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Advisory Council on Employee Welfare and Pension Benefit Plans
Employee Benefits Security Administration
U. S. Department of Labor
200 Constitution Avenue, N. W.
Washington, D.C. 20210

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Subject: Evaluating the Department's Regulations and Guidance on ERISA Bonding Requirements and Exploring Reform Considerations

Ladies and Gentlemen:

Thank for you inviting me to provide my input to the Advisory Council on this subject and the five related areas of inquiry raised by the Department. Each of the areas of inquiry is restated in this letter, along with my comments on each. As an Insurance Broker specializing in crime insurance, my role is to assist organizations in securing insurance coverage that provides comprehensive protection of their financial assets against the perils of fraud and dishonesty, perpetrated by both the organization's employees and outside third parties, and to ensure that their insurance coverage complies with relevant regulatory requirements, such as section 412 of ERISA. My comments on the areas of inquiry outlined below should be viewed through this lens.

Inquiry: To what extent are the fidelity bonds currently being secured by plan officials insuring against losses resulting from *any* act of fraud and dishonesty that is currently required under section 412 of ERISA?

Comment:

There are generally two categories of fidelity bond forms available in the commercial insurance market. Industry standard bond forms have been developed by the industry trade groups and proprietary bond forms have been developed by individual insurance companies. The two predominant industry trade groups that have developed industry standard bond forms are the Insurance Services Office (ISO) and the Surety and Fidelity Association of America (SFAA). Insurance companies that have not developed proprietary bond forms will adopt and issue industry standard bond forms from ISO or SFAA or both. Insurance companies that have developed proprietary bond forms will typically adopt and issue an industry standard form in addition to their proprietary forms.

Despite there being numerous bond forms available, the coverage provided under these various forms is fairly homogeneous, particularly as respects the coverage provided in satisfaction of

section 412 of ERISA. There is virtually no material difference among the ISO, SFAA and proprietary forms in terms of coverage provided in satisfaction of section 412 of ERISA.

None of these bond forms was intended to provide "all risk" coverage. Consequently, most forms include a definition of what is considered a dishonest or fraudulent act and these definitions have the potential to limit the applicability of coverage under certain loss fact patterns. Additionally, there are exclusions common to all these bond forms that may adversely impact the availability of coverage required under section 412 of ERISA for an act of fraud or dishonesty. Some of these exclusions have been included to address risks that insurance companies believe are either uninsurable (e.g. war, nuclear) or business risks (e.g. extensions of credit).

Within the last year, however, ISO, SFAA and insurance companies with proprietary forms have developed endorsements to the bond forms to broaden the scope of coverage applicable to ERISA Plans. These new endorsements have been designed to bring the definition of a covered act of fraud or dishonesty in line with the intent of section 412 and have addressed the coverage issues that may arise because of certain common exclusions. These endorsements have been adopted by the vast majority of insurance companies who write fidelity bonds.

While many fidelity bonds that cover both Plan Sponsor entities and ERISA Plans are renewed on an annual basis, and, therefore, have or soon will include these new endorsements, there are significant numbers of fidelity bonds covering ERISA Plans only that are written for three-year terms. It is unclear whether these new endorsements are being added to these bonds midterm or whether these new endorsements will not be added until these three-year term bonds come up for renewal. If not added midterm, it may be another two years before some of these bonds will provide coverage that better aligns with section 412 requirements.

While it is my belief that insurance companies have always intended to provide the coverage required by section 412 of ERISA, either through use of industry standard forms or proprietary forms, with the wide adoption and implementation of these recently developed endorsements, in my opinion, the bonds being secured by plan officials today are better suited to provide the coverage required under section 412 of ERISA.

Inquiry: To what extent are the fidelity bonds currently being secured by plan officials covering *all* plan officials who handle funds or other property as required under section 412 of ERISA?

