding their plan benefits through Benefits Advisors. The Benefits Advisors provide direct technical assistance to plan participants and beneficiaries by responding to more than 163,000 inquiries and complaints to EBSA's toll free number and Web site in fiscal year 2004 alone. They recovered over $76.4 million in benefits for participants that were improperly denied through an informal resolution process with the employer. Benefits Advisors explain how the relevant statutes apply to the participant or beneficiary and inform the employer about his or her responsibilities under the law. The Benefit Advisors facilitate resolution of complaints without formal investigation or litigation when possible. If the Benefits Advisors determine that a complaint is valid but are unable to resolve it informally, the complaint is referred for investigation. In 2004, EBSA restored over $307.97 million from 1,236 investigations opened as a result of referrals from Benefits Advisors. EBSA has a total of 111 Benefits Advisors in the national and field offices.

The Agency's Web site hosted 1.73 million unique Web visitors in fiscal year 2004, giving them access to numerous FAQs, publications and other useful compliance and consumer information. EBSA now has 63 publications in print; over 800,000 hard copies were distributed last year, and the publications are posted on the Agency's Web site.

EBSA's Fiscal Year 2004 Enforcement Results

In fiscal year 2004, EBSA opened 4,131 civil cases and closed 4,399 civil cases. Over 60 percent of the civil cases closed (or 2,642 civil cases) were closed with fiduciary results. This means that violations of ERISA's fiduciary duties and prohibited transaction provisions were found and corrected. During that year, EBSA referred 310 investigations to the SOL for litigation. Often these referrals were resolved through voluntary compliance rather than contested litigation. In fiscal year 2004, SOL filed litigation in 125 cases, an increase of 16 filings over the prior fiscal year.

In fiscal year 2004, EBSA opened 205 criminal cases and closed 152 criminal cases. One hundred twenty-one individuals were indicted in connection with EBSA's criminal investigations during the fiscal year. Sixty-two criminal cases were closed with convictions or guilty pleas during fiscal year 2004.

EBSA's investigations and compliance assistance efforts have a large financial impact on plans and their participants. Total monetary results for fiscal year 2004 were over $3 billion. These recoveries include the value of actions which EBSA obtained to correct prohibited transactions ($2.4 billion), money restored to the plan or plan participants to correct losses resulting from fiduciary breaches ($199.7 million), assets which were protected from significant risk by EBSA intervention that secured appropriate safeguards to protect the plan assets and reduce the risk of future losses ($141.6 million), and benefits recovered on behalf of individual plan participants ($76.4 million). Additionally, $264.6 million in corrections were achieved through the VFCP.

Criminal Enforcement

Under the Comprehensive Crime Control Act of 1984, the Secretary of Labor is given responsibility to investigate violations of the criminal provisions of ERISA and Title 18 of the U.S. Code that relate to employee benefit plans. To fulfill that responsibility, EBSA conducts criminal investigations as part of its enforcement program. Field managers consult with local U.S. Attorneys as early as possible in a criminal investigation to determine whether there is prosecutorial interest in the case and to receive any necessary direction.

EBSA's investigators evaluate the facts of every case for possible criminal violations. A civil investigation may turn into a criminal investigation when facts indicating possible criminal misconduct are uncovered and the case is referred to the appropriate U.S. Attorney for consideration of criminal prosecution. In some instances, civil and criminal investigations will be conducted at the same time using separate field investigators and supervisory oversight in order to avoid the illegal disclosure of grand jury information as well as to avoid the appearance of using the civil process to conduct a criminal investigation. In other instances, the investigation will be conducted as a criminal investigation only.

EBSA dedicates approximately 15 percent of its investigative resources to criminal cases. EBSA's criminal investigations are often worked jointly with agents from the Department of Labor's OIG, the Office of Labor Management Standards in the Department's Employment Standards Administration; the FBI; the IRS; and the Postal Inspection Service. Criminal investigations cover a wide variety of pension and welfare plans, including 401(k) plans and Multiple Employer Welfare Arrangements (MEWAs), as well as service providers such as investment managers and third party administrators.

Reporting and Disclosure

ERISA section 103 requires employee benefit plans to file an annual report (Form 5500) with the Secretary of Labor. The Secretary has authority under section 502(c)(2) of ERISA to assess civil penalties of up to $1,100 per day against plan administrators who fail or refuse to file complete and timely annual reports. EBSA identifies deficient, late or non-filers by reviewing and maintaining the ERISA Form 5500 Database. Non-filers are usually identified through referrals from other EBSA offices, the Internal Revenue Service, or computer targeting.

Our primary objective is to obtain compliance with ERISA's reporting and disclosure requirements. As a result, civil monetary penalties are usually significantly abated, once compliance is achieved. In fiscal year 2004, EBSA resolved 3,282 deficient filer cases, assessing $3,058,000 in penalties. In fiscal year 2004, EBSA also pursued 360 non-filer cases, assessing $829,500 in related penalties and the Agency closed 276 late filer cases with $172,000 in civil penalties.

EBSA's Delinquent Filer Voluntary Compliance (DFVC) program was established to assist filers in correcting situations involving the late filing or non-filing of Form 5500 annual reports. This program, which began in 1995 and was significantly revised in 2002, encourages delinquent filers to come forward and correct violations by offering significantly reduced civil monetary penalties. Participation in this program also protects plan filers from potential Internal Revenue Service late filing penalties. Since the 2002 revision, the DFVC program has received over 37,000 filings and $25.6 million in reduced civil penalty payments. The DFVC program has been enormously successful in getting these plans on our "radar screen" so they can be effectively monitored.

When Congress enacted ERISA in 1974, it included a requirement that a plan's annual report must include an audit opinion issued by an independent qualified public accountant (IQPA) stating whether the plan's financial statements (and other schedules required to be included in the annual report) are presented fairly in conformity with generally accepted accounting principles (GAAP). The audit requirement is intended to ensure the integrity of financial information that is incorporated in the annual reports. While ERISA's auditing provisions have worked to provide DOL and plan participants and beneficiaries with information about the safety of plan operations, experience has shown that IQPA audits do not consistently meet professional standards. The Department's Office of Inspector General separately identified this as a high-risk area.

In fiscal year 2005, EBSA is placing special emphasis on reviewing the audit practices of the 37 CPA firms that audit plans holding the overwhelming majority of reported assets. This review will include examining policies and procedures that these firms employ to assure the quality and completeness of their audit work. As part of reviewing each CPA firm, a sample of plan audit engagements will be selected for more detailed review and analysis. In addition to reviewing these firms' overall employee benefit plan audit practices, our Office of the Chief Accountant will review audit workpapers of these and other firms to assess the quality of the underlying audit work. As in the past, deficient plan auditors will be referred to the AICPA's Professional Ethics Division or to the appropriate State board of accountancy.

The accounting profession has also taken steps to improve the quality of plan audits. In October 2003, the American Institute of Certified Public Accountants (AICPA) created an Employee Benefit Plan Audit Quality Center (Center) with the goal of improving the quality of employee benefit plan audits. The Center is composed of CPA firms who, through voluntary membership, made a commitment to audit quality by adhering to the Center's membership requirements affecting their management practices, including the designation of a partner-in-charge of the quality of the firm's employee benefit plan audit practice. The Center's membership requirements also include obtaining employee benefit plan specific training; establishing and maintaining quality control practices and procedures specific to the firm's employee benefit plan audit practice; self monitoring of adherence to policies and procedures; and making the results of their external peer review of their audit practice publicly available. Over 900 firms joined the Center in its first year of operation.

EBSA's First Investigation of Capital Consultants

Capital Consultants, Inc. (CCI) was an investment management firm located in Portland, Oregon, that managed more than $900 million for approximately 340 clients, many of which were employee benefit plans. More than 60 of these employee benefit plans were jointly administered union pension and welfare benefits plans located primarily in the Pacific Northwest. In addition, CCI provided investment services to numerous private trusts and individual clients.

The firm was owned and controlled by Jeffrey Grayson, who was its chief executive officer, and his son, Barclay Grayson, who was its president. Effective June 30, 1999, Capital Consultants underwent a corporate restructuring and was renamed Capital Consultants, LLC. Therefore, the company is sometimes referred to as CCI and sometimes CCL, depending on the time frame, but its ownership, officers, and line of business remained the same.

EBSA opened its first investigation of CCI in March 1992, based on information indicating that CCI engaged in prohibited transactions and self-dealing. In addition to the investigation of CCI, EBSA opened three other investigations of plans that entered into investments through CCI. They were the Oregon Laborers-Employers Pension Trust, Northern Alaska Carpenters Retirement Fund, and the Morse Brothers, Inc. Profit Sharing Plan.

The investigations were completed in March 1993 and referred to SOL. The investigations revealed that CCI and Jeffrey Grayson violated ERISA by entering into a fee arrangement with the Oregon Laborers-Employers Pension Trust (Oregon Laborers Trust) that enabled them to increase their own compensation. Investment managers usually charge their clients a fee based on a percentage of assets under management. Under CCI's fee arrangement with the Oregon Laborers Trust, CCI and Grayson charged the usual fee based on assets under management and charged an extra fee for real estate related investments. This extra fee, which they called an "acquisition fee," was charged each time CCI made a real estate related investment for a plan. This was a one-time fee based on a percentage of the gross asset value of the transaction.

As investment manager, CCI and Jeffrey Grayson had the discretion to determine the amount and frequency of the Oregon Laborers Trust's real estate-related investments. Therefore, this fee arrangement placed them in the position of being able to affect their own compensation. Each time CCI and Jeffrey Grayson invested the Oregon Laborers Trust's assets in another real estate-related investment; CCI and Jeffrey Grayson would receive an additional fee.

The investigation did not, however, establish any evidence that CCI and Jeffrey Grayson increased the Trust's real estate investments with the motive of increasing their fees, and a number of trustees stated that they specifically authorized the real estate related investments. Nevertheless, under ERISA, a fiduciary cannot set its own compensation, regardless of whether that fee is reasonable. To the extent CCI set its fees, rather than a fiduciary independent of CCI, it violated ERISA.

The investigations also revealed that CCI invested more than $100 million of its clients' assets, including almost $90 million in loans and $13 million in stock purchases, in Crown Pacific, Ltd. (Crown), from which CCI received $5.2 million in fees as its consultant. This allegation related not only to the Oregon Laborers Trust but also to the other two plans under investigation, the Northern Alaska Carpenters Retirement Fund and the Morse Brothers Profit Sharing Plan. The timing of the transactions suggested that CCI and Jeffrey Grayson might have invested their client plans' assets in Crown in return for consulting fees from Crown. If true, this too would violate the self-dealing provisions of ERISA. However, there was no direct evidence of a relationship between CCI's consulting agreements with Crown and the investments that CCI caused the Plans to make in Crown. Neither was there direct evidence that CCI had invested plan assets in Crown specifically because CCI was being paid the consulting fees. Jeffrey Grayson actually performed consulting services for Crown, and there was only one instance of a simultaneous correlation between CCI's loans to Crown and Crown's payment of consulting fees to Jeffrey Grayson. Moreover, the loans, which were secured by land, personal guaranties, and stock did not appear to cause any losses to the plans. Therefore, the decision was made to proceed solely on the fee arrangement issue.

As is its usual practice, pursuant to Executive Order 12778, SOL engaged in settlement negotiations before filing the complaint and reached agreement on a consent order, which was filed simultaneously with the complaint in December 1995 in the U.S. District Court for the District of Oregon. The consent order provided that CCI would pay the Oregon Laborers Trust $2 million, and permanently enjoined CCI and Jeffrey Grayson from operating and collecting fees under any fee arrangement which would permit them to use their discretion over the assets of ERISA-covered plans to affect the amount of their fees from such plans. In February 1996, the Secretary of Labor assessed a 502(l) civil penalty [2] of $182,000 against Jeffrey Grayson and CCI. All of the payments required by the consent order and civil penalty assessment were made.

EBSA's Second Investigation of Capital Consultants

EBSA's Seattle District Office opened its second investigation of CCL in October 1997, based upon the receipt of a complaint filed against Jeffrey Grayson and CCL by one of its plan clients, the A.G.C. International Union of Operating Engineers Local 701 Pension Trust Fund. The complaint's principal allegation was that CCL made imprudent real estate investments for the plan, contrary to the Plan's investment guidelines and without the approval of the trustees. Although the Operating Engineers Fund settled its lawsuit in March 1998, EBSA's investigations continued. The breadth of the fiduciary misconduct which was uncovered in EBSA's second in-

[2] Under Section 502(l) of ERISA, the Secretary of Labor must assess a penalty against any recoveries obtained pursuant to settlement or court order. In effect, the penalty, which is payable to the Treasury, acts as a tax on settlements with the Secretary, creates a disincentive to settlement, and makes it more difficult for the Secretary to intervene in private actions without making settlement much more difficult for private litigants. Moreover, because the assets available to fund settlements are typically limited, the penalty often comes from amounts that could otherwise have been paid to reduce plan losses or enhance future benefits. Because of these problems, the Department has, for many years, urged Congress to amend section 502(l) of ERISA to make the penalties discretionary, rather than mandatory.

vestigation was astonishing, ultimately causing EBSA to open 58 investigations, devote over 13 civil and criminal investigative staff years to date, collect and review hundreds of thousands of pages of documents covering dozens of private loans and equity investments, and institute 19 separate lawsuits against plan trustees.

This second investigation of CCL involved CCL's investment of plan assets in loans called "collateralized notes," which were loans for which the collateral consisted largely of the borrower's potential revenues. These loans were unlike the loans to Crown, which were secured by land, personal guaranties and stock. The bulk of the loans were first made to Wilshire Credit Corporation (WCC) beginning in July 1995, more than 2 years after EBSA's first investigation had ended. Subsequent loans were made largely to shell corporations and entities that did not exist at the time of the first investigation. Thus, EBSA's second CCL investigation did not involve the same loans, the same borrowers, or the same type of collateral as the first case.

WCC was an Oregon S-Corporation, which acquired and serviced performing and non-performing consumer loans. CCL and Jeffrey and Barclay Grayson invested $160 million of their clients' assets in a series of loans to WCC from July 1995 through October 1998. The loans were "interest only" with a stipulated maturity date but no periodic payments of principal. The collateral for the loans was cash amounting to only 15 percent of the loan amount and WCC's expected revenues from loan servicing contracts with third parties, primarily Wilshire Financial Services Group ("WFSG"), a publicly traded corporation managed by the principals of WCC. WCC's expected revenues were not guaranteed, and if WCC's business volume declined, the fees from third parties would not sufficiently collateralize the loan. The WCC loan agreements were amended several times to allow for increased principal, reduced collateral, extended maturity dates and lower interest rates. This made the terms of the loans even less favorable to the investors and increased the risk of non-performance.

Shortly after the final loan was made to WCC, WFSG experienced severe financial problems. As a result, WFSG was no longer an income source for WCC, and WCC defaulted on the loans. In fact, WFSG filed for Chapter 11 bankruptcy in March 1999, and its Reorganization Plan indicated that the $160 million in loans from CCL clients to WCC, consolidated into "the Wilshire Loan," was valued at only $6.45 million on a liquidation basis.

Rather than report or acknowledge investors' losses on the WCC investment, CCL and Jeffrey and Barclay Grayson engaged in a series of transactions with other companies (Sterling Capital, LLC; Oxbow Capital Partners, LLC; Brooks Financial, LLC and Beacon Financial Group, LLC) to facilitate "paper sales" of all or a portion of the Wilshire Loan at an inflated price. This concealment is what some have referred to as the "ponzi scheme." Essentially, CCL was able to continue to make interest payments on the loans.

First, in November 1998, Daniel Dyer, a prior recipient of CCL loans, created Sterling Capital LLC (Sterling). Sterling was a shell company with no assets or revenues, yet it entered into an agreement with CCL to purchase the Wilshire Loan for $160 million plus interest. Sterling retained the right to terminate payments under the agreement at any time and without further liability.

Subsequently, in January 1999, Dyer created Oxbow Fund I, a venture capital fund which was to raise funds from investors through a private offering and use the funds to pay for Sterling's purchase of the Wilshire Loan. Oxbow Fund I was to be marketed by Dyer through his ownership of a broker/dealer firm, CJM Planning Corporation. Dyer's purchase of CJM Planning had been funded in 1998 through loans from CCL's clients. Also, CCL assured its clients by letter that the Wilshire Loan was being sold to Sterling for $160 million plus interest at prime + 3.75 percent. CCL continued to value the Wilshire Loan at $160 million and charged its clients a fee of 3 percent per annum on the face value.

The Oxbow Fund I offering failed to attract any significant investors. As a consequence, Dyer told CCL that Sterling could not make the Wilshire Loan payments and he wanted to terminate the agreement. Instead, Sterling entered into an agreement with CCL and another company, Brooks Financial LLC (Brooks), whereby Brooks agreed to take over two thirds of Sterling's loan obligation.

Brooks was a shell company formed by the owner of Florida Automobile Finance Corporation, a sub-prime automobile finance company. Brooks' agreement to purchase two-thirds of the Wilshire Loan was specifically conditioned on receiving a $50 million loan from CCL. On that same day, CCL entered into a loan agreement with Brooks, committing CCL's clients to loan Brooks up to $50 million. Pursuant to the agreement, CCL loaned $38.1 million to Brooks. CCL used $7.843 million from its clients' escrow account to make "interest payments" on the Wilshire Loan. CCL reported to its clients throughout this period that Brooks was making timely interest payments and the clients' investment in the Wilshire Loan was still worth a total of $160 million.

Then, in January 2000, CCL entered into a second loan agreement committing its clients' funds to loaning up to another $50 million to Beacon Financial LLC (Beacon), a newly created shell company under common ownership with Brooks. CCL loaned approximately $33.88 million to Beacon. Again, CCL retained another $7.37 million in escrow and used this money to make monthly interest payments on the Wilshire Loan. CCL repeatedly assured its clients that both Brooks and Beacon were performing on their respective loans and were making the interest payments on the Wilshire Loan. As a consequence, CCL continued to report the Wilshire Loan at its original value of $160 million.

Throughout this period, CCL billed its clients 3 percent per annum for investment management fees on the Wilshire Loan and the Brooks and Beacon loans.

This not only caused their clients to pay fees in excess of those amounts to which CCL and Jeffrey and Barclay Grayson were entitled, but also concealed from their clients the declining value of their investments. A diagram of the scheme is attached as Appendix A to the written statement.

In February 2000, after completing its investigation of CCL and its principals, EBSA referred the case to SOL for litigation. In July 2000, per the SEC's request, a copy of the EBSA Report of Investigation, along with voluminous exhibits, was provided to the SEC in Los Angeles. The SEC and the Department decided to proceed against CCL jointly. This litigation strategy was advantageous because the Department had an indepth knowledge of the underlying facts and the SEC could more readily have a receiver appointed over the entire business of CCL, which included non-ERISA clients as well as the ERISA plans.

On September 20, 2000, SOL and SEC attorneys jointly met with counsel for CCL and its principals in Oregon. Counsel for CCL and its principals represented that their clients agreed to the receivership. SOL and SEC attorneys negotiated the language of their respective consent orders. The consent orders were presented to the U.S. District Court and were entered by the Court on September 21, 2000. The court orders appointed a receiver to make an accounting and to protect the interests of CCL's ERISA plan clients and other investors. Through the consent orders, the SEC was able to freeze the defendants' personal assets and EBSA was able to enjoin them from doing business with ERISA plans.

CCL has been in receivership since the suit was filed in September 2000. Settlements totaling more than $101 million have been reached in private litigation, resolving claims brought by the court-appointed receiver, trustees of ERISA plans and other investors against plan fiduciaries and other parties who provided services to or had business relationships with CCL.[3] These settlement amounts were made a part of the receivership estate. To date, the receiver has marshaled estate assets of more than $189 million in part by collecting on outstanding loans and selling CCL's assets. The receiver estimates that the total amount of settlements and marshaled assets accumulated in the receivership to date is $291 million of which about $193 million was already distributed to CCL's private placement clients, including the ERISA plans.

Barclay Grayson settled with the receiver and private plaintiffs for $500,000, but the Department did not agree to the settlement. The Department is currently in settlement negotiations with him to obtain injunctive relief. Barclay Grayson is bankrupt and the Bankruptcy Court has discharged all of his debts. Jeffrey Grayson suffered a stroke and is currently in a nursing home. The receiver has sold Jeffrey Grayson's property. His remaining assets have been frozen and he is currently drawing a monthly stipend to cover his living and medical expenses.

The receiver has approximately $76.36 million remaining for distribution. It will be distributed in accordance with the court-approved distribution plan, minus the remaining receivership fees and expenses, which are approximately $1 million. The total cost of the receivership is $8.5 million. Overall, the employee benefit plans recovered well over 70 percent of their losses through the receivership, and many plans have recovered additional losses through settlements of litigation resulting in at least $42 million.

Related Litigation Against Trustees

In addition to the investigation of CCL, EBSA's Seattle, San Francisco, Cincinnati, Detroit, Kansas City, and Los Angeles offices opened investigations of plans that invested in private placements through CCL. In total, EBSA opened 58 related

[3] Over $42 million was paid as a result of additional litigation by the Department and others against plan fiduciaries and service providers. This number is not included in the receivership assets.

investigations and filed 19 lawsuits against trustees of 34 plans in Oregon, Idaho, California, Nevada, Utah, Arizona, Colorado, Minnesota and Ohio. In these lawsuits, the Department alleged that the trustees imprudently authorized CCL to invest in high-risk investments (the collateralized notes), failed adequately to investigate the merits of the investments, and failed adequately to monitor the investments. In some cases, the complaints also alleged that the investments violated the plans' own investment guidelines, and that a number of trustees violated ERISA's self-dealing provisions by accepting gratuities from CCL, including free hunting trips, rifles, and tickets to football games.

In April 2002, the Department entered into consent orders with 10 plans and their trustees in the District of Oregon. The consent orders provided for the resignation of a number of trustees and permanently enjoined others from serving as ERISA fiduciaries or service providers. The consent orders also provided for significant plan reforms, including internal controls and procedures relating to plan investments, contracts with service providers, written investment guidelines, communication procedures, quarterly meetings, reviewing and monitoring plan fiduciaries, the pursuit of litigation, and the retention of experts to serve as investment monitors, managers, auditors, and attorneys. The plan reforms are binding on the plans' current trustees as well as successor trustees.

Contemporaneously with the filing of the consent orders, private plaintiffs settled their class action lawsuits against the same plan fiduciaries as a result of court-ordered mediation in which the Department participated. In the mediation, the private litigants obtained settlements totaling $15.8 million. Of that amount, $9.5 million was to be paid by Legion Insurance Company, which is currently in liquidation in Pennsylvania. It is expected, however, that much or all of that money eventually will be recovered as a result of private negotiated settlements with the State insurance guaranty funds and through the liquidation of Legion by the Pennsylvania State Insurance Commission.

After the April 2002 settlements, the Department continued to monitor the receivership and to pursue cases against other trustees. In March 2004, the Department obtained consent orders providing for restitution of $4.875 million to 12 employee benefit plans in California, Nevada and Utah. The consent orders also required payment of $975,000 in civil penalties to the Government. In addition, the consent orders provided for plan reforms, including internal controls and procedures relating to plan investments similar to those contained in the earlier settlements. The consent orders resolved five lawsuits and covered more than 17,000 participants and beneficiaries.

In January 2005, the Department obtained additional consent orders providing for restitution of $4.31 million to 10 employee benefit plans in Arizona, Colorado, Minnesota and Ohio that invested plan assets through CCL. The consent orders also required payment of $862,413 in civil penalties to the Government. In addition, the consent orders provided for plan reforms similar to those in the other cases. The consent orders resolved eight lawsuits and covered more than 25,000 participants and beneficiaries.

In total, the Department filed 19 lawsuits against plan trustees, covering 34 employee benefit plans. The consent orders issued in these cases called for the retirement or resignation of 51 plan trustees, and permanent injunctions barring 31 plan trustees and one investment advisor and his firm from serving as ERISA fiduciaries or service providers. The orders also imposed significant internal reforms on the 34 affected plans to help prevent future fiduciary breaches. In addition to the money collected by the Receiver, and the $15.8 million recovery from the Oregon mediation (subject to Legion's insolvency proceedings), the Department obtained $9.2 million to date in these cases against trustees, and assessed and received a total of $1,837,427.86 in civil penalties.

Criminal Investigations of CCL and Related Entities

In December 1999, in coordination with the U.S. Attorney's Office for the District of Oregon in Portland, Oregon, EBSA and other law enforcement agencies began the criminal investigation of the CCL matter. By the summer of 2000, under the direction of the U.S. Attorney's Office, the investigation had developed into a task force which included EBSA, the Internal Revenue Service, the Department of Labor's Office of Inspector General and the Office of Labor Management Standards, as well as the Federal Bureau of Investigation.

The criminal investigations of Jeffrey and Barclay Grayson led to other investigations surrounding the CCL debacle. By December 2000, under the direction of the U.S. Attorney's Office, the task force opened an investigation of Lawrence Mendelsohn and Andrew Wiederhorn, owners of Wilshire Credit Corporation. In June 2001, the investigations into CCL and its officers and employees expanded to

Dean Kirkland, the principal salesperson for CCL. These investigations revealed that CCL had engaged in a practice of paying gratuities to trustees of union sponsored employee benefit plans which invested funds through CCL.

From May 2002 to July 2002, the task force conducted a number of criminal cases on various trustees of union sponsored benefit plans. As a result of a task force investigation guilty verdicts and pleas were obtained from Barclay Grayson and Dean Kirkland of CCL; plan trustees John Abbott, Robert Mayhew, John Lontine, and Dennis Talbot; and Andrew Wiederhorn and Larry Mendelsohn of Wilshire. Two other trustees Gary Kirkland and Robert Legino were acquitted of gratuities charges after a lengthy trial. The charges against Jeffrey Grayson were dismissed due to Grayson's mental and physical impairment. An attorney from the Department of Justice's Criminal Division participated in the prosecution of the plan trustees and Dean Kirkland.

Conclusion

CCL owed a duty of undivided loyalty to its benefit plan investors under ERISA. It breached that duty on an almost unprecedented scale causing hundreds of millions of dollars in losses to both ERISA plans and non-ERISA investors. It took an extraordinary effort to uncover CCL's misconduct and to remedy the violation because the transactions were extraordinarily complex and CCL consistently misled its investors about the nature of the transactions and the existence and magnitude of the resulting losses. There simply were no easy shortcuts available to the Agency to uncover and remedy CCL's violations.

As a result of EBSA's efforts, in tandem with the work of the SEC and private litigants, the participants of the ERISA-covered plans will recover well over 70 percent of their losses. The Department and the SEC had a receiver appointed to marshal CCL's assets and protect the interest of CCL's investors. The Department also enjoined Jeffrey and Barclay Grayson from doing business with ERISA plans. In total, the Department filed 19 lawsuits against the plan trustees of 34 employee benefit plans and obtained consent orders calling for the resignation and retirement of 51 trustees and permanent injunctions barring 31 additional trustees (as well as one investment manager) from ever serving as ERISA fiduciaries or service providers. The additional injunctive relief obtained by the Department included significant plan reforms, including internal controls and procedures relating to plan investments that will provide long-term protections for plan participants and beneficiaries. In addition to the money collected by the receiver and through the mediation in the third party litigation, the Department obtained restitution of $9.2 million to date in cases against plan trustees. A total of $1,837,427.86 in civil penalties were assessed and paid. A chart that describes the results of the civil investigations is attached as Appendix B to the written statement.

EBSA's work also resulted in the Justice Department indicting 11 individuals for various crimes resulting from their participation in the CCL debacle. Seven of these individuals pleaded guilty. One case was dismissed, while two individuals were acquitted in a bench trial and one was convicted. Four defendants served prison time ranging from 15 to 24 months, for a total of 81 months served, while others served probation. A chart that describes the results of the criminal investigations is attached as Appendix C to the written statement.

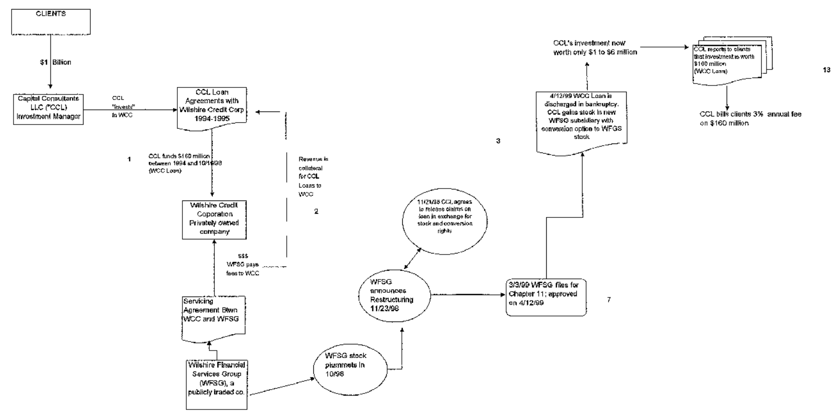
The scheme was of great sophistication and had a veneer of respectability provided by the cooperation of so many professionals including attorneys, accountants, and investment advisors. EBSA's investigation uncovered a complex scheme to defraud investors through the unprecedented use of newly created shell companies, paper transactions, and false reports.

Finally, ERISA places the ultimate responsibility for the governance of plans on individual plan fiduciaries. CCL was able to find fiduciaries that failed to responsibly oversee the retirement assets of the plans' participants and beneficiaries. These fiduciaries, as well as CCL, failed to prudently discharge their obligations to the plans' participants. All too often, the trustees (and their advisors) failed to understand the nature of CCL's investments, to review the investments, or even adhere to the plans' own investment guidelines.

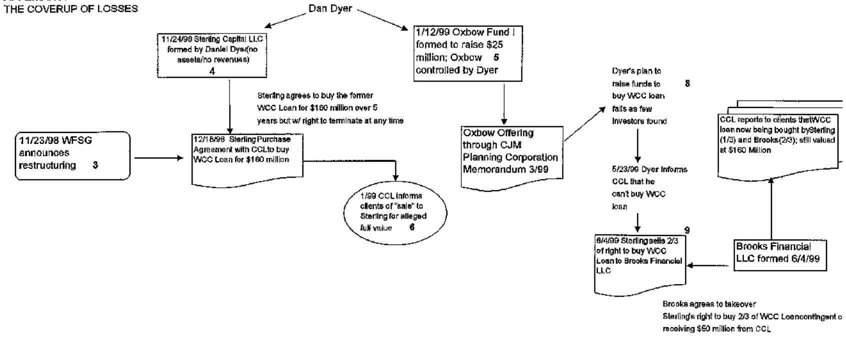
Mr. Chairman and members of the committee, thank you again for the opportunity to appear before you to discuss EBSA's enforcement program and this very important case. This concludes my testimony. I would be pleased to answer any questions you may have.

APPENDIX A

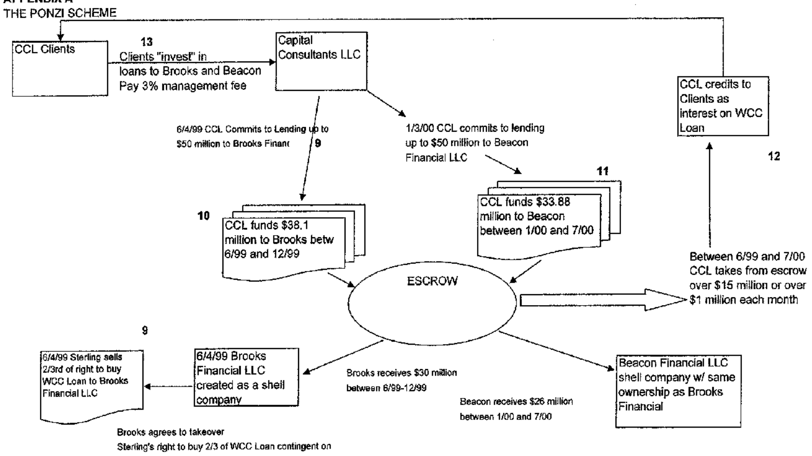
CCL Loan to Wilshire Credit Corporation



APPENDIX A
THE COVERUP OF LOSSES



APPENDIX A
THE PONZI SCHEME



APPENDIX B

Plan	EBSA Case	Results	502(l)	Injunctive
Oregon Laborers-Employers Pension Plan	Chao vs. Abbott	$4,035,153 (fn1)		Yes
Oregon Laborers Employers Defined Contribution Trust Fund	Chao vs. Abbott			Yes
Oregon Laborers-Employers Hlth & Wlfr Trust	Chao vs. Abbott			Yes
Eight District Electrical Pension Fund Annuity Plan	Chao vs. Legino	$4,585,729 (fn1)(fn2)		Yes
Elec Indus Bene Vac & Pd Hol Fund	Chao vs. Legino	$238,648 (fn1)(fn2)		Yes
Eighth District Electrical Benefit Fund	Chao vs. Legino	$426,034 (fn1)(fn2)		Yes
Office/Professional Ee Iu # 11 401(K) Plan	Chao vs. Kirkland	$475,000 (fn1)		Yes
Western States Local Union Tr Fund Of The Office Emp Interntl Union	Chao vs. Kirkland	$478,000 (fn1)(fn2)		Yes
U.A.Local 290 Plumbers Pension	Chao vs. Fullman	$3,738,864 (fn1)(fn2)		Yes
Signatory Employers Idaho Laborers Pension Trust	Chao vs. Hazzard	$1,900,000 (fn1)		Yes
Electrical Workers Local 292 Annuity Plan	Chao vs. Shafranski	733,669.00	$146,733.83	Yes
Electrical Workers Local 292 Pension Plan	Chao vs. Shafranski	526,928.00	$105,385.67	Yes
Ibew Local 38 Health & Welfare Fund	Chao vs. Chilia	211,667.50	$42,333.50	Yes
Ibew Local 38 Pension Plan	Chao vs. Chilia	350,782.50	$70,156.50	Yes
Tri-County Bldg Trades Health Fund	Chao vs. Talbott	90,782.00	$18,156.33	Yes
Sheet Metal Workers Local Pension Fund	Chao vs. Derreberry	103,495.00	$20,669.00	Yes
Ibew Local 212 Pension Plan	Chao vs. Bolling	2,031,207.00	$406,241.33	Yes
Sheet Metal Workers Loc 9 H & W Trust Fund	Chao vs. Keating	63,459.00	$12,709.83	Yes
Operating Engineers & Brickmasons Health & Welfare Fund	Chao vs. Brown	79,553.00	$15,910.67	Yes
Arizona Sheet Metal Trade Trust Fund	Chao vs. Chacon	120,430.00	$24,086.00	Yes
Arizona Sheet Metal Pension Trust Fund	Chao vs. Chacon	$575,524 (fn1)		Yes
Sheet Metal Workers Lu 9 Pen Plan	Chao vs. Swartz	$1,780,000 (fn1)		Yes
Shopmens Ironworkers Health & Welfare	Chao vs. Eckert	86,450.00	$17,290.00	Yes
Shopmens Iron Workers Pen Tr Of So Calif	Chao vs. Eckert	467,717.00	$93,543.33	Yes
Teamsters Local Union No 533 Health & Welfare Trust Fund	Chao vs. Martino	53,833.00	$10,766.67	Yes
Teamsters Vacation Savings Trust Fund	Chao vs. Martino	117,000.00	$23,400.00	Yes
Utah Carpenters And Cement Masons Pension Plan	Chao vs. Eyre	836,354.00	$167,270.83	Yes
Utah Carpenters And Cement Masons Health And Welfare Trust	Chao vs. Eyre	67,812.00	$13,562.50	Yes
Northern Nevada Laborers H & W	Chao vs. Rusnak	593,000.00	$118,600.00	Yes
Northern Nevada Laborers Pension Trust Fund	Chao vs. Rusnak	400,000.00	$80,000.00	Yes
Northern Nevada Construction Workers Vacation Savings Plan	Chao vs. Rusnak	442,226.00	$88,445.20	Yes
Carpenters Health & Insurance Trust Fund For Northern Nevada Board	Chao vs. Wiggins	350,000.00	$70,000.00	Yes
Carpenters Vacation Savings Plan	Chao vs. Wiggins	565,748.00	$113,149.60	Yes
Carpenters Pension Fund For Northern Nevada	Chao vs. Wiggins	895,085.00	$179,017.07	Yes
		27,420,150.00	$1,837,427.86	

(fn1) This settlement amount was the result of mediation involving the DOL, private class action plaintiffs, and the defendant plan trustees. The monetary settlement was paid through the private class action settlement agreement.

