

STATE
COMPENSATION
INSURANCE
FUND

IN REPLY REFER TO:

December 20, 2007

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DEC 24 2007

Adam M. Cole, Esq.
General Counsel
California Department of Insurance
Legal Division
45 Fremont Street
Sacramento, CA 94105

**Re: RSM McGladrey Examination of State Compensation Insurance Fund;
Potential Conflict of Interest**

Dear Mr. Cole:

We are writing to you about the recent operational review of State Compensation Insurance Fund ("State Fund") conducted by RSM McGladrey, Inc. as Special Examiner on behalf of the California Department of Insurance ("CDI"). Given the importance to all concerned that the general public maintains confidence in the independence of independent auditors, this letter is State Fund's notification to the CDI of a potential conflict of interest or appearance of conflict of interest that has been discovered. Although RSM McGladrey, Inc. was given a letter by the CDI dated March 21, 2006 asking RSM to confirm that it had no conflicts of interest, it has now come to our attention that over the last four years State Fund has paid significant brokerage commissions to a wholly owned subsidiary of RSM McGladrey pursuant to State Fund's Broker Program.

State Fund and PWR Insurance Services, Inc., dba Pavlo, Weinberg & Associates Insurance Brokers had an active broker relationship in 2003. RSM McGladrey Employer Services, a wholly owned subsidiary of RSM McGladrey, Inc., purchased brokerage PWR Insurance Services in November of 2004 and created a new company known as RSM McGladrey Insurance Services, Inc. that became entitled to the brokerage commissions. State Fund paid brokerage commissions to PWR and/or RSM McGladrey Insurance Services, Inc. from 2003-2007. Effective April 1, 2007, USI Holdings, Inc. purchased Pavlo, Weinberg & Associates, RSM McGladrey, RSM McGladrey Insurance Services, Inc., RSM Employers Services Agency and RSM McGladrey Insurance Services of California and began operating those firms through current State Fund broker USI of Southern California Insurance Services, Inc.



Mr. Adam Cole, Esq.
December 20, 2007
Page 2

If you wish any further information, please do not hesitate to contact me.

Sincerely,

A handwritten signature in cursive script that reads "Robert W. Daneri". The signature is written in black ink and is positioned above the printed name.

ROBERT W. DANERI
Chief Counsel

cc: Jeanne Cain, Board Chair
Francis Quinlan, Board Member
Janet Frank, President and CEO
Barbara Simmons, Internal Audit Manager

DEPARTMENT OF INSURANCE**Legal Division, Office of the Commissioner**

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February 4, 2008

Robert W. Daneri, Esq.
Chief Counsel
State Compensation Insurance Fund
P.O. Box 420807
San Francisco, CA 94142-0807

Re: RSM McGladrey Operational Review of State Compensation Insurance Fund

Dear Mr. Daneri:

This responds to your December 20, 2007 letter informing us of "a potential conflict of interest or appearance of conflict of interest" involving RSM McGladrey, Inc. ("RSM"), a consultant retained by the California Department of Insurance ("Department") to conduct an operational review of State Compensation Insurance Fund ("SCIF"). I have copied this letter to those copied on your letter. I ask that you forward this letter and your December 20, 2007 letter to the remaining SCIF board members and officers as well.

Needless to say, we take extremely seriously any assertion that there may have been a conflict of interest or any other factor undermining the integrity of RSM's operational review of SCIF. Accordingly, I telephoned you on December 27, shortly after receiving your letter, to discuss it. To my astonishment, you stated that SCIF had been aware of a "potential conflict of interest or appearance of conflict of interest" "for a couple of months," but that informing us of the issue "got stuck in the back of the pile." On behalf of the Department, let me express my disappointment that SCIF waited several months to bring this matter to our attention.

The Department initially retained RSM in March 2006 in an advisory capacity to assist with the Department's December 31, 2005 financial examination of SCIF. On May 18, 2007, the Department retained RSM to conduct an operational review of SCIF. On both occasions, the Department required RSM to confirm that it had no conflicts of interest. On both occasions, RSM did so.

Your letter states that in 2004 a subsidiary of RSM, RSM McGladrey Employer Services ("RSM Employer Services"), purchased a brokerage company, PWR Insurance Services, Inc. ("PWR"), which had been providing some brokerage services to SCIF since 2003. Your letter states that at the time RSM Employer Services acquired PWR, RSM also created a new company, RSM

McGladrey Insurance Services, Inc. ("RSM Insurance"), which received commissions from PWR. SCIF continued to use PWR for some brokerage services until 2007. Your letter states that on April 1, 2007, USI Holdings, Inc. ("USI") purchased PWR, RSM, RSM Employer Services and RSM Insurance. Since April 1, 2007, SCIF has obtained some brokerage services from USI of Southern California Insurance Services, Inc., an affiliate of USI.

We have thoroughly reviewed the information in your letter. We conclude that RSM did not have a conflict of interest.

To begin, we identified several incorrect statements in your letter. First, RSM Employer Services was not a subsidiary of RSM; it was a subsidiary of RSM McGladrey Business Services, Inc., which in turn was a subsidiary of H & R Block Group, Inc. Second, RSM Employer Services did not purchase PWR; RSM Insurance Services purchased PWR. Third, our research shows that although USI purchased PWR, it did not purchase RSM, RSM Employer Services or RSM Insurance.

Thus, since April 1, 2007, RSM (the consultant that performed the operational review of SCIF) has been entirely separate from PWR and USI. The Department retained RSM to conduct an operational review of SCIF on May 18, 2007, *after* the indirect corporate affiliation between RSM and PWR had ended. RSM therefore had no conflict of interest in connection with its operational review of SCIF.

The Department initially retained RSM in an advisory capacity in March 2006. From that time to May 18, 2007, RSM was not conducting an operational review of SCIF. Accordingly, the corporate affiliation between RSM and PWR from March 2006 to March 2007 could not, and did not, affect the operational review and therefore did not give rise to a conflict of interest.

Our review also found that during the period March 2006 to March 2007, SCIF paid approximately \$311,000 in brokerage fees to PWR. Those payments amounted to less than 1/2 of 1% of RSM's revenues during that period. To put this in a larger context, RSM's ultimate corporate parent, H & R Block, Inc., had revenues in 2007 of more than \$4 billion. The total amount of commissions paid by SCIF to PWR constitutes well under 1/10 of 1% of H & R Block's 2007 revenue.

Our review further found that during the period when RSM and PWR were indirectly affiliated, they maintained separate operations, separate staff, and separate facilities and did not integrate

Robert W. Daneri, Esq.
February 4, 2008
Page 3

operations in any way. Our interviews with RSM since receiving your letter also confirmed that there was no communication between RSM personnel and PWR personnel.

In sum, there was no conflict of interest with respect to the Department's engagement of RSM.

Very truly yours,

A handwritten signature in black ink, appearing to read 'A.M. Cole', with a long horizontal flourish extending to the right.

Adam M. Cole

General Counsel
California Department of Insurance

cc: Jeanne Cain, SCIF Board Chair
Francis Quinlan, SCIF Board Member
Janet Frank, President and CEO of SCIF
Barbara Simmons, Internal Audit Manager at SCIF