2018 Advisory Council on Employee Welfare and Pension Benefit Plans Evaluating the Department's Regulations and Guidance on ERISA Bonding Requirements and Exploring Reform Considerations

Written Testimony
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The Surety & Fidelity Association of America ("SFAA") is a non-profit corporation whose member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is a licensed rating or advisory organization in all states and is designated by state insurance departments as a statistical agent for the reporting of premium and loss statistics for fidelity and surety bonds. As part of its role as an advisory organization, SFAA drafts standard fidelity bond forms that protect businesses and financial institutions against loss caused by employee dishonesty. SFAA files these forms with state insurance regulators, and our members are free to adopt them. We appreciate the opportunity to provide comments regarding the Issue Statement by the 2018 Advisory Council on Employee Welfare and Pension Benefit Plans: "Evaluating the Department's Regulations and Guidance on ERISA Bonding Requirements and Exploring Reform Considerations".

General Comments

Before addressing the specific inquiries set forth in the Issue Statement, we provide a few general points that the Council should consider when making any recommendations to the Department of Labor regarding the bond requirement established by Section 412 of ERISA.

The effect of scope of coverage changes in a fidelity bond

Section 412 does not dictate the form of bond that must be provided and does not explicitly mandate a fidelity bond. However, the statute[1] and regulations[2] suggest that blanket fidelity bonds are acceptable. A fidelity bond is a form of insurance. Insurance can be underwritten and priced reasonably when the parameters of the risk are established clearly and specifically in the policy form. This is why insurance policies typically have definitions and conditions – to delineate the risk. Key terms must be defined and risks that were not contemplated must be excluded. Otherwise, the insurer may be assuming risks and exposures for which it has not underwritten and priced.

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[1] 29 U.S.C. § 1112
[2] 29 C.F.R. §§ 2580.412-1 through 2580.412-36

To illustrate, prior to 1976, fidelity bonds typically covered losses caused by "dishonesty" – an undefined term. After 1976, industry forms were amended to define dishonesty to be an act by the employee with the manifest intent to cause the insured a loss. The primary reason the "manifest intent" language was introduced to the market was that courts were interpreting dishonesty quite broadly to include even an employee's negligence or laziness. An insurer's underwriting and pricing under a fidelity bond with the "manifest intent" definition of dishonesty contemplates that the exposure is the loss of money or property directly attributable to a dishonest scheme by an employee. Thus, the insurer underwrites the soundness of the insured's internal controls to thwart embezzlement or theft schemes. If an insurer provides coverage for a risk which is undefined, the insurer assumes a risk that cannot be quantified or priced. Of course, coverage could be written such that there are no clear markers of the risk. Because underwriting for such "all fraud" coverage would be difficult, coverage would be either unavailable or very expensive.

The inquiries set forth in the Issue Statement involve the scope of coverage, with respect to the perils insured against, the covered property, the covered plan officials and the amount of coverage. Broadening the scope of coverage is possible. However, the revised coverage still must be subject to definite parameters in the policy. Otherwise the coverage becomes less available or more expensive.

State insurance regulation

The McCarran-Ferguson Act established states as the primary regulators of insurance. As a type of insurance, the fidelity line of business is subject to state insurance regulation. Such regulation includes the requirement that revised or new fidelity forms be filed with the state insurance department for review and approval. Advisory organizations such as SFAA and individual companies must seek this approval from the states of the revised forms. Therefore, if any revisions to guidance or regulation necessitate amendments to fidelity forms, the Council should be aware that such amendments require many months to implement.

<u>Specific Responses</u>

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?

In 2015, SFAA learned that the Department of Labor Employee Benefit Security Administration ("EBSA") Regional Offices, particularly the New York Regional Office, objected to standard fidelity bond language, opining that such language did not comply with section 412 of ERISA or with 29 CFR 2580.412-9. Such objections took the form of audit letters to plan sponsors and administrators related to bond forms issued by insurers. With respect to SFAA forms, EBSA objected to the language in the employee dishonesty insuring agreement. Insuring Agreement 1 in SFAA's Crime Protection Policy states:

> We will pay for loss resulting directly from dishonest acts committed by an **employee**, whether identified or not, acting alone or in collusion with other persons, with the manifest intent to:
>
> a. Cause you to sustain loss; and
>
> b. Obtain an improper financial benefit for:
>
> (1) The **employee**; or
>
> (2) Any person or organization intended by the **employee** to receive that benefit.

The New York Regional Office opined that such language violated the coverage requirements to bond against "fraud or dishonesty" set forth in section 412 of ERISA because the language requires manifest intent by the employee to cause a loss and obtain a financial benefit for someone.