(fn2) The monetary settlement in this case was originally negotiated with Legion Insurance Company who insured the defendant trustees. After the case was settled but before the monetary payment was made, Legion was determined to be insolvent and placed into receivership by the Pennsylvania Insurance Commission. Therefore, the settlement amount was never paid, but negotiations are underway to recover the settlement amount from other sources.

APPENDIX C

Name	Date	Jail	Probation	Fines	Restitution	Charges
Barclay Grayson	11/20/01	24	36 (mo)	$100	-0-	***Guilty Plea*** **18 U.S.C. 1341**
John Abbott	11/21/01	15	12 (mo)	$200	$194,400	***Guilty Plea*** **18 U.S.C. 1954; 26 U.S.C. 7206(1)**
Larry Mendelsohn	5/24/04	-0-	18 (mo)	$100	$105,454	***Guilty Plea*** **26 U.S.C. 7206(1)**
Jeffrey Grayson	5/26/04	-0-	-0-	-0-	-0-	***Dismissed***
Andrew Wiederhorn	6/03/04	18	-0-	$25,200	$2,000,000	***Guilty Plea*** **18 U.S.C. 1954; 26 U.S.C. 7206(1)**
Gary Kirkland	6/15/04	-0-	-0-	-0-	-0-	***Acquitted***
Robert Legino	6/15/04	-0-	-0-	-0-	-0-	***Acquitted***
Robert Mayhew	7/01/04	-0-	12 (mo)	$1,000	-0-	***Guilty Plea*** **29 U.S.C. 1131; 18 U.S.C. 2**
John Lontine	7/01/04	-0-	12 (mo)	$1,000	-0-	***Guilty Plea*** **29 U.S.C. 1131; 18 U.S.C. 2**
Dennis Talbott	7/15/04	-0-	36 (mo)	$1,000	-0-	***Guilty Plea*** **18 U.S.C. 1954**

Name	Date	Jail	Probation	Fines	Restitution	Charges
Dean Kirkland	2/10/05	24	24 (mo)	$5,000	$15,756	***Conviction*** ***18 U.S.C. 1954; 18 U.S.C. 1343; 18 U.S.C. 1503(a)***

Key

Title 18 U.S.C. 2	Principals.
Title 18 U.S.C. 1341	Frauds and Swindles.
Title 18 U.S.C. 1343	Fraud by wire, radio, or television.
Title 18 U.S.C. 1503(a)	Influencing or injuring officer or juror generally.
Title 18 U.S.C. 1954	Offer, acceptance, or soliciation to influence operations of employee benefit plan.
Title 26 U.S.C. 7206(1)	Making and subscribing a false return, statement or other document.
Title 29 U.S.C. 1131	Willful violation of Part I of ERISA.

The CHAIRMAN. Ms. Bovbjerg?

Ms. BOVBJERG. Thank you, Mr. Chairman, Senator Bingaman. Thank you for inviting me here today to discuss past GAO work on the Department of Labor's enforcement of ERISA.

Labor's Employee Benefit Security Administration, EBSA, is charged with safeguarding the economic interests of the more than 150 million people who participate in employee benefit plans. Recent abuses by plan fiduciaries, trading scandals in mutual funds, and the bankruptcy of companies like United Airlines and Enron have exposed vulnerabilities in our country's pension system. They also underscore the importance of legal protections for workers and the vigorous enforcement of such protections.

Today, I will discuss three things. First, the ways in which EBSA enforces ERISA. Second, the measures EBSA has taken to improve. And finally, the challenges that remain. My remarks are based on a body of GAO work on pension vulnerabilities and ERISA enforcement.

First, EBSA's enforcement practices. EBSA's enforcement program is conducted by its regional offices and focuses primarily on investigations. Investigations result mainly from participant complaints, but are also initiated as part of a coordinated national enforcement effort. For example, one of EBSA's current national priorities focuses on employee contributions to defined benefit plans, which is a type of retirement saving that has grown dramatically in recent years.

In an effort to leverage its enforcement resources, EBSA also carries out education programs for plan participants, sponsors, and service providers. For participants, EBSA seeks to establish an environment where individual law workers can recognize potential legal violations and report them. For sponsors and service providers, EBSA has launched campaigns to explain and publicize fiduciary responsibilities under ERISA. In addition, EBSA has initiated the voluntary fiduciary correction program, which encourages plan officials to identify and correct ERISA violations on their own. EBSA's investigations, education, and voluntary corrections are intended to comprise a multifaceted approach to enforcement.

Let me now turn to recent improvements in EBSA's enforcement. In the past, most recently in 2002, we reported weaknesses in this program that we felt affected its efficiency and effectiveness. Since then, EBSA has taken a number of steps to improve. For example, we observed that EBSA knew little about the levels of compliance with different aspects of the law, making it difficult, if not impossible, to really target enforcement resources at the areas of greatest need.

In response, EBSA has completed a compliance study on large multiemployer health plans and is currently conducting a study to determine the level of timely employee contribution transmission. Although these studies are more limited than the broader survey we believe is needed, they represent important steps toward better targeting of resources.

And such improvement, as Mr. Lebowitz says, has borne fruit. Prohibited transactions corrected and plan assets restored rose from $566 million in 2002 to $2.5 billion in 2004.

But despite these improvements, of course, challenges remain, and some have their roots in the law. The primary source of pension information, for example, the Form 5500, is not timely and it hinders its utility as an enforcement tool. Statutory deadlines allow sponsors 285 days to file information and, as we reported last week in our report on this topic, processing adds more time. As a result, EBSA today is using 2003 Form 5500 data for enforcement targeting, which does little to help identify compliance problems as they emerge.

EBSA is also hobbled by ERISA in assessing penalties. Work we did last year for Senator Kennedy highlighted EBSA's inability to assess penalties in certain circumstances. As a consequence, EBSA has fewer enforcement tools than other regulatory agencies like the SEC.

But not all enforcement shortcomings stem from legal restrictions. Some would benefit from managerial changes. For example, recent evidence of abusive trading practices in mutual funds and conflicts of interest by pension consultants highlight the need for EBSA to work even more closely with the SEC, as they did with Capital Consultants. Last year, these agencies each acted separately to address mutual fund issues, but some of the actions originally proposed by the SEC could have had adverse effects on pension funds as investors. These two agencies should have worked more closely together on these issues, as pension plans invest about one-fifth of their capital in mutual funds. Certainly limited enforcement resources could be better utilized if the agencies better coordinated in areas of mutual interest.

To conclude, EBSA is a relatively small agency with a crucially important responsibility of protecting retirement income savings at a time when private pensions and Social Security are increasingly under fiscal pressure. Although the agency strengthened its enforcement program, pension fraud continues to harm working Americans and threaten their standards of living in retirement. Better law and continuous improvement in enforcement will be necessary to assure workers that pension promises made will be retirement income promises delivered.

That concludes my statement, Mr. Chairman. I would be happy to answer any questions you have.

The CHAIRMAN. Thank you very much.

[The prepared statement of Ms. Bovbjerg follows:]

PREPARED STATEMENT OF BARBARA D. BOVBJERG

EMPLOYEE BENEFITS SECURITY ADMINISTRATION

IMPROVEMENTS HAVE BEEN MADE TO PENSION ENFORCEMENT PROGRAM BUT SIGNIFICANT CHALLENGES REMAIN

Why GAO Did This Study

Congress passed the Employee Retirement Income Security Act 1874 (ERISA) to address public concerns over the mismanagement and abuse of private sector employee benefit plans by some plant sponsors and administrators. The Department of Labor's Employee Benefits Security Administration (EBSA) shares responsibility with the Internal Revenue Service and the Pension Benefit Guaranty Corporation for enforcing ERISA. EBSA Works to safeguard the economic interest of more than 150 million people who participate in an estimated 6 million employee benefit plans with assets in excess of $4.4 trillion. EBSA plays a primary role in ensuring that employee benefit plans operate in the interests of plan participants, and the effective management of its enforcement program is pivotal to ensuring the economic security of workers and retirees.

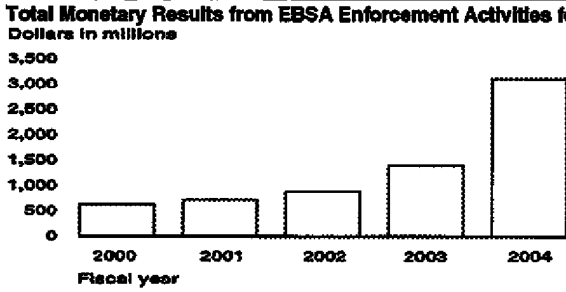
Recent scandals involving abuses by pension plan fiduciaries service providers, as well as trading scandals in mutual funds that affected plan participants and other investors highlight the importance of ensuring that EBSA has an effective and efficient enforcement program. Accordingly, this testimony focuses on describing EBSA's enforcement strategy, EBSA's efforts to address weaknesses in its enforcement program along with the challenges that remain.

What GAO Found

EBSA's enforcement strategy is a multifaceted approach of targeted plan investigations. To leverage its enforcement resources, EBSA provides education to plan participants and plan sponsors. EBSA allows its regional offices the flexibility to tailor their investigations to address the unique issues in the regions, within a framework established by EBSA's Office of Enforcement. The regional offices then have a significant degree of autonomy in developing and carrying out investigations using a mixture of approaches and techniques they deem most appropriate. Participant leads are still the major source of investigations. EBSA officials told us that they open about 4,000 investigations into actual and potential violations of ERISA annually. To supplement their investigations, the regions conduct outreach activities to educate both plan participants and sponsors. The purpose of these efforts is to gain participants' help in identifying potential violations and to educate sponsors in properly managing their plans and avoiding violations. Finally, EBSA maintains a Voluntary Fiduciary Correction Program through which plan officials can voluntarily report and correct some violations without penalty.

EBSA has taken steps to address many of the recommendations we have made over the years to improve its enforcement program, including assessing the level and types of noncompliance with ERISA, improving sharing of best investigative practices, and developing a human capital strategy to better respond changes in its workforce. EBSA reported a significant increase in enforcement results for fiscal year 2004, including $3.1 billion in total monetary results and closing about 4,400 investigations, with nearly 70 percent of those cases resulting in corrections of ERISA violations. Despite this progress, EBSA continues to face a number of significant challenges to its enforcement program, including (1) the lack of timely and reliable plan information, which is highlighted by the fact that EBSA is currently using plan year 2002 and 2003 plan information for its computer targeting, (2) restrictive statutory requirements that limit its ability to assess certain penalties, and (3) the need to better coordinate enforcement strategies with the Securities and Exchange Commission, which is highlighted by recent scandals involving the trading practices and market timing in mutual funds and conflicts of interest by pension consultants.

Total Monetary Results from EBSA Enforcement Activities for Fiscal Years 2000-2004



Source: GAO analysis.

Mr. Chairman and members of the committee, I am pleased to be here today to provide an overview of our past work reviewing the Department of Labor's Employee Benefits Security Administration (EBSA) enforcement program. EBSA works to safeguard the economic interest of more than 150 million people who participate in an estimated 6 million employee benefit plans with assets in excess of $4.4 trillion. EBSA plays a primary role in ensuring that employee benefit plans operate in the interests of plan participants, and the effective management of its enforcement program is pivotal to ensuring the economic security of workers and retirees.

Congress passed the Employee Retirement Income Security Act of 1974 (ERISA) to address public concerns over the mismanagement and abuse of private sector employee benefit plans by some plan sponsors and administrators. ERISA is designed to protect the rights and interests of participants and beneficiaries of employee benefit plans and outlines the responsibilities of the employers and administrators who sponsor and manage these plans. The recent bankruptcies of some large corporations and the effects on employees' retirement savings and the Federal pension insurance program expose certain vulnerabilities in our private pension system. Such problems point out the need for comprehensive pension reform. Also, recent scandals involving abuses by pension plan fiduciaries and service providers, as well as trading scandals in mutual funds that affected plan participants and other investors highlight the importance of ensuring that EBSA has an effective and efficient enforcement program.

Today, I would like to discuss the evolution of EBSA's enforcement program and the challenges that remain. GAO has conducted several studies of ERISA enforcement issues, and my statement is largely based on that work.

In summary, EBSA's enforcement strategy is a multifaceted approach of targeted plan investigations supplemented by outreach and education. To leverage its enforcement resources to prevent and detect violations and promote overall compliance with ERISA, EBSA provides education to plan participants and sponsors and allows the voluntary self-correction of certain transactions without penalty. EBSA's education program for plan participants aims to increase their knowledge of their rights and benefits under ERISA. EBSA has taken steps to address many of the recommendations we have made over a number of years to improve its enforcement program, including assessing the level and types of noncompliance with ERISA, improving sharing of best investigative practices, analyzing the sources of cases, and developing a human capital strategy to better respond changes in its workforce. EBSA reported a significant increase in enforcement results for fiscal year 2004, including $3.1 billion in total monetary results and closing nearly 4,400 investigations, with nearly 70 percent of those cases resulting in corrections of ERISA violations. Despite this progress, EBSA continues to face a number of significant challenges to its enforcement program. Such challenges include lack of timely and reliable plan information, restrictive statutory requirements that limit its ability to assess certain penalties, and the need to better coordinate enforcement strategies with the Securities and Exchange Commission. As we have previously reported, legislative changes will be required to address some of these issues. Furthermore, the Congress should consider providing EBSA with additional enforcement tools, such as enhanced penalty authority, to meet these challenges. Finally, EBSA needs to continue to look for ways to better target investigations to leverage its limited resources.

Background

Three agencies share responsibility for enforcing ERISA: the Department of Labor (EBSA), the Department of the Treasury's Internal Revenue Service (IRS), and the

Pension Benefit Guaranty Corporation (PBGC). EBSA enforces fiduciary standards for plan fiduciaries of privately sponsored employee benefit plans to ensure that plans are operated in the best interests of plan participants. EBSA also enforces reporting and disclosure requirements covering the type and extent of information provided to the Federal Government and plan participants, and seeks to ensure that specific transactions prohibited by ERISA are not conducted by plans.[1] Under Title I of ERISA, EBSA conducts investigations of plans and seeks appropriate remedies to correct violations of the law, including litigation when necessary.[2] IRS enforces the Internal Revenue Code (IRC) and provisions that must be met which give pension plans tax-qualified status, including participation, vesting, and funding requirements. The IRS also audits plans to ensure compliance and can levy tax penalties or revoke the tax-qualified status of a plan as appropriate. PBGC, under Title IV of ERISA, provides insurance for participants and beneficiaries of certain types of tax-qualified pension plans, called defined benefit plans, that terminate with insufficient assets to pay promised benefits. Recent terminations of large, underfunded plans have threatened the long-term solvency of PBGC. As a result, we placed PBGC's single-employer insurance program on our high-risk list of programs needing further attention and congressional action.[3]

ERISA and the IRC require plan administrators to file annual reports concerning, among other things, the financial condition and operation of plans. EBSA, IRS, and PBGC jointly developed the Form 5500 so that plan administrators can satisfy this annual reporting requirement. Additionally, ERISA and the IRC provide for the assessment or imposition of penalties for plan sponsors not submitting the required information when due.

About one-fifth of Americans' retirement wealth is invested in mutual funds, which are regulated by the Securities and Exchange Commission (SEC), primarily under the Investment Company Act of 1940. The primary mission of the SEC is to protect investors, including pension plan participants investing in securities markets, and maintain the integrity of the securities markets through extensive disclosure, enforcement, and education. In addition, some pension plans use investment managers to oversee plan assets, and these managers may be subject to other securities laws.

EBSA Uses a Multifaceted Enforcement Strategy

EBSA's enforcement strategy is a multifaceted approach of targeted plan investigations supplemented by providing education to plan participants and plan sponsors. EBSA allows its regions the flexibility to tailor their investigations to address the unique issues in their regions, within a framework established by EBSA's Office of Enforcement. The regional offices then have a significant degree of autonomy in developing and carrying out investigations using a mixture of approaches and techniques they deem most appropriate. Participant leads are still the major source of investigations. To supplement their investigations, the regions conduct outreach activities to educate both plan participants and sponsors. The purpose of these efforts is to gain participants' help in identifying potential violations and to educate sponsors in properly managing their plans and avoiding violations. The regions also process applications for the Voluntary Fiduciary Correction Program (VFCP) through which plan officials can voluntarily report and correct some violations without penalty.

EBSA Enforces ERISA Primarily Through Targeted Investigations

EBSA attempts to maximize the effectiveness of its enforcement efforts to detect and correct ERISA violations by targeting specific cases for review. In doing so, the Office of Enforcement provides assistance to the regional offices in the form of broad program policy guidance, program oversight, and technical support. The regional offices then focus their investigative workloads to address the needs specific to their region. Investigative staff also have some responsibility for selecting cases.

The Office of Enforcement identifies national priorities—areas critical to the well-being of employee benefit plan participants and beneficiaries nationwide—in which all regions must target a portion of their investigative efforts. Currently, EBSA's na-

[1] Certain transactions are prohibited under the law to prevent dealings with parties who may be in a position to exercise improper influence over the plan. In addition, fiduciaries are prohibited from engaging in self-dealing and must avoid conflicts of interest that could harm the plan.

[2] Prior to 1979, there was overlapping responsibility for administration of the parallel provisions of Title I of ERISA and the Internal Revenue Code (IRC) by the Department of Labor and IRS, respectively.

[3] See GAO, *Pension Benefit Guaranty Corporation Single-Employer Program: Long-Term Vulnerabilities Warrant High-Risk Designation*, GAO-03-1050SP (Washington, D.C.: Jul. 23, 2003).

tional priorities involve, among other things, investigating defined contribution pension plan and health plan fraud. Officials in the Office of Enforcement said that national priorities are periodically re-evaluated and are changed to reflect trends in the area of pensions and other benefits.

On the basis of its national investigative priorities, the Office of Enforcement has established a number of national projects. Currently, there are five national projects pertaining to a variety of issues including employee contributions to defined contribution plans, employee stock ownership plans (ESOP), and health plan fraud. EBSA's increasing emphasis on defined contribution pension plans reflects the rapid growth of this segment of the pension plan universe. In fiscal year 2004, EBSA had monetary results of over $31 million and obtained 10 criminal indictments under its employee contributions project. EBSA's most recent national enforcement project involves investigating violations pertaining to ESOPs, such as the incorrect valuation of employer securities and the failure to provide participants with the specific benefits required or allowed under ESOPs, such as voting rights, the ability to diversify their account balances at certain times, and the right to sell their shares of stock.[4] Likewise, more attention is being given to health plan fraud, such as fraudulent multiple employer welfare arrangements (MEWAs).[5] In this instance, EBSA's emphasis is on abusive and fraudulent MEWAs created by promoters that attempt to evade State insurance regulations and sell the promise of inexpensive health benefit insurance but typically default on their benefit obligations.[6]

EBSA regional offices determine the focus of their investigative workloads based on their evaluation of the employee benefit plans in their jurisdiction and guidance from the Office of Enforcement. For example, each region is expected to conduct investigations that cover their entire geographic jurisdiction and attain a balance among the different types and sizes of plans investigated. In addition, each regional office is expected to dedicate some percentage of its staff resources to national and to regional projects—those developed within their own region that focus on local concerns. In developing regional projects, each regional office uses its knowledge of the unique activities and types of plans in its jurisdiction. For example, a region that has a heavy banking industry concentration may develop a project aimed at a particular type of transaction commonly performed by banks. We previously reported that the regional offices spend an average of about 40 percent of their investigative time conducting investigations in support of national projects and almost 25 percentage of their investigative time on regional projects.

EBSA officials said that their most effective source of leads on violations of ERISA is from complaints from plan participants. Case openings also originate from news articles or other publications on a particular industry or company as well as tips from colleagues in other enforcement agencies. Computer searches and targeting of Form 5500 information on specific types of plans account for only 25 percent of case openings. In 1994, we reported that EBSA had done little to test the effectiveness of the computerized targeting runs it was using to select cases. Since then, EBSA has scaled down both the number of computerized runs available to staff and its reliance on these runs as a means of selecting cases.[7] Investigative staff are also responsible for identifying a portion of their cases on their own to complete their workloads and address other potentially vulnerable areas.

As shown in figure 1, EBSA's investigative process generally follows a pattern of selecting, developing, resolving, and reviewing cases. EBSA officials told us that they open about 4,000 investigations into actual and potential violations of ERISA annually. According to EBSA, its primary goal in resolving a case is to ensure that a plan's assets, and therefore its participants and beneficiaries, are protected. EBSA's decision to litigate a case is made jointly with the Department of Labor's

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[4] In 2002, we reported that the financial collapse of the Enron Corporation and other large firms and the effects on workers and retirees had raised questions about retirement funds being invested in employer securities and the laws governing such investments. We recommended that the Congress consider amending ERISA to require plan sponsors to provide defined contribution plan participants with an investment education notice that includes information on the risks of certain investments such as employer securities and the benefits of diversification. See GAO, *Private Pensions: Participants Need Information on the Risks of Investing in Employer Securities and the Benefits of Diversification*, GAO-02-943 (Washington, DC: Sept. 6, 2002).

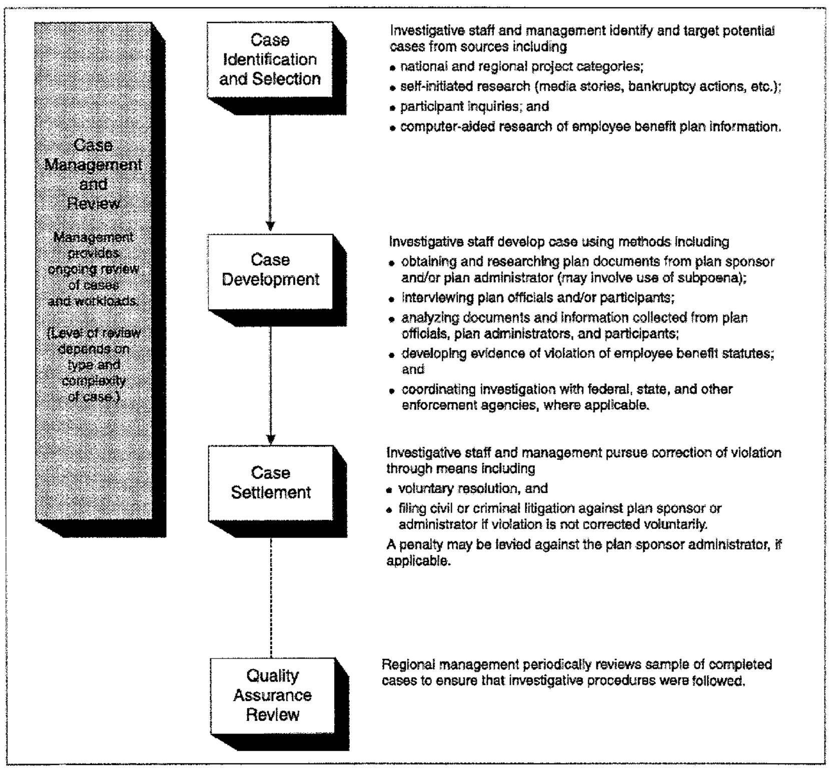
[5] A MEWA is a welfare benefit plan or any other arrangement (other than an employee welfare benefit plan), which is established or maintained for the purpose of offering or providing a welfare benefit to employees of two or more employers. Typically, such arrangements often involve small employers that are either unable to find or cannot afford the cost of health care coverage for their employees.

[6] See GAO, *Employee Benefits: States Need Labor's Help Regulating Multiple Employer Welfare Arrangements*, GAO/HRD-92-40 (Washington, D.C.: Mar. 10, 1992).

[7] See GAO, *Pension Plans: Stronger Labor ERISA Enforcement Should Better Protect Plan Participants*, GAO/HEHS-94-157 (Washington, D.C.: August 8, 1994).

Regional Solicitors' Offices. Although EBSA settles most cases without going to court, both the Agency and the Solicitor's Office recognize the need to litigate some cases for their deterrent effect on other providers.

Figure 1: Overview of EBSA's Investigative Process



Source: GAO analysis.

As part of its enforcement program, EBSA also detects and investigates criminal violations of ERISA. From fiscal years 2000 through 2004, criminal investigations resulted in an average of 54 cases closed with convictions or guilty pleas annually. Part of EBSA's enforcement strategy includes routinely publicizing the results of its litigation efforts in both the civil and criminal areas as a deterrent factor.

EBSA Uses Education, Outreach, and a Voluntary Fiduciary Correction Program to Supplement Its Investigations

To further leverage its enforcement resources, EBSA provides education to plan participants, sponsors, and service providers and allows the voluntary self-correction of certain transactions without penalty. EBSA's education program for plan participants aims to increase their knowledge of their rights and benefits under ERISA. For example, EBSA anticipates that educating participants will establish an environment in which individuals can help protect their own benefits by recognizing potential problems and notifying EBSA when issues arise. The Agency also conducts outreach to plan sponsors and service providers about their ongoing fiduciary responsibilities and obligations under ERISA.

At the national level, EBSA's Office of Participant Assistance develops, implements, and evaluates agencywide participant assistance and outreach programs. It also provides policies and guidance to other EBSA national and regional offices involved in outreach activities. EBSA's nationwide education campaigns include a fiduciary education campaign, launched in May 2004, to educate plan sponsors and service providers about their fiduciary responsibilities under ERISA. This campaign also includes educational material on understanding fees and selecting an auditor.

EBSA's regional offices also assist in implementing national education initiatives and conduct their own outreach to address local concerns. The regional offices' benefit advisers provide written and telephone responses to participants. Benefit advisers and investigative staff also speak at conferences and seminars sponsored by trade and professional groups and participate in outreach and educational efforts in conjunction with other Federal or State Agencies. At the national level, several EBSA offices direct specialized outreach activities. As with EBSA's participant-directed outreach activities, its efforts to educate plan sponsors and service providers also rely upon Office of Enforcement staff and the regional offices for implementation. For example, these staff make presentations to employer groups and service provider organizations about their ERISA obligations and any new requirements under the law, such as reporting and disclosure provisions.

To supplement its investigative programs, EBSA is promoting the self-disclosure and self-correction of possible ERISA violations by plan officials through its Voluntary Fiduciary Correction Program.[8] The purpose of the VFCP is to protect the financial security of workers by encouraging plan officials to identify and correct ERISA violations on their own. Specifically, the VFCP allows plan officials to identify and correct 18 transactions, such as delinquent participant contributions and participant loan repayments to pension plans. Under the VFCP, plan officials follow a process whereby they (1) correct the violation using EBSA's written guidance; (2) restore any losses or profits to the plan; (3) notify participants and beneficiaries of the correction; and (4) file a VFCP application, which includes evidence of the corrected transaction, with the EBSA regional office in whose jurisdiction it resides. If the regional office determines that the plan has met the program's terms, it will issue a "no action" letter to the applicant and will not initiate a civil investigation of the violation, which could have resulted in a penalty being assessed against the plan.

EBSA Has Taken Steps to Address Weaknesses in Its Enforcement Program, but Significant Challenges Remain

EBSA has taken steps to address many of the recommendations we have made over a number of years to improve its enforcement program, including assessing the level and types of noncompliance with ERISA, improving sharing of best investigative practices, and developing a human capital strategy to better respond changes in its workforce. EBSA reported a significant increase in enforcement results for fiscal year 2004, including $3.1 billion in total monetary results and closing nearly 4,400 investigations, with nearly 70 percent of those cases resulting in corrections of ERISA violations. Despite this progress, EBSA continues to face a number of significant challenges to its enforcement program, including the lack of timely and reliable plan information, restrictive statutory requirements that limit its ability to assess certain penalties, and the need to better coordinate enforcement strategies with the SEC.

EBSA Has Made Progress in Improving Its Enforcement Program

EBSA has taken a number of steps, including addressing recommendations from our prior reports that have improved its enforcement efforts across a number of areas. For example, EBSA has continued to refine its enforcement strategy to meet changing priorities and provided additional flexibility to its regional office to target areas of investigations. More recently, EBSA implemented a series of recommendations from our 2002 enforcement report that helped it strategically manage its enforcement program, including conducting studies to determine the level of and type of noncompliance with ERISA and developing a Human Capital Strategic Management Plan (see table 1).[9]

[8] In April 2005, the Department of labor published in the *Federal Register* a revised VFCP that according to EBSA, simplified and expanded the original program.

[9] See GAO, *Pension and Welfare Benefits Administration: Opportunities Exist for Improving Management of the Enforcement Program*, GAO-02-232 (Washington, DC: March 15, 2002).

Table 1: Examples of EBSA's Actions in Response to GAO Recommendations to Improve its Enforcement Program

GAO observation	GAO recommendation to EBSA	Examples of EBSA Actions
EBSA had not adequately estimated the nature of employee benefit plans' noncompliance with ERISA provisions.	Develop a cost-effective strategy for assessing the level and type of ERISA noncompliance among employee benefit plans.	In fiscal year 2001 conducted national compliance study of group health plans' compliance with new health care laws in ERISA. In 2003 conducted compliance study focusing on large multiemployer health plans. Currently conducting baseline study to determine the level of compliance with ERISA requirements on timely transmission of employee contributions to pension plans.
EBSA had not routinely analyzed the full range of cases investigated to determine which sources were the most effective in terms of detecting and correcting violations.	Conduct regular reviews of the sources of cases that lead to investigations.	Conducted analysis on cases closed in fiscal years 2001, 2002, and 2003. Agreed to perform reviews of the sources of cases that lead to investigations on an annual basis as long as resources permit.
EBSA did not coordinate the sharing of best practices information among its regions regarding case selection and investigative techniques.	Coordinate the sharing of best practices information among regions relating to the optimum and most productive techniques for selecting and conducting investigations.	Established a Best Practices Sharing Team composed of enforcement staff and regional representatives. Developed an intranet site to allow EBSA investigators to share best practices, such as investigative plans, subpoenas, letters, and investigative guides.
EBSA lacked a centrally coordinated quality review process to ensure that its investigations are conducted in accordance with its investigative procedures..	Develop a closed case quality review process that ensures the independence of reviewers and sufficiently focuses on substantive technical issues.	In fiscal year 2003, an EBSA team composed of Office of Enforcement and field managers developed a closed case quality review program that focuses on substantive technical case issues and is reported centrally. The program also includes procedures to ensure the independence of the case reviewer.
Certain requirements, such as notifying plan participants of potential violations and levying excise taxes on prohibited transactions, may hinder participation in the VFCP..	Analyze barriers to participation in the VFCP and explore ways to reduce them.	EBSA modified key features of the program eliminating notice requirements to participants, and provided a limited excise tax exemption for those who participate in the program.
EBSA gave limited attention to human capital management despite anticipated workforce and enforcement workload changes. For example, the Agency had not considered succession planning and workforce retention, which could undermine the continuity and effectiveness of its enforcement program..	Conduct a comprehensive review of its future human capital needs, including the size of its workforce; the skills and abilities needed; succession planning challenges; and staff deployment issues.	EBSA conducted an employee workforce analysis and an employee training needs assessment. In 2003, EBSA issued its Human Capital Strategic Management Plan. The plan identified strategies that address current and project skills shortages, anticipated future staffing needs, competency requirements to ensure that employees possess or acquire the critical skills needed to accomplish program mission and functions, and the recognition and reward of quality performance.

Source: GAO summary and analysis of EBSA documents.

EBSA has reported a substantial increase in results from its enforcement efforts since our last review. For fiscal year 2004, EBSA closed 4,399 civil investigations and reported \$3.1 billion in total results, including \$2.53 billion in prohibited transactions corrected and plan assets protected, up from \$566 million in fiscal year 2002. Likewise, the percentage of civil investigations closed with results rose from 58 percent to 69 percent. Also, applications received for the VFCP increased from 55 in fiscal year 2002 to 474 in 2004. EBSA has been able to achieve such results with relatively small recent increases in staff. Full-time equivalent (fte) authorized staff levels increased from 850 in fiscal year 2001 to 887 ftes in fiscal year 2005. The President's budget for fiscal year 2006 requests no additional ftes.

