Statement of Norman Stein

Before the ERISA Advisory Council

On the Subject Of

"Fidelity Bonds"

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Good morning. I am Norman Stein. I am a professor at the Drexel University School of Law, where I teach and write principally in the areas of employee benefits and tax law. I also am a policy consultant for the Pension Rights Center in Washington. The Pension Rights Center is the country's oldest consumer organization dedicated solely to protecting and promoting the retirement security of American workers, retirees, and their families. I am, however, testifying today on my own behalf and am not representing either Drexel University or the Pension Rights Center. I should also add that it is always a pleasure to appear before this Advisory Council, of which I am an alumnus, on its important work.

I appreciate the opportunity to testify on the topic of fidelity bonds. I want to say at the outset , however, that this is not, so far as I know, an ERISA hot topic. When I was first contacted by the Advisory Council on the issue, I noted that my understanding of ERISA fidelity bonds did not go much beyond familiarity with the ERISA statutory language on the subject. I contacted fellow academics, both through the ERISA legal academics list-serve and a number of phone calls to see if somewhere, anywhere, there was an ERISA legal academic who had studied ERISA fidelity bonds, but perhaps not surprisingly found no one. There is only limited writing on the subject, and that writing is generally prescriptive, describing the requirements of the statute without addressing any of the fundamental questions raised by those requirements, such as whether the basic rule that plans be required to purchase fidelity bonds, at least in the rule's current statutory form, makes sense in today's world; whether fidelity bonds provide meaningful protection for plan participants; and whether the protection it does purchase is worth the price that plans, in the aggregate, pay for the protection.[1] We do not, at least from accessible academic literature, seem to know how the requirement that plans purchase fidelity bonds is doing in the real world—whether plans are complying with the statutory requirements, how many claims are made against such bonds, how often plans are actually compensated for their losses, and whether and how often the surety companies that pay claims against the bonds are made whole by the wrong doers. (I assume that some of this information will be provided by other witnesses—those who purchase fidelity bonds and those who issue them.) And we cannot find in the academic literature suggestions on how the statute, or the Department's guidance on the statute, might be modified to better adapt the fidelity bond requirements to today's world, which is quite different from the world of 1962, when a statutory requirement for benefit plan fidelity bonds was first introduced. These are, I think, important topics. At the very least, if the current requirements impose costs on the plan but provide few genuine benefits, we should question whether such bonds financially burden the system without providing commensurate benefits and ask whether we can improve the requirements and if not, eliminate them or replace them with something different.

[1] The most comprehensive article on section 412 that I have located is Edward G. Gallagher, *ERISA Bonding Requirements and the Fidelity Insurer*, 14 FIDELITY L.J. 247 (2008). The article might have been prompted by the Department's 2008 sub-regulatory guidance on fidelity bonds.

My testimony will be in three parts: the first part will provide a bit of historical context for the fidelity bond requirement and note how the benefits world has changed since 1962, when today's fidelity bond requirement was first enacted by Congress, and since ERISA's enactment in 1974; the second section will suggest factual questions that Council should attempt to answer, without which it will be difficult to know whether the current law provides net value to plans, plan sponsors and their participants; and the third section will suggest some possible areas in which the fidelity bond requirement and related regulatory provisions might be modified or elaborated on to better address the problems plans and their participants face in today's world.

I. Historical Context and Our Post-ERISA World

The fidelity bond requirement under ERISA is actually a pre-ERISA requirement for employee benefit plans, initially enacted in 1962 as part of the amendments to the Welfare and Pension Plan Disclosure Act ("WPPDA"). Regulations were issued almost immediately after the 1962 statutory amendments. In 1974, when Congress enacted ERISA and repealed the WPPDA, it carried forward, without meaningful change in language, the fidelity bond provisions, switching it from Section 13 of the WPPDA to Section 412 of ERISA. Certain ERISA concepts—such as the idea of plan assets—might have had an indirect effect on the meaning of some of the fidelity bond statutory requirements, but the bond requirement in ERISA used the same language that Congress had written a dozen years earlier, in 1962. And the provisions made a lot of sense in 1962, when first enacted, when there was little direct regulation of employee benefit plans and acts of dishonesty by plan officials would not necessarily be remediated by the employer or plan fiduciaries—itself an ERISA rather than a WPPDA concept.

The Department of Labor, in 1975, issued temporary regulations under section 412, adopting virtually verbatim, the regulations issued under the WPPDA in 1962, and in 1985 adopted a final rule that only modestly changed the original WPPDA regulations. Congress made minor changes to the statute in 2006, adding an exemption for broker-dealers and increasing the maximum limit on fidelity bonds in cases of plans holding employer stock. (And plans wishing to use the small plan audit provisions must purchase fidelity bonds equal to the value of certain non-qualified assets.)

Much has changed in employer benefits since the amendments to the WPPDA in 1962 and enactment of ERISA in 1974. We have moved from a world in which defined benefit plans were the most common type of retirement arrangement and where the orthodox structure of defined contribution plans were pooled investments. We have seen the evolution and growth of plans holding securities of the employer. We have seem the amount of average plan assets grow exponentially. We have seen the advent of 401(k) plans and self-directed investments. We have also seen the creation of the concept of the ERISA fiduciary, who has responsibilities to select and monitor those people and entities who have access to plan assets and who have fiscal responsibility when they fail to exercise their fiduciary duties with adequate prudence and honesty. We have seen dramatically increased reliance by plans on third-party service providers.

We have also seen a shift of primary concern in employee benefit regulation from preventing outright theft, fraud and dishonesty in the physical handling of plan assets—a major concern in the WPPDA era—to issues such as cyber-security, misrepresentation in participant disclosures, high investment and administrative costs, administrative lapses and conflicts of interest by service providers and investment advisors, and in the small plan area, failure of employers to timely remit payroll deduction contributions. Outright theft and fraud are, of course, still issues, but instances of them are relatively rare and their significance has been eclipsed by the other issues I mentioned.