All fidelity bonds are constructed in a similar fashion. Coverage is designed to respond to acts of fraud or dishonesty committed by "Employees" as that term is defined. With regard to the

coverage provided for ERISA Plans, insurance companies have always been willing to expand the definition of "Employee" to include all natural person fiduciaries and plan officials who are affiliated with the Plan Sponsor or the Plan itself.

Where issues can arise are situations where the management of Plan assets is outsourced to third party investment managers that are natural person independent contractors or organizations that do not fall within the scope of the exemptions for certain types of financial institutions outlined in section 412. Fidelity bonds purchased by Plans or Plan Sponsors do not generally include these outside third party investment managers within the definition of "Employee". Consequently, the fidelity bond purchased by a Plan or Plan Sponsor does not include coverage for acts of fraud or dishonesty committed by outside third party investment managers or their employees despite the fact that these third parties do handle funds or property of ERISA Plans and, therefore, are subject to the section 412 bonding requirement.

Where the third party investment manager is a natural person independent contractor, the best course of action is to secure agreement from the insurance company providing the fidelity bond to the Plan to amend the definition of "Employee" to include that individual. Not all insurance companies are willing to make such an amendment, however.

The more common situation is where the third party investment manager is an organization. And for this situation there is a product widely available in the commercial insurance market known as an ERISA Fiduciary Fidelity Bond or, alternatively, a Third Party ERISA Bond. This type of bond is typically purchased by an investment manager to satisfy its section 412 bonding requirements in relation to its work for ERISA Plans. This type of bond includes as Insured each ERISA Plan for which the Named Fiduciary (the investment manager) handles funds or property. The bond protects each Insured Plan against acts of fraud or dishonesty committed by the employees of the Named Fiduciary. There is no industry standard form in wide use, however, several insurance companies have developed proprietary bond forms and all of these forms are similarly structured.

These forms are designed to meet the needs of third party fiduciaries by providing a separate statutorily required limit of liability for each Insured Plan and providing automatic coverage for an ERISA Plan as soon as the Named Fiduciary is engaged to handle funds or property of such Plan.

While most US-domiciled commercial insurers on the U.S. Treasury's list of approved sureties cannot provide coverage to investment managers domiciled outside the U.S., this type of bond is also available from certain Underwriting Syndicates at Lloyd's of London who fall within the scope of the Lloyd's exemption to the Treasury listing requirement. Therefore, this coverage is available

to investment managers domiciled outside the U.S. and provides them a way to satisfy the section 412 coverage requirement as well.

Inquiry: To what extent are the fidelity bonds currently being secured by plan officials providing sufficient recovery amounts to offset the *full* losses caused by acts of fraud or dishonesty?

Historically, the incidence of loss due to fraud or dishonesty by plan officials incurred by ERISA Plans has been very low. However, aside from the increase in the maximum limit requirement for Plans holding employer securities enacted via the Pension Protection Act of 2006, I do not believe the maximum required limit of $500,000 has change since ERISA was enacted. And in that time, Plan assets have grown significantly. In early 1975, the Dow Jones Industrial Average was at around 700. It is now over 25,000. While far from a perfect measure of the growth in Plan assets, the change in the DJIA gives us a sense of the magnitude of this growth.

While I believe it may be appropriate to raise the maximum limit required, if for no other reason than to adjust for inflation, I am cognizant of the fact that insurance companies, while generally comfortable with the fraud and dishonesty exposure presented by ERISA Plans, do remain somewhat uncomfortable with the first dollar nature of this exposure (i.e. the prohibition on the application of a deductible or self-insured retention). Insurance carriers may be resistant to the imposition of substantial increases in maximum limit requirements if they are not allowed to impose a modest deductible. Additionally, large third party investment managers may find it difficult, if not impossible, to obtain the limits necessary to comply with higher maximum limits under ERISA Fiduciary Fidelity Bonds.