Untimely and Incomplete Plan Information Continues to Hinder Enforcement Efforts

Previously, we and others have reported that ERISA enforcement was hindered by incomplete, inaccurate, and untimely plan data.[10] We recently reported that the lack of timely and complete Form 5500 data affects EBSA's use of the information for enforcement purposes, such as computer targeting and identifying troubled plans.[11] EBSA uses Form 5500 information as a compliance tool to identify actual and potential violations of ERISA. Although EBSA has access to Form 5500 information sooner than the general public, the Agency is affected by the statutory filing deadlines, which can be up to 285 days after plan year end, and long processing times for paper filings submitted to the ERISA Filing Acceptance System. EBSA receives processed Form 5500 information on individual filings on a regular basis once a form is completely processed. However, Agency officials told us that as they still have to wait for a sufficiently complete universe of plan filings from any given plan year to be processed in order to begin their compliance targeting programs. As a result, EBSA officials told us that they are currently using plan year 2002 and 2003 Form 5500 information for computer targeting. They also said that in some cases untimely Form 5500 information affects their ability to identify financially troubled plans whose sponsors may be on the verge of going out of business and abandoning their pension plans, because these plans may no longer exist by the time that Labor receives the processed filing or is able to determine that no Form 5500 was filed by those sponsors.

The Form 5500 also lacks key information that could better assist EBSA, IRS, and PBGC in monitoring plans and ensuring that they are in compliance with ERISA. EBSA, IRS and PBGC officials said that they have experienced difficulties when relying on Form 5500 information to identify and track all plans across years. Although EBSA has a process in place to identify and track plans filing a Form 5500 from year to year, problems still arise when plans change employer identification numbers (EIN) and/or plan numbers. Identifying plans is further complicated when plan sponsors are acquired, sold, or merged. In these cases, Agency officials said that there is an increased possibility of mismatching of EINs, plans, and their identifying information. As a result, EBSA officials said they are unable to (1) verify if all required employers are meeting the statutory requirement to file a Form 5500 annually, (2) identity all late filers, and (3) assess and collect penalties from all plans that fail to file or are late. Likewise, PBGC officials said that they must spend additional time each year trying to identify and track certain defined benefit plans so that they can conduct compliance and research activities. EBSA officials said they are considering measures to better track and identify plans but have not reached any conclusions. Our recent report makes a number of recommendations aimed at improving the timeliness and content of Form 5500 that will likely assist EBSA's enforcement efforts.[12]

In addition to problems with Form 5500 information, concerns remain about the quality of annual audits of plans' financial statements by independent public accountants. For many years, we, as well as the Department of Labor's Office of Inspector General (OIG), have reported that a significant number of these audits have not met ERISA requirements. For example, in 1992 we found that over a third of the 25 plan audits we reviewed had audit weaknesses so serious that their reliability and usefulness were questionable. We recommended that the Congress amend ERISA to require full-scope audits of employee benefit plans and to require plan administrators and independent public accountants to report on how effective an employee benefit plan's internal controls are in protecting plan assets.[13] Al-

[10] See, GAO, *Employee Benefit Plans: Efforts to Streamline Reporting Requirements and Improve Processing of Annual Plan Data*, GAO/HEHS-98-45R (Washington, DC: Nov. 14, 1997).

[11] See GAO, *Private Pensions: Government Actions Could Improve the Timeliness and Content of Form 5500 Pension Information*, GAO-05-491 (Washington, DC: June 3, 2005).

[12] See GAO-05-491.

[13] Under ERISA, investments held by certain regulated institutions, such as banks and insurance companies, may be excluded from the scope of a plan audit The resulting lack of audit work can result in an auditor disclaiming an opinion on the plan's financial statements. See GAO, *Employee Benefits: Improved Plan Reporting and CPA Audits Can Increase Protection under ERISA*, GAO/AFMD-92-l4 (Washington, D.C.: April 9, 1992) and *Employee Benefits: Limited*

Continued

though such changes were subsequently proposed, they were not enacted. In 2004, Labor's OIG reported that although EBSA had reviewed a significant number of employee benefit plan audits and made efforts to correct substandard audits, a significant number of substandard audits remain uncorrected. Furthermore, plan auditors performing substandard work generally continue to audit employee benefit plans without being required to improve the quality of the audits.[14] As a result, these audits have not provided participants and beneficiaries the protections envisioned by Congress. Labor's OIG recommended, among other things, that EBSA propose changes to ERISA so that EBSA has greater enforcement authority over employee benefit plan auditors.

Restrictive Statutory Requirements Limit Assessment of Fiduciary Penalties

As we have previously reported, restrictive legal requirements have limited EBSA's ability to assess penalties against fiduciaries or other persons who knowingly participate in a fiduciary breach.[15] Unlike the SEC, which has the authority to impose a penalty without first assessing and then securing monetary damages, EBSA does not have such statutory authority and must assess penalties based on damages or, more specifically, the restoration of plan assets.[16] Under Section 502(1), ERISA provides for a mandatory penalty against (1) a fiduciary who breaches a fiduciary duty under, or commits a violation of, Part 4 of Title I of ERISA or (2) against any other person who knowingly participates in such a breach or violation. This penalty is equal to 20 percent of the "applicable recovery amount," or any settlement agreed upon by the Secretary or ordered by a court to be paid in a judicial proceeding instituted by the Secretary. However, the applicable recovery amount cannot be determined if damages have not been valued. This penalty can be assessed only against fiduciaries or knowing participants in a breach who, by court order or settlement agreement, restore plan assets. Therefore, if (1) there is no settlement agreement or court order or (2) someone other than a fiduciary or knowing participant returns plan assets, the penalty may not be assessed. For example, last year we reported that ERISA presented legal challenges when developing cases related to proxy voting by plan fiduciaries, particularly with regards to valuing monetary damages.[17] As a result, because EBSA has never found a violation that resulted in monetary damages, it has never assessed a penalty or removed a fiduciary because of a proxy voting investigation. Given the restrictive legal requirements that have limited the use of penalties for violations of ERISA's fiduciary requirements, we recommended that Congress consider amending ERISA to give the Secretary of Labor additional authority with respect to assessing monetary penalties against fiduciaries. We also recommended other changes to ERISA to better protect plan participants and increase the transparency of proxy voting practices by plan fiduciaries.

Recent Scandals Highlight the Need for Better Coordination With SEC

Recent events such as the abusive trading practices of late trading and market timing in mutual funds and new revelations of conflicts of interest by pension consultants highlight the need for EBSA to better coordinate enforcement strategies with SEC. Last year we reported that SEC and EBSA had separately taken steps to address abusive trading practices in mutual funds.[18] At the time we issued our report, SEC had taken a number of actions to address the abuses including:

- charging some fund companies with defrauding investors by not enforcing their stated policies on market timing,
- fining some institutions hundreds of millions of dollars (some of this money was to be returned to long-term shareholders who lost money due to abusive practices),
- permanently barring some individuals from future work with investment companies, and
- proposing new regulations addressing late trading and market timing.

Scope Audit Exemption Should Be Repealed, GAO/T-AIMD-98-75 (Washington, D.C.: February 12, 1998).

[14] See U.S. Department of Labor Office of Inspector General—Office of Audit, *EBSA Needs Additional Authority to Improve the Quality of Employee Benefit Plan Audits*. (Washington, D.C.: Sept. 30, 2004).

[15] See GAO/HEHS-94-157.

[16] EBSA can also seek removal of a fiduciary for breaches of fiduciary duty or seek other sanctions.

[17] See GAO, *Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting*, GAO-04-749 (Washington, D.C.: August 10, 2004).

[18] See GAO, *Mutual Funds: SEC Should Modify Proposed Regulations to Address Some Pension Plan Concerns*, GAO-04-799 (Washington, D.C.: July 9, 2004).

Separate from SEC activities, EBSA began investigating possible fiduciary violations at some large investment companies, including those that sponsor mutual funds, and violations by plan fiduciaries. EBSA also issued guidance suggesting that plan fiduciaries review their relationships with mutual funds and other investment companies to ensure they are meeting their responsibilities of acting reasonably, prudently, and solely in the interest of plan participants. Although SEC's proposed regulations on late trading and market timing could have more adversely affected some plan participants than other mutual fund investors, EBSA was not involved in drafting the regulations because it does not regulate mutual funds.

In another example of how EBSA and SEC enforcement responsibilities can intersect, SEC recently found that potential conflicts of interest may affect the objectivity of advice pension consultants are providing to their pension plan clients.[19] The report also raised important issues for plan fiduciaries who often rely on the advice of pension consultants in operating their plans. Recently, EBSA and SEC issued tips to help plan fiduciaries evaluate the objectivity of advice and recommendations provided by pension consultants.

Concluding Observations

Americans face numerous challenges to securing their economic security in retirement, including the long-term fiscal challenges facing Social Security; the uncertainty of promised pension benefits; and the potential volatility of the investments held in their defined contributions plans. Given these concerns, it is important that employees' benefits are adequately protected. EBSA is a relatively small Agency facing the daunting challenge of protecting over $4 trillion in assets of pension and welfare benefits for millions of Americans. Over the years, EBSA has taken steps to strengthen its enforcement program and leverage its limited resources. These actions have helped better position EBSA to more effectively enforce ERISA.

EBSA, however, continues to face a number of significant challenges to its enforcement program. Foremost, despite improvements in the timeliness and content of the Form 5500, information currently collected does not permit EBSA and the other ERISA regulatory agencies to be in the best position to ensure compliance with Federal laws and assess the financial condition of private pension plans. Given the ever-changing complexities of employee benefit plans and how rapidly the financial condition of pension plans can deteriorate, it is imperative that policymakers, regulators, plan participants, and others have more timely and accurate Form 5500 information. In addition, there is a legitimate question as to whether information currently collected on the Form 5500 can be used as an effective enforcement tool by EBSA or whether different information might be needed. Without the right information on plans in a timely manner, EBSA will continue to have to rely on participant complaints as a primary source of investigations rather than being able to proactively identify and target problem areas. Second, in some instances, EBSA's enforcement efforts continue to be hindered by ERISA, the very law it is charged with enforcing. For example, because of restrictive legal requirements, EBSA continues to be hindered in assessing penalties against fiduciaries or others who knowingly participate in a fiduciary breach. Congress may want to amend ERISA to address such limits on EBSA's enforcement authority. Finally, the significant changes that have occurred in pension plans, the growing complexity of financial transactions of such plans, and the increasing role of mutual funds and other investment vehicles in retirement savings plans require enhanced coordination of enforcement efforts with SEC. Furthermore, such changes raise the fundamental question of whether Congress should modify the current ERISA enforcement framework. For example, it is important to consider whether the current division of oversight responsibilities across several agencies is the best way to ensure effective enforcement or whether some type of consolidation or reallocation of responsibilities and resources could result in more effective and efficient ERISA enforcement. We look forward to working with Congress on such crucial issues.

Mr. Chairman, this concludes my statement. I would be happy to respond to any questions you or other members of the committee may have.

Contact and Acknowledgments

For further information, please contact me at (202) 512–7215. Other individuals making key contributions to this testimony included Joseph Applebaum, Kimberley Granger, Raun Lazier, George Scott, and Roger Thomas.

[19] See SEC, *Staff Report Concerning Examinations of Select Pension Consultants, The Office of Compliance Inspections and Examinations* (Washington, D.C.: May 16, 2005).

The CHAIRMAN. I appreciate the testimony by both of you. I am just guessing, but I suspect that I am the only person in Congress that has actually filled out Form 5500 and been audited on them.

Ms. BOVBJERG. You likely are.

[Laughter.]

The CHAIRMAN. One of my pet peeves on it always was that both pensions and health benefits use the same form, and the questions do not apply to both. So I asked why there was the same Form 5500 for two such different functions and I was told it was the fault of the Paperwork Reduction Act. To do two forms would penalize the agency. Pretty poor excuse, I think.

But at any rate, there are some problems and we need to know how to find the answers to those problems a little bit earlier. Mr. Lebowitz, can you elaborate on some of the hardships and difficulties that members faced when they found out their retirement savings had been lost?

Mr. LEBOWITZ. In the CCL—in connection with——

The CHAIRMAN. Yes, in CCL. We are going to confine it to that.

Mr. LEBOWITZ. Well, it varied dramatically from plan to plan. There were, as I said in my testimony, dozens of plans that had invested some of its assets with CCL and some of these plans invested a rather significant proportion of their assets, one, if I am not mistaken, as much as 70 percent of its assets.

So for those plans, the consequence of CCL's collapse was catastrophic. Others had invested smaller amounts, but something in the order of the low 20s, plans had invested 10 percent or more of their total assets in these collateralized notes through CCL. Some of these were health plans. Some of them were 401(k) plans, where the losses directly translated to losses to participants. And others were traditional defined benefit plans where ultimately the employers contributing to the plans had to make up those losses.

The CHAIRMAN. Over the past several years, EBSA has stepped in many times to protect plan participants against these effects of corporate fraud, but EBSA subjected Capital Consultants to intense scrutiny for several years without spotting these Ponzi-like schemes. When the SEC got involved, they spotted the fraud in a few weeks and took action to close Capital Consultants. Why didn't EBSA spot the Capital Consultants' fraud sooner?

Mr. LEBOWITZ. Well, the Ponzi scheme really developed rather late in the process. As I said in my oral testimony, our investigation opened in October of 1997 and the scheme that is described on the chart over there was really something that came about in 1999 and 2000, after the collapse of Wilshire Financial and its consequent effect on CCL.

When we—in the middle of 2000, sometime in June of 2000, I believe, we began to communicate with the SEC about what we had found. They were interested in knowing what we knew and we were certainly interested in bringing them into it. So we made available to the Commission our entire investigative record.

Now, as far as I know, up to that point, they had not undertaken any formal investigation. So everything they knew about CCL which formed the basis for their ability to bring the action that they and we brought in September was based on our investigation.

So I think that, in fairness, one needs to look back and see that the Commission was able to take advantage of all the work that our investigators had done in putting the case together over the 2 or 3 years prior to their becoming involved in it. Then, of course, they moved very quickly and were very effective in what they did.

The CHAIRMAN. For either of you, since they had to do Form 5500s on this and the Form 5500s, if you have more than 100 employees, have to be audited, why didn't the accounting firm that did the auditing find some of this?

Mr. LEBOWITZ. That is a question we have asked many times, many auditors. CCL, of course, is itself not a plan. It was an investment advisor, investment manager that held plan assets, and as such, it is a plan fiduciary and, therefore, subject to ERISA's rules. The 5500s are filed by the individual plans that invested in CCL, the 60 or so that I described earlier. It is those plans' auditors who have a responsibility under ERISA's audit rules to opine on the fairness of the financial statements that are prepared by the plan administrator.

We looked—our Chief Accountant's Office looked very closely at the 20 plans that had invested material amounts, 10 percent or more of their assets, in CCL over a period of years, and what we found was, unfortunately, not surprising based on our history of reviewing the quality of ERISA audits over the years. So what we found was that, for the most part, plan auditors were more than willing to just accept the valuations that CCL and its service providers, its auditors and evaluators, attached to these assets and rarely raised any question about it.

There were a couple of instances where the auditors did raise questions, and a couple of instances where plan investment advisors made very strong comments to their clients about their concerns about CCL investments, and those plans were able to get out without any harm. So it was capable of being detected by careful auditing and by careful review, but for the most part, plans' auditors failed in their responsibility to do that.

The CHAIRMAN. My time has expired in the first round, so I will go to Senator Bingaman.

Senator BINGAMAN. Thank you very much. Thanks for having this hearing, Mr. Chairman. I think you are uniquely qualified to be helping Congress do some oversight on this important issue.

From the little I know about this—I don't claim any great expertise—it sounds to me like the Department of Labor is really not geared up to do effective monitoring or enforcement in this area. I read the report from GAO and they say that we are using plan year 2002 and 2003 plan information in your computer targeting, and you lack timely and reliable plan information. Is that an accurate criticism, as you understand it, Mr. Lebowitz?

Mr. LEBOWITZ. It is accurate. The Form 5500, as Ms. Bovbjerg said in her testimony, the Form 5500 does not have to be filed until seven-and-a-half months after the close of the plan year to which it applies. And then there is obviously a period of time for review and processing. There is an enormous amount of paper. There are about 1.4 million 5500 series returns that are filed with us. It is a joint form that contains information for us, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation. As the chairman noted, it is a very complex form. It is very difficult, very technical. And then there is information that comes—that has to be presented on the form but comes from other parties, from the plan's auditors, from the plan's actuaries, all of which adds to the time and to the complexity of it.

And our system for receiving and processing these 1.4 million forms which contain somewhere on the order of 25 or 30 million pages is one that is rapidly coming to the end of its life. We have been spending a good bit of time developing approaches that would streamline that process, take advantage of modern technologies, and move us away from this enormous amount of paper which is——

Senator BINGAMAN. Is there a plan to do that, to essentially change this system and come up with a new streamlined, more timely system?

Mr. LEBOWITZ. There are a variety of options that are being considered now——

Senator BINGAMAN. But there is nothing proposed yet?

Mr. LEBOWITZ. There is nothing that the Department has proposed at this point, that is right.

Ms. BOVBJERG. We have made recommendations that they move to an electronic filing system.

Senator BINGAMAN. Right.

Ms. BOVBJERG. It seems absolutely essential to speed things up in the processing side and to have better access to the information. But the deadline for getting the information in and the 285 days is statutory.

I know that one of the things that we certainly talked about is whether, if you were going to alter that statutory deadline, whether it would be appropriate to treat everyone the same, which it probably is not, or whether you would try to look at a shorter deadline for riskier plans.

Senator BINGAMAN. Getting to this issue of riskier plans, does the Department of Labor currently have open investigations going against investment advisors? This was a case where you had about a half-billion dollars in fraud that was perpetrated by this Capital Consultants group, as I understand it. Does the Department of Labor have other cases like that that are currently being investigated that are coming to a head, or what is the status?

Mr. LEBOWITZ. We have—over the years, we have had investigations, or undertaken investigations of financial services companies that provide investment management and other fiduciary services to plans and have found violations of various sorts. I don't know that we found anything quite like what we ultimately found in the CCL matter, but review of investment managers is a part of our enforcement program.

Senator BINGAMAN. But you do have cases currently under investigation of investment advisors?

Mr. LEBOWITZ. Yes. Yes, we do.

Senator BINGAMAN. OK. There is a suggestion in here, in the GAO report, that there is a need for the restrictive statutory requirements that limit the ability of the Department of Labor to assess certain penalties. Are you of the view that we should stiffen those penalties or change those statutory provisions? Mr. Lebowitz, is this something that you considered asking Congress to do, or do you request that we do this, or——

Mr. LEBOWITZ. At this point, there is no—the Department has not made a request of that sort with regard to ERISA's penalties. There are a variety of penalties, civil money penalties, in the statute now, most of which relate to late filing and matters that—documents that have to be made available to the Department. And then there is a civil penalty under Section 502(l) of ERISA, which is sort of an add-on to amounts that are recovered in the course of litigation or in settlement agreements.

The SEC, for example, has some additional penalties that it uses rather effectively in the course of undertaking its investigations. There are other models to look at, but we have not made any formal request at this point.

Senator BINGAMAN. My time is up, Mr. Chairman. Go ahead.

The CHAIRMAN. Thank you. To return to the question I was asking earlier, Mr. Lebowitz, the commercial bank regulators visit every bank regularly to make sure it is being managed in a safe and sound manner. By contrast, EBSA has, I thought it was about 400 investigators, I think you said 867, to investigate 700,000 private pension plans and 6 million health and welfare plans. That is almost 17,000 plans per investigator. How do you proactively target the troubled plans to investigate?

Mr. LEBOWITZ. Well, it is a challenge, Mr. Chairman. Just to clarify the number, our total staff for the entire agency, authorized staff, is 887 FTE, and our investigative staff is 470.

At that level, we obviously have to be very careful and very analytical in terms of the cases that we select for targeting. We use a variety of sources. We traditionally have not done random reviews of plans or of service providers, but rather have opened cases based on indicators from the annual report, from complaints filed by participants, from referrals from other agencies, and we have—we measure our performance, or GIPRA goal, our principal GIPRA goal in the enforcement area is one that measures how well we do at targeting. It basically looks to see what proportion of the cases that we open actually end up finding violations and correcting those violations. The percentage—and that is how we define success in terms of our Agency's performance objectives.

It is a process that involves very careful analysis of the information that comes to us and we have been improving that percentage every year. But it is a challenge to make sure that we are—that we have a presence across the board, not just in one segment of this very large plan universe and service provider universe, but that we are seen as being involved in investigations in connection with small plans, large plans, and service providers of various sorts, as well as geographically.

Ms. BOVBJERG. If I could break in for a minute——

The CHAIRMAN. Sure.

Ms. BOVBJERG. We had recommended that EBSA do a little compliance survey of a sample of plans that would be projectable so you would have some sense of what really are the problems out there. This is something that the IRS has done with pension plans for their responsibilities under the IRC to review funding, investing, and some of those elements of pension plans. They pulled the sample and audited the plans. This is a way to really know where the compliance problems are out there, a projectable way, and another way that you could target resources.

I think that EBSA has done some of these things in sort of different pieces of their plan responsibilities, but I think a more comprehensive look at it would be warranted.

The CHAIRMAN. OK. I also have—it is a little more into some technical things on what that percentage of success is and how it is determined that we will follow up on in writing.

Ms. Bovbjerg, for 20 years, GAO has consistently recommended stronger enforcement of ERISA by the Department of Labor. In your assessment, does the Department of Labor have the latitude to strengthen its enforcement strategies or is legislative action needed to empower that kind of change?

Ms. BOVBJERG. Some of both. I think the Department has been responsive to many of our recommendations for manager changes of enforcement and I applaud them for that. I think there is still more to be done. Some of it would be legislative, and one of the points about penalties, you can't assess penalties against fiduciaries for violation of fiduciary duty unless you have an estimate of monetary damage. If it is a proxy voting issue, you may not ever be able to estimate monetary damage. So they can't assess a penalty. That is statutory. That would require a change to the law.

There are a number of legal changes that we have recommended over the years to ERISA, both to strengthen the law and to provide additional tools for EBSA to use. I think that they have made a lot of progress in this area, but we are particularly concerned about targeting. We think that they need to be more proactive and less reactive to complaints. Certainly following up on complaints is important, but it should not be the primary approach.

The CHAIRMAN. Thank you. My time has expired again.

Senator Bingaman?

Senator BINGAMAN. Thank you, Mr. Chairman. I will ask a couple more questions, if I could here.

The Securities and Exchange Commission has come out with this study which has been referred to a few times, I think, and as I understand it, they have basically concluded that after their review of some of these investment advisors, registered investment advisors, they have concluded that maybe half of them or more have some kind of a conflict, I mean, that they basically have a financial deal with some financial company that they are then recommending to their clients they invest in these firms.

Is this something that—what is the Department of Labor doing about that? First, do you agree with their conclusion? Do you think they are right? This sounds like something that would violate ERISA. Am I wrong about that?

Mr. LEBOWITZ. It could, and we consulted with the Commission staff over the course of the period during which they did that study, and shortly afterwards, we jointly issued guidance for plan fiduciaries to follow——

Senator BINGAMAN. Yes, but what if they don't?

Mr. LEBOWITZ. I think it is probably useful to take a half-step back here and think about what the Commission said. The Commission is the regulator of investment advisors under various securities laws. We don't regulate investment advisors, per se. We regulate plan fiduciaries. So the first part of any investigation that we do——

Senator BINGAMAN. What is that distinction again, now? I thought investment advisors had some kind of a fiduciary responsibility. Do they not?

Mr. LEBOWITZ. They do under the securities laws. They are, as I understand it, they are considered to be fiduciaries for purposes of the Investment Advisors Act. But the ERISA definition of fiduciary is more of a functional thing. It doesn't really matter what you are called. It matters what you do. So an investigation by us to determine whether a fiduciary has violated ERISA first has to determine whether the party is a fiduciary, which means going in and looking very carefully at the kinds of services that that entity is providing and determine whether it fits under ERISA's rather technical definition of fiduciary, meaning do they have discretion and control over plan administration or management. That is what we have to find.

In the Commission's case, the investment advisor is, by virtue of filing a Form ADV, it is—and registering—it is a fiduciary with respect to——

Senator BINGAMAN. So are you saying that the SEC, by virtue of their authority, is better positioned to deal with this problem of conflict of interest on the part of investment advisors than you are?

Mr. LEBOWITZ. They are certainly—I would think—I would agree that they are in a better position to deal with the issue of these kinds of conflicts by investment advisors whom they regulate. Now, their concern is whether the potential conflicts or the actual conflicts that they found were adequately disclosed. Adequate disclosure may or may not be enough under ERISA if there are real—if there is real self-dealing going on. It doesn't necessarily cure the ERISA problem. It might cure the securities law problem.

Senator BINGAMAN. Well, it would seem to me that it would be worthwhile for us to have a clear definition of the responsibility to ensure that not only that disclosure occur, but that conflict of interest or self-dealing kinds of arrangements be prohibited, and you are basically saying that you are unable to do that because of your limited authority. SEC is unable to do that because they are really more interested in disclosure than they are with the problem of self-dealing. So are you saying there is a gap in there? There is no one whose job it is to prevent this self-dealing from occurring?

Mr. LEBOWITZ. No, and I certainly wouldn't want to speak for the Commission and can't speak for the Commission in terms of what they are interested in. But the nature of this study that they did focused on whether these potential conflicts were adequately disclosed to the plan clients of these investment advisors.

I don't know that there is a gap necessarily, Senator, but it is a complex area and it highlights the fact that while we operate in the same general area as the SEC, we have a different law and the people who are subject to our law are not necessarily the same ones or subject in the same way that they are to the securities laws, and it is difficult sometimes to parse through all of that to make sure that everything that should be covered is covered.

Ms. BOVBJERG. Could I jump in 1 second?

Senator BINGAMAN. Yes, please. Go ahead.

Ms. BOVBJERG. I think that from what I understand of the back and forth, these investment advisors could be fiduciaries under ERISA. We don't know. And if the SEC has pulled a sample, which is what I understand they did, and they found that about half of them had conflicts, it bears looking at. It bears looking at——

Senator BINGAMAN. Bears looking at by whom?

Ms. BOVBJERG. From the two agencies together. This is one of those areas where we really think that they need to continue to try to have a more collaborative enforcement process.

Senator BINGAMAN. So you are saying that if this survey by the SEC turned out half of 1,700 people they surveyed, 1,700 investment advisors that they surveyed have conflicts, you are saying the Department of Labor ought to get the information from the SEC as to which investment advisors they believe have conflicts and run that to ground?

Ms. BOVBJERG. What I think I—the question it makes me ask is, well, how many—might some of these investment advisors be fiduciaries under ERISA, and as an analyst, I would want to pull a representative sample and just take a look at a few of them to see what the incidence might be. Maybe none of them are, but we don't know.

Mr. LEBOWITZ. If I might just clarify a couple of the numbers here, as I understand it, there are 1,700 registered investment advisors who indicate that they provide pension consulting services. That is the total number. And the Commission looked at something on the order of 25 of them, I think. They did not look at all 1,700.

Senator BINGAMAN. I see.

Mr. LEBOWITZ. And they have provided us with the information that we have asked for with regard to the identity some of the advisors that they looked at where they found problems.

Senator BINGAMAN. And are you taking action with regard to those?

Mr. LEBOWITZ. We will certainly look very carefully at what they give us.

Senator BINGAMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Ms. Bovbjerg, in the past, GAO reports have highlighted some confusion over the ability of individual States to regulate the employer-based health plans. Given the existing ERISA framework, what more can individual States do to help combat pension fraud? What role can States play?

Ms. BOVBJERG. We did that work a really long time ago and I am concerned that things have changed substantially since then with regard to health plans and with regard to Labor's responsibility for health plans under HEPA that I am really afraid to go there. We could get back to you for the record, though.

The CHAIRMAN. I will submit a written question to you on that, then, so that we can do that.

Mr. Lebowitz, the sophisticated financial instruments today can provide high rates of return, but usually that means high rates of risk, as well, and as we found in this situation, they can also mask fraud, as in Enron, Capital Consultants, some of the other corporate scandals. Now, the riskiest transactions were hard for investigators and regulators to spot. They were footnoted or otherwise obscured. How are your investigators trained to recognize the suspicious financial activity? Is that where some of the targeting comes in?

Mr. LEBOWITZ. I might just note that many of these frauds were not detected by lots of people in the financial markets, not just government agencies, but other investors, very large, sophisticated financial institutions themselves were fooled by them. So they are very difficult to find.

Our investigators are very determined and very highly skilled people. They work methodically, as the investigative team that worked on the CCL case did, to go through the elements of the proof that are necessary to develop an ERISA case, which, as I said, starts with the notion of whether—the idea of whether the entity is a fiduciary under ERISA, then to determine whether what that entity did constituted a breach of their fiduciary responsibilities, and then to determine whether that breach actually caused any losses.

It is a complicated and difficult process. I have great confidence in our investigators. I think they are very dedicated, highly skilled people, and work very hard at what they do and very determined to get to the bottom of things. Sometimes, just by the nature of what they are looking at, it takes a long time.

The CHAIRMAN. I appreciate all the responses. I do have a few questions that get into more technical detail of numbers and things, which I really enjoy, but I won't subject everybody to those.

Senator Kennedy was called to the Judiciary Committee over a nominee, so he won't be here for questions on this, but for all members of the committee, we leave the record open for 10 days so that they can submit questions immediately, not 10 days from now, and then we can get a response from you that will be a part of building this record.

Of course, what we really need to know is what sorts of legislative things can be done to make a change, make things easier for the investigators, but still fair for everybody involved and not overburden people with paperwork. I will be concentrating on the Form 5500 a little bit, but I have been doing that for 8 years and it hasn't done any good, so——

Mr. LEBOWITZ. Well, we have a booklet called "A Troubleshooter's Guide to the 5500." We will be happy to send you one, Senator.

The CHAIRMAN. I used to subscribe to a special service that put out a notebook that was about that thick that helped me to determine what each line meant, regardless of what it said.

[Laughter.]

Ms. BOVBJERG. We encourage you to submit it electronically.

The CHAIRMAN. Electronically might help. It would help if the instructions were embedded in the electronic work so that a person didn't have to have a number of references to go to and—actually, it would really help again if they divided it so that health was different than pensions, which are completely different animals, in my opinion, and the questions never applied, which is why you had to have the huge manual to understand what the question meant. So it might be time to redo it so that there are two forms, but that they are easier to fill out.

Of course, I once suggested to the IRS that if they put a little bit more instruction in their forms, that it would be easier to fill out, as well, and that is where I learned about the Paperwork Reduction Act. They can add to the manual as much as they want without being penalized, but to add to the form has a pretty strong Congressional penalty. So we will see if we can't get a few more accountants so we can help people to understand that.

Thank you very much for your testimony today and we will move to the second panel. I would appreciate it if the two of you would listen to the testimony in the second panel, which may give some insight to the questions that we will be asking based on their testimony, asking of you based on their testimony.

As is traditional, while they are getting settled, I will introduce the panel and then we will call on them individually to give their statements.

The first witness on the second panel is Mr. John Endicott from Oregon. He is the Business Manager and Financial Secretary of Local 290 of the Plumbers, Steamfitters and Marine Fitters Union.

The next witness will be Mr. Barclay Grayson from Portland, Oregon, and served as the former Vice President and CEO of Capital Consultants before operations were closed.

The next witness is the attorney Stephen English with the law firm of Bullivant Houser Bailey in Portland, Oregon, and Mr. English served as the lead attorney for the successful recovery effort.

And the final witness is attorney James S. Ray from the Law Offices of James S. Ray in Alexandria, Virginia.

We appreciate your taking the time from your busy schedules to provide us with some information. Again, your complete text will be a part of the record. You will also have a chance to expand on that after the hearing if you wish to do that. We just appreciate any information you can give that will make sure that our pension is intact.

Mr. Endicott?

STATEMENTS OF JOHN ENDICOTT, BUSINESS MANAGER AND TRUSTEE, LOCAL UNION 290, PLUMBERS, STEAMFITTERS AND MARINE FITTERS, TUALATIN, OREGON; BARCLAY GRAYSON, FORMER CHIEF EXECUTIVE OFFICER, CAPITAL CONSULTANTS, PORTLAND, OREGON; STEPHEN F. ENGLISH, BULLIVANT HOUSER BAILEY, PORTLAND, OREGON; AND JAMES S. RAY, LAW OFFICES OF JAMES S. RAY, ALEXANDRIA, VIRGINIA

Mr. GRAYSON. Chairman Enzi, first, I would like to thank you very much for the opportunity to come and share with you the stories of the hard-working members of Plumbers and Pipe Fitters Local 290.

My name is John Endicott. I am from Gresham, Oregon. I have been a steamfitter for over 30 years and have been a member of the United Association Local 290 Plumber and Steamfitter and Marine Fitter Union since 1972. I am the Business Manager of UA Local 290, which is located in Tualatin, Oregon. I have been a union trustee since March 2002, and I currently serve as Secretary of the UA Local 290 pension plan and trust 401(k) plan, health and welfare plan, pre-funded retiree health trust, educational reimbursement trust, Local 290 training trust, and the Local 290 scholarship trust, among other local trust funds.

In my current position as Business Manager, I represent approximately 4,300 steamfitters and plumbers. Virtually all of the membership participates in one or more of the trusts. Most of those members have families who are also beneficiaries of the trusts. In the aggregate, our trusts administer pension, health and welfare, and other benefits for over 22,000 participants and beneficiaries, recognizing there is a substantial overlap where members and their families participate in one or more of the trusts.

A census of the membership in 2004 shows that members of my local and participants and beneficiaries of my local's trust live in 30 of the 50 States in this country, including Alabama, Georgia, Wyoming, Iowa, Maryland, Nevada, New Mexico, North Carolina, and Washington. The majority of our active members live and work in Oregon, Washington, and Northern California.