SFAA engaged in discussions with EBSA regarding the employee dishonesty insuring agreement. SFAA amended the coverage with respect to welfare and benefit plans so that the insuring agreement covers loss caused by "fraud or dishonesty". Because key terms in an insurance policy should be defined, SFAA defined "fraud or dishonesty" consistent with the description of "fraud or dishonesty" set forth in 29 CFR 2580.412-9. Further, because the bond required under section 412 is not intended to cover loss caused by negligent acts, the revised language includes an exclusion for negligence. The New York Regional Office has advised SFAA that the revised language addresses EBSA's concerns.

The revised SFAA forms have been filed in all jurisdictions and are available for use in all states except Hawaii. (The filing in Hawaii is still pending.) Therefore, forms are available to SFAA members, which EBSA has advised are consistent with section 412 and cover loss caused by "fraud or dishonesty". We understand insurers and other advisory organizations also have drafted forms that cover fraud or dishonesty consistent with section 412.

We note that the question refers to coverage for "any" act of fraud and dishonesty. This language differs from the language in section 412, which requires bonding "against loss by reason of acts of fraud or dishonesty". Considering that forms are currently available in the market that protect against loss caused by fraud or dishonesty, is the Advisory Council contemplating a broader scope of coverage by adding the qualifier "any" in reference to fraud and dishonesty?

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

As an initial matter, section 412 does not require that the plan obtain a single fidelity bond covering the acts of all plan officials who handle plan funds or other property. The section 412 bond requirement is expressed in terms of making it unlawful for any plan official to handle funds "without being bonded". The statute does not reference explicitly a fidelity bond and it does not require a single bond cover all handlers. In fact, a fiduciary is not required to purchase

all the fidelity policies covering all handlers. The fiduciary simply must ensure that all plan officials and service providers handling funds or property are bonded in some way. As stated in EBSA guidance, "A [third party] service provider can purchase its own separate bond insuring the plan, and nothing in ERISA specifically requires the plan to pay for that bond." Field Assistance Bulletin 2008-04, Response to Q.10. It is common that service providers obtain their own fidelity coverage and name the plans for which it provides services as named insureds. These proprietary policies offered by insurance companies are available in the market.

SFAA does not have data to show to what extent single fidelity policies obtained by the plan are covering loss caused by the acts by <u>all</u> handlers.

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 and dishonesty?

SFAA does not have data that shows the amount of losses in excess of amounts paid under bonds or policies that would have been covered but for the fact the limit of liability was insufficient. Although we can conceive that certain losses might exceed the current minimum liability limits required by ERISA, we are not aware of instances in which an otherwise covered loss was not covered because the policy limits were not sufficient.

If the Council is contemplating losses that were not covered by the fidelity bond because the nature of the loss was beyond the scope of coverage, we are not aware of any examples or anecdotes.

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?

29 CFR §2580.412-5 provides that money becomes funds of the plan when it is transferred to an independent administrator or when it is placed in a segregated account. Merely withholding funds from employees without a transfer or segregation does not make the funds plan assets. From a fidelity bond underwriting perspective, the regulation's treatment of when funds become plan assets allow for reasonable underwriting. A fidelity bond covers loss incurred by the insured caused by employee dishonesty. An insurer underwrites this risk by assessing the internal controls to prevent the loss. By expanding the meaning of "funds or other property of the Plan" to include funds or assets to which the insured plan is merely entitled, the insured plan may have no ability to mitigate loss of such funds or assets.

Fidelity forms available in the market currently require that a covered loss is one that is incurred directly by the insured. In addition, under SFAA's Crime Protection Policy (CPP), the property involved in the loss must be property:

> a. That you [the insured] own or hold; or
> b. That is owned and held by someone else under circumstances that made you responsible for the property prior to, and independent of, the loss.

A scope of coverage that extends to funds to which the insured is entitled, may not be consistent with the CPP's condition.

We acknowledge that there may be an exposure to theft of funds that have not yet been transferred to the plan or an independent administrator. We submit that there may be other policies that more appropriately address this exposure, such as the fidelity policy on which the insured is the employer (and not the plan).

Should the Department's current guidance and reporting requirements be modified to clarify (and to 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?

SFAA supports any additional guidance or education for plan officials and regulators that would improve the understanding and awareness of the various types of policies available in the market and the coverages that they provide.

Conclusion

As noted above, the questions in the Issue Statement suggest that the Council's evaluation is with a view toward expanding the scope of the fidelity bond required under section 412. Rather than identifying all the exposures faced by a plan and then mandating the section 412 fidelity bond to cover these exposures, we propose that the Council and the Department of Labor take a different approach. We suggest that, after a comprehensive review to identify the exposures faced by welfare and benefit plans, the Council should identify the policies available in the market that most appropriately address each of these exposures (e.g. cybercrime, fiduciary liability, fidelity). Any regulatory action recommended by the Council should involve the requirement of the right coverage for the right exposure, rather than simply forcing exposures that were not contemplated under a fidelity bond to be covered by a fidelity bond. We suggest that the Council and the Department of Labor should consider the requirement of other types of policies in addition to the fidelity bond.