Section 412, although amended in minor ways since enactment of ERISA, appears almost quaint in today's world, particularly given the statutory limit on the size of required bonds. A fundamental question is whether fidelity bonds are still an important component of the employee benefit landscape.

II. Factual Questions that Council Should Answer Pertaining to ERISA Fidelity Bonds

1. How often are claims made by plan against the issuers of fidelity bonds? How many of these come from large plans and how many from small plans?

2. How often are such claims contested by issuers and how often are bond amounts paid to plans?

3. What are the premiums for fidelity bonds for small plans? For large plans? Who actually pays them?

4. Do we have information on levels of compliance with section 412, particularly in the small plan area? Are there regulatory burdens beyond cost associated with fidelity bonds beyond cost?

5. Does the PBGC ever file claims against fidelity bonds and if so, how often?

6. What are aggregate annual premiums for fidelity bonds and what are aggregate annual payouts from such bonds?

7. How often do plans purchase comprehensive fidelity bonds for all internal plan actors? Do plans purchase bonds in excess of the statutory required maximums?

8. How successful are issuers of fidelity bonds in recovering payments on bonds from wrongdoers?

9. How often are claims against fidelity bonds denied because not discovered within the discovery period, typically one year?

10. When claims against bonds are paid, how often do the plan losses exceed the recovery and by how much?

III. Particular Issues Regarding Section 412

1. Does the net benefit of fidelity bonds justify their cost? Would a centralized federal program, perhaps run by the PBGC, be a more cost-efficient alternative for plans?

2. Should payroll deductions for contributions to 401(k) plans (and other employee contributions) be covered by fidelity bonds before they become plan assets? This is an important issue for small employers, but it does raises difficult questions for fidelity bonds—how much would premiums increase, and how much more burdensome would application protocols need to be, to cover such losses? But such failures to transmit contributions are certainly in the zone of interests that fidelity bonds are intended to protect and they do result in benefit losses.

3. The maximum bond amounts--$500,000 for most plans (increased to $1,000,000 for plans that carry employer stock in 2006) but no more than 10% of a plan's assets—was established in 1962. The Secretary has authority to require larger bonds after a hearing and due notice. It is not clear from the regulations whether this authority is limited to an action initiated against a particular plan or whether the Secretary may, through regulation, increase

the maximum for all plans. (It is not clear how often, if ever, the Secretary has used this authority against particular plans.) In any event, the current maximums are small given the holdings today of even small plans and almost certainly should be expanded if the fidelity bond requirement is to remain in the statute. It is also questionable whether the 10% limit makes sense in relatively small plans, where a person—for example the owner of the business—might have access to more than 10% of a plan's assets.

4. It is not clear what types of behavior in plans holding employer securities trigger fidelity liability, and in particular, what constitute handling plan assets in the case of plans holding substantial amounts of employer securities. Are the actions of corporate employees to loot a company, or to misrepresent the value of employer stock, actions involving the handling of plan assets and thus subject to fidelity bonds? Without answers to these questions, it is difficult to analyze whether having an increased maximum for the required bond in the case of plans holding employer stock is sensible.

5. Should appraisers of employer stock or other assets requiring appraisal be required to carry fidelity bonds?

6. Are kickbacks from third parties to plan officials covered by fidelity bonds and if so, is the loss the kickback or the total loss to the plan (in terms, for example, of payment of excessive fees)?

7. Should plan sponsors be able to self-insure if the employer meets certain credit and solvency requirements?

8. Current bonds typically provide for a one-year discovery of loss provision after the term of the bond expires. Should this period be extended beyond one year?

9. Courts have disagreed about whether participants may sue to enforce a fidelity bond. Should participants or fiduciaries be able to bring such actions and to intervene in suits brought by the plan?

10. What is the interplay between ERISA fiduciary standards and the fidelity bond requirement? Can it be imprudent for a plan to limit fidelity bond coverage to the statutory maximum? Does prudence sometimes require a plan to purchase, or require a plan official or service provider to purchase, fidelity bonds whose coverage goes beyond loss caused by the dishonesty of a person who handles plan assets (for example, breaches in electronic security)? What would ERISA's fiduciary standards require in the way of bonding and insurance if the express fidelity bond provisions were repealed? Would repeal and guidance as to the fiduciary rules lead to the creation of new products that provide more meaningful protections in today's benefits landscape?

CONCLUSION

Section 414 of ERISA reflects concerns in 1962 that outright theft and dishonesty was one of the major issues plaguing employee benefit plans. The $500,000 limit on such bonds were in 1962 substantial and for small plans would likely be large enough to cover most covered plan losses. Today's benefit world differs: the problems are different and plan accumulations have grown geometrically. A threshold question is whether the aggregate costs of fidelity bonds justify their benefits to the system. It seems conceivable that statutory fidelity bonds, by adding cost and some administrative friction to the maintenance of employee benefits, discourage plan sponsorship at the margins and unnecessarily increase plan costs. If this is so, then the Advisory Council might consider enlarging the scope of fidelity bond coverage or updating the statutory maximums, would add benefit to the system, or alternatively, whether the costs of fidelity bonds can be reduced by, for example, permitting in appropriate circumstances self-insurance by the plan sponsor or by allowing the PBGC or some sort of plan coops to cover losses. Finally, the Council may want to consider whether eliminating section 414 from ERISA and relying on the fiduciary rules to govern whether a plan should purchase a fidelity-type bond, and if so, the amount of the bond and the scope of the risks covered by the bond.