I want to tell you about the serious impact that the collapse of Capital Consultants had on me and my fellow union members and the debacle that we faced when we first heard that much of our hard-earned pension, health, and other benefits had been stolen, misappropriated, or lost through reckless and fraudulent schemes concocted by corrupt money managers we had entrusted to handle our funds.

In addition, Mr. Chairman, I want to mention some things I think the Federal Government needs to do in order to protect workers' pensions and benefit trust funds. This is money that our members have spent a lifetime accumulating and need to depend upon to pay for their retirement, medical, and other benefits in sickness and old age.

Mr. Chairman, the members of my local are all hard-working men and women. Many of us have labored for decades with our hands and our backs. We know a lot about plumbing and pipefitting. When it comes to investing our trust fund assets, we turn to professionals to give us advice. We rely on investment managers, pension consultants, lawyers, accountants, and insurance agents when it comes to the decisions about investments in stock funds, real estate, trusts, hedge funds, or collateralized notes. To help us make the kinds of prudent decisions we need to be making with our members' money, trustees like me depend upon the advice of those professionals that we hire.

Beginning in approximately 1975, my local began to invest through the Capital Consultants firm in Portland, Oregon. By June of 2000, the UA Local 290 trust had entrusted more than $159 million of our workers' pension and other trust fund money with that firm. This was all the money the trust was trying to safeguard for our members, money that they would require for their retirement and for their medical bills and the like. Those funds represented much of the safety net our members were depending upon.

Capital Consultants knew that they had an obligation to invest that money prudently and in the best interest of our participants and beneficiaries. However, in a blink of an eye, much of that money evaporated into thin air, almost like a cloud of steam, along with all the hopes and dreams of most of our members. I, like our

4,300 members and their families, were shocked and devastated to discover that we had lost more than $75 million, most of that in what Capital Consultants described as insured collateralized note program. Unbeknownst to us, the notes were neither insured nor collateralized. Our 401(k)s were frozen, which meant that we could not move our investments.

Mr. Chairman, we had hired professionals to guide and advise us, and those professionals had all assured us that Capital Consultants was doing a good job and our money was safe. Unfortunately, as we were later to discover, many of those professionals we had paid were dead wrong. The professionals we depended upon had simply failed us. They just didn't do the kind of work or exercise the due diligence that we have a right to expect. They didn't provide the level of oversight that we depended upon. We were fooled, and as a result, our members lost.

How could this have happened to us? Equally important, how can we protect others from experiencing this type of loss in the future?

First, the representatives of Capital Consultants lied to us. As we later learned, Capital Consultants never told us the true nature of their investments in private placement loans. For example, they represented that our investments through Capital Consultants' collateralized note program were secured by collateral and that the notes were insured. Neither was true.

What we later learned was that when the loans failed or when investigators sought to terminate the relationship with Capital Consultants, Capital Consultants simply sought out more pension money to prop up the failed loans or to liquidate clients who wanted to terminate Capital Consultants. In the most egregious case, Capital Consultants had loaned more than $157 million of mostly union trust fund money, and when those loans were discharged in bankruptcy, Capital Consultants hid that fact by lying to the trust and representing that it had a new investor who had assumed those loans. What Capital Consultants did not tell us was that it had pumped an additional $80 million through entities functionally controlled to create an appearance that the failed loans were actually performing.

Second, the Government entities charged with oversight of investment managers for employee benefit plans subject to ERISA should have more clearly defined authority to act on the local level. I understand that Capital Consultants was under scrutiny and investigation by the Department of Labor through most of the 1990s. At the local level, we had little, if any, information from the Department of Labor that Capital Consultants was under investigation.

In addition to having clear authority to act at the local level, the Department of Labor should employ personnel specifically trained to understand the investment money managers make with employee benefit plan assets. Alternatively, the Labor Department should work closely with the Securities and Exchange Commission to enforce compliance regarding investments made by investment managers.

Third, clarify civil laws and regulations that apply to pension consultants, investment managers, and other professionals who advertise the ability to monitor employee benefit plan investment managers. These financial professionals place themselves between the trustees and the investment managers and their credentials suggest that they are in the best position to warn of improprieties in an investment manager's operations.

Finally, enforce the criminal law. A man who robs a store of a few hundred dollars at gunpoint might be sentenced to 10 years in prison. The sentences in this case seem very light in comparison to the losses.

Thank you for giving me the opportunity to share with you my concerns and those of the members of my local union. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Endicott follows:]

PREPARED STATEMENT OF JOHN ENDICOTT

Mr. Chairman and members of the committee, my name is John Endicott. I am from Gresham, Oregon. I have been a steamfitter for over 30 years and have been a member of the United Association Local 290 Plumber, Steamfitter and Marine Fitter union since 1972. I am the Business Manager of U.A. Local 290, which is located in Tualatin, Oregon.

I have been a union trustee since March 2002, and I currently serve as Secretary of the U.A. Local No. 290 Plumber, Steamfitter, and Shipfitter Industry Pension Plan and Trust; the U.A. Local No. 290 Plumber, Steamfitter, and Shipfitter Industry 401(k) Plan and Trust; the U.A. Local No. 290 Plumber, Steamfitter, and Shipfitter Industry Health and Welfare Plan and Trust; the U.A. Local No. 290 Pre-Funded Retiree Health Trust; U.A. Local No. 290 Educational Reimbursement Trust; U.A. Local No. 290 Training Trust; and the U.A. Local No. 290 Scholarship Trust, among other Local trust funds.

In my current position as Business Manager I represent approximately 4,300 steamfitters and plumbers. Virtually all of the membership participates in one or more of the Trusts. Most of those members have families who are also beneficiaries of the Trusts. In the aggregate, our Trusts administer pension, health, and welfare, and other benefits for over 22,000 participants and beneficiaries, recognizing that there is substantial overlap where members and their families participate in more than one Trust. A census of the membership in 2004 shows that members of my Local, and participants and beneficiaries in my Local's Trusts, live in 30 of the 50 States in this country, including Alabama, Georgia, Wyoming, Iowa, Maryland, Nevada, New Mexico, North Carolina, and Washington.[1] The majority of our active members live and work in Oregon, Washington, and Northern California.

I want to tell you about the serious impact that the collapse of Capital Consultants had on me and on my fellow union members and the debacle that we all faced when we first heard that much of our hard-earned pension, health and other benefits had been stolen, misappropriated or lost through reckless and fraudulent schemes concocted by corrupt money managers who we had entrusted to handle our funds. In addition, Mr. Chairman, I want to mention some things that I think the Federal Government needs to do in order to protect workers' pension and benefit trust funds. This is money that our members have spent a lifetime accumulating and need to depend upon to pay for their retirement, medical and other benefits in sickness and old age.

Mr. Chairman, the members of my Local are all hard-working men and women. Many of us have labored for decades with our hands and our backs. We know a lot about plumbing and pipefitting. When it comes to investing our Trust Fund assets, we turn to professionals to give us advice. We rely on investment managers, pension consultants, lawyers, accountants, and insurance agents when it comes to decisions about investments in stock funds, real estate trusts, hedge funds or collateralized notes. To help us make the kinds of prudent decisions we need to be making with our members' money, trustees like me depend upon the advice of those professionals that we hire.

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[1] The remaining States with members, participants or beneficiaries include Arkansas, Arizona, California, Colorado, Delaware, Florida, Hawaii, Idaho, Louisiana, Minnesota, Missouri, Mississippi, Montana, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, South Dakota, Texas, and Wisconsin.

Beginning in approximately 1975, my Local began to invest through the Capital Consultants firm in Portland, Oregon. By June of 2000, the U.A. 290 Trusts had entrusted more than $159 million of our workers' pension and other Trust fund money with that firm. This was all money that the Trusts were trying to safeguard for our members—money that they would require for their retirement and for their medical bills and the like. Those funds represented much of the safety net our members were depending upon. Capital Consultants knew that and they had an obligation to invest that money prudently and in the best interests of our participants and beneficiaries. However, in just a blink of an eye, much of that money evaporated into thin air—almost like a cloud of steam—along with all of the hopes and dreams of most of our members. I, like our 4,300 members and their families, was shocked and devastated to discover that we had lost more than $75 million, most of that in what Capital Consultants described as an insured, collateralized note program. Unbeknownst to us, the notes were neither insured nor collateralized. Our 401(k)s were frozen, which meant that we could not move our investments.

Mr. Chairman, we had hired professionals to guide and advise us, and those professionals had all assured us that Capital Consultants was doing a good job and our money was safe. Unfortunately—as we were later to discover—many of those professionals we had paid were dead wrong. The professionals we depended upon had simply failed us. They just didn't do the kind of work or exercise the due diligence that we have a right to expect. They didn't provide the level of oversight that we depended upon. We were fooled and—as a result—our members lost.

How could this have happened to us and, equally important, how can we protect others from experiencing this type of loss in the future? First, the representatives of Capital Consultants lied to us. As we later learned, Capital Consultants never told us the true nature of their investments in private placement loans. For example, they represented that our investments through Capital Consultants Collateralized Note Program were secured by collateral and that the Notes were insured. Neither was true. What we later learned was that when loans failed or when investors sought to terminate their relationship with Capital Consultants, Capital Consultants simply sought out more pension money to prop up the failed loans or to liquidate clients who wanted to terminate Capital Consultants. In the most egregious case, Capital Consultants had loaned more than $157 million of mostly union trust fund money and when those loans were discharged in bankruptcy Capital Consultants hid that fact by lying to the Trusts and representing that it had a new investor who had assumed the loans. What Capital Consultants did not tell us was that it pumped an additional $80 million through entities it functionally controlled to create an appearance that the failed loans were actually performing.

Second, the governmental entities charged with oversight of investment managers for employee benefit plans subject to ERISA should have more clearly defined authority to act on the local level. I understand that Capital Consultants was under scrutiny and investigation by the Department of Labor through most of the 1990s. At the local level, we had little if any information from the Department of Labor that Capital Consultants was under investigation. In addition to having clear authority to act at the local level, the Department of Labor should employ personnel specifically trained to understand the investments money managers make with employee benefit plan assets. Alternatively, the Department of Labor should work closely with the Securities and Exchange Commission to enforce compliance regarding investments made by investment mangers.

Third, clarify civil laws and regulations that apply to pension consultants, investment managers and other professionals who advertise the ability to monitor employee benefit plan investment managers. These financial professionals place themselves between the Trustees and the investment managers and their credentials suggest that they are in the best position to warn of improprieties in an investment manager's operations.

Finally, enforce the criminal law. A man who robs a store of a few hundred dollars at gun point might be sentenced to 10 years in prison. The sentences in this case seem very light in comparison to the losses.

Thank you for giving me the opportunity to share with you my concerns and those of the members of my Local.

The CHAIRMAN. Mr. Grayson?

Mr. GRAYSON. Good morning. My name is Barclay Grayson. I am 35 years old. I have a wife and three young children. I obtained my undergraduate business degree from the University of Oregon in 1992 and I obtained my MBA from Colombia Business School with an emphasis in finance and real estate in 1996. I am currently Senior Vice President of BDC Advisors based in Portland, Oregon, where I facilitate senior housing real estate acquisitions.

In 1996, I joined my father's registered investment advisory firm which he founded in 1968. At its height, Capital managed assets in excess of $1 billion. Approximately 75 percent of these assets were Taft-Hartley regulated funds, of which half were derived from my father and the other half from Dean Kirkland, who was my father's primary union salesman. The company invested about half of its finance capital in privately originated loans and investments.

One of Capital's private borrowers was named Wilshire Credit Corporation, led by Andrew Wiederhorn. Over a period of 9 years, Wilshire borrowed over $150 million from Capital, which it used to acquire high-risk, sub-performing loans. These loans represented nearly 15 percent of Capital's total assets.

Two years after I joined the firm, Wilshire defaulted on its loans and effectively failed. Instead of closing Wilshire's default and shutting down the borrower, Capital advised its clients that it was undertaking a "workout." This workout first involved maximizing what little was left following the collapse of Wilshire. It next involved the formation of three new shell entities that then collectively borrowed in excess of $80 million of additional funds from Capital's clients. The majority of these funds were used to make high-risk used car and credit card loans. The balance was used to keep the original Wilshire loans current.

As a result of these complex transactions, the company's clients largely had no idea that their ongoing contributions were effectively being circulated through each of these shell borrowers to keep their Wilshire investments current. This gave the false impression that all the firm's loans were fully performing, fully secured, and of limited risk.

At the end of 1999, a year following the effective loss of the Wilshire assets, my father appointed me President of the company. In mid-2000, the SEC determined that the initial Wilshire loans were likely worthless and that the loans being made going forward were highly risky and the disclosures to clients were insufficient. This resulted in Capital being placed into court-ordered receivership on September 21, 2000.

I immediately cooperated with all parties to maximize the recovery of client assets following being placed into receivership and assisted in the ensuing Department of Justice investigation. It quickly became clear to me that I had failed to live up to my fiduciary disclosure duties as President relative to what is required on behalf of the firm's clients.

In 2001, I therefore pled guilty to one count of mail fraud. I thereafter entered into a global settlement with all the company's clients and the SEC. Due to my extensive cooperation, the prosecution ultimately recommended that I be sentenced to 1 year of home detention. However, due to public accountability issues, I received a sentence of 18 months and a 3-year term of subsequent probation.

After spending 14 months at FPC Sheridan, I returned home and started over. Due to my conduct and extraordinary assistance, the sentencing judge terminated my probation 2 years early. She explained this was a very rare occurrence, but was warranted.

There are three natural questions that would follow after hearing this story. The first question that arises is why did Capital loan so much money to Mr. Wiederhorn. These reasons include, one, my father received improper personal loans from Mr. Wiederhorn. Two, Capital received a management fee of 3 percent of promptly invested assets. Three, Mr. Wiederhorn acquired earlier failed investments at face value from the company. And four, Capital's excessive concentration with Mr. Wiederhorn resulted in a loss of control.

The second question is why did the union clients invest so much money into Capital's private investment program initially and why did the money keep flowing in for so long after Wilshire's failure? There were several reasons. One, gifts and gratuities provided by my father and Dean Kirkland to the firm's trustees were extensive. They included extensive dinners, golf trips, club memberships, lavish parties, sporting events, fishing and hunting trips, foundations, hiring of union members, donations to causes, raffles, loans, and employment of trustees postunion employment. Second, we had established relationships with service providers associated with recommending which investment advisors were selected for management.

The third question is whether there was any regulatory oversight of us. Due to complaints dating back to the early 1990s, the DOL reviewed many of Capital's private investments. No specific issues were found to exist with Wilshire, but the DOL did determine that Capital was charging excessive fees relative to one investment on behalf of one client which resulted in a $2 million fine that was, in fact, returned to one of the affected clients. There was little detailed follow-through to ensure that the funds Capital used to pay this fine were derived from legitimate sources, of which they were not.

Although the DOL opened another investigation into Capital's private investments, including Wilshire, in 1997, the company continued to be allowed to operate for almost 3 more years until the SEC announced the receivership proceedings. All told, the DOL effectively witnessed over 8 years of abuses without taking significant action to close the firm.

Based on my observations, the DOL has a limited understanding of private investments and a general lack of accounting skills. This results in the DOL having long open files, which makes them largely ineffective. In this case, the DOL were largely reactionary as opposed to being proactive.

The SEC began its core investigation in 2000. They first spoke to past employees and existing borrowers of Capital. They then came in hard and fast with a team of forensic accountants. They looked at every private investment in the portfolio and they met with all members of the private investment management team at Capital. Within very short order, they were working toward placing Capital into receivership.

The last question relates to what recommendations I would make to you to better check pension assets going forward. First, we need to educate. Courses and licensing should be required for all parties associated with Taft-Hartley regulated funds. No such requirements exist. Trustees would particularly benefit. And second, courses and licensing should be required for all parties investing in privately-held loans and investments. Many are ill-prepared to properly analyze private investments.

Second, we need to strengthen regulatory oversight. The DOL needs to employ highly-trained accountants and business experts like the SEC who will audit pension investments at least once every 2 years, as well as all the service providers providing services to the unions themselves to ensure that no conflicts of interest exist. Second, the DOL needs to implement more strict Taft-Hartley investment guideline requirements that set real limits on investment alternatives and investment concentration.

Third, we need to expand the laws regulating Taft-Hartley assets. No. 1, limiting receipt of gifts and gratuities by trustees and service providers associated with the trust, in my opinion, to no more than $100 per item or event and no more than $500 annually would be satisfactory. The law should be clear that if a trustee or service provider accepts a gift or gratuity over a stated level, regardless of whether influence can be proven, it is a violation of the law. Second, any trustees or service providers desiring to accept gifts or gratuities within legal limits should be required to disclose said items to the trustees—the rest of the trustees—prior to taking receipt. And third, to help mitigate future pension losses, there should be a minimum level of E&O insurance coverage required for all investment advisors. This minimum should be tied to each manager's total assets, in my opinion, under management so as to provide additional coverage, but yet still be cost effective for providers.

That is my testimony. Thank you.

The CHAIRMAN. Thank you, and especially for your willingness to testify and your specific suggestions.

[The prepared statement of Mr. Grayson follows:]

PREPARED STATEMENT OF BARCLAY GRAYSON

Good afternoon, my name is Barclay Grayson. I am 35 years old. I have a wife and three young children. I obtained my undergraduate business degree from the University of Oregon in 1992 and I obtained an MBA from Colombia Business School with an emphasis in Finance and Real Estate in 1996. I am currently Senior Vice President of BDC Advisors, LLC, based in Portland, OR, where I facilitate senior housing real estate acquisitions.

In 1996, I joined my father's registered investment advisory firm which he founded in 1968. At its height, Capital managed assets in excess of $1 billion. Approximately 75 percent were Taft-Hartley regulated funds, of which half were derived from my father and the other half from Dean Kirkland who was my father's primary union salesman. The company invested about half of its clients' capital in privately originated loans and investments.

One of Capital's private borrowers was named Wilshire Credit Corporation, led by Andrew Wiederhorn. Over a period of 9 years, Wilshire borrowed over $150 million which it used to acquire high risk, sub-performing loans. These loans represented nearly 15 percent of Capital's total assets. Two years after I joined the firm, Wilshire defaulted on its loans and effectively failed.

Instead of disclosing Wilshire's default and shutting down the borrower, Capital advised its clients that it was undertaking a "work-out." This work-out first involved maximizing what little was left following the collapse of Wilshire. It next involved the formation of three new shell entities that then collectively borrowed $80 million of additional funds from Capital's clients. The majority of these funds were used to make high risk car and credit card loans. The balance was used to keep the original Wilshire loans current. As a result of these complex transactions, the Company's clients largely had no idea that their ongoing contributions were effectively being circulated through each of these shell borrowers to keep their Wilshire investments current. This gave the false impression that all of the firm's loans were fully performing, fully secured and of limited risk.

At the end of 1999, a year following the effective loss of the Wilshire assets, my father appointed me president of the company. In mid-2000 the SEC determined that the initial Wilshire loans were likely worthless, that the loans being made going forward were highly risky and that the disclosures to clients were insufficient. This resulted in Capital being placed into court-ordered receivership on September 21, 2000. I immediately cooperated with all parties to maximize the recovery of client assets and assist in the ensuing DOJ investigation. It quickly became clear to me that I had failed to live up to my fiduciary duties as President relative to required disclosures to the firm's clients. In 2001, I therefore pled guilty to one count of mail fraud. I thereafter entered into a global settlement with all of the company's clients and the SEC.

Due to my extensive cooperation, the prosecution ultimately recommended that I be sentenced to 1 year of home detention. However, due to public accountability issues, I received a sentence of 18 months and a 3 year term of subsequent probation. After spending 14 months at FPC Sheridan, I returned home and started over. Due to my conduct and extraordinary assistance, the sentencing Judge terminated my probation 2 years early. She explained that this was a very rare occurrence but was warranted.

There are three natural questions that would follow after hearing this story:

The first question that arises is why did Capital loan so much money to Mr. Wiederhorn.

The reasons include:

1. My father received improper personal loans from Mr. Wiederhorn;
2. Capital received management fees of 3 percent from clients on promptly invested assets;
3. Mr. Wiederhorn acquired earlier failed investments at face value;
4. Capital's excessive concentration with Mr. Wiederhorn resulted in a loss of control.

The second question is why did the union client's invest so much money into Capital's private investment program initially and why did the money keep flowing in for so long after Wilshire's failure?

1. Gifts and gratuities provided by my father and Dean Kirkland to the firm's union trustees including:
    a. Expensive Dinners & Golf Trips;
    b. Club Memberships;
    c. Lavish parties/transportation/travel, etc.(trustees and families);
    d. Sporting Events (Football/Basketball/Golf);
    e. Very Expensive Fishing/Hunting Trips;
    f. Establishment and funding of Foundations;
    g. Hiring relatives of Union members;
    h. Donations to causes/raffles of trustees/family;
    i. Investments in directed investments benefiting trustees (labor only investments, relatives, friends, etc.);
    j. Loans (trustees and family) and Cash or equivalents;
    k. Employment of trustees post union employment. Big compensation.
2. Established relationships with service providers associated with recommending which investment advisors are selected for management.

The third question is whether there was any regulatory oversight?

Due to complaints dating back to the early 1990's, the DOL reviewed many of Capital's private investments. No specific issues were found to exist with Wilshire, but the DOL did determine that Capital was charging excessive fees. This resulted in a $2 million fine. There was little detailed follow-through to ensure that the funds Capital used to pay this fine were derived from legitimate sources; of which they were not. Although the DOL opened another investigation into Capital's private investments (including Wilshire) in 1997, the company continued to be allowed to operate for almost 3 years until the SEC announced the receivership proceedings. All told, the DOL effectively witnessed almost 10 years of abuses without taking significant action to close the firm.

Based on my observations, the DOL has a limited understanding of private investments and a general lack of accounting skills. This results in the DOL having long "open files" which makes them largely ineffective. In this case, the DOL were largely reactionary as opposed to being pro-active.

2. The SEC began its core investigation in 2000. They first spoke to past employees and existing borrowers of Capital. Then they came in hard and fast with a team of forensic accountants. They looked at every private investment in the portfolio and met with all members of the private investment management team at Capital.

Within very short order they were working towards placing Capital into receivership.

The last question relates to what recommendations would I make to Congress to better protect pension assets:

First, we need to educate:

1. Courses and licensing should be required for all parties associating with Taft-Hartley regulated funds. No such requirements exist. Trustees would particularly benefit.

2. Courses and licensing should be required for all parties investing in privately held loans/investments. Many are ill-prepared to properly analyze private investments.

Second, we need to strengthen regulatory oversight:

1. The DOL needs to employ highly trained accountants and business experts like the SEC who will audit pension investments at least once every 2 years, as well as all of the service providers providing services to the unions themselves to ensure that no conflicts of interest exists.

2. The DOL needs to implement more strict Taft-Hartley investment guideline requirements that set real limits on investment alternatives and investment concentration.

Third, we need to expand the laws regulating Taft-Hartley assets:

1. Limit receipt of gifts and gratuities by trustees and service providers associated with a Trust to no more than $100 per item or event and no more than $500 per year. The law should be clear that if a trustee or service provider accepts a gift or gratuity over stated level, regardless of whether influence can be proven, that it is a violation of the law.

2. Any trustees or service providers desiring to accept gifts or gratuities within legal limits should be required to disclose said items to the Trust prior to taking receipt.

3. To help mitigate future pension losses there should be a minimum level of E&O insurance coverage required for all investment advisors. This minimum should be tied to each manager's total assets under management, so as to provide additional coverage, but yet still be cost effective for providers.

The CHAIRMAN. Mr. English?

Mr. ENGLISH. Good morning, Mr. Chairman. I am pleased to be here today to discuss an area of concern to all of us, protection of retirement funds, and to share my experience prosecuting a fraud against ERISA benefit plans.

The fraud was perpetrated by Capital Consultants and others. As you heard, it affected over 300,000 participants and beneficiaries from all 50 States, putting at risk the retirement dollars and health insurance of hard-working plumbers, laborers, office workers, and other private investors and workers.

I am an attorney with Bullivant Houser Bailey in its Portland, Oregon, office. Bullivant represented several of the Taft-Hartley plans which were defrauded. I was asked to be lead counsel in a plaintiffs' consortium, which ultimately represented all potential claimants. This plaintiffs' consortium consisted of attorneys from Nevada, Oregon, Washington, California, Ohio, and several other States. Altogether, there were 97 attorneys representing plaintiffs and defendants.

Capital Consultants had more than 300 clients, including ERISA retirement and medical benefit plans and private investors. Their losses, as you have heard this morning, were estimated at half-a-billion dollars. As a result of the efforts of the plaintiffs' consortium, working with the court-appointed receiver, we have been able to recover so far approximately $350 million for the benefit of the claimants. We created a model, which I believe should be replicated, to investigate and maximize recovery of losses in this type of case.

We developed a plan to obtain the greatest net return, factoring in time and cost. The plaintiffs' consortium gave a complete release to any defendant who agreed to settle and created a court-ordered claims bar to protect them from further litigation. A summary of the specifics of this recovery plan is contained in my written submission.

During our civil prosecution, we worked cooperatively with a task force headed by Assistant U.S. Attorney Lance Caldwell which included the FBI, IRS, Office of Labor Racketeering and Fraud, OLMS, and EBSA. Our job was to recover assets. Theirs was to prosecute wrongdoers. We were urged by our clients to cooperate with Mr. Caldwell's team and any government investigation fully, no matter where it led.

In August 2000, I led a small group of attorneys and former Federal investigators to gather facts quickly to determine who the potential defendants were. I would like to acknowledge the presence here today of some members of that team, including my partner, Robert Miller, and investigators Joe Gavalas and Norm Transit with CTG and Associates. Several other members of the consortium have submitted statements, including Mike Farnell, another key member of the consortium who is here today, and who, I might add, flew all night to get here.

One month later, based on the information we gathered, in September 2000, we filed an 80-page lawsuit which included claims for fraud, RICO, breach of fiduciary duty, securities violations, and ERISA violations to address a Ponzi scheme which had been in existence for several years and apparently had been investigated for 3 years by the Department of Labor.

We made available to all potential plaintiffs the information we had gathered in return for their agreement to form a consortium that would create an efficient division of labor, minimize overlapping of effort, and thereby maximize recovery. We rejected a scorched earth approach, which could have been financially beneficial to the attorneys but would have been disastrous for our clients.

We then obtained a mandate from U.S. District Judge Garr M. King requiring all parties to stay discovery and to enter into a speedy mediation procedure. This allowed us to approach the resolution of these claims as a business solution as opposed to a legalistic fight between lawyers, thereby avoiding the cost of trials and appeals. We were then able to utilize the mediation services of senior Ninth Circuit Judge Edward Leavy, who was brilliant in his ability to move the parties forward toward settlement.

To conclude, the time from our initial investigation to the court's approval of the settlements and entry of a claims bar to depositing the settlement money in an escrow account took under 2 years. Because of the coordination of effort, the legal fees for the recovery amounted to under 10 percent of the total recovery. To date, approximately $350 million has been recovered for distribution to claimants. Under the court's distribution plan, this equates to approximately 70 cents on the dollar for every dollar invested by a retiree or investor at a recovery cost of under 7 cents on a dollar. The success in this Oregon formula could be repeated in similar cases elsewhere.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much. The summary of your successful recovery plan will be shared with the governors, too, so that we can follow up on that.

[The prepared statement of Mr. English follows:]

PREPARED STATEMENT OF STEPHEN F. ENGLISH

Mr. Chairman and members of the committee, I am pleased to be here today to discuss with you an area of concern to all of us, protection of retirement funds.

I am an attorney in practice in Portland, Oregon with the regional law firm of Bullivant Houser Bailey, PC. I have been a trial lawyer on both sides of the bar for 32 years. Although much of my experience has been as a defense attorney, I have taken the lead role as plaintiffs attorney in a number of complex commercial and financial cases.

I have been asked to provide you with a description of the process I worked to develop to investigate the claims against Capital Consultants and related entities. As you know, the losses in this scandal were estimated in the range of $350,000,000 to $470,000,000. Capital Consultants had more than 300 clients, and over 150 of them were employee benefit plans. Those plans had more than 300,000 participants and beneficiaries and they came from nearly every State in the country. We built a business model that I think can be replicated to investigate and recover losses in this type of case. We were successful in putting together litigation settlements in excess of $125,000,000 from the time I started working on the case in August of 2000. Subsequent recoveries are in the $35,000,000 range and the Receiver was able to conserve approximately $170,000,000 in assets, all for the benefit of the pensioners and others who were defrauded by Capital Consultants and the players associated with the fraud.

In total, the litigators and the Receiver were able to return in excess of $330,000,000 at a cost in legal fees, Receiver fees, and investigation costs of less than 10 percent. I would like to give you an overview of how we handled the litigation and mediation effort in an efficient and expedient manner. The key to what we accomplished lies in the fact that we developed a plan to engage in settlement negotiations that would yield the greatest net return to the clients in exchange for a complete release in favor of any defendant that agreed to settle, and a mechanism to ensure that they would not be sued by any other claimant or sued for contribution by any other potential defendant.

1. I led a small group of attorneys and investigators to identify the scope of the legal and factual problem and obtain a sufficient understanding of the problems and potential liability to be able to speak knowledgeably and get the potential defendants' attention. We did not expend unnecessary resources on any specific individual defendant, but rather focused on developing a case against a number of potential defendants so as to create a broader base from which recovery could be sought. The initial case focused on approximately 10 of the major entities responsible for the losses. The case focused on Capital Consultants as the investment manager, the borrowers with the greatest culpability, and the lawyers and accountants that worked with those companies.

2. We purposely did not engage in an exhaustive scorched earth approach at this stage for the simple reason that we did not know whether there would be a recovery sufficient to make such efforts worthwhile to our clients and because we felt time was of the essence in any recovery.

3. We prepared a lawsuit based on a sufficient amount of information to be able to tell our story to the defendants and give other claimants an understanding of what we were doing.

4. We made available to all other potential plaintiffs all of the information that we had obtained, as well as giving them full access to our investigation. We based this on the condition that they agree to cooperate with us in forming a united front so as to maximize recovery and minimize overlapping of effort. We gave each group of claimants the right to veto any settlement decision submitted to the group, and that element proved to be one of the strengths in keeping the group together and providing a unified front to the numerous defendants.

5. We negotiated an agreement among all plaintiffs to work together and divide the work in such a way so that all lawyers involved could have meaningful participation, but with a minimum of duplication of efforts and costs. As a group, we understood and committed that the approach would be one which would aim toward a speedy resolution as opposed to an exhaustive, scorched earth approach. Such an

exhaustive, scorched earth approach would be financially beneficial to the attorneys, but could be financial disaster to our clients. We then sought a mandate from U.S. District Court Judge Garr M. King to require defendants to enter into a mediation process which combined a sufficient exchange of information so that a businesslike evaluation could be made by the defendants of their potential exposure. Again, in the interest of moving a resolution forward, we sought and obtained the court's approval and guidance so as to freeze or limit the amount of time spent on expensive, time consuming discovery tactics that could be employed by defendants and plaintiffs in this type of case. Our overriding goal in this regard was to approach the resolution as a business solution as opposed to a legalistic or legal solution.

6. As we anticipated, at least a few of the defendants immediately saw the value in this. As a part of the resolution we offered these defendants, we first gathered authority from all potential plaintiffs and obtained the court's authority to act on their behalf. By doing this we were able to promise and make good on promises to defendants that when they settled with us they resolved all claims by all plaintiffs. As a further condition of this approach, we agreed that once they resolved claims with us we would protect them from cross-claims by other defendants. This essentially allowed us to go to a defendant and say, settle with us and you can resolve everything. This translated into a monetary value for not just the defendants, but their insurance carriers, who understood the value of having finality obtained quickly and efficiently on a case of this exposure.

7. Once it became clear that the court not only approved of this process, but was fully supportive of it, were able to utilize the mediation services of senior status Ninth Circuit Judge Edward Leavy, who proved nothing short of brilliant in his ability to move the parties forward. The process allowed for several weeks of mediation, with each party generally mediating two to three times before resolution was obtained satisfactory to both parties.

8. Once the settlements began, there occurred a "tipping point" at which it became apparent that no defendant wanted to remain as the only holdout. In addition, the fact that many defendants paid less than they might have had to pay if they had chosen to go through a trial created a sufficient amount of money so that plaintiffs did not have to have the maximum possible amount from any individual defendant. Again, one of our overriding strategies was that a businesslike approach required getting money quickly and at the least possible cost as opposed to holding out to squeeze every last dime from entities or individuals and risk the cost of trial and appeals.

9. The individual lawyers for various plaintiffs understood that in order to maximize the overall recovery in the most efficient manner possible, they had to sacrifice aggressive attempts on their part to maximize their personal clients' recovery to the detriment of other plaintiffs. In other words, it became apparent to the plaintiffs attorneys that by following a strategy that would move the recovery process forward in the most beneficial way for the plaintiffs as a whole, they were actually acting in the best interest of their individual clients.

10. The case was able to be concluded from initial investigation through filing of the lawsuits, completion of the mediation of defendants and the court approval of the full settlement and claims bar in 22 months. All of the lawyers on the plaintiffs side meaningfully participated, but because of the coordination of effort and cooperation, the legal fees for the recovery amounted to under 10 percent of the total recovery. To date, approximately $330,000,000 has been recovered for distribution to pensioners and others. Under the calculation of losses in the distribution plan approved by the Court, this equates to approximately $.70 on the dollar for every dollar paid invested in a retirement account or investment account by a retiree or investor at a cost of under $.07 on the dollar. We believe this formula and its success should not be unique to Oregon.

The CHAIRMAN. Mr. Ray?

Mr. RAY. Thank you, Mr. Chairman. I am pleased and honored to again appear before this distinguished committee. I welcome this opportunity to discuss the protection of employee benefit plans from fraud. My perspective is that of an employee benefits lawyer who has been representing pension plans for more than 25 years. Fortunately, none of my client plans were investors in Capital Consultants.

I would like to focus my comments on a few critical points, Mr. Chairman. First, we are discussing a dangerous intersection between the ethics in the marketplace and fiduciary duty. Capital

Consultants is an example of a broader problem with the investment services community. Pension plans offer investment firms an opportunity to generate enormous fees and to make investment professionals fabulously wealthy.