With regard to third party investment managers, it may be worth taking note that most such organizations also purchase a separate fidelity bond covering the entity's assets and those of its clients, including ERISA Plan clients. These bonds, while subject to self-insured retentions, do generally provide significantly higher limits of a liability than the statutory requirement provided under the ERISA Fiduciary Fidelity Bond. The coverage essentially sits excess of the coverage provided by the ERISA Fiduciary Fidelity Bond. While this coverage is typically subject to a slightly narrower definition of dishonesty and subject to the common exclusions found in fidelity bonds, it will typically provide significant additional limits of coverage for ERISA Plan assets in the care, custody and control of third party investment management organizations.

Inquiry: Should the plan funds or other property mandated to be insured under section 412 of ERISA against losses attributable to acts of fraud and dishonesty be expanded to include participant contributions prior to their deposit in the plan?

Participant contributions should be considered Plan assets and afforded the same coverage as all other Plan assets even though they have not yet been deposited in the Plan. As participant contributions, they are not assets of the Plan Sponsor. But for the existence of the Plan, the contributions would not be deducted from the participants' wages. If the premise of the section 412 bonding requirement is to protect the assets of the Plan participants and beneficiaries, the moment participants contributions are designated as such, they should be considered plan assets.

From an insurance standpoint, contributions not yet deposited do pose a greater risk of loss due to fraud or dishonesty perpetrated by a plan official. But this increase in exposure is not so significant as to cause disruption in the market for ERISA fidelity bond coverage.

Inquiry: Should the Department's current guidance and reporting requirements be modified to clarify (and better educate plan officials as to) the value of, and the distinctions among, fidelity bonds, insurance policies covering crime (including cybercrime), insurance policies covering liability and insurance policies indemnifying fiduciaries?

There is often confusion between liability insurance for fiduciaries and fidelity bond coverage but this confusion rarely results in a Plan failing to satisfy the section 412 requirement. In my experience, it sometimes leads to confusion as to which coverage to evidence when completing the Form 5500.

More important, I believe, is educating plan officials about the coverage advantages that a comprehensive crime insurance policy provides. While the terms "fidelity bond" and "crime insurance policy" are often used interchangeably, in the ERISA context, they mean vastly different things. A fidelity bond only provides coverage for fraudulent or dishonest acts of plan officials. It provides no coverage for acts of outside third parties. If constructed correctly, with the ERISA Plan included as an Insured for all coverages, a comprehensive crime insurance policy not only provides the required coverage for acts of fraud and dishonesty by plan officials, it also provides coverage for other perils such as forgery or alteration of checks issued by the Plan, funds transfer fraud and, most importantly, the emerging risk of Social Engineering fraud.

While I have seen very few acts of fraud or dishonesty by plan officials in my three decades in the crime insurance industry, in the last 12 months, I have learned a several losses to ERISA Plans arising from Social Engineering fraud. Social Engineering fraud has reached epidemic proportions. It is a global issue impacting businesses large and small and it has now made its way into the ERISA Plan world. In the ERISA context, the typical scenario involves the theft of a

Plan beneficiary's Plan account credentials via a Phishing attack. This then leads to the Plan Administrator receiving an instruction from a fraudster purporting to be the Plan beneficiary directing the Plan Administrator to make a distribution from the Plan via electronic funds transfer to the fraudster's bank account. These scams have resulted in losses of hundreds of thousands of dollars from participants' 401k accounts.

While employee theft has traditionally been the most frequent and severe cause of loss under crime insurance policies, I believe it will soon be matched and possibly eclipsed by Social Engineering and other methods of funds transfer fraud. As such, in my view, the Council may want to consider recommending that all Plans purchase comprehensive crime insurance coverage, even if the Plan must bear some sort of self-insured retention/deductible in order to acquire this broader, more comprehensive coverage.

Thank you again for the opportunity to share these comments with you. I hope you find them useful in addressing the issues raised by the Department.

Sincerely,

Kevin M. Guillet

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