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By E-Mail: garys@naplia.com &
U.S. Mail

Gary Sutherland
Chief Executive Officer
North American Professional Liability Insurance Agency, LLC
5 Whittier Street, 4th Floor
Framingham, MA 01701

RE: Employee Benefit Plan Bonding Questions

Dear Gary:

You have asked for a description of the persons who must be bonded pursuant to Section 412 of ERISA. We understand that NAPLIA believes that a benefits plan advisor should be bonded if, as discussed below, he or she has the authority to direct payment of his fee from the plan. Our discussion of this issue follows.

Handling Plan Funds.

ERISA Section 412(a), the statutory provision that imposes the bonding requirement, applies to "every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan." The concept of "handling" is central to defining the group, referred to as "plan officials," that must be bonded. It would appear that the term, "handles," as used in the statute, modifies and limits both the fiduciaries and other persons that must be bonded. Thus, the Department of Labor (DOL) has clarified that plan fiduciaries must be bonded only if they "handle" funds or other property of the plan and do not fall within one of the exceptions to Section 412.[1] Accordingly, a person who renders investment advice to a plan in a fiduciary capacity, but does not exercise and does not have the right to exercise discretionary authority with respect to purchasing or selling securities is not required to be bonded unless that person is acting in some other capacity that constitutes "handling" plan funds.[2]

It should be noted that ERISA's bonding requirements apply to natural persons. Thus, where a plan administrator, service provider or other plan official is an entity (e.g. a corporation, or a committee), it is the natural persons who perform the "handling" functions on behalf of the entity that must be bonded.[3]

[1] Field Assistance Bulletin 2008-4, Q-7.
[2] Field Assistance Bulletin 2008-4, Q-9.
[3] Field Assistance Bulletin 2008-4, Q-5, Q-19 & Q-20.

Under DOL regulations, the touchstone for determining whether a person is handling plan funds or property is whether the person's duties and activities are such that there is a "risk" that plan funds or other property could be lost in the event of fraud or dishonesty by the person to be bonded.[4] Thus, those persons charged with the duty of receipt, safekeeping or disbursement of plan funds will generally be deemed to be "handling" funds and must be bonded.

While physical contact with plan assets is important, the term, "handling" has a broader meaning so that physical contact is not the ultimate determining factor. Thus, persons who may have physical contact with plan funds or property will not be viewed as "handling" the funds and/or property if the risk of loss is negligible, as would be the case where a clerk comes into possession of checks, securities or title papers without the power to negotiate such instruments.[5] In addition, where physical contact is subject to close supervision and control, the following clerical functions, and functions like them, would not be deemed to be "handling": (i) counting, (ii) packaging, (iii) tabulating, and (iv) messenger duties.[6] On the other hand, with respect to certain types of property, i.e., cash and checks, the power to exercise physical contact or control constitutes "handling" whether or not physical contact actually takes place. The latter is illustrated by access to a safe deposit box or similar depository, access to cash or negotiable assets, powers of custody, and the power to withdraw funds from a bank or other account.[7]

In addition to physical contact or the power to exercise physical contact, the power to transfer funds or other property to oneself or to a third party is an indicator that there is "handling". This criterion is primarily applicable to mortgages, and titles to land, buildings and securities. If a person can cause such property to be transferred to himself or herself, whether through actual or apparent authority, he or she must be bonded.[8]

Other criteria that may result in a determination that "handling" exists are (i) disbursement authority or the authority to direct disbursement, (ii) authority to sign checks or other negotiable instruments, and (iii) supervisory or decision making responsibility over activities that require bonding. It is important to remember that each of these items is subject to the basic standard that risk of loss to the plan resulting from the dishonesty or fraud of the authorized person or supervisor must be present. Thus, in the case of a person with general responsibility for the business affairs of the plan, whether that person is "handling" funds or property must be determined, case by case, based on such factors as (i) the system of controls, (ii) the closeness and

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[4] ERISA Regulation Section 2580.412-(6)(a)(1).
[5] ERISA Regulation Section 2580.412-(6)(a)(2); Field Assistance Bulletin 2008-4, Q-18.
[6] ERISA Regulation Section 2580.412-(6)(b)(1).
[7] ERISA Regulation Section 2580.412-(6)(b)(2).
[8] ERISA Regulation Section 2580.412-(6)(b)(3).

continuity of supervision and (iii) who is in fact charged with responsibility for determining whether specific disbursements, investments, contracts or benefit claims are bona fide and made in accordance with the applicable plan and trust documents.[9]