The competition for pension plan clients can be fierce. It is not surprising that some investment people ignore or bend the rules or intentionally remain ignorant. There is a sense that the risk of getting caught is an acceptable business risk and that the costs of being caught are manageable costs of doing business.

Consider the financial industry scandals that have been making headlines over just the past few years, scandals that have cost investors millions of dollars: The mutual fund trading abuses and overcharges; fraudulent investment recommendations by brokers to attract investment banking business; kickbacks or pay-to-play arrangements between the two largest insurance brokers in this country and insurance companies; and there are others, again, that have involved billions of dollars of loss to investors.

Many of the leading names in the financial services community, the cream of the crop of Wall Street, have been required to pay restitution and fines in the hundreds of millions of dollars. Does it make any difference to them? They continue to do business.

The second point I would like to make is that it is unreasonable to expect pension plans to ferret out fraud and abuse by investment managers. As I explained in my written statement, soundly administered pension plans use an array of professionals to develop and oversee their investment programs and to manage their investment assets. I might make a note that it is the investment people, not the plan fiduciaries, who make the money. The typical plan governing fiduciary, like a board of trustees, they are typically unpaid volunteers. It is the investment people who make the big money off pension plans.

However, no matter how many professionals a pension plan hires to monitor other plan professionals, and no matter how much expense a plan incurs to protect itself against fraud, there is simply no way that a pension plan could be guaranteed that it will not fall victim to investment fraud.

Deception is the hallmark of fraud. Investment fraud typically involves sophisticated schemes involving complex financial transactions and secret conspiracies conceived and executed by smart people motivated by greed. Look at the lengths to which Capital Consultants went to commit and conceal its fraud against its client pension plans: Lies about the investment managers bona fides; lies about the nature of the complex multilevel collateralized note investment; lies about the performance or nonperformance of the investment; the creation of shell companies to conceal the collapse of the investment; secret arrangements with people in the position to make decisions.

Unfortunately, the nature and scope of this fraudulent scheme became clear only in hindsight, after investigation by the SEC and the Labor Department and extensive and expensive private litigation. Capital Consultants managed to defraud some very smart professional people, not merely layman trustees.

Only the government has the investigative authority and resources to effectively deter and detect fraud. Only the government has the power to compel production of internal documents and testimony through subpoenas. In particular, this is a responsibility of the Securities and Exchange Commission, as the primary regulator of the investment industry. The SEC has a program of examinations of investment firms, not merely the authority to investigate when a problem arises. The SEC has the specialized knowledge and expertise about how investment firms operate and are supposed to operate.

But as recently noted in a speech by outgoing SEC Chairman Donaldson, quote, "There is a mindset that holds that significant action is appropriate only in retrospect, only after things have gotten so bad that the risk of investment harm threatens to become an uncertainty," unquote. He went on to explain in this May 2005 speech that efforts by the SEC to initiate programs that anticipate investment industry abuses and stop them before they occur have been actively resisted, both within the SEC and by outside forces.

The committee might want to note in this regard that the warnings by Chairman Donaldson and Federal Reserve Chairman Greenspan lately about the hedge fund industry. Pension plans, and other investors are scrambling now to find higher returns than the modest returns being projected for traditional equity and fixed-income portfolios. Plans are still trying to deal with the consequences of the negative markets in 2000 through 2002. Hedge funds and other very complex, sophisticated investment vehicles are being aggressively marketed to pension plans as the path to higher returns. Pension plans and other investors are counting on the SEC to protect them.

The third and last point I would like to make is that there is no lack of laws to deal with the fraud committed by Capital Consultants. It is a matter of finding out that the fraud is taking place. The securities fraud laws, ERISA's fiduciary and prohibited transaction standards, criminal laws, most notably 18 U.S.C. 1954 and 664, and yes, even the Racketeering Influenced and Corrupt Organizations law provided ample remedies to deal with the Capital Consultants fraud. The issue was finding the fraud, and that is where pension plans are counting on the SEC to do its job to regulate the investment community.

When I say pension plans, Mr. Chairman, I want to emphasize, I am not merely speaking about union trust funds, as the chart indicates and prior testimony indicates. There are far more corporate plans that are just as susceptible to investment fraud and need the protection of the SEC and Congress, as well.

Thank you, Mr. Chairman. I would be happy to answer any questions.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Ray follows:]

PREPARED STATEMENT OF JAMES S. RAY

Chairman Enzi, Ranking Member Kennedy, and members of the committee, I am pleased and honored to again appear before this distinguished, storied committee. I welcome this opportunity to discuss protecting employee pension plans from fraud, and applaud you for having the discussion.

Overview

I bring to your discussion the perspective of an experienced employee benefits law practitioner who has represented pension plans as well as plan participants and plan sponsors for more than 25 years. I have had the honor of serving two, three-year terms on the ERISA Advisory Council of the Labor Department, most recently as Chair for 2002, in both Republican and Democratic administrations. I have also held several positions with the American Bar Association, including Chair of its Joint Employee Benefits Committee and as a member of the governing Council of the Section on Labor and Employment Law. I am a Charter Fellow in the College of Labor and Employment Lawyers as well as a Charter Fellow of the American College of Employee Benefits Counsel, both of which are peer-elected honorary organizations. Of course, I am not speaking on behalf of any of these organizations.

My focus in this discussion is on the relationship between pension plans and the investment services industries. That relationship is a dangerous intersection between the ethics of the marketplace and fiduciary duty to plan participants. The U.S. Supreme Court has made the following observation about that intersection:

> "Many forms of conduct permissible in a workaday world of those acting at arms-length are forbidden to those bound by fiduciary ties. A [fiduciary] is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior [for fiduciaries]." *Pegram* v. *Herdrich*, 530 U.S. 211, 224–25 (2000).

Unfortunately, the opportunities to make enormous profits and the competition for those opportunities have led too many in the investment services community to abuse their fiduciary duties to pension plans and other investors, and to entice other plan fiduciaries to violate their duties. Too often the morals of the marketplace are that the risk of being caught wrongdoing is an acceptable business risk, and the restitution or penalty imposed if caught is a manageable cost of doing business. The words "everybody does it" are too often uttered in defense of wrongdoing. There is a certain arrogance that comes with the investment community's strong influence over the Nation's economy.

The recent spate of investment community scandals, many involving frauds on pension fund investors, suggests that the lessons of earlier scandals have not been learned. And, signals from the Securities and Exchange Commission (SEC), the Federal Reserve, and media reports indicate that more scandals can be expected, particularly among hedge funds, as pension funds and other institutional investors search for higher investment returns than traditional investments in equities and fixed income securities are expected to produce in the foreseeable future.

The Capital Consultants fraud is but one illustration of a broader problem of the investment community placing business interests ahead of fiduciary duty.

There needs to be a change in the culture of the investment community concerning dealings with employee pension plans. And, that cultural change seems possible only if there is greater regulatory oversight of investment services providers by the SEC. In this world of an ever-increasing variety and complexity of investment vehicles, only government has the resources and authority to deter and detect sophisticated fraud; pension funds do not.

Will the SEC meet this challenge? Will Congress have the political will to allow the SEC to meet this challenge?

Pension Plans Depend On Investment Community

Employee pension plans collectively constitute one of the largest pools of domestic investment capital, especially if you include "401(k) plans" as pension plans. Pension plan investments are valued in the trillions of dollars. Naturally, they receive a lot of attention from the investment services industry, including investment managers, investment consultants, brokers, banks, insurance companies, mutual funds, hedge funds, other collective investment funds, and lots of other organizations and individuals. Pension plans are a gold mine of investment fees.

Pension plans depend on the investment services community. The typical pension plan engages a collection of investment professionals to perform services related to the plan's investments. Private sector plans are, as a practical matter, compelled to do so by the Employee Retirement Income Security Act (ERISA). ERISA's fiduciary standards of conduct require, among many other things, that a plan's investment program be prudent in structure and operation. Prudence is really a process standard; whether an investment decision is prudent is measured by the soundness of the decisionmaking process, not by the future success or failure of the decision. Prudent investment decisionmaking generally requires specialized knowledge and expertise that few laymen possess. Indeed, many newly developed investment vehicles and financial instruments have become so complex that few professionals, and even fewer regulators, understand them.

An investment consultant (or consultants) is engaged: to develop and monitor the plan's asset allocation; to develop and monitor investment guidelines and policies; to recommend investment managers and investment vehicles; and to monitor the performance of the investment managers and investment vehicles. Generally the investment consultant is an advisor to the plan's governing fiduciary (*e.g.*, board of trustees in a multiemployer plan setting, corporate officers in a single employer plan setting). Nonetheless, the consultant is a fiduciary within the meaning of ERISA because the consultant is giving investment advice for a fee. In performing its services for the plan, the consultant is subject to ERISA's fiduciary standards of conduct and prohibited transactions rules.

An investment management firm (investment manager) generally is engaged to assume discretionary, fiduciary responsibility to manage a specified portion of the pension plan's investment portfolio (*e.g.*, large cap equity, small cap equity, fixed income or balanced account). The investment manager decides which specific investments to make, hold and sell (*e.g.*, buy or sell a particular company's stock or a particular corporate bond). Typically, a plan engages more than one investment manager, each with fiduciary responsibility for a portion of the plan's portfolio, reflecting the plan's asset allocation decisions and the need for investment diversification. Each investment manager is an ERISA fiduciary with respect to the plan because it has discretionary authority regarding the management of plan assets.

ERISA strongly encourages the engagement of investment managers beyond the need for prudent investment decisionmaking. If a pension plan's governing fiduciaries engage an investment manager, ERISA generally shields the governing fiduciaries from liability for the investment manager's investment decisions. For this statutory shield to apply, the investment manager must be registered with the SEC or a similar State agency, unless it is a regulated bank or insurance company. The investment manager must also acknowledge in writing that it is a fiduciary with respect to the pension plan under ERISA.

The governing fiduciaries continue to have a fiduciary obligation to monitor the performance of the investment manager relative to the pension plan's investment policies and guidelines as well as relative to some established benchmarks, and decide whether to retain or discharge the investment manager. This monitoring function, however, is generally assigned to the investment consultant who advises the plan's governing fiduciaries.

Investment brokers are engaged by the pension plan's investment managers to execute the manager's decisions to buy and sell particular securities for the plan's portfolio. The investment manager generally selects the broker for each transaction and agrees to pay the broker a commission for its trading services. The commission is paid to the broker using the pension plan's assets, not the manager's own assets. Often, a portion of the commission, or its value, is rebated to the investment manager by the broker under so-called "soft dollar" arrangements. The investment manager personally benefits from these soft dollar rebates by, at a minimum, reducing its own business overhead costs. To some extent, SEC rules allow investment managers to maintain soft dollar arrangements with brokers, despite their questionable status under ERISA. (More about this later.) Some pension plans try to preempt such soft dollar arrangements by participating in so-called commission recapture programs under which one or more brokerage firms agree to rebate a portion of the commissions to the plan, rather than to the plan's investment managers.

Increasingly, pension plans are investing (buying units or shares) in pooled investment vehicles managed by investment managers, rather than engaging the investment manager to manage a separate portfolio for the plan. Some investment managers are encouraging this shift, asserting that pooled arrangements are most cost efficient (although I suspect that the managers have their own motives as well).

For the governing fiduciaries of the plan, a decision to buy units in a pooled investment fund presents a fundamentally different decision than a decision to hire an investment manager to manage a separate portfolio, viewed from ERISA's perspective. The governing fiduciaries are the decisionmakers on the question of whether to invest in the pooled fund; that is, whether to buy units in the fund. Once the investment is made, the manager of the pooled fund has fiduciary responsibility for the management of the fund's assets (including the money invested by the pension plan) in accordance with the investment fund's governing documents and applicable law. But, the decision to make the investment in the fund is the responsibility of the pension plan's governing fiduciaries, not the manager of the investment fund. (Managers of pooled investment funds typically include such a disclaimer in the investment documentation.) Well-advised pension plan governing fiduciaries will rely on a qualified investment consultant to conduct a prudent, due diligence review of the investment vehicle and to advise them on whether the investment is appropriate for the pension plan. Few governing fiduciaries of plans are qualified to make such an investment decision without professional advice.

The amount of fees that investment managers earn from pension plan investments is enormous. Generally management fees are based on a percentage of the market value of the portfolio or fund being managed. As the value of the portfolio or fund increases, the manager's fee automatically increases. The value of the portfolio may increase through investment growth or by the addition of investment capital (e.g., new investors). With each new pension plan client, an investment management firm typically gains an additional fee base (more assets to manage) without much additional work because the firm applies essentially the same strategies to all of its clients or to groups of clients.

In contrast to the investment managers and other investment professionals, the governing fiduciaries of pension plans are typically unpaid volunteers. In a multiemployer plan setting, the governing fiduciary is the board of trustees, consisting of labor and management representatives in accordance with the Labor Management Relations ("Taft-Hartley") Act. ERISA prohibits the pension plan from compensating these trustees for their services to the plan if they are (as is usual) full-time employees of the sponsoring union and of contributing employers. They can only be reimbursed for their actual and reasonable expenses incurred in performing services for the plan. In a single employer plan setting, the governing fiduciaries are typically employees of the plan sponsor whose plan duties are part of their corporate duties.

In short, pension plans are at the mercy of the investment services community.

Investment Services Community Abuses and Corruption

Conflicts of interest, self-dealing and other abuses are no strangers to the investment services community. Indeed, there seems to be a continuing stream of major scandals in the community. Some recent examples:

- Mutual Fund Abuse Scandal (2003–04): Several large mutual funds were found to have permitted favored customers to engage in market-timing and late trading abuses to the detriment of other investors. In addition, the SEC found that a large percentage of brokerage firms were assisting the favored clients to engage in these abuses. Several financial institutions were required to make restitution and pay fines in the tens and hundreds of millions of dollars (e.g., Bank of America—$675 million; Alliance Capital Management—$600 million; Massachusetts Financial Services—$350 million; Canary Capital Partners—$40 million). The SEC belatedly took action to prevent these types of abuses. Notably, in a March 2004 report, the SEC admitted that its review of mutual fund records "did not reveal the covert arrangements that fund executives had with select shareholders" prior to the abuses becoming public.
- Mutual Fund Overcharges (2003): The SEC and NASD found that more than 400 securities firms had overcharged investors for sales charges on mutual fund investments by $86 million in 2001 and 2002.
- Self-Dealing Investment Research (2002–03): Merrill Lynch agreed to pay a $100 million fine and take other actions in response to New York Attorney General's complaint that the Merrill Lynch analysts were recommending questionable stocks to investors in the hope of gaining the investment banking business of the companies whose stock they were falsely promoting. Nine other "Wall Street" investment firms entered into a private litigation settlement under which they collectively agreed to pay $1.4 billion.
- Insurance Broker Fraud (2005): Marsh & McLennan Companies, the Nation's largest insurance broker, agreed to pay $850 million in restitution to settle charges by the New York Attorney General that it steered its brokerage clients to insurance companies that paid kickbacks to Marsh & McLennan, and that it staged phony bidding among insurance companies to conceal the "pay to play" kickback scheme from clients. Even more recently, AON, the second largest insurance broker, agreed to pay $190 million to settle the same charges. Other insurance brokerage firms have been implicated as well.

Not so long ago hedge fund manager Long-Term Capital Management had to be saved from collapse with a $3.6 billion bailout, that investment firms were peddling inappropriate derivative investments and junk bonds to pension plans.

Today, as pension plans and other institutional investors search for higher returns in the face of predictions of low returns in traditional equity and fixed income portfolios, the investment community is developing and marketing even more complex and exotic investment vehicles that are supposed to outperform traditional investments. Some of these vehicles are so complex and multilayered that they are not well-understood by professionals and regulators, much less laymen.

Hedge funds are being aggressively marketed to pension plans as the clear path to higher returns. The extraordinary management fees charged by hedge funds (typically 2 percent of assets plus 20 percent of capital gains and appreciation) have made hedge fund managers wealthy beyond imagination. Yet, dire predictions are being made that the hedge fund industry will produce the next major scandal. The SEC has reported "an increasing incidence of fraud" among hedge funds; 51 cases of hedge fund theft, fraud and abuse caused a loss of more than $1 billion to investors. In its 2003 report on hedge fund growth, the SEC stated: "The Commission's inability to examine hedge fund advisers has the direct effect of putting the Commission in a 'wait and see' posture vis-a-vis fraud and other misconduct." Federal Reserve Chairman Greenspan opined earlier this week that many hedge funds are pursuing high risk and complex trading strategies that could result in significant losses.

Yet, the SEC's recent action to require the vast majority of hedge funds to register with the SEC for the first time in 2006 was greeted with condemnation in the investment community. Indeed, the SEC vote on the new requirement was 3–2. In commenting on this controversy in a May 12, 2005 speech, outgoing SEC Chairman Donaldson made the following observations about the difficulty of expanding regulatory oversight of the investment community, and the difficulty of deterring and detecting fraud:

> "There is a certain mindset that holds that significant regulatory action is appropriate only in retrospect, or only after things have gotten so bad that the risk of investor harm threatens to become a certainty. We have sought to launch the Commission on a different course, an approach that anticipates problems before they develop, and deals with areas of concern that have perhaps lingered unattended for many years with their pernicious consequences long unnoticed by the public at large . . . .
>
> "The controversy generated by these reforms [i.e., hedge fund registration and market structure reforms] both within and without the Commission also illustrates the practical difficulties faced by the Commission when it seeks to take action that is anticipatory in nature, as well as reactive . . . .
>
> "At the same time, there has been an increased number of enforcement actions involving hedge funds, and it was difficult to deter this fraud—or to discover it—without a compliance regime and a program of examinations and inspections by our staff . . .
>
> "If history is any guide, it is just this sort of [competitive] pressure that can lead otherwise well-intentioned professionals to pursue practices that ultimately result in disaster for the investors that they serve."

Inherent Conflicts Of Interest Among Investment Firms

Conflicts of interest are inherent in some of the arrangements among investment community members that have come to be accepted practice ("everybody does it"). The most obvious of these practices is the so-called "soft dollar" arrangement. Most investment management firms have what are essentially kickback arrangements, called "soft dollar" arrangements, with the securities broker selected by the manager to execute trades for the investment manager's client pension plan. Under these arrangements, the investment manager pays a commission to the broker for the broker's services (using the pension plan's assets), and the broker rebates a portion of the commission to the investment manager in some form.

In other words, in addition to the investment management fee that the manager receives directly from the client pension plan, the manager receives a rebate of the plan-paid commission from the broker. This is big business inasmuch as pension plans, mutual funds and other institutional investors pay billions of dollars each year in brokerage commissions ($12.7 billion in 2002, half of which was rebated in the form of soft dollar goods and services according to the *Wall Street Journal*).

The Security Act and SEC rules allow investment managers to use soft dollar arrangements to obtain from brokers so-called "research" related products and services (*e.g.*, securities research materials, software, Bloomberg terminals, magazine subscriptions); in essence allowing the use of commission rebates to offset what would normally be business overhead costs. This is called the Section 28(e) soft dollar safe harbor rule.

In a 1998 report on soft dollar practices, the SEC observed that soft dollars have been used to benefit the investment managers in ways that went well beyond the scope of "research." An SEC survey found that 35 percent of the brokers examined provided some clearly non-research goods, services and other things of value to investment managers, including office rent, office equipment and furnishings, employee compensation, and personal travel and entertainment. The SEC also found that the disclosure requirements for such arrangements were widely ignored.

While both the SEC and the Labor Department have recognized that soft dollar arrangements place a pension plan's investment manager in a conflict of interest, they have not been prohibited because Section 28(e) remains on the books. The SEC has a Task Force on Soft Dollars considering whether to narrow the scope of the "research" for which soft dollars can be used under 28(e) and whether to require more disclosure to pension plans and other investors about soft dollar arrangements.

From the ERISA perspective, soft dollar arrangements would be treated as prohibited transactions, essentially like kickbacks, but for ERISA's deference to other Federal law, Section 28(e). So, the Labor Department has accept that managers may have soft dollar arrangements. However, according to Labor Department guidance, the plan's governing fiduciaries must monitor each investment manager's soft dollar arrangements to ensure that the manager is not being excessively compensated by the plan (considering both the investment management fee paid to the manager directly by the plan and the brokerage commissions rebated to the manager by the brokers). This is a mission impossible for most, if not all, pension plans. Pension plans do not have the resources or investigative authority of the SEC or the Labor Department.

Another example of conflicts of interest in the investment community are investment consultants that have arrangements with investment managers and investment funds to recommend the managers or funds to the consultants' clients in exchange for payments or other things of value to the consultant (so-called "pay to play" arrangements). Pension consultants' conflicts of interest was the subject of a May 2005 SEC staff report. It reports that it is commonplace for investment consulting firms to have arrangements with investment managers and investment funds that compromise the independence of the investment advice that the consultants give to pension plan clients about the investment managers and funds.

In a joint guidance statement issued on June 1, 2005, the Labor Department and the SEC placed responsibility for ferreting out consultants' conflicts of interest on the pension plans' governing fiduciaries. The statement is entitled: "Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries." I've been asked by clients how the government can expect them to discover such consultant conflicts when it took the SEC so long to find them.

Capital Consultants Fraud

I understand that the committee is particularly interested in the fraud perpetrated on various pension plans by Capital Consultants LLC in the 1990s, and that other witnesses have recounted the facts and circumstances of that matter to the committee.

To me, the Capital Consultants matter is yet another example of how difficult it is to prevent and detect fraud by investment firms. In hindsight, it all seems so clear. But, at the time, Capital Consultants had the appearance of propriety: a large client base, good performance figures, and some good references. Moreover, the collateral notes investment pool being marketed by Capital Consultants was a complex investment. Some of the pension plans' consultants blessed the plans' investment with Capital Consultants, although it is unclear how deeply they probed (or were capable of probing) into the complexities of the investment and the undisclosed arrangements among the players.

It was not until after Capital Consultants' collapse—with the benefit of aggressive and expensive private litigation and intervention by the SEC and Labor Department—that the corrupt machinations among Capital Consultants, Wilshire Financial, and various other firms and individuals were uncovered. Few, if any, pension plans have the wherewithal to engage in such an indepth investigation of sophisticated conspiracies and complex financial instruments.

Much has been made of the fact that Capital Consultants salesman Dean Kirkland provided free trips and other valuable gifts to some trustees of some pension plans, and that one trustee was paid substantial cash kickbacks. Needless to say, this conduct was improper in an ERISA context. Kirkland and a trustee who received the cash kickbacks were properly convicted of crimes under existing law. There is no lack of law prohibiting such misconduct, or governmental authority to investigate. Section 1954 of Title 18 of the United States Code, under which Kirkland was convicted, makes it a crime for service providers (and others) to offer or give a kickback to ERISA plan fiduciaries, and makes it a crime for any ERISA plan fiduciary to solicit or receive a kickback. In addition, ERISA itself treats such a kickback as a prohibited transaction that subjects the giver and the recipient to various civil remedies. And, in the context of labor-management relations, the Taft-Hartley Act (Section 302 of Title 29 of the United States Code) generally prohibits employer payments to union representatives.

The Labor Department's Employee Benefits Security Administration has broad authority (including subpoena powers) to investigate whether such a criminal or civil violation has occurred. In the context of multiemployer plans, the Labor Department's Inspector General also has criminal investigative authority.

The fact is that many in the investment community consider "travel and entertainment" for pension plan clients to be normal marketing; the kind of thing that "everybody does" because if they don't their competitors will. This is how business is conducted in the marketplace. I've heard some investment firm representatives say that their firms get upset if they don't spend their marketing budgets to get "face time" with clients. There seems to be little understanding among investment firms, or at least their representatives, that some marketing practices that might be "business as usual" are simply unlawful, even criminal, if used in the context of an ERISA-covered pension plan. This needs to change, but will only change if the investment firms realize that their business interests are better served by compliance with ERISA's restrictions on payments to or for plan fiduciaries. If investment firm representatives cease offering gifts and gratuities to plan fiduciaries, there will be nothing for plan fiduciaries to accept.

Conclusion

In sum, protecting pension plans from fraud requires a commitment to greater regulatory oversight of the investment services community. It is unrealistic to expect that pension plans can adequately protect themselves against sophisticated schemes involving complex financial transactions and secret conspiracies conceived and executed by smart people who are motivated by unmitigated greed. Only the SEC has the authority, expertise and other resources needed to deter and detect investment fraud. The question of the day is whether the SEC has the will and backing to more aggressively police the investment community. Thank you again for this opportunity to participate in the committee's discussion of this important issue. I would be pleased to answer your questions.

The CHAIRMAN. A very interesting panel, probably more specific suggestions than we usually get on any of the action that we are contemplating, so I appreciate all the expertise that is gathered here. I will ask a few questions to get a little bit more information from you. And again, members of the committee will be submitting questions in writing so that we can add to the record today, too.

Mr. Grayson, again, I want to thank you for your willingness to participate in the hearing today. The information and insights that you provided go a long way toward assisting in preventing future pension frauds.

Now, you stated that the Department of Labor had several opportunities to uncover the Capital Consultants scheme but that it was the SEC that more decisively uncovered this Ponzi-like scheme and examined the collateralized note program. Can you describe the instances in which the Department of Labor or other government agencies reviewed the books and records of Capital Consultants and your observation about the effectiveness of those reviews? I am particularly interested in your perspective on the difference in enforcement capability between the Department of Labor and the SEC.

Mr. GRAYSON. Yes, sir. The Department of Labor reviewed Capital's books and records actually consistently over many years, the first of which was in 1992 when they opened their file, and then the second of which was in 1997, all told, almost—over 8 years of ongoing investigations by the Department of Labor where they were looking in depth at all of Capital's private investments.

Unfortunately, though, that review over both periods of time was not to the point where individual details associated with those private investments were really focused on. There was not a real forensic accounting analysis done of the private investments on either occasion. It was more kind of a general, broad approach. They did look at them all, but instead of focusing on the more complex transactions, like the Wilshire investment, during both cases, it was really more of a focus on the more simpler ones, easier to get their hands around, which unfortunately, I think, resulted in missed opportunities.

The SEC, on the other hand, when they came in, they came in with a team. I believe there were five forensic accountants that came in. They interviewed everybody in our office. They looked at every file, every single page, and they basically camped at our office that entire time. They were very diligent. They talked to clients. They looked at correspondence. They pretty much did everything one could ever hope for from a true audit. And then they reacted very quickly.

So I guess the real difference in perspective between the two agencies, from my perspective, is that one resulted in general conclusions about problems with specific private investments but didn't result in any true uncovering of real issues and took more of a legal approach, a general, simple approach, whereas the other took a very detailed, focused look at all of the assets in our management and uncovered wrongdoing very quickly and then took immediate corrective action.

The CHAIRMAN. You mentioned forensic accountants coming in. Were the others, were the Department of Labor folks accountants or——

Mr. GRAYSON. They were attorneys, primarily, coming in. They lacked an overall business skill set, and in fact, our counsel even pointed that out to them on several occasions. To understand private investments, it takes an extensive business background, accounting background. As you are aware, numbers can be adjusted and one has to truly know what the available options are and how to understand the true basis for a lot of these investments. Fortunately, the SEC had the staff and had the capabilities and went in there hard and spent the time. It is spending the time that is critical. You can't get by with just a couple days on site. You need to really go in and talk to everybody.

The CHAIRMAN. Thank you. Could you expand a little bit on the nature of the collateralized note program and its significance to Capital Consultants in this operation? I am also interested in understanding how the private auditors and the government investigators can improve their oversight of these collateralized note programs.

Mr. GRAYSON. The collateralized note program is really just a branding title that my father and Capital assigned to a subprime lending program, a receivable basis program, which, by the way, the receivables at the end of the day were effectively straw receivables. So there were obviously deficiencies in the program itself.

But in terms of the program, because it was defined as effectively a high-income-producing fixed-income investment, it provided a very high rate of return, which was desirable to a lot of the Taft-Hartley regulated funds with which Capital was marketing. As a result, when Capital would go into client presentations for new money, they would be competing against other money managers who had publicly traded debt instruments as alternatives. The relative comparison is that the collateralized note program would provide investment returns typically 400 or 500 basis points higher than what the rest of the market was available.

Obviously, that inherently means that there is higher risk, collateral potential issues, a variety of other options. But in the end, Capital was typically selected over other money managers on a regular basis because nobody could compete with that product.

That, as a result, resulted in a very continuing flow of funds into the company. They were regular. They were coming in monthly in large amounts, millions of dollars, and they would come in and those dollars were the source of funds that allowed the Wilshire investment and other collateralized notes to be kept current, effectively. If the source of those dollars did not continue, then what occurred could not have occurred.

In terms of what regulators could have done, from a governmental standpoint, they have authority to come in at any time and spend a significant amount, more amount of time. When the initial red flags went up, in my opinion, there should have been more analysis done. That was actually prior to my arrival at the firm. But the analysis should have been more intense.

Just as an example, that $2 million fine that was imposed by the Department of Labor, the source of those funds were actually from Wilshire. Wilshire loaned my father the $2 million, which was then in turn paid to the clients. Then those $2 million that were paid to the clients in turn were returned to Capital to invest on their behalf, and then that $2 million was, in turn, loaned back to Wilshire. So that circular nature of funds could have been pretty easily identified by a forensic accountant or somebody who went in within a very short period of time and the Department of Labor instead just asked for a letter from Capital confirming that they were, in fact, Capital's own funds. So there is a pretty significant difference.

The CHAIRMAN. Thank you.

Mr. English, in your testimony, you mentioned some other people that are here with you, but we don't know who they are. Would you mind re-introducing the——

Mr. ENGLISH. Absolutely. I would be happy to, Mr. Chairman. I mentioned my partner, Bob Miller.

Mr. Miller. Good morning, Mr. Chairman.

The CHAIRMAN. Good morning.

Mr. ENGLISH. And Joe Gavalas and Norm Transit. And I reluctantly admit that Mr. Transit is a forensic accountant—[Laughter.]—although I think the lawyers had something to do with this, also.

The CHAIRMAN. Oh, yes.

Mr. ENGLISH. Mr. Farnell, Mike Farnell, he is another attorney that was a member of the consortium.

The CHAIRMAN. Thank you. It is usually almost impossible for accountants to operate without attorneys, but once in a while, when there is something good said about them, I do like to emphasize that.

[Laughter.]

Which I would do for attorneys, too.

[Laughter.]

Mr. ENGLISH. Understood.

The CHAIRMAN. Now, it appears that the consortium of attorneys and other professionals who pulled together to deal with this matter were unusually successful in rapidly returning the trust fund the hundreds of millions of dollars that the workers lost in the pension and the benefit funds. In your view, why was the consortium so successful at getting back so much of the money in this particular case?

Mr. ENGLISH. There are several reasons. No. 1, I think we quickly got our arms around the facts in the case to create a strong understanding of the facts as well as a variety of legal theories that, frankly, went beyond the normal ERISA remedies. Oregon is blessed with a Securities Act that creates liability not just for the issuer of a security, but for those who materially aid in a debt, and that was a tool that we were able to use as a part of our claim.

In addition to having a strong case, we had an extremely cooperative Federal judge, Judge Garr M. King, who shut down discovery before it got rolling. That allowed us to take a more business-like approach to gathering information quickly without individuals having to go through the typical extremely expensive scorched earth discovery process.

And we were able to share with the other plaintiffs or potential plaintiffs all of our information that we had gathered. We did this because we thought the most efficient way to get this done was to have a united front of attorneys making one claim so that a defendant could write one check and have all of his claims resolved.

Typically, this doesn't occur. Typically, resolutions are slowed because a defendant not only has to deal with a particular plaintiff, but with cost claims by other defendants or by claims that could exist for not yet identified plaintiffs. We solved those problems through a mechanism that allowed recovery and settlement by a defendant to resolve all issues at once.

The CHAIRMAN. Thank you.

Mr. Grayson, from your statement, it sounds as though there wasn't any limit under the pension laws on the gifts and gratuities that firms can provide to pension fiduciaries. It also sounds as though the gifts and gratuities were a major part of Capital Consultants' method of conducting business. Could you explain to the committee how much was set aside annually for gifts and gratuities and describe a little bit more about how the firm used those gifts and gratuities to conduct business? I am particularly interested in the extent to which you believe other firms across the country might be using gifts and gratuities, as well.

Mr. GRAYSON. Yes, sir. Capital Consultants had an annual budget for travel and entertainment of Taft-Hartley regulated funds and also other trustees of $500,000. It was an annual T&E budget that was exhausted each year.

The use of gifts and gratuities is very prevalent in this industry. It is known as the wine-and-dine industry. There are exceptions. You are one of them. But there are exceptions to the rule, but it goes on quite often. Unfortunately, it is to the point where it is almost expected.

When I talked about the expensive dinners and the trips before, those are all regular events and those are things that are experienced not only by ourselves but by our competition. From my personal experience, I know that it was going on in most of our competitors associated with the trustees. In our industry, it is viewed that you have to maintain your relationship with trustees, and therefore, wining and dining is part of that.

Others, the general rule that we go by is that there is not supposed to be anything taken of value away from a trustee following some sort of entertainment. Obviously, Capital historically did not follow that rule to the letter, and unfortunately, in my personal opinion, I believe that that goes on, as well. But that general rule of thumb of not taking away anything of value is the kind of guideline that we deal with.

Of more difficulty in dealing with the current law, the current law, as was witnessed in the recent trial associated with this case of two trustees, unless it can be proven that gifts and gratuities directly influenced their investment decisions and behavior, it was determined that they were not guilty, and that was the finding of the court. So if there is no criminal conduct associated with the receipt of gifts and gratuities unless you can prove, and that is very difficult to prove, that it influenced decisions, it is going to continue that way for quite a while because it is a normal course of business.

Obviously, not everybody does this and there are some very good standpoints, people who rest entirely on their performance alone, but it is a regular event.

The CHAIRMAN. Thank you. I appreciated your comments and your testimony on that, too.

Mr. English—and I will get to the other two here in a minute—do you know what benefit plan service providers think about current provisions and practices regarding gifts and gratuities within the industry? In your opinion, does Congress need to clarify or prescribe additional rules?

Mr. ENGLISH. As to the first question, Mr. Chairman, I am not a benefit plan service provider myself, but I have some experience and have been exposed to them. I think it is confusing, at the least. Marketing 101 for business in the United States is that one wines and dines one's clients. I am sure you are familiar with that from your experience in the accounting industry and other industries. Taking a client to lunch, taking a client to a game or whatever is considered standard operating procedure.

To have that same kind of conduct be not just a basis for civil but criminal liability makes it confusing, and as Mr. Barclay Grayson just identified, the definition is one that is somewhat confusing. It needs to be clarified. If Congress really wants to prohibit any kind of influence, then they should have it a broader-based law as opposed to what I perceive right now to be a rifle shot.

The opinion of Judge Brown actually sets that out in some detail. She was the judge that articulated some of the problems with the current law.

The CHAIRMAN. And we will pay some particular attention to the way that she expedited that. I appreciate that.

Mr. Ray, would you like to comment on that, gifts and gratuities.

Mr. RAY. If I may, Mr. Chairman. This is that intersection between market ethics and fiduciary duty that I was talking about before. I agree with my colleague, Mr. English, that that is the way business is done, and I think in the investment community, they don't see the bright line between the way business is normally done and when you are dealing with an ERISA fiduciary, an ERISA plan. The rules are different. The morals of the marketplace aren't enough, as I say in my written statement. The U.S. Supreme Court has observed that, as well.

There has to be a change in culture in the investment community. Either through education or other means, they have to understand that it is not the right thing to do and they have to understand that if they stop doing wrongdoing, they are not going to have to worry about losing the business to some competitors. There has to be some assurance, a safe harbor, if you will, in the investment community as to not assure they are going to lose business if they don't provide gifts and gratuities.

Another quick point. Current law prohibits these things. There isn't an absence of law, again, Mr. Chairman. They are prohibited transactions under ERISA. They are breaches of fiduciary duty under ERISA. And they can constitute criminal violations of Section 1954.

Now, with regard to the District Court decision that has been referenced by Mr. Grayson, I, frankly, think that the District Court was wrong and I think her decision was inconsistent with a whole collection of other Court of Appeals cases in other Federal courts. It is no, I think, coincidence that her opinion fails to mention any of these other 1954 cases that have been decided before that have a different standard of intent that is required. I think it is, frankly, one District Court decision that is wrong. It is not some systematic problem with the Federal statute.

The CHAIRMAN. Thank you. I paid particular attention when you mentioned this under section of ethics and fiduciary responsibility. I read a book by a friend of mine, Amitai Etzioni, who is an economics professor at the George Washington University. He taught ethics at Harvard Business School in the 1970s. It is an interesting chapter in his book about how black and white the questions had to get before he could get them away from the question of how does it affect the bottom line. If you think about it, the ones from the 1970s would be the corporate managers today.

I am not particularly picking on the Harvard School of Business, but that is the only example that I had of somebody that went to teach ethics that early. It was very distressing to see what the schools might have been doing at that point in time.

Mr. Endicott, what message would you want to send to the Department of Labor, who is responsible for regulating the pension fund fiduciaries?

Mr. GRAYSON. Well, I think in hindsight, if this would have been discovered earlier, a little more attention made to it, it would have saved millions and millions of dollars to our participants of our trusts. Just the lack of getting to the bottom of what was going on and not letting the prior trustees know there was an investigation going on really harmed our members. If you see something is wrong, you should go after it, and the delay in time cost lots of money to our members.

The CHAIRMAN. Is there any particular message you would like to send to the pension fund fiduciaries who were, you know, making these investment decisions?

Mr. GRAYSON. It is just—you have got to look really hard at the people's money you are investing. These are just hard-working folks. They know how to put pipe in the ground and build powerhouses and hospitals and schools and that is why we hire those professionals, licensed professionals, to look out for the best interest of our funds. That should be their prime mission.

The CHAIRMAN. Thank you.

I have some other questions, but I will submit those in writing to you. They, again, they get into more specific accounting actions and a little bit more detail on some of the shortcomings and limitations that each of you may have found as you worked on it.

I really appreciate your outstanding testimony today and this bank of expertise that we have. We will try and utilize it so that problems like this don't happen in the future and make sure that Congress does what it can do, which is not only making laws, but also providing some oversight over the agencies that are responsible for these sorts of things and making sure that coordination happens. Obviously, from an accounting standpoint, there are some things in coordination that can be done that will help to disclose things a little bit earlier.

I thank you all for being here. The record will stay open for another 10 days so that others can submit questions and also so that any of you can expand on your testimony, if you wish to. Thank you.

The hearing is adjourned.

[Additional material follows.]

ADDITIONAL MATERIAL

RESPONSE TO QUESTIONS OF SENATORS ENZI, KENNEDY, HATCH, AND BINGAMAN BY ALAN LEBOWITZ

SENATOR ENZI

Question 1. You testified that EBSA is regularly in contact with the SEC regarding investment advisor and related fiduciary enforcement matters. Excluding telephone calls and e-mails, how often and at what level have EBSA officials met with the SEC during the past 6 months and what matters were discussed at those meetings? Have EBSA and the SEC formalized how often to meet and what their joint enforcement priorities are?

Answer 1. EBSA works very closely with a number of Federal Agencies, including the SEC, IRS, PBGC, the Department of the Treasury, DOJ, and OCC on a wide variety of interpretative and enforcement issues. For example, the Department and the SEC staff recently jointly published "Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries," following the release of an SEC staff report on potential conflicts of interest by pension consultants. In addition, we worked very closely with SEC staff in the development of our regulations under the Sarbanes-Oxley Act and in the review of their regulations. EBSA routinely seeks comment from SEC, IRS, and OCC and routinely provides comments to these agencies on matters of mutual interest and concern.

Some Agencies, such as the SEC, IRS, and Federal banking agencies, require special procedures in order to share investigative information. We find that these procedures provide a workable framework, and we have no difficulty in coordinating and sharing investigative information with these Agencies. Meetings between the SEC and EBSA are held as needed, and there is frequent telephonic communication as well. Meetings between EBSA and the SEC are summarized in Appendix 1.

Question 2. GAO indicated that "targeting" remains a "big concern" and that, while improvement has been made, EBSA needs to be more proactive and less reactive. You testified that EBSA does not measure success based on the effectiveness of its targeting, but instead measures success based on the aggregate results of opened investigations. How do you determine which plans to investigate in the first place? How is the EBSA targeting program proactive?

Answer 2. Broadly speaking, case selection is guided by EBSA's Strategic Enforcement Plan (StEP), which sets forth our national long-term investigative priorities and establishes a general framework by which EBSA's enforcement resources are focused to achieve the Agency's policy and operational objectives as established by the Secretary and Assistant Secretary. Short-term enforcement priorities are established annually, through the Program Operating Plan (POP) Guidance issued by the national office. Preparation of the POP Guidance begins with the identification of recent enforcement trends, an analysis of particular areas of noncompliance, and a review of current policy considerations. In this manner EBSA shifts its enforcement resources to respond quickly when new and emerging issues are spotted while staying within the long-term framework established by the StEP. It is through the POP Guidance that EBSA establishes each fiscal year's national enforcement projects, provides guidance for choosing regional enforcement projects, identifies any other specific policy priorities that will require investigative resources, integrates the Agency's GPRA goals into the planning process, and provides general guidance with regard to the selection of investigations.

EBSA's Regional Directors have discretion in the use of their investigative resources as long as sufficient resources are made available to perform necessary investigative functions in connection with designated national projects and policy priorities. For fiscal year 2005, EBSA has identified the following national enforcement projects: Employee Contributions Project (delinquent employee contributions); Health Fraud/Multiple Employer Welfare Arrangements; Orphan Plans; Rapid ERISA Action Team (bankruptcy issues); and Employee Stock Ownership Plans. In addition, regions are encouraged to develop and implement regional projects, with national office review and approval. Such regional projects focus on plans, investments, service providers, and other arrangements that warrant concentrated attention in a particular geographic jurisdiction. Through the use of this format, which combines flexibility with oversight, EBSA has a proactive targeting program.

Specific cases may be selected based on the analysis of the Form 5500 Annual Report database, computer targeting, referrals from the national office or other Government Agencies, leads from bankruptcy trustees and plan service providers, information reported in the media, and complaints from participants or other people. The results of this review are used to enhance EBSA's targeting program.

The Voluntary Fiduciary Correction Program (VFCP) is the Department's correction program for fiduciary breaches. EBSA implemented the VFCP in 2000 and enhanced the program in 2002 and 2005. The VFCP enables plan officials and their service providers to self-identify and correct certain violations of Title I of ERISA. If an eligible party documents the acceptable correction of a specified transaction in its application to EBSA, EBSA will issue a no-action letter. EBSA is proactive in its efforts to reach out to fiduciaries to self-identify and correct ERISA violations through VFCP conferences and workshops, a comprehensive Web site and general education. In the last fiscal year, EBSA verified $264 million in corrections under the VFCP involving 436 plans.

Question 3. What percentage of fidelity bonds complies with ERISA? What is the Department's process for assuring compliance? Does EBSA either monitor individual ERISA plans to make sure the form of bond is correct or monitor the largest insurers to verify their issuance of the correct type of bond?

Answer 3. So far this fiscal year EBSA found that 79 percent of the employee benefit plans investigated have fidelity bonds that comply with ERISA. For the past 5 fiscal years (current year included) 81.6 percent of employee benefit plans investigated have fidelity bonds in compliance with ERISA.

In every investigation, EBSA investigators determine plan compliance with the fidelity bonding requirements under ERISA section 412. Section 412(a) of ERISA requires that every fiduciary and every person who handles plan assets be covered by a fidelity bond in an amount not less than 10 percent of the plan assets handled by such person. Per the statute, the amount of the bond is required to be not less than $1,000 but no more than $500,000. The surety on the bond must be an acceptable surety on Federal bonds as approved by the Secretary of the Treasury (listed in U.S. Treasury Circular 570). EBSA investigators complete a bonding checklist and/or bonding calculation spreadsheet for every investigation. Additionally, investigators cross-reference the sureties used by the plans with the Treasury's Listing of Approved Sureties located on the Treasury Web site.

EBSA seeks correction of ERISA section 412 violations by inquiring whether fiduciaries and other persons that handle plan assets are covered by the bond; the bond is for the appropriate dollar amount; the bond pays from the first dollar loss (no deductibles are permitted); and the bond names the plan or plans as the insured or has a rider or separate agreement to make certain that any reimbursement collected under the bond will be for the benefit and use of the plan suffering a loss.

SENATOR KENNEDY

Question. Barclay Grayson testified that there were stark differences between EBSA's investigations of Capital Consultants and those of the SEC. Notably, he said that EBSA's personnel lacked the necessary accounting skills. What is being done to recruit and retain the personnel needed to detect violations?

Answer. EBSA actively recruits and retains highly qualified personnel who have the professional skills necessary to root out the sort of fraud that Mr. Grayson perpetrated against the innocent workers and families whose retirement plan assets were invested with Capital Consultants. EBSA played a central role in the criminal investigation that led to Mr. Grayson's conviction and prison sentence. Our investigators have expertise in a wide variety of fields including law, accounting, banking, securities, and business. We recruit entry-level investigators and auditors who have specialized experience in such areas as accounting, finance, economics, business, insurance, securities, and banking, or who have graduated with advanced degrees. For other than entry-level investigative positions, EBSA requires specialized experience relevant to conducting complex financial investigations, such as past work experience in government, a law firm, a pension plan administration firm, or a bank trust department.

Our Agency has an active training program for its employees. All EBSA investigators attend a comprehensive basic training course on the fiduciary responsibility provisions of ERISA that also covers civil and criminal investigative techniques. EBSA's specialized criminal enforcement training is provided to most investigative staff. The criminal enforcement course includes guest speakers from the Department of Justice, U.S. Probation Office, Federal Law Enforcement Training Center (FLETC), local prosecutors and private sector attorneys specializing in criminal defense. Individuals without a significant accounting background also attend EBSA's Employee Benefit Plan Accounting training. These courses are all residential programs of at least 2 weeks in length, and offer academic and practical instruction led by EBSA staff and guests from government and the employee benefits field. In addition, EBSA's Office of Enforcement provides annual field office training on topics determined by enforcement priorities, regulatory and legal developments, and industry trends. Also, on a space available basis, some of our investigators attend courses such as Law Enforcement Advanced Interviewing Techniques and Financial Forensic Techniques at the FLETC in Glenco, Georgia. EBSA encourages on-board staff to acquire additional training, and agency funding has enabled individuals to attain the Certified Employee Benefits Specialist and Certified Fraud Examiner designations and other credentials as well as maintain other professional certifications.

With respect to accounting skills, we would note that not only do we provide training for our accountants and investigators, but we also have an aggressive program to improve the skills of the accounting profession generally with respect to employee benefit plan audit and accounting issues. Since 1988, EBSA has worked closely with the American Institute of Certified Public Accountants (AICPA) to update the guidance and technical materials available to CPAs performing employee benefit plan audits.

Without question, recruiting and retaining high quality people is a challenge for every organization—public and private. We work in an area for which there is great demand for experienced people in the private sector as well as in government. Although we do experience attrition as employees move to positions outside EBSA, we also have had success in hiring people from other Federal regulatory agencies and the private sector.

SENATOR HATCH

Question. Mr. Lebowitz, with respect to monitoring and enforcement, what went wrong in the Capital Consultants case? What lessons has DOL learned from this case?

Answer. Applying the measures that are traditionally used to judge the success or failure of an investigation, the CCL case had a very positive outcome. In the civil case, the cooperative actions of the Department of Labor and the Securities and Exchange Commission resulted in the appointment of a receiver and the recovery of approximately $291 million or 70 percent of the losses suffered by plans and other CCL investors. The Department conducted 58 related investigations of the actions of trustees of investing plans and filed 19 lawsuits against the trustees of 34 plans. These cases resulted in the recovery of an additional $9.2 million and called for important injunctive relief such as the retirement or resignation of 51 plan trustees and the permanent bar of 31 trustees and one investment adviser from further plan service. The task force that conducted related criminal investigations, which included EBSA, the FBI, IRS, OIG and OLMS, resulted in the Justice Department indicting 11 individuals for various crimes. Seven of these individuals pleaded guilty, and one was convicted. It is fair, however, to ask why the investigation took as long as it did, and what could have been done to prevent the fraud from occurring in the first place.

To be successful in an ERISA action such as CCL, the Department must prove that the offending party was a fiduciary under the statute's functional definition, that the actions taken by the fiduciary were, in fact, imprudent (which almost always requires sophisticated financial analyses and the use of expert witnesses) or an act of fiduciary self-dealing or other breach of a fiduciary's obligations under ERISA. Finally, we must prove that the violation caused the losses that we seek to recover. The scheme constructed by CCL was extraordinarily complex and sophisticated. CCL consistently misled its investors about the nature of the transactions and existence and magnitude of the resulting losses. As Mr. Grayson acknowledged in his written testimony, the Wilshire transactions were "complex" arrangements designed to give "the false impression that all of the firm's loans were fully performing, fully secured, and of limited risk." CCL co-opted attorneys, accountants, and investment advisers into putting their stamps of approval on its Ponzi scheme. EBSA's investigators were able to unravel the scheme despite Mr. Grayson's deliberate efforts to hide the truth through a complex series of paper transactions, shell companies, and false reports. Even with the benefit of hindsight, a completed investigation, and the explanatory materials created by the Government in connection with that investigation, it is no simple matter to grasp all the elements of the fraud in which Mr. Grayson participated.

No shortcuts were available to EBSA to uncover and remedy CCL's violations, nor is it likely that additional investigative resources would have allowed EBSA to stop the scheme much sooner. EBSA expended significant resources on more than 60 CCL-related investigations, sorting through the thousands of pages of documents, interviewing numerous witnesses, and figuring out exactly what happened. As is our practice, EBSA puts the resources on the investigations as they are needed, and will continue to strategically deploy its investigative resources to address the most egregious problems. The lawsuits and recoveries, which followed EBSA's investigation, represent the work of many people and organizations, public and private, but the results all built upon the foundation laid by EBSA's investigation.

In our view, schemes like that presented in the CCL case can succeed only when they are provided with a veneer of respectability by the attorneys, accountants, investment advisers and other professionals employed by the perpetrator. The failure of those directly responsible for protecting plans, their trustees and their advisers, to understand the true nature of CCL's investments or even adhere to their own investment guidelines was a necessary ingredient in the success of the scheme. As late as 3 months before we and the SEC shut down CCL, counsel for several plans was disputing with us that a loss had even been experienced.

SENATOR BINGAMAN

Question 1. In responding to my questions, you seemed to imply that the majority of those people who provide investment advice to plans are not fiduciaries. That is contrary to my understanding of recent case law. Could you please elaborate on your answer to clarify your position?

Answer 1. ERISA-covered plans and their fiduciaries rely upon many consultants and service providers to assist them in plan administration and asset management. Not all of these consultants and service providers are fiduciaries. In general, ERISA takes a "functional" approach to fiduciary status—a person is a fiduciary to the extent he engages in certain "fiduciary" activities, without regard to title or position. Under ERISA, a person acts as a fiduciary when he or she (i) exercises discretionary authority or control over the management of a plan or exercises any authority or control over the management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of a plan or has any authority or responsibility to do so, or (iii) has discretionary authority or responsibility in the administration of a plan.
ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(A).

The term "investment adviser" is not defined under ERISA. The Investment Advisers Act of 1940 defines "investment adviser" but only for purposes of securities laws.[1] All "investment advisers" under the Investment Advisers Act are fiduciaries for purposes of the Federal securities laws. Many persons who provide investment services to ERISA plans call themselves investment advisers as well as consultants, investment monitors or performance monitors. Investment advisers who lack authority or control over plan assets are not fiduciaries under ERISA unless they render investment advice for a fee or other compensation with respect to plan assets, in a manner described in the Department's regulations.

Under the Department's regulations, a person renders investment advice to a plan only if the person gives advice as to the value of securities or other property or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property, and either (1) has discretionary authority or control over purchasing or selling securities or other property for the plan, or (2) renders the advice on a regular basis pursuant to a mutual agreement or understanding that the advice will serve as a primary basis for the plan's investment decisions, and that the advice will be individualized to the plan based on the plan's particular needs. The courts have consistently accepted these five requirements for finding an investment adviser to be an ERISA fiduciary from the regulation's promulgation in 1975 to the present. See, e.g., *Dudley Supermarket, Inc.* v. *Transamerica Life Ins. & Annuity Co*., 302 F.3d 1 (1st Cir. 2002) (a financial services company was a fiduciary where it was compensated as the primary, individualized and routine provider of investment advice for the plan); *Thomas, Head & Greisen Employees Trust* v. *Buster*, 24 F.3d 1114 (9th Cir. 1994), *cert. denied*, 513 U.S. 1127 (1995) (a mortgage broker who sold trust deeds to a plan was a fiduciary where all five elements of the test were satisfied); *Schloegel* v. *Boswell*, 994 F.2d 266 (5th Cir.), *cert. denied*, 510 U.S. 964 (1993) (insurance broker who advised the plan on insurance purchases did not meet the five requirements and therefore was not a fiduciary).

As the SEC noted in a recent staff report on pension consultants, many consultants believe that they have structured their arrangements with plans so that they are not ERISA fiduciaries. Even if a consultant is an SEC-registered investment adviser and, consequently, owes a fiduciary duty to its clients under the Advisers Act,

[1] Under the National Securities Markets Improvement Act of 1996 and SEC rules, investment advisers register with the SEC if they provide continuous and regular supervisory or management services to securities portfolios totaling at least $25 million, or if they act as a pension consultant with respect to assets of plans having an aggregate value of at least $50 million. Other investment advisers are regulated by State securities administrators.

the consultant is an ERISA fiduciary only if it meets the five requirements set forth above. If, for example, the consultant provides advice on an irregular basis, or does not provide advice specific to the particular needs of the plan, he is not an ERISA fiduciary. The consultant's status in any particular case depends on the specific facts and circumstances of that case.

Question 2. In responding to my questions, you stated that the Department of Labor has not brought many cases or enforcement actions against investment advisers. Could you please provide a brief summary of all the cases/actions over the past 10 years or so that have been brought against investment advisers, including the results? Also, please provide how many cases/actions are currently pending.

Answer 2. Over the past 10 years, EBSA's civil investigations involving investment advisers yielded monetary results totaling approximately $1.7 billion, the correction of ERISA reporting and disclosure violations, the appointment of independent fiduciaries, as well as the imposition of internal controls. EBSA's criminal investigations relating to investment advisers advisors led to the indictment of 29 individuals. EBSA has 66 currently open criminal and civil investigations involving investment advisers. All EBSA cases conducted over the past 10 years involving civil litigation and criminal prosecution are summarized in Appendix 2.

Question 3. In responding to my question, you stated that the SEC was the primary Agency to monitor the actions of those who provide investment advice to plans. What about those who provide investment advice but are not registered investment advisors? Do you monitor their activities? Does the DOL have the ability to provide adequate enforcement if the SEC ceases these activities? Do you believe DOL currently has the proper level of staffing to handle oversight of investment advisors?

Answer 3. EBSA investigates ERISA plans, including their fiduciaries and service providers, as discussed in the response to Question 4 below. The agency investigates the activities of plans' investment advisers and consultants, whether or not they are registered under the Investment Advisers Act of 1940, if they provide services to ERISA plans. ERISA provides for the direct recovery of losses only from fiduciaries. If a consultant or adviser fails to meet the test for fiduciary status set forth in the response to Question 1 above, the Department could seek relief from the consultant only if he "knowingly participated" in a fiduciary breach, and could obtain "equitable" relief, including injunctive relief and the disgorgement of fees. Under ERISA, the Department could not recover any monetary losses caused by a non-fiduciary consultant's misconduct.

If the SEC were to stop monitoring the actions of registered investment advisers, EBSA would continue to investigate their activities with respect to ERISA-covered plans.

We are confident that our existing resources are adequate to fulfill our mandate under the law.

Question 4. Does ERISA provide an adequate remedy to deter the type of fraud perpetrated in the Capital Consultants matter? If so, why was the action brought, and effectively settled, based on Oregon securities law?

Answer 4. The Department of Labor and the SEC brought the initial lawsuits against CCL, Jeffrey Grayson, and Barclay Grayson. The Department based its claims on ERISA, and the SEC filed suit based on the Federal securities laws. The court appointed a receiver over CCL in the Government's litigation, and the majority of the money recovered for distribution—well over $180 million—has come from the receiver's efforts. Additionally, the Department of Labor and private parties have filed lawsuits against the trustees of 34 plans based upon ERISA, resulting in more than $27 million in judgments and penalties, and injunctive relief, including the removal of plan fiduciaries and the imposition of plan reforms.

Private litigants, including the receiver, also recovered more than $100 million from a variety of non-fiduciary defendants, such as accountants, attorneys, consultants, and parties to the Wilshire transactions based, in substantial part, on State law claims of negligence, negligent misrepresentation, fraud, breach of contract, fraudulent transfers, and securities laws, as well as other State and Federal laws apart from ERISA. ERISA, as interpreted by the Supreme Court, does not provide a damage remedy against non-fiduciary defendants, even if they knowingly participated in a fiduciary breach. At most, ERISA permits the recovery of "equitable" relief against non-fiduciaries, which may include disgorgement of fees in certain cases, but does not include recovery of the damages caused by the non-fiduciary's misconduct. In the cases at issue, the recoveries available from the State law claims were much larger than the amount of the non-fiduciaries' fees, and the private litigants accordingly pursued those claims, which the Department of Labor does not have standing to assert. The Department did, however, file an amicus brief in opposition to arguments by an accounting firm that the private litigants' State law claims were preempted by ERISA.

ERISA primarily gives the Secretary standing to bring claims for violations of its provisions in two remedial sections. First, under Section 502(a)(2), participants, plan fiduciaries and the Secretary can file suit seeking relief allowed under ERISA Section 409. Section 409 allows recoveries only against plan fiduciaries, and includes the recovery of plan losses, as well as the restoration of profits made by a fiduciary through the use of plan assets, and other "equitable or remedial relief" as the court may deem appropriate including removal of a breaching fiduciary. Recently, however, one Circuit Court has held, incorrectly in the Department's view, that a loss recovery is not available, even against fiduciaries, under Section 502(a)(2), where the fiduciary breach harmed only some of the plan's participants and was not targeted at the plan as a whole. *Milofsky* v. *American Airlines*, Inc., 404 F.3d 338 (5th Cir. 2005).

Second, section 502(a)(5) of ERISA allows the Secretary to sue to enjoin any act or practice that violates Title I of ERISA, and also allows other appropriate equitable relief which courts have defined as the relief that was "typically" available in courts of equity. The Supreme Court has held, in cases involving non-fiduciaries, that "equitable" relief does not include the recovery of money damages (*Great-West Life & Annuity Ins. Co.* v. *Knudson*, 534 U.S. 204 (2002); *Mertens* v. *Hewitt Associates*, 508 U.S. 248 (1993)), and a number of lower courts have extended the Supreme Court's holding to fiduciaries as well as non-fiduciaries, holding that no damages remedy is available against any defendants under ERISA's authorization for "equitable" relief. By way of contrast, the State laws at issue in the private litigation permitted a much broader range of recoveries and defendants. For example, the Oregon securities law provides a loss remedy, not only against the seller of a security, but against every person who directly or indirectly controlled the seller and every person who participated or materially aided the unlawful sale.

Appendix 1. Summary of Collaboration Between the U.S. Department of Labor, Employee Benefits Security Administration and the U.S. Securities and Exchange Commission

Date	Matters discussed
March 2004	
3/3	An EBSA Investigator and District Supervisor met with an SEC Enforcement Attorney and two SEC Examiners to discuss potential ERISA violations uncovered during an SEC investigation.
3/8	An EBSA Investigator met with two SEC Enforcement Attorneys, an Assistant SEC Branch Chief, and an SEC Assistant District Administrator to discuss conducting a joint investigation into the potential market timing activity of a particular investment management company.
3/12	Two EBSA Investigators and two SEC Compliance Examiners conducted a joint interview of a witness in connection with an enforcement matter.
3/17	The Associate Director of SEC's Office of Compliance Inspections and Examinations provided a 2-hour training presentation to EBSA managers and senior investigators on issues that included: SEC organization and operation; methods for identifying improper trading practices in mutual funds; and the SEC's ongoing analysis of pension consultants.
3/23	EBSA Assistant Secretary met with officials from the SEC and other Federal agencies to discuss investigative coordination.
April 2004	
4/29	An EBSA Senior Investigator met with an SEC staff attorney to discuss the status of their investigation into an investment adviser. EBSA opened an investigation into the same subject as a result of media reports. The SEC granted EBSA access to SEC files on their pending matter.
May 2004	
5/3	An EBSA Senior Investigator met and began ongoing collaboration with an SEC Senior Attorney. Over the course of several months, an EBSA investigator met four times (5/3, 5/24, 6/29, & 7/16) to collaborate with the SEC to set investigative assignment report findings, and develop investigative strategy. On January 21, 2005 the SEC provided EBSA with a copy of the complaint filed as a result of their collaborative effort.
5/17	An EBSA Supervisor, EBSA Senior Investigator, and EBSA Investigator met with an SEC Assistant District Administrator, an SEC Branch Chief of Examinations, and an SEC Branch Chief of Enforcement to discuss the status of parallel SEC and EBSA investigations into the same company and to arrange for EBSA access to relevant SEC files.

Appendix 1. Summary of Collaboration Between the U.S. Department of Labor, Employee Benefits Security Administration and the U.S. Securities and Exchange Commission—Continued

Date	Matters discussed
5/24	An EBSA Senior Investigator met and continued ongoing collaboration with an SEC Senior Attorney to set investigative assignment report findings and develop investigative strategy. On January 21, 2005, the SEC provided EBSA with a copy of the complaint filed as a result of their collaborative effort.
	June 2004
6/16	An EBSA Investigator and three SEC Compliance Examiners conducted a joint interview of a witness in connection with an enforcement matter.
6/21	An EBSA Senior Investigator met with an SEC Branch Chief to discuss certain issues in a prior SEC investigation, as part of an EBSA investigation. EBSA obtained documents from the SEC.
6/25	An EBSA Regional Director, EBSA Group Supervisor, and two EBSA Investigators met with an SEC Associate District Administrator and an SEC Branch Chief of Enforcement. The SEC presented information to EBSA with respect to certain cases currently being pursued by the SEC. As a result, the SEC's Office of Economic Analysis offered to assist the Department of Labor.
6/29	An EBSA Senior Investigator met and continued ongoing collaboration with an SEC Senior Attorney to set investigative assignment report findings and develop investigative strategy. On January 21, 2005, the SEC provided EBSA with a copy of the complaint filed as a result of their collaborative effort.
	July 2004
7/7	An EBSA Group Supervisor, two EBSA Senior Investigators, and two EBSA Investigators attended the 18th Annual Joint Regulatory Conference held in Los Angeles. Other participating regulatory agencies included: the Pacific Regional Office of the SEC, Public Company Account Oversight Board (PCAOB), NASD, NYSE, U.S. Attorney's Office (California, Nevada, Oregon), and North America Securities Administrators Association. State agencies included: Hawaii Department of Commerce and Consumer Affairs, Washington Department of Financial Institutions, Nevada Secretary of State, Securities Division, California Department of Commerce, Washington Department of Financial Institutions, Arizona Corporation Commission, Oregon Division of Finance and Corporate Securities.
7/9	The Assistant Secretary of EBSA met with an SEC Commissioner to discuss agency coordination.
7/16	An EBSA Senior Investigator met and continued ongoing collaboration with an SEC Senior Attorney to set investigative assignment report findings and develop investigative strategy. On January 21, 2005, the SEC provided EBSA with a copy of the complaint filed as a result of their collaborative effort.
7/21	An EBSA Regional Director, an EBSA Deputy Regional Director, an EBSA Supervisory Investigator, an EBSA Acting Group Supervisor, two EBSA Senior Investigators, and an EBSA Investigator met with an SEC Assistant District Administrator, and an SEC Branch Chief, to discuss the SEC's audit process with respect to specific mutual funds and common collective investment trusts that were the subject of parallel SEC and EBSA investigations. During the meeting, each agency shared their regulatory backgrounds and investigative procedures, specifically with respect to auditing this particular entity for market timing and late trading issues.
7/22	An EBSA Regional Director and an EBSA Senior Investigator addressed the quarterly meeting of the SEC Enforcement and the SEC Examinations sections. The EBSA staff presented information regarding EBSA enforcement matters within the region.
7/26	An EBSA Senior Investigator and an EBSA Investigator met with an SEC Attorney and her assistant to obtain documents associated with an SEC investigation as part of an EBSA investigation into the retirement plan of the same company. The discussion included details of the SEC's and EBSA's respective investigations, and yielded documents obtained by the SEC during its investigation that were relevant to EBSA's investigation.
7/30	The Assistant Secretary of EBSA met with the SEC Director of Compliance Inspections and Examinations and the former SEC Director of the Office of Investment Management to discuss agency coordination.
	August 2004
8/3	The Assistant Secretary of EBSA met with the SEC Chief Accountant to discuss Investor Education.
8/4	A Senior Investigator arranged a meeting with SEC staff to discuss the findings of an SEC investigation of a plan sponsor who is also the subject of an EBSA investigation. The initial meeting led to a series of subsequent meetings on October 18, 21, 22, 25, 26, 2004; and December 1, 2004. During the subsequent meetings, EBSA was permitted to review documents obtained by the SEC pursuant to its investigation.
8/11	An SEC Assistant District Administrator for Enforcement and an SEC Assistant District Administrator for Examination addressed an EBSA quarterly meeting for the Boston region. The SEC staff presented information regarding SEC Enforcement efforts within the region and changes made in response to the market timing cases brought in the fall of 2003.

Appendix 1. Summary of Collaboration Between the U.S. Department of Labor, Employee Benefits Security Administration and the U.S. Securities and Exchange Commission—Continued

Date	Matters discussed
8/30	An EBSA Senior Investigator attended a corporate fraud conference sponsored by the FBI. During that conference, the Senior Investigator established a contact with an SEC staff attorney regarding a specific EBSA investigation, and referred this attorney to the appropriate regional office that was conducting this investigation. The Senior Investigator also spoke with another SEC staff attorney regarding general provisions of the Sarbanes-Oxley Act.
September 2004	
9/10	Two EBSA Senior Investigators, two EBSA Investigators, and an EBSA Computer Specialist met with an SEC Branch Chief of Examinations regarding the sharing of information of interest to EBSA that was collected during an SEC ''mini-sweep'' of mutual funds.
9/15	An EBSA Senior Investigator and an EBSA Investigator observed an interview of a witness conducted by an SEC Staff Attorney and an SEC Branch Chief.
9/16	The EBSA Director of Enforcement and two EBSA Lead Investigators met with the SEC's Director of Compliance Inspections and Examinations, an SEC Associate Director, Division of Enforcement, and an SEC Associate Director, Office of Compliance Inspections and Examinations, to address areas of concern for EBSA. Among other things, the meeting covered a GAO report on proxy voting matters and enhanced coordination with the SEC.
9/17	An EBSA Investigator attended the deposition of a witness to an SEC enforcement matter. An SEC Enforcement Attorney and an SEC Examiner conducted the deposition. The deposition involved securities trades that may have violated ERISA.
9/18	An EBSA Senior Investigator and an EBSA Investigator met with an SEC Staff Attorney and Chief. The SEC updated EBSA regarding the status of a particular SEC enforcement investigation that paralleled an EBSA enforcement investigation.
9/22	EBSA Assistant Secretary met with officials from the SEC and other Federal agencies to discuss investigative coordination.
9/23	The SEC Associate Regional Director of the Midwest Regional Office spoke at an EBSA regional office quarterly training session.
9/27	An EBSA Senior Investigator observed witness interviews conducted jointly by an SEC Staff Attorney and an EBSA Investigator. The interviews were conducted to provide information simultaneously for an EBSA enforcement investigation and its parallel SEC enforcement investigation.
October 2004	
10/18 and 10/21–10/26	An EBSA Senior Investigator met with SEC staff to discuss the findings of an SEC investigation of a plan sponsor who is also the subject of an EBSA investigation. During the meeting, EBSA was permitted to review documents obtained by the SEC pursuant to its investigation.
November 2004	
11/9	The Assistant Secretary of EBSA met with the Chairman and Executive Director of the SEC's Investor Education Plan to discuss investor education.
11/16	An EBSA Senior Investigator met an SEC Senior Enforcement Investigator and an SEC Assistant District Administrator to discuss open investigations of an investment adviser. Several subsequent meetings have occurred to exchange information on this matter. EBSA's investigations were launched as a result of the SEC's suggestion that it had uncovered indications of potential ERISA violations during the course of its investigation.
December 2004	
12/1	An EBSA Senior Investigator and an SEC Staff Attorney jointly convened a meeting with the attorneys for the subject of parallel SEC and EBSA enforcement investigations to discuss various issues.
12/1	An EBSA Senior Investigator met with SEC staff to discuss the findings of an SEC investigation of a plan sponsor who is also the subject of an EBSA investigation. During the meeting, EBSA was permitted to review documents obtained by the SEC pursuant to its investigation.
January 2005	
1/11	An EBSA Senior Investigator and an SEC Staff Attorney jointly convened a meeting with the attorneys for the subject of SEC and EBSA enforcement investigations to discuss various issues.

Appendix 1. Summary of Collaboration Between the U.S. Department of Labor, Employee Benefits Security Administration and the U.S. Securities and Exchange Commission—Continued

Date	Matters discussed
1/25	Two EBSA Investigators met with an SEC Enforcement Attorney regarding the SEC's investigation of an investment adviser. The EBSA investigators were briefed on the SEC's case against the investment adviser and they requested documents pertaining to affected employee benefit plans.
February 2005	
2/4	Two EBSA Senior Investigators met with an SEC Examiner at his office to discuss late trading and market timing issues with respect to an EBSA investigation.
2/18	EBSA staff from the Office of the Chief Accountant met with the Public Company Account Oversight Board (PCAOB) inspection staff to generally discuss the PCAOB inspection programs. EBSA's Office of the Chief Accountant was implementing a new inspection program and sought this meeting to learn from the PCAOB's experience in conducting similar investigations.
March 2005	
3/17	An EBSA Senior Investigator met with two SEC Staff Attorneys. The SEC provided EBSA with access to records from an SEC investigation of two ERISA-covered funds.
3/21	An EBSA Senior Investigator met with an SEC Staff Attorney. The SEC provided EBSA with access to records from an SEC investigation of two ERISA-covered funds.
3/21	An EBSA Regional Director, an EBSA Deputy Regional Director, and EBSA staff members who are investigating corporate fraud or market timing cases met with an SEC Assistant District Administrator of Enforcement. The meeting served to introduce the newly appointed EBSA Regional Director to the SEC Assistant District Administrator of Enforcement. The meeting reaffirmed EBSA's interest in the continued cooperative relationship between the agencies. Items of mutual interest discussed included corporate fraud; trading practices such as market timing, late trading and fee arrangements relating to mutual funds; hedge funds; criminal statutes as they relate to ERISA and the SEC; and the referral of cases between the EBSA Regional Office and the SEC. The SEC Assistant District Administrator of Enforcement indicated that he is forming a Regulatory Working Group for Northern California law enforcement agencies and industry organizations in the securities area and invited the EBSA Regional Office to participate. The EBSA Regional Office accepted the invitation and is participating.
3/31	Several members of EBSA's Enforcement staff and Office of Information Technology staff met with Information Technology staff at the SEC to discuss avenues for electronic sharing of information.
3/31	EBSA Deputy Assistant Secretary for Program Operations, EBSA Director of the Office of Regulations and Interpretations, EBSA Director of Enforcement, and an EBSA Lead Investigator met with the Director of SEC's Office of Compliance Inspections and Examinations and an Associate Director of the SEC's Office of Compliance Inspections and Examinations to discuss the SEC's upcoming release of their study of conflicts of interest involving pension consultants. The SEC provided draft copies of the report. As a result the two agencies agreed to coordinate the release report with guidance for plan fiduciaries in the selection and oversight of pension consultants.
April 2005	
4/7	An EBSA Senior Investigator met with an SEC Examiner to discuss an EBSA investigation into a defunct plan sponsor. EBSA sought SEC views with respect to certain issues that had arisen in EBSA's investigation. The meeting included a discussion of SEC disclosure requirements.
4/12	Two EBSA investigators met with an SEC Branch Chief to examine documents of interest to EBSA that were collected by the SEC during its ''mini-sweep'' of mutual funds. The conversation included a general discussion of the SEC's findings.
4/26	An EBSA investigator visited SEC offices to review documents pertaining to an SEC investigation. The investigator was onsite from 4/26 to 4/29. During the course of the document review, the Investigator met with an SEC Branch Chief, an SEC Assistant Regional Director, and an SEC Group Supervisor. The discussions included specific questions relevant to the investigation as well as a general discussion of information sharing.
4/28	An EBSA Regional Director, members of his staff who are investigating corporate fraud and market timing cases, and the Regional Special Agent In Charge of the Department's Office of Inspector General, Office of Labor Racketeering and Fraud Investigations, attended the Northern California Securities Fraud Working Group. EBSA's attendance was at the invitation of an SEC Assistant District Administrator of Enforcement, who leads the group. The group consists of Federal law enforcement agencies that investigate corporate fraud cases. The group meets quarterly to explore areas of mutual interests and to identify cases that may lend themselves to joint investigations.

Appendix 1. Summary of Collaboration Between the U.S. Department of Labor, Employee Benefits Security Administration and the U.S. Securities and Exchange Commission—Continued

Date	Matters discussed
4/29	The Chicago, Cincinnati, and Kansas City offices of EBSA and SEC hosted a regional conference to discuss areas of mutual interest and concern. Employees of both SEC and EBSA attended the meeting. An SEC Examiner led the informal discussion that sought to inform each agency about the nature of the other agency's investigative and enforcement activities. The purpose was to foster an understanding of the types of issues that might be referred between the two agencies and areas appropriate for joint investigations.
	May 2005
5/9	An EBSA Investigator met with two SEC Examiners to discuss cross-trading issues that had been cited in an SEC investigation. EBSA was reviewing the impact of these issues on the benefit plans connected to the subject of the SEC's investigation.
5/9–5/20	An SEC attorney attended EBSA's Basic Training Course.
5/11	An EBSA Senior Investigator and EBSA District Supervisor met with an SEC staff attorney. The SEC was conducting a civil investigation that paralleled an EBSA investigation. The SEC provided EBSA with an index of records from their investigation.
5/26	Assistant Secretary met with officials from the SEC and other Federal agencies to discuss investigative coordination.
	June 2005
6/9	The Assistant Secretary of EBSA met with an SEC Commissioner to discuss agency coordination.
6/16	An EBSA Regional Director participated in a panel discussion at the Securities and Exchange Commission, Pacific Region's 19th Annual Joint Regulatory Conference on "Vulnerable Investors: Current Issues Regarding Pension Plans, 401(k)s and IRAs." Staff from the SEC and the California Department of Corporations were also on the panel. The EBSA Regional Director provided a brief overview of ERISA and discussed how in regulating employee benefit plans EBSA often has concerns and objectives in common with securities regulators. Approximately 120 people attended this conference of regulators. Attendees in addition to the SEC included representatives from the New York Stock Exchange, NASD, CFTC and the U.S. Attorney's Office for the Central District of California.
6/16	Two EBSA Investigators attended the 19th Annual Joint Regulatory Conference in Los Angeles. The Securities and Exchange Commission's Pacific Region invited EBSA's San Francisco Regional Office to attend the general session. The Conference is a closed, regulators-only meeting to discuss common enforcement and regulatory concerns; participants typically include the SEC, State securities regulators, self-regulatory organizations, and Federal white-collar crime agents and prosecutors. Staff members from EBSA's San Francisco Regional Office regularly attend this conference.
6/22	The EBSA Director of Enforcement, the EBSA Chief of the Division of Fiduciary Interpretations, the EBSA Chief, Division of Field Operations, an EBSA Pension Law Specialist, and an EBSA Lead Investigator met with the SEC Associate Director for the Division of Enforcement and an SEC Division of Enforcement Assistant Litigation Counsel. The purpose of the meeting was to discuss potential ERISA issues and concerns arising from the distribution of proceeds by Independent Distribution Consultants resulting from SEC's settlements with mutual fund companies for trading practice violations including market timing and late trading.
6/29	EBSA's Chief, Division of Reporting Compliance, Office of the Chief Accountant met with the SEC Chief of Market Surveillance to share information regarding EBSA's blackout notice rule enforcement program. These EBSA and SEC entities have an ongoing relationship whereby EBSA informs the SEC of any blackout notice rule cases involving SEC registrants for possible enforcement action under Federal securities laws.

APPENDIX 2. EBSA INVESTMENT ADVISER INVESTIGATIONS RESULTING IN CIVIL LITIGATION OR CRIMINAL PROSECUTION

BOSTON REGION

Beaumont Nursing Home Pension Plan—Northbridge, MA

The investigation disclosed that the plan invested over 49 percent of its assets in convertible securities rated below investment grade. Under the direction of investment adviser Melvin Cutler, the plan invested a high percentage of its assets in convertible securities that were low investment grade.

The Department filed a complaint on May 3, 1989. On October 24, 1996, a consent order was reached resulting in $51,282 restored to the plan. This amount was based upon the questionable investments in convertible securities.

Blackstone Investment Advisors—Providence, RI

In the late 1980s and early 1990s George Kilborn, an investment adviser with Blackstone Investment Advisors, invested assets on behalf of approximately 27 employee benefit plans in investment vehicles offered by Security Finance Group. These investment vehicles included loan agreements, construction loans, and other real estate investments. Security Finance Group filed bankruptcy and the investments became virtually worthless. The investigation disclosed the failure of Kilborn to properly evaluate the investments prior to investing employee benefit plan assets.

The Department filed a complaint on January 22, 1999. The Department recovered $210,000 from Blackstone Investment Advisors on behalf of employee benefit plans.

Joseph Strutynski—Fayetteville, NY

Strutynski held himself out to be a professional financial planner and investment adviser who advised a benefit plan participant to roll over her account balance into an IRA account. Strutynski deposited the rollover into an account controlled by him. The participant never received a statement. A guilty plea was entered on January 17, 2003. Strutynski was sentenced to 1 month in jail, with court-ordered restitution of $42,000.

Shawmut Investment Advisors—Boston, MA

The investigation was related to a kickback scheme that involved broker commission allocation and soft dollar practices. EBSA's investigation revealed that Shawmut Investment Advisors ("SIA") allocated brokerage commissions to selected brokers by an SIA salesman purportedly because these brokers were helpful to the sales efforts in securing clients for SIA. This review further disclosed that the alleged research that was received from selected brokers was substandard or non-existent. In addition, SIA also used "Sub-Advisors" and "Interpositioning Brokers" to direct trades to a particular brokerage firm.

The investigation further revealed that the benefactors of the directed trades wired large portions of the commissions to the Cayman Islands. From the Cayman Islands, the funds were redirected back to certain trustees in the United States.

The participants of the scheme were indicted on a number of charges including Federal racketeering conspiracy, pension fund kickback, and money laundering charges arising out of commission kickbacks paid to two trustees of Chicago-based labor union pension funds. One investment adviser pleaded guilty to an Information on one count of Offer, Acceptance or Solicitation to Influence the Operation of an Employee Benefit Plan/kickback statute, while a second investment adviser was sentenced to 36 months imprisonment, 36 months supervised release, asset forfeiture in the amount of $7,433,845, and a special assessment of $2,350.

Todd J. LaScola—Providence, RI

Todd LaScola was the subject of a 55-count indictment returned November 17, 2000, charging him with employee benefit plan embezzlement, employee benefit plan kickbacks, and fraudulent financial transactions that victimized individual investors, family trust funds, and pension plans. Forty-two of the counts charged wire fraud violations. On February 23, 2001, he pleaded guilty to three counts of mail fraud, and one count of embezzlement from an employee benefit plan. He was subsequently sentenced to 96 months in prison and ordered to pay $8 million in restitution.

Between 1997 and 1998, LaScola invested approximately $6.3 million of a $16 million pension fund belonging to IBEW LU 99 with a real estate firm in a manner contrary to his management agreement with the plan which forbade him from investing pension money in non-publicly traded securities and from investing more than 5 percent of the plan's monies in any one investment. In exchange for these investments, LaScola allegedly received unlawful commissions of $241,000 from the real estate even though he was compensated under a management agreement by means of a fixed fee paid him by the plan based on the amount of plan assets. When the investments went bad, he took $6 million from private investor accounts to repay the union plan.

Investment Committee of IBEW LU 99—Cranston, RI

EBSA's civil investigation of the Investment Committee of International Brotherhood of Electrical Workers Local Union 99 was related to the criminal investigation of Todd J. LaScola (above). The Department filed a complaint on January 29, 2001. Under the terms of a default judgment entered July 24, 2001, the court ordered LaScola and his company to repay $1.2 million to the plan.

Melvin Cutler, Investment Manager—Worcester, MA

This case involved the issue of imprudently investing a significant percentage of plan assets in "junk" convertible securities. Cutler served as an investment manager for a number of pension and profit sharing plans. Cutler's investment philosophy was to invest nearly the entire assets of the plans in preferred convertible bonds. A significant percentage of these bonds were considered "junk" bonds by Standard & Poor's rating service. The Department settled the case with approximately $182,364 in losses being restored to several of the affected plans.

CHICAGO REGION

Capital Financial Services, Inc. and Colonial Financial Services—Buffalo Grove, IL

EBSA opened this investigation involving issues of fiduciary imprudence associated with client plans' acquisition of three private limited partnership investments. The Department filed a complaint in Federal District Court in Chicago, Illinois on May 31, 1994. The complaint alleged that the defendants realized considerable personal gain when they exercised substantial influence over the plans and their trustees to cause the plans to invest in the three limited partnerships. One individual, Arthur McManus, entered into a consent order with the Department whereby he was enjoined from serving as a fiduciary, administrator, trustee, or service provider to any employee benefit plan for 10 years.

Michael Daher—Englewood, CO

In 1994, the trustees of the International Longshoremen's Association Local Union 1969 caused the plan to invest $1.4 million in a joint venture with RODEVCO, a housing development company out of Mesquite, Nevada. The investment served as construction financing. The loan was secured by a mortgage on the undeveloped land, which was appraised at $988,000. The trustees' loans to RODEVCO totaled $3.1 million. In 1995, the trustees caused the plan to purchase for $975,000 adjoining land to be developed for condominium housing. Also that year, the trustees caused the plan to loan $1.3 million to a brewery in Colorado. Of the $6,434,985 in plan assets at year ended 1995, $4,391,986 was invested in RODEVCO and brewery loans.

The trustees alleged that their investment adviser, Mike Daher, orchestrated a scheme to defraud the plan of its assets by causing it to invest in the RODEVCO development. Mike Daher owned RODEVCO. On January 22, 2003, a Federal Trial Court ordered Mr. Daher to restore more than $1.6 million to the plan and permanently barred him from serving ERISA-covered plans.

Strong Corneliuson Capital Management—Menomonee Falls, WI

EBSA opened this investigation based on a referral from the SEC. This case involved the issue of cross-trading of securities between client accounts that were under Strong Corneliuson's discretionary control. Strong Corneliuson used plan assets in several of the cross-trades to purchase assets owned by a limited partnership in which Strong Corneliuson's management had investment interests. In addition, many of the securities traded were considered to be junk bonds. Most of the client accounts involved were ERISA-covered employee benefit plans. The case was settled with Strong Corneliuson restoring losses of $5,986,378 to the affected client plans.

Dallas Region—Christopher "Puffer" Haff—Dallas, TX

Haff was indicted on April 24, 2001, and entered a guilty plea on May 17, 2001. Haff was the owner of Haff Financial Group. He obtained a check for $46,699 from the Dallas law firm of McCathern, Mooty and Buffington. The check was to be invested on behalf of the law firm's pension plan and deposited for investment through Alliance Benefit Group with the investments to be held by the Guardian.

Instead, he endorsed the check and deposited it in an account owned by Haff at a related company. He subsequently used all but $1,400 of the funds for personal expenses.

KANSAS CITY REGION

Arthur G. Stevenson III—St. Louis, MO

Between January 1996 and March 2002, Stevenson provided investment management services to individuals and employee benefit plans. Instead of depositing funds he received in bona fide investments, Stevenson kept client funds for his own use. As a result of EBSA's joint investigation with the FBI and the Postal Inspectors, on June 21, 2002, Stevenson pleaded guilty to one count of mail fraud and one count of embezzling from an employee benefit plan. On September 20, 2002, Stevenson was sentenced to 87 months in prison, ordered to pay restitution of over $4 million to over 50 victims and barred from service to any employee benefit plan for 13 years.

B.K. Foster—Golden, CO

EBSA and the FBI conducted a joint investigation of B.K. Foster, an investment adviser to an employee benefit plan. Foster pleaded guilty to single counts of embezzlement of pension funds and wire fraud. On May 26, 2000, he was sentenced to 5 months imprisonment, supervised release for 3 years and ordered to make restitution of $2,318,024.

Frank L. Gazzola—Mankato, MN

From 1999 through 2002, through his investment company, Gazzola obtained money from employee benefit plans and other investors by promising high rates of return on supposedly secure investments. In actuality, Gazzola was operating a $7 million "Ponzi" scheme.

As a result of the EBSA's joint investigation with the FBI and the FDIC, Gazzola was indicted on December 1, 2003, on four counts of mail fraud, nine counts of bank fraud, four counts of false statements, one count of counterfeit security, two counts of theft from pension plans, four counts of falsification of pension plan records and two counts of bankruptcy fraud. On May 17, 2004, Gazzola pleaded guilty to one count of mail fraud, one count of bank fraud, and two counts of theft from employee pension plans. Gazzola died prior to sentencing.

Investment Advisors Inc.—Minneapolis, MN

Investment Advisors, Inc. (IAI) was a registered investment adviser to the IAI mutual funds. IAI also entered into Investment Management Agreements with ERISA plan clients, including the IAI Pension and Profit Sharing Plans for its employees. From 1991 through April 1996, IAI caused the employee benefit plans to invest plan assets in IAI mutual funds that paid 12b-1 fees to IAI Securities, Inc. (IAIS), a registered broker-dealer and affiliate of IAI. On March 21, 1996, the shareholders of IAI funds voted to eliminate the 12b-1 fees payable to IAIS.

On July 17, 1998, the Department obtained a consent judgment requiring IAI to pay to its in-house plans and those plans containing individually managed accounts invested in IAI mutual funds, the sum of $376,815.59, which represented the amount of 12b-1 fees paid by IAI mutual funds to IAIS plus an amount representing additional earnings that would have accrued if the 12b-1 fees had not been paid. In addition, IAI represented that it would not cause any employee benefit plan to invest in IAI mutual funds that pay 12b-1 fees to IAI, its affiliates, subsidiaries, or parties in interest except as permitted by statutory exemption granted under ERISA.

Michael W. Heath D/B/A Gfc—Kansas City, MO

Heath was operating a "Ponzi" scheme to defraud investors, including employee benefit plans. Heath promised returns of up to 30 percent on investments made for 30 to 45 days. He instead used the investor money for his own business and personal expenses. He also falsely represented to investors that his companies were registered to sell securities in Missouri or Kansas and claimed he was a registered investment adviser even though his only professional registration allowed him to sell insurance.

As a result of a joint investigation with the U.S. Postal Inspection Service, the Criminal Investigation Division of the Internal Revenue Service, and the Office of the Securities Commissioner for the State of Kansas, Heath pleaded guilty to single counts of mail fraud, embezzlement of pension funds, and money laundering. The amount of embezzlement from pension plans totaled $450,000. Heath was sentenced to 35 months in prison and was ordered to pay $1,565,860 in restitution to his victims.

Will Hoover—Cherry Creek, CO

Hoover's investment company was operating a "Ponzi" scheme. Hoover and his company were alleged to have stolen over $8 million from clients including employee benefit plans.

As a result of EBSA's joint investigation with the Denver District Attorney's Office and the Colorado Securities Exchange Commission, on June 3, 2004, Hoover was found guilty of 43 felony counts of securities fraud and theft. On June 23, 2004, he was sentenced to 100 years in jail, ordered to make restitution of $15,388,347 ($226,655 to employee benefit plans), and barred from service to any employee benefit plan for 13 years.

William H. Kautter—Leawood, KS

Kautter, a financial adviser, solicited funds from benefit plans by selling investments that promised high rates of return on the investments. After using his clients' assets for personal purposes, Kautter filed for Chapter 7 bankruptcy.

Kautter was indicted on November 13, 2001, on 3 counts of mail fraud, one count of making a false statement, and one count of defrauding a financial institution. On May 23, 2002, he was sentenced to 12 months and 1 day in prison with 3 years probation on one count of mail fraud. The court required Kautter to pay restitution of $626,670—$452,500 was identified as monies owing to ERISA covered plans.

LOS ANGELES REGION

3first Pension Corporation—Orange, CA

EBSA opened an investigation into 3first, a pension administrator that offered investments in junior trust deeds to its clients. The clients suffered more than $121 million in losses, including $66.7 million that was actually invested and an additional $54.8 million in interest that purportedly accrued. The losses occurred after losses in the underlying investments were hidden from investors, resulting in a Ponzi scheme to hide the mounting losses. As a result of the joint investigation by EBSA and the FBI, the three principals received lengthy jail sentences.

Anthony G. Dipace—Latham, NY

Dipace, an investment consultant in Albany, New York, was indicted on 11 counts of mail fraud for executing a scheme to defraud the Hotel Union and Hotel Industry of Hawaii Pension Plan and Trust by lying about his credentials in an effort to be hired by the pension plan as its investment adviser. Had he been hired, he would have received more than $300,000 in annual compensation and would have put plan assets of more than $200 million at risk. He was found guilty on February 8, 2000. He was sentenced to 60 months imprisonment.

Cohen & Baizer—Santa Monica, CA

Cohen and Baizer served as the investment manager or adviser for the company's defined benefit plan, which held $1.1 million in assets as of December 1988, and performed a variety of services for several other pension plans. EBSA opened this case based on participant complaints of unsecured and unpaid loans and on the plan's imprudent investment of $400,000 in a $1.1 million note receivable, which was never paid. The Department's litigation resulted in $81,598 recovered by the plan, the appointment of an independent appraiser, and $163,628 in distributions to participants.

Wm. Mason & Co., Inc.—Los Angeles, CA

Wm. Mason & Co. served as an investment manager or adviser for ERISA-covered plans and invested in derivatives. The Department filed a complaint against William Francis Mason on July 6, 1998, and obtained a consent decree 2 days later permanently enjoining Mr. Mason from providing services or controlling assets of ERISA covered plans.

PHILADELPHIA REGION

Advanced Investment Management—Pittsburgh, PA

The Philadelphia Regional Office opened its investigation of Advanced Investment Management (AIM) based on media reports that AIM, an investment manager, was terminated by two municipal employee pension funds for alleged investment guideline violations. AIM is now defunct and as of July 2003 had approximately 40 clients including 10 ERISA-covered plans.

Between January 2001 and June 2002, AIM allegedly violated the risk guidelines of its clients. AIM's clients lost more than $415 million. The affected clients (including the ERISA covered plans) filed individual lawsuits in 2002. Soon thereafter AIM went out of business. AIM and its senior officers settled the lawsuits by distributing to the plaintiffs a proportionate share of a settlement fund totaling $14.5 million. In 2003, all litigants executed an omnibus settlement agreement/release.

On April 11, 2005, the Department obtained a consent judgment permanently barring Jeff Thomas Allen, AIM's Chairman, President, CEO and an investment manager to the ERISA-covered plans, from serving as a fiduciary or service provider to any ERISA-covered plan.

LIUNA and Trust Fund Advisors—Washington, DC

EBSA opened its investigation of Laborers International Union of North America (LIUNA) and its service provider Trust Fund Advisors (TFA)/ULLICO to determine whether there were potential ERISA violations involving two LIUNA pension funds (the Local Union and District Counsel Pension Fund and the National Industrial Pension Fund).

On March 22, 2002, the Department sued Trust Fund Advisors (TFA), an SEC-registered investment adviser, and ULLICO for imprudently investing more than $10 million in assets of the two Laborers International Union pension funds in 120 acres of raw land near Las Vegas, NV. The land was bought for the purpose of developing it into residential lots, without an accurate appraisal or adequate due diligence. The funds suffered losses when the property was sold in 1999 for less than the money invested by the funds. The Department obtained a consent judgment requiring TFA and ULLICO to pay $2.4 million in restitution to the two Laborers International Union pension funds and civil penalties to the Department.

SAN FRANCISCO REGION

Capital Consultants, Inc.—Portland, OR

On September 21, 2000, the Department filed a lawsuit against Capital Consultants and its principals Jeffrey and Barclay Grayson. Concurrently, the court entered a consent order that appointed a receiver to make an accounting and protect the interests of CCL's ERISA plan clients and other investors. Through the consent orders, the SEC was able to freeze the defendants' personal assets and EBSA was able to enjoin them from doing business with ERISA covered plans.

CCL has been in receivership since the suit was filed in September 2000. Settlements totaling more than $101 million have been reached in private litigation, resolving claims brought by the court-appointed receiver, trustees of ERISA plans and other investors against plan fiduciaries and other parties who provided services to or had business relationships with CCL.[2] These settlement amounts were made a part of the receivership estate. To date, the receiver has marshaled estate assets of more than $189 million in part by collecting on outstanding loans and selling CCL's assets. The receiver estimates that the total amount of settlements and marshaled assets accumulated in the receivership to date is $291 million of which about $193 million was already distributed to CCL's private placement clients, including the ERISA plans.

The receiver has approximately $76.36 million remaining for distribution. Overall, the employee benefit plans recovered well over 70 percent of their losses through the receivership, and many plans have recovered additional losses through settlements of litigation resulting in at least $42 million.

Jeff Grayson—Portland, OR

On April 16, 2002, an Information was filed charging Jeffrey Lloyd Grayson with one count of mail fraud in violation and one count of assisting in the preparation of a false tax return. The Information described an extensive fraud against employee benefit plans beginning in about 1994 and continuing through September 2000. On April 23, 2002, Jeffrey Grayson pleaded guilty to one count of mail fraud and one count of assisting in the preparation of a false tax return. As part of his plea, Grayson agreed to cooperate with the U.S. Attorney's Office in the continuing criminal investigation of Capital Consultants' borrowers and investors. The charges were dismissed due to Grayson's poor health.

[2] Over $42 million was paid as a result of additional litigation by the Department and others against plan fiduciaries and service providers. This number is not included in the receivership assets.

Barclay Grayson—Portland, OR

Barclay Grayson pled guilty to mail fraud, a felony, admitting that he engaged in a scheme to defraud pension plans by overstating the value of certain investments made by Capital Consultants Inc. He agreed to testify against his father, Jeffrey Grayson, and union officials in exchange for a deal with Federal prosecutors that would tentatively recommend 18 months in prison. Barclay Grayson was sentenced to 24 months in prison and 3 years probation. The AUSA and the court agreed to restitution of $500,000 as negotiated in the civil class action suit.

Andrew Wiederhorn and Lawrence Mendelsohn—Portland, OR

EBSA's criminal investigation of Andrew Wiederhorn and Lawrence Mendelsohn, was opened as a spinoff of the Jeffrey and Barclay Grayson criminal investigations (above). Andrew Wiederhorn and Lawrence Mendelsohn are the primary owners and officers of Wilshire Credit Corporation.

An Information was filed against Lawrence Mendelsohn on November 20, 2003. On November 24, 2003, he pleaded guilty to one count of filing a false tax return. As part of his plea agreement, Lawrence Mendelsohn agreed to cooperate with the Government in its continuing investigation of CCL.

On June 4, 2004, Wiederhorn pleaded guilty to paying an illegal gratuity to Jeffrey Grayson, and to filing a false tax return. Andrew Wiederhorn agreed to pay $2 million in restitution, and pay a $25,000 fine. He was sentenced to 18 months in prison.

Dean Kirkland—Portland, OR

This investigation was a spinoff of the criminal investigations of Jeffrey and Barclay Grayson, after it was alleged that Dean Kirkland knowingly provided false information to employee benefit plan trustees in his CCL sales presentations, as well as provided gratuities to plan trustees.

On August 21, 2002, a 41 count Federal indictment was handed down against Dean Kirkland. On September 5, 2002, he entered a not guilty plea. On September 8, 2003, a 57 Second Superceding Indictment was handed down by the grand jury, after the District Court dismissed the 41 count Superceding Indictment on July 11, 2003. Kirkland was charged in the Second Superceding Indictment with 21 counts of violations of Offer, acceptance, or solicitation to influence operations of employee benefit plan by providing pension plan trustees with hunting and fishing trips, sporting event tickets, and other gifts. Dean Kirkland is also charged in the Indictment with 13 counts of wire fraud and with obstruction of justice.

On February 10, 2005, Dean Kirkland was sentenced to 24 months in Federal prison, ordered to pay restitution in the amount of $15,756.20, and fined $5,000. Dean Kirkland is barred for 13 years from serving in a fiduciary capacity or consultant to pension and other employee benefit plans covered by ERISA. In addition, Kirkland is barred from serving as an officer, employee, or representative of any labor organization or in any capacity with decisionmaking authority concerning labor union funds or assets for 13 years.

RESPONSE TO QUESTIONS OF SENATOR HATCH BY JOHN ENDICOTT

Question 1. Mr. Endicott, you mentioned that beginning in 1975, your Local began to invest its pension funds through Capital Consultants, and that by June of 2000, Local 290 had invested more than $159 million with that firm. What percentage of the total plan assets did this represent?

Answer 1. By June of 2000, Local 290 had entrusted $159 million of its pension and benefit trust funds to Capital Consultants for management and investment. These investments through Capital Consultants represented about 45 percent of our members' pension and benefit trust funds. At the time it was closed, Capital had put approximately $85 million in publicly traded investments and $74 million into private placements. It was the Local's $74 million that had been invested in private placements that was lost.

Question 2. Did Local 290 have an investment advisor to give overall advice as to where to invest its pension funds, and how to allocate its investments?

Answer 2. Capital Consultants was a well-known and highly-regarded Portland, Oregon investment management firm which was given the discretion by the trustees of Local 290 to select investments which fit within 290's investment portfolio, subject to the plan's overall investment strategy, guidelines, and objectives. Local 290 hired a pension consultant, Salomon Smith Barney, a registered investment advisor, to monitor the performance of Capital Consultants in order to determine whether Capital was doing a competent job in handling these investments. Salomon Smith Barney was also hired to give the Trust advice as to how to allocate its investments and how to define its investment objectives. Local 290 is currently in litigation against Salomon Smith Barney over its failure to properly monitor the performance of Capital Consultants, among other things.

RESPONSE TO QUESTIONS OF SENATORS KENNEDY AND HATCH BY STEPHEN ENGLISH

SENATOR KENNEDY

Question 1. The DOL and SEC have recently issued "tips for plan fiduciaries" to address potential conflicts of interest between pension consultants and investment advisors. This guidance puts the burden on fiduciaries to police complex financial transactions. Do you believe this guidance will be effective at task, or is something more needed?

Answer 1. In some instances, additional information offered by the SEC and DOL may be helpful to trustees and other fiduciaries. Nevertheless, the fact remains that the duties and responsibilities of trustees are immense—especially when they have accountability for multimillion dollar trust fund assets. As we saw with Capital Consultants, it is probably not realistic to expect that most trustees could ever effectively police the kinds of complex financial transactions and potential conflicts of interest that can be involved in today's larger investment portfolios. Even trained diligent experts can fail to recognize fraudulent activity that is purposefully disguised or hidden from the view.

By and large, most benefit plan trustees come from the ranks of current or former members of their respective trade unions. As such, their work experience mainly has been derived from the many years they worked as electricians, plumbers, steam fitters, laborers and the like. Their prior work experience simply does not arm them with the kinds of knowledge and experience they would need to successfully ferret out complex financial transactions or the types of conflicts of interest that can arise. Apparently—at least in the case of Capital Consultants—these activities even eluded the purview of accountants, lawyers, plan monitors, and other professional advisors whom the trustees had hired to advise them and to oversee their various activities. Expecting trustees to perform the level of scrutiny or oversight that would be required of them is perhaps ill-advised, and may simply shift the Government's oversight burden onto working people who are not well prepared to perform those tasks. It is unlikely that preparing a "tips for plan fiduciaries" could ever do much to remedy that situation very effectively.

Without specific legislative and regulatory action by the Government, I do not see the situation improving to the degree that is needed. What I believe is required are strengthened criminal sanctions for violations of ERISA, including the clarification of prohibitions against gifts and gratuities for trustees and plan officials. In addition, the minimum fidelity bonds need to be increased to compensate for decades of inflation and the huge growth in benefit plan assets. Also, insurance must be required for fiduciaries so that the plans' funds are better safeguarded from depletion or loss through non-criminal conduct. All parties-in-interest need to submit annual disclosures to the plan administrators regarding any financial dealings or their receipt of anything of value relating to their benefit plan responsibilities. Finally, conflicts of interest that plan advisors have that keep them from performing their jobs solely on behalf of the plan's beneficiaries should be identified and eliminated, or if they cannot be eliminated, the plan advisors should be required to voluntarily resign.

Question 2. Do you have any thoughts on how the SEC and DOL can better coordinate their efforts to enforce existing laws and to discover pension financial fraud?

Answer 2. Simply put, there needs to be more effective laws and/or more oversight resources allocated to pension and benefit plan protection. There simply are not enough resources currently arrayed by the Government to protect the trillions of dollars in pension and benefit funds that workers, retirees and their dependants count upon to take care of their present and future benefit needs. Experience in the Capital Consultants case and others has shown us that these funds are ripe for loss through fraud or mismanagement caused by unscrupulous or unskilled investment managers, or through the lack of trained oversight by plan advisers whose job is to find out about such fraud or mismanagement.

The extent of Federal oversight needs to be increased so that there is a real likelihood that wrongdoing will be quickly detected and stopped before losses to the funds become massive and jeopardize a trust fund's ability to meet its obligations. In addition, criminal sanctions need to be strengthened in order to provide a greater deterrence to fraud and abuse. Finally, the bonding requirements for fiduciaries need to be clarified and strengthened, so that in the event of a loss or other event, there is an adequate safety net available to protect a plan's participants and beneficiaries.

In the Capital Consultants case, the SEC demonstrated that it had the skills to clearly recognize the extent of the problems that the DOL investigator had first uncovered, as well as the will and the wherewithal to move against Capital quickly and aggressively. Perhaps SEC has some important skill sets and analytic abilities that DOL may currently lack because of a shortage of manpower and training. By working together with the SEC, I believe the DOL could become an even more effective agency at safeguarding workers' pension and benefit plans.

SENATOR HATCH

Question. Mr. English, the agreement you were able to negotiate with the other plaintiff attorneys seems nothing short of remarkable. How were you able to get such a large number of attorneys and their clients to put their own self-interest aside in favor of increasing the chances for everyone coming out better?

Answer. The short answer is that we (1) assessed the overall loss to Capital Consultant's clients, (2) assessed the culpability of the investment manager, its primary borrowers, and the accountants, consultants and attorneys advising the manager and the borrowers, (3) assessed the financial resources available to each of the parties, and (4) set out a realistic estimate of the recovery we could expect from each, based on our best estimate of the potential liability of each. We discussed this assessment with all of the plaintiffs' lawyers within 120 days after filing the first Complaint in District Court, and discussed probable distribution plans and the range of amounts each trust or group of individuals might realize from a distribution based on our assessment of the likely range of recovery. We then agreed to act unanimously. Any single group of represented plaintiffs could veto a settlement decision. Admittedly, the plaintiffs consortium worked hard internally to resolve differences that often arose so that we could maintain unanimity. However, this united front allowed us to move against the defendants with tough but reasonable settlement proposals that lead to a terrific result for the clients of Capital Consultants.

By way of background, it became quickly apparent to many of us that the benefit losses incurred by the plans' participants would be massive and devastating to participants and to their families. In fact the number of individuals affected by the Capital Consultants debacle would eventually total some 300,000, with losses of about a half billion dollars.

Early on, I can vividly recall standing in front of some 1,000 desperate and angry union members whose lifetime accumulation of pension and benefit trust funds had been lost. They needed help. We realized that it would be vital for us to try to do everything that we possibly could to recover and restore as much of their lost money as quickly as possible. To best conserve assets, we realized we had to work efficiently and cooperatively with the many other attorneys and firms who were now involved in the case. Therefore, we developed a plan to share the legal work among the various firms, recognizing the skills that each firm could bring to the process. Our objective was to avoid duplication of efforts and a lengthy and costly discovery process that could greatly reduce the benefits funds that would be available.

We knew that this would not be an easy process, but we were willing to do whatever was necessary to make it happen. We understood that we had to make sound business decisions and were truly fortunate that so many formidable attorneys were willing to set aside their egos and work together. We were gratified that a real spirit of cooperation eventually emerged among the plaintiffs' attorneys. By operating more like businessmen than as typical litigators, we were able to keep the recovery effort and the legal costs from spiraling out of control. I believe the lessons we learned in handling this case can be instructive in similar situations, thereby conserving plan assets for the benefit of all of the plan participants.

RESPONSE TO QUESTIONS OF SENATORS KENNEDY AND BINGAMAN BY GAO

SENATOR KENNEDY

Question. In your testimony, you discussed the need for EBSA to supplement its targeted enforcement strategy with a survey of pension plans and that EBSA has yet to perform a more detailed analysis along the lines you have recommended. Please tell us what further steps you believe the Department needs to take to better identify fraudulent transactions and enforce ERISA protections.

Answer. In our testimony, we acknowledge the Department of Labor's efforts to determine the level of noncompliance with ERISA provisions among certain health and retirement savings plans. We continue to believe that Labor can build upon these efforts to develop a cost-effective and systematic approach to better assess the level and type of ERISA noncompliance for the entire plan universe.

We have also made a number of recommendations to Labor that we believe, if implemented, will enhance Labor's ERISA enforcement efforts. For example, we recently reported on steps Labor can take to further improve the timeliness and content of Form 5500 reports.[1] In 2004, we recommended that the Congress take steps to improve the transparency of proxy voting practices by plan fiduciaries. Furthermore, we recommended that Labor take appropriate action to more regularly assess the level of compliance with proxy voting requirements and enhance coordination of enforcement strategies with the Securities and Exchange Commission (SEC) in this area.[2] We continue to believe that additional transparency and an enhanced enforcement presence would be beneficial in this area.

SENATOR BINGAMAN

Question 1. In responding to my questions, you indicated that you had concerns about the lack of oversight of those who provide investment advice to plans. Could you please elaborate and provide any relevant information that you have compiled in this area? Do you believe that DOL has the resources to provide this type of oversight?

Answer 1. We have previously testified that plan participants may need more individualized investment advice and that such advice becomes even more important as participation in 401(k) and other defined contribution plans increases.[3] Investment advice that is honest and uncompromised by conflicts of interest could help employees better understand their future retirement income needs as well as emphasize the need for proper diversification. Previously, some legislative proposals have been introduced that would address employers' concern about fiduciary liability for making investment advice available to plan participants and make it easier for fiduciary investment advisors to provide investment advice to participants when they also provide other services to the participants' plan. We have noted that concerns remain that such proposals may not adequately protect plan participants from conflicted advice. More recently, the SEC found that potential conflicts of interest may affect the objectivity of advice pension consultants are providing to their pension plan clients. Labor and SEC issued guidance to assist plan fiduciaries in reviewing conflicts of interests of pension consultants. Labor should also take appropriate enforcement actions to determine to what extent ERISA violations may have occurred in the instances the SEC identified and use this information to better target enforcement activity.

To better leverage limited enforcement resources, we believe that Labor should coordinate enforcement strategies with the SEC in areas where their oversight responsibilities intersect.

Question 2. If current rules were liberalized allowing investment advisers with conflicts of interest to begin to provide advice to plan participants in defined contributions, would DOL be able to provide adequate oversight of this newer larger class of investment advisers? Would such a change in ERISA cause you concern based on DOL's current handling of oversight of investment advisers providing advice to professional plan managers? Could these concerns be assuaged with a significant increase in staff for oversight at DOL?

Answer 2. If current rules were changed to allow investment advisers with conflicts of interest to provide advice to plan participants, the Congress may also want to consider changes to ERISA to ensure that adequate safeguards are in place to protect participants. For example, requiring investment advisers to disclose conflicts could be one safeguard, but would not by itself be sufficient. Additional safeguards would be needed to ensure that plan participants are not negatively affected by advice from investment advisers with conflicts of interest. Thus, Congress may want to amend ERISA to address limits on Labor's enforcement authority. For example, Labor continues to be hindered by restrictive legal requirements in assessing monetary penalties against those who knowingly participate in a fiduciary breach.

As we noted above, Labor should coordinate enforcement strategies with the SEC in areas where their oversight responsibilities intersect such as the oversight of pension consultants and investment advisers.

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[1] See GAO, *Private Pensions: Government Actions Could Improve the Timeliness and Content of Form 5500 Pension Information*, GAO-05-491 (Washington, DC: June 3, 2005).

[2] See GAO, *Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting*, GAO-04-749 (Washington, DC: August 10, 2004).

[3] *Private Pensions: Key Issues to Consider Following the Enron Collapse*, GAO-02-480T (Washington, DC: February 27, 2002).

Absent information on the level and extent of plans' noncompliance with ERISA provisions, it is difficult to determine what effect a significant increase in staff at Labor would have on ERISA enforcement. Without such information, Labor cannot ensure that it is accurately identifying the areas in which it needs to focus to most efficiently and effectively allocate its limited resources.

RESPONSE TO A QUESTION OF SENATOR HATCH BY BARCLAY GRAYSON

Question. Mr. Grayson, do you believe you had the adequate knowledge and training about ERISA requirements relating to fiduciary responsibilities at the time your father appointed you president of Capital Consultants? Do you believe that current law requirements as to knowledge and training of investment managers are adequate?

Answer. The question posed is both insightful and extremely relevant to the Capital Consultants case, as well as to the rest of the investment advisory community at large. To my knowledge, there are absolutely no specific ERISA training requirements of any registered investment advisor by either current law requirements or regulatory agency requirements. As a registered investment advisor who was selling securities or otherwise providing investment advice to clients, I was required to obtain a Series 7 and Series 63 securities license by the Securities and Exchange Commission. These licenses required extensive education and training relative to general National and State securities laws. These licenses do not speak specifically to ERISA law and there is little, if any, mention of there being any separate laws or requirements associated with the management and administration of ERISA related funds. Further, at no time during my 5 years at Capital was I ever tested on my knowledge of ERISA law, required to attend training or continuing education or otherwise learn any laws relative to the management of ERISA regulated funds. The answer to your first question is therefore that I absolutely do not believe that I had adequate knowledge or training about ERISA requirements at the time my father appointed me president of Capital Consultants (other than what limited information my father told me based on his personal interpretation of the law) relating to fiduciary responsibilities associated with the management of ERISA regulated funds.

In terms of your second question, it is absolutely clear to me that few salesmen and management personnel in the registered investment advisory community have the legal training or knowledge required to properly manage and invest ERISA regulated funds. As discussed, no training or education of which I am aware, is required either by law or regulatory agency in order to manage ERISA regulated funds. As far as I am aware, if one works for a registered investment advisor and holds a Series 63 and Series 7 license, I am not aware of anything that would preclude a sales person from selling to or otherwise managing ERISA funds. This results in most sales people only having knowledge of the general securities laws as required by the SEC, rather than having an understanding of ERISA law, which is entirely unique. I am not personally aware of any investment advisors independently requiring specific in-house ERISA law training for all sales staff. Obviously, there may be firms that require such independent training, but I am unaware of such programs based on personal experience.

I should note that many ERISA attorneys are hesitant to provide concrete information relative to ERISA law as so much of that body of law is considered to be grey or otherwise untested. Given a general lack of clear instruction from the Department of Labor relative to the proper management of ERISA regulated funds, most managers tend to follow a general rule of acting prudently as required by fiduciary standards. However, being a prudent fiduciary is in many cases not enough when it comes to managing ERISA regulated funds as some behavior that would normally be acceptable, is prohibited when it comes to the management of ERISA funds. As an example, in the investment advisory industry (and most other industries for that matter), it is common course to entertain prospective clients. However, under ERISA law an investment advisor is generally prohibited from providing a trustee charged with overseeing ERISA regulated funds with anything of value. Further, trustees are prohibited from receiving anything of value if said entertainment will influence the trustees decision making relative to ERISA regulated funds. Prior to Capital being placed into receivership, the firm attempted to clarify with its attorneys whether entertainment of trustees overseeing ERISA funds was prohibited. This question was specifically asked of counsel that specializes in ERISA law (and in one case to a past Department of Labor official). Only after extensive research did Capital learn exactly what type of behavior was prohibited according to ERISA. As it turned out, Capital had improperly entertained clients, along with most of the investment advisory industry as far as I can tell, for the last 30 years. This is but one of several areas in the industry which currently does not follow ERISA law primarily as a result of a lack of education and training. Given the lack of mandatory training, it took Capital extensive efforts to identify said prohibited acts. Capital also conducted other improper behavior, but the fact of the matter is that the industry as a whole is largely not following current ERISA law in several areas given the lack of guidance from the Department of Labor and a general lack of mandatory ERISA training and education.

RESPONSE TO QUESTIONS OF SENATORS KENNEDY AND HATCH BY JAMES S. RAY

THE LAW OFFICES OF JAMES S. RAY,
ALEXANDRIA, VIRGINIA 22314–3679,
July 1, 2005.

Hon. MICHAEL B. ENZI,
Chairman,
Committee on Health, Education, Labor, and Pensions,
U.S. Senate,
Washington, D.C. 20510–6300.

Re: Protecting America's Pension Plan From Fraud: Will Your Savings Retire Before You Do?

DEAR CHAIRMAN ENZI: Thank you for your letters of June 13 and June 24, 2005. I am pleased to submit the following responses to the questions for the record included with your June 24th letter.

SENATOR KENNEDY

Question 1. The DOL and SEC have recently issued "tips for plan fiduciaries" to address potential conflicts of interest between pension consultants and investment advisers. This guidance puts the burden on fiduciaries to police complex financial transactions. Do you believe this guidance will be effective at that task, or is something more needed?

Answer 1. The DOL and SEC issued a joint statement entitled "Selecting and Monitoring Pension Consultants: Tips For Plan Fiduciaries" on June 1, 2005 in response to the SEC's staff report on conflicts of interest between investment consultants and the pension plans for which the consultants provide investment advice. This guidance was nice. Certainly, a pension plan's governing fiduciaries should require their plan's investment consultant(s) to answer the conflict of interest questions included in the guidance. Honest consultants will provide honest answers.

But, what if the pension consultant lies? The point is that the pension plan's governing fiduciaries won't know that the consultant is lying. Plans lack the authority, expertise and resources to ferret out fraudulent conduct by investment firms, including their investment consultants. The SEC, which regulates pension consultants as investment management firms, was unaware of the extent of pension consultants' conflicts of interest with investment managers until its staff conducted the study that led to the report.

As stated in my testimony, it is the SEC's responsibility to regulate investment firms; not only the investment consultants but also the investment management firms that actually make the investment decisions. The SEC has the authority to regularly examine the operations of each firm to prevent and detect fraud and other wrongdoing. The SEC has enforcement powers to quickly compel an investment firm to cease and desist from wrongful conduct, or to place a firm in receivership. The SEC is expected to have the expertise to detect fraud and abuse by investment consultants and managers. The sophistication of many of the investment vehicles and schemes being marketed to pension plans today is beyond the understanding of the plans' governing fiduciaries and, frankly, of many of the plans' professional advisers. But for some unexpected problems in the financial markets that caused the Capital Consultants' dominos to begin falling, the Capital Consultants' fraud might have continued undetected by plan fiduciaries and professionals.

A typical investment firm has many pension plan clients. By preventing an investment firm from engaging in or continuing a fraud, the SEC can protect multiple pension plans. This is sometimes referred to as the hub-and-spokes approach to enforcement.

In short, the answer to the question is that more and better SEC regulation of the investment services community is needed; not merely the issuance of nice statements however helpful. The answer is not for the SEC to "privatize" its enforcement responsibilities by shifting the burden to pension plans. Pension plans and their participants and beneficiaries are relying on the SEC to police the investment services community.

Question 2. Do you have any thoughts on how the SEC and DOL can better coordinate their efforts to enforce existing laws and to discover pension financial fraud?

Answer 2. As noted in answer to the first question, the SEC has primary responsibility and authority to regulate the investment services community. The SEC needs to do a better regulatory job.

Moreover, the SEC should share with the DOL information about investment firms that the SEC has under investigation for wrongdoing, and about findings of wrongdoing. The DOL should be free to advise pension plans' governing fiduciaries of an investment consulting or investment management firm that has engaged in wrongdoing. It is inexcusable if the SEC and/or the DOL knows of wrongdoing by an investment firm, but fails to notify pension plans that are or may be affected by the wrongdoing. If an agency is not going to protect a plan, it should provide the plan's governing fiduciaries with the information they need to protect the plan.

The SEC is unwilling to share enforcement information with pension plans. Some years ago, I had occasion to ask the SEC for information about an investment manager engaged by one of my client pension plans; specifically, I asked whether the SEC knew if the manager had an unlawful "soft dollar" (kickback) arrangement with brokers used by the manager for securities transactions on behalf of the plan. The. SEC had conducted a "sweep" of investment firms and found that many of the firms had "soft dollar" arrangements with brokers that exceeded the scope of the so-called "research safe harbor" permitted by law. The SEC refused to respond to my inquiry.

With regard to the DOL, ERISA Section 504(a)(2) [29 U.S.C. § 1134(a)(2)], provides that:

> ". . . the Secretary may make available to any person actually affected by any matter which is the subject of an investigation under this section, and to any department or agency of the United States, information concerning any matter which may be the subject of such investigation; except that information obtained by the Secretary pursuant to Section 6103(g) of the Internal Revenue Code of 1954 shall be made available only in accordance with regulations prescribed by the Secretary of the Treasury."

This ERISA provision gives the DOL authority to notify the governing fiduciaries of pension plans about wrongdoing by investment firms of which the DOL becomes aware. My experience has been that the DOL is reluctant to exercise this authority and share information.

SENATOR HATCH

Question 1. Mr. Ray, you mentioned in your testimony that typically, a plan engages in more than one investment manager, each with fiduciary responsibility for a portion of the plan's portfolio, and that one of the reasons for this is to increase investment diversification. To your knowledge, was Capital Consultants the sole investment manager for any of the pension plans that it served? In other words, did any pension plan lose a major portion of its portfolio because of the Capital Consultants fraud?

Answer 1. I am not aware of Capital Consultants being the only investment manager engaged by any of its client pension plans. Based on the reports of the receiver for Capital Consultants, Capital Consultants had 301 clients in September 2000 (when it was placed in receivership), the average client had $3.4 million under management by Capital Consultants, and 50 percent of the clients had less than $400,000 in assets under Capital Consultants' management. There were a few plans that had much larger investments under management by Capital Consultants, and some plans took multi-million dollar losses. Fortunately, as described by DOL Deputy Assistant Secretary Lebowitz and Stephen English, Esq. in their respective testimony to the committee, the efforts of the receiver, the DOL, and the private litigation have enabled the pension plans to recover 70 percent or more of their losses.

Question 2. Are there ERISA rules governing the minimum number of investment managers a pension plan must use? Would it be permissible under ERISA for a pension plan to put all of its investments with one investment manager?

Answer 2. ERISA does not expressly mandate that a pension plan engage even a single investment manager. ERISA does expressly encourage the governing fiduciaries of a pension plan to engage an investment manager by providing a statutory shield against liability for acts or omissions of an "investment manager." See ERISA Sections 405(d) and 3(38) [29 U.S.C. §§ 1105(d), 1002(38)].

But, the fiduciary standards of conduct, particularly the "prudent man" standard of ERISA Section 404(a)(1)(B) [29 U.S.C. § 1104(a)(1)(B)], have the effect of requiring governing fiduciaries of a plan to engage a qualified investment professional to manage the plan's investment if the plan fiduciaries themselves are not qualified to manage the investments. Rarely are the governing fiduciaries themselves qualified to manage their plan's investments.

How many investment managers a pension plan engages depends on many variables, including the type of plan, the amount of its assets, its asset allocation, its liquidity needs, the extent to which it prefers passive versus active management, and whether it prefers balanced or specialized managers. It is generally a "facts and circumstances" issue.

However, in the case of a medium or large size pension plan, it would be highly unusual for the plan to engage only one investment manager. Prudence, as well as the diversification rule of ERISA Section 404(a)(1)(C) [29 U.S.C. § 1104(a)(1)(C)], would require diversifying the plan's portfolio among different types of investments and it is highly unlikely that one investment manager would be appropriate to manage all types of investments. In this regard, the authoritative ERISA Conference Report, states that:

> "Ordinarily the fiduciary should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise. . . ." [H. Rep. No. 1280, 93d Cong, 2d Sess. (1974) at 304, reprinted in 1974 U.S.C.C.A.N. 5085].

Placing all of the assets of a medium or large pension plan under the management of one investment manager would be to make the success of the plan's investment portfolio "dependent upon the success of one enterprise": the investment manager.

I am aware of one case in which this argument, in essence, is being advanced, and it happens to be a case in which I am involved. On behalf of retirees of the Prudential Insurance Company of America, I, along with the law firm of Leiff, Cabraser, Heimann & Bernstein LLP, am in litigation against Prudential and its Board of Directors challenging the investment of virtually all $8–9 billion of the Prudential Employees' Pension Plan in investment products of Prudential that are managed by Prudential and its affiliated companies. Senior Prudential officers decide how all of the plan's assets are invested; they choose all the investment vehicles without independent investigation or negotiation over the terms. And, they almost always choose Prudential products managed by Prudential managers. Indeed, on several occasions, Prudential's officers decided to use the Pension Plan's assets to provide "seed capital" for new Prudential investment products. The Pension Plan pays Prudential millions of dollars each year for managing the Plan's investments in Prudential products, at fee rates unilaterally set by Prudential without negotiation or independent investigation.

The plaintiff-retirees' lawsuit alleges that Prudential and its Directors engaged in massive self-dealing, prohibited transactions and breaches of fiduciary duty in violation of ERISA. The appointment of an independent fiduciary for the Plan is among the remedies being demanded by the retirees. This case went to trial in 2004, and is awaiting decision by the trial judge. [*Dupree, et al.* v. *Prudential Insurance Company of America, et al*., Civil Action No. 99-8337-CIV-JORDAN, U.S.D.C. S.D. FL. (Miami Div.)].

I hope that you and the committee members, and particularly Senator Kennedy and Senator Hatch, find these answers to be responsive and helpful.

Respectfully,

JAMES S. RAY.

STATEMENT OF MICHAEL J. ESLER

ESLER, STEPHENS & BUCKLEY,
ATTORNEYS AT LAW,
PORTLAND, OREGON 97204–2021,
May 25, 2005.

I have been practicing law in Northwest since 1971, when I graduated from the University of Chicago Law School. My practice has been focused on business litigation, with a heavy emphasis on securities fraud and other business torts. I have spoken on the subject to various bar associations and recently spoke at the 25th Annual Northwest Securities Institute, a conference of State securities regulators from Oregon, Washington, Idaho and British Columbia.

In the Capital Consultants Litigation, my firm and I prosecuted the claims of most of the non-ERISA investors, including those who were represented through the receiver. The total group of plaintiffs we represented had lost about $100 million.

One of our smallest clients was the Intertribal Timber Council. However, their experience underscores the need for reform in this area.

The Intertribal Timber Council ("Council") is a nonprofit 501(c)(3) organization consisting of over 65 member Tribes and Alaska Native Corporations that have timber or other natural resource management interests. It operates under the direction of an elected Board of Directors consisting of 11 Tribes. The Council was formed in 1976 to enhance communications with the Bureau of Indian Affairs by providing a forum for Tribes to express collective concerns and to be more actively involved in the management of Indian forestry services. Among its many accomplishments and activities are its annual scholarship awards to outstanding students for excellence in Indian natural resource management.

After a strong sales presentation in Fall 1998 by Jeffrey Grayson, head of Capital Consultants LLC ("CCL"), the Council changed its investment adviser and placed approximately $200,000 of its Scholarship Fund with CCL. Grayson told the Council that CCL could get a better return on the Scholarship Fund than the Council's existing manager, enabling the Council to fund three to four more scholarships a year. At the time of this change, CCL and its cohorts were already insolvent and deeply mired in the Ponzi scheme that led to its failure. Shortly before CCL collapsed in September 2000, the Council had approximately $480,000 invested in two accounts with CCL. This $480,000 on deposit with CCL had taken 15 to 20 years to accumulate, since the organization does not have a major emphasis on donations, even though it is a 501(c)(3) nonprofit organization. Its revenues come principally from member dues, symposium fees and work shop fees. CCL was fully aware that the funds in its care were for scholarship purposes.

On average, some 15 scholarships were awarded annually prior to the collapse of CCL. Approximately $22,800 was awarded in 2000. With the collapse of CCL, the Council estimated it would have available only $15,000 to award in 2001, with far less in 2002, and that would involve invading its principal to support the college students already dependant on the stipend. Essentially, the collapse of CCL created an immediate loss of five to six forestry scholarships to Native American high school students and has jeopardized the entire program. As a result of the Receiver's efforts and litigation under the Oregon securities laws, the Council will recover about 55 percent of its losses (which were virtually 100 percent of its CCL investments).

The partial recovery for the Council has enabled it to go forward with a much reduced scholarship program. In large part, that recovery was made possible by the Oregon Securities Laws, which, unlike ERISA and Federal securities laws, give investors the right to pursue a broad range of professionals who participate in this conduct. This included professionals who were employed by CCL and the entities with whom CCL had invested the Council's funds and who were participating in the Ponzi scheme. Had the Council and other CCL investors been limited to remedies under the existing Federal securities laws and ERISA, the amount recovered for them would have been a small fraction of what has been recovered to date, despite the efforts of the Department of Labor and the SEC. There is a need for stronger laws to protect people like the Council by extending full liability for losses to anyone who materially aids or participates with an ERISA fiduciary in a scheme to defraud them.

Yours truly,

MICHAEL J. ESLER.

WHAT TO DO WHEN YOUR ERISA FIDUCIARY SCREWS UP—LESSONS LEARNED FROM THE CAPITAL CONSULTANTS LITIGATION

I. ERISA MAY PROVIDE ONLY LIMITED REMEDIES TO A PLAINTIFF INJURED BY AN INVESTMENT ADVISOR'S MISCONDUCT

A. As Noted ERISA Does Provide for Remedies, But, as to Non-ERISA Fiduciaries, These May be Limited. However, Common Law and Other Statutory Bases for Recovery May Be Available

Most recently in *Harris Trust & Savings Bank* v. *Solomon Smith Barney, Inc*., 530 US 238 (2000), the Supreme Court made it clear that the relief available under ERISA is limited to "appropriate equitable relief." ERISA § 503(a)(3). *Bast* v. *Prudential Insurance Co. of America*, 150 F3rd 1003 (9th Cir 1998), as amended. See, also, *Toumajian* v. *Frailey*, 135 F3rd 648 (9th Cir 1998). In *Toumajian*, the court summarized this confusing area of the law, stating: "Once again the mysteries of the ERISA—a statute intended to provide a system of uniformity and simplicity in the complex regulatory field of employee benefits—provided added complexity in this action." The question faced in *Toumajian* was whether ERISA preempted run-of-themill professional malpractice claims. (In *Toumajian*, the issue of limited remedies under ERISA is discussed and becomes a part of the bases for denying Federal jurisdiction.) See, also, *Nieto* v. *Ecker*, 845 F2d 868, 873 (9th Cir 1998) and *Harris Trust*, *supra*, 530 US at 240. The lesson here is to avoid ERISA claims or triggering ERISA preemption by careful pleading.

B. ERISA May Preempt Other Common Law and Statutory Claims

Pilot Life Ins. Co. v. *Dedeaux*, 481 US 41 (1987) (ERISA preempts all common law and State law claims that relate to an employee benefit plan). A cause of action relates to an employee benefit plan if it has a connection with, or reference to, such a plan. *New York State Conference of BlueCross & BlueShield Plan* v. *Travelers Insurance Co*., 514 US 645 (1995). The Ninth Circuit has held that a complaint for intentional mishandling of plan assets against accountants, actuaries and attorneys, including nonfiduciaries, was preempted. *Concha* v. *London*, 62 F3rd 1493 (9th Cir. 1995) (this case may be distinguishable because the entire control and management of the plan was entrusted to a CPA). In *Rutledge* v. *Seyfarth, Shaw, Fairweather & Jaroldson*, 201 F3rd 1212 (9th Cir 2000), the Ninth Circuit observed that Federal preemption applied to a claim for excessive attorney compensation. However, if the case had been for substandard performance, ERISA would not have preempted the claims.

The Supreme Court has stated that courts must address claims of preemption starting with the presumption that Congress did not intend to supplant State law. *Travelers*, 514 US at 655. In *Arizona State Carpenters Pension Trust Fund* v. *Citibank*, 125 F3rd 715 (9th Cir. 1997), the Ninth Circuit held that ERISA does not preempt State law claims for breach of contract, breach of common law fiduciary duty, breach of the implied covenant of good faith and fair dealing, negligence or common law fraud against a service provider bank that aided an investment manager's breaches of fiduciary duty by failing to notify the trustees of defaults.

In *Donrs* v. *KPMG Peat Marwick*, 876 F Supp 1116 (CD Cal 1994), the court held that ERISA does not preempt common law claims for accounting malpractice.

There is a split of authority on the subject, and this is a highly contested area of the law. If there is an ERISA cause of action, then preemption may occur.

C. Common Law Remedies Are Probably Better—If Available

Assuming ERISA does not preempt common law causes of action, like breach of fiduciary duty, common negligence, professional negligence, negligent misrepresentation and fraud, these claims may provide a better source of relief than ERISA or the Securities Act.

II. THE OREGON SECURITIES LAW PROVIDES BROAD REMEDIES AGAINST PARTICIPANTS, IF APPLICABLE [1]

A. Federal Cases Interpreting Oregon Law Require a Liable Seller in Order to State a Claim Under the Oregon Securities Act

See, e.g., *Nesbitt* v. *McNeal*, 896 F2d 380 (9th Cir.) 1990).

B. Oregon Cases State Court Decisions Are Somewhat Ambiguous on the Subject

Anderson v. *Carden*, 146 Or App 675, 683, 934 P2d 562 (1997) ("The liability of the nonseller participant under ORS 59.115(3) is predicated on the violation of the seller."); *Metaltech Corp.* v. M*etal Teckniques, Inc*., 74 Or App 297, 306, 703 P2d, 237 (1985); *Towery* v. *Lucas*, 128 Or App 555, 562, 876 P2d 814 (1994)(the 1985 amendments excluded from coverage offers to sell securities).

C. Investment Advisors Generally Act as the Agent of the Buyer and Not the Agent of the Seller

Pool v. *Frank*, 1990 WL 267360, at 3-5 (D.Or. 1990) (holding that an investment advisor acting as agent for its investing clients could not be liable under Oregon Securities Law as a seller of securities because it was agent for the purchaser); *Rolex Employees Retirement Trust* v. *Orgraphics Corp*., 1990 WL 45714, at 4 (D.Or. 1991) ("The reference to "offers" in ORS 59.115(1) was expressly deleted from the statute during legislative revisions in 1985 . . ." and "the language in ORS 59.115(1) provides no basis for this court to extend liability under the statute beyond a person who actually passes title to a security.")

[1] Note, in *Central Bank of Denver* v. *First Interstate Bank*, 511 US 164 (1994), aider and abettor liability under § 10b of the Securities Act of 1934 was essentially eliminated.

D. Potential Responses

Potential responses to these arguments include the following: (i) the term "seller" is not defined in the statue, and there is no reason to interpret it to exclude a person who does the act of selling; and, (ii) the investment program offered by the investment advisor could, in and of itself, constitute a security. The definition of "security" is very broad and includes: "Note, stock, treasury stock, bond, debenture, evidence of indebtedness, collateral trust certificate, investment contract, etc." Can the investment program be re-cast as a mutual fund or an investment contract? Is the investment advisor acting in a duel capacity?

III. COMMON LAW CLAIMS MAY BE AVAILABLE

A. The Existence of a Special Relationship

Common law claims are stronger because of the existence of a special relationship. *Onita Pacific Corp.* v. *Trustees of Bronson*, 315 Or 149, 843 P2d 890 (1992) and Restatement (2nd) Torts, § 552. Compare with *Conway* v. *Pacific University*, 324 Or 231, 924 P2d 818 (1990). By definition, an ERISA fiduciary should be acting for the benefit of the plaintiff and a special relationship should exist. Professionals and others hired by the ERISA fiduciary may be liable as sub-agents—agents of an agent with fiduciary responsibilities.

B. Fiduciary Duties Include Duties of Undivided Loyalty, Full Disclosure, Fair Dealing, Good Faith, and Due Care

The failure to exercise reasonable care in selecting investments should be connected to losses when those investments flounder to satisfy the causation requirement, but this is a common defense. *Soleberg* v. *Johnson, 306 Or 484, 760 P2d 867 (1988).*

C. Duty of Disclosure

A duty of disclosure mandates that the investment advisor explains risks and advise his client when he believes his client is embarking in fool-hearty investments. See attached copies of a recent decision in *Moak* v. *Sloy*.

D. Establishment of a Duty of Care

Establishment of a fiduciary duty makes an investment advisor responsible for simple negligence. *Stuart* v. *Jefferson Plywood Co.*, 255 Or 603, 469 P2d 783 (1970) (a person may be found negligent if he ought reasonably to have foreseen that his conduct would expose another to an unreasonable risk of harm); and *Dodge* v. *Darrit Const. Co.*, 146 Or App 612, 934 P2d 591 (1997), *rev denied*, 326 Or 530 (1998).

E. Participant Liability is Available

Participant liability can be established by showing that the participant either conspired with, or aided and abetted, the tortious conduct of the investment advisor. *Granewich* v. *Harding*, 329 Or 47, 985 P2d 788 (1999) (incorporating Restatement (2nd) of Torts, § 876 (1979). The elements of conspiracy or aiding and abetting include either: (i) a tortious act in concert with another or pursuant to a common design with another; (ii) knowledge that the other person's conduct involved a breach of duty and substantial assistance; or (iii) substantial assistance to the other to accomplish tortious results when, independently of the other, the conduct involved a breach of duty to the third person. Acting in concert has been defined to mean the performance of an action that is "mutually contrived or planned," "agreed on," "performed in unison or done together." *Slegel* v. *Hubbard, 176 Or App 1, 29 P3d 1195 (2001). Acting in concert only requires that the tortious conduct be performed together. Sprinkle* v. *Lemley*, 243 Or 521, 414 P2d 797 (1966) (each of two doctors operating together could be liable for the negligence of the other because they acted in concert). An agreement to act together can be implied and understood to exist from the conduct itself. Restatement (2nd) of Torts, § 876, comment a ("Agreement need not be expressed in words and may be implied and understood to exist from the conduct itself.") and *Slegel*, *supra*, 29 P3rd at 1197 (Court inferred from the conduct of defendant and third party that they had agreed to engage in tortious conduct); and *Granewich*, *supra*, 329 Or at 59 (allocations that give rise to an inference to an agreement are sufficient). Passive conduct, such as a failure to disclose, can also constitute substantial assistance where there is a duty to disclose. *Gregory* v. *Novak*, 121 Or App 651, 855 P2d 1142 (1993) ("One who makes a representation that is misleading because it is in the nature of a 'half truth' assumes the obligation to make a full and fair disclosure of the whole truth.")

[Whereupon, at 11:45 a.m., the committee was adjourned.]

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