In accordance with the preceding discussion, a supervisor would be "handling" funds to the extent that (i) he or she acts as plan administrator with ultimate responsibility for the plan, (ii) exercises close supervision of corporate trustees responsible for dealing with plan funds, (iii) conducts daily audits of the person "handling" plan funds, or (iv) has veto power over and regularly reviews the actions of a disbursing official. On the other hand, a supervisor would not be "handling" merely because the supervisor (i) conducts periodic audits, (ii) has an essentially advisory role, (iii) has the general power to delegate authority in favor of an officer who possesses the final responsibility for specific expenditures, or (iv) hold a role similar to that of a board of directors.[10]

In addition, if a bank or corporate trustee performs all the day-to-day functions of plan administration, a plan supervisor will not be deemed to be "handling" plan funds. On the other hand, the DOL takes the position that if a plan committee has the final authority to direct a corporate trustee whether to pay benefits, such power constitutes "handling" and requires each member of the committee to be bonded. Similarly, if a committee has the power to make investment decisions that are not subject to someone else's approval (as distinguished from the mere power to make investment recommendations), the committee members must be bonded.

Funds or Other Property.

The bonding requirement applies when a person "handles" plan "funds or other property". This term refers to all funds or property that a plan uses or may use as a source of benefits to plan participant or beneficiaries, including contributions from employers, employees and employee organizations. Generally, this status attaches at the time the funds or other property are received by the plan administrator.[11] However, there is a special rule for employee contributions when the employer itself is the plan administrator. In this case, withholding from employee salaries will not be "funds or other property" of the plan until they are segregated from the employer's general assets.[12] Segregation occurs if funds are (i) placed in a special bank account or investment account, (ii) identified on a separate set of books or records, (iii) paid over to a corporate trustee or (iv) used to purchase benefits from an insurance carrier or other organization. In the latter case, the "funds or other property" would be represented by the insurance contract.[13]

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[9] ERISA Regulation Section 2580.412-(6)(b)(6).
[10] Id.
[11] ERISA Regulation Section 2580.412-(5)(a).
[12] ERISA Regulation Section 2580.412-(5)(b)(1).
[13] ERISA Regulation Section 2580.412-(5)(b)(2).

Plan "funds or other property" include cash, checks, and other negotiable instruments, government obligations, marketable securities and all other property that may be converted into cash. Also included are land and buildings, mortgages, and securities in closely-held corporations. The key issue is whether these items are held or acquired for the ultimate purpose of distribution to plan participants or beneficiaries.[14] It should be noted, however, that "funds or other property" does not include operational assets that may be used by the plan, like furniture or equipment.

There are certain exceptions to the bonding requirements that are related to definition of plan funds. Thus, benefit plans that are completely unfunded are exempt from the bonding requirement. For purposes of this exemption, an unfunded plan is one that pays benefits only from the general assets of the employer. The assets used to pay benefits may not be segregated in any way from the employer's general assets until they are distributed, although special ledger accounts or accounting entries that are an integral part of the general books and ledgers of the employer will not be treated as segregation and will not cause the exemption to be lost. On the other hand, a plan will not be treated as unfunded, and, therefore, will not be exempt from the bonding requirement if: (i) any benefits are provided or underwritten by an insurer, (ii) there is a trust to which contributions are made, (iii) contributions to the plan are made by employees, or (iv) there is a separately maintained bank account or separately maintained books and records for the plan or other evidence of a segregated fund.[15]

Exceptions.

Section 412 of ERISA also provides exceptions from the bonding requirement for the following:

• An entity which is registered as a broker or a dealer under Section 15(b) of the Securities Act of 1934, provided that the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization within the meaning of the 1934 Act;[16] and

• Any fiduciary (or any director, officer or employee of such fiduciary) that is a bank with trustee powers or an insurance company and which is (i) organized and doing business under state or federal law, (ii) subject to state or federal supervision or examination and (iii) meets certain capitalization requirements.[17]

There are also several regulatory exemptions from the bonding requirement. These include an exemption for banks and trust companies that are subject to regulation and

[14] Field Assistance Bulletin 2008-4, Q-17.
[15] Field Assistance Bulletin 2008-4, Q-13.
[16] ERISA Section 412(a)(2).
[17] ERISA Section 412(a)(3). Under the statute, the bank or insurance company must have combined capital and surplus of at least $1,000,000 or such minimum amount that may be established by, as yet unissued, regulations.

examination by the Comptroller of the Currency, the Board of Governors of the Federal Reserve or the Federal Deposit Insurance Corporation.[18] Regulations also exempt any insurance carrier that provides or underwrites welfare or pension benefits in accordance with state law.[19] In contrast to the statutory exemption for banks and insurance companies, these exemptions apply regardless of whether the institution is a plan fiduciary. Finally, there is an exemption for savings and loan associations when they are administrators of plans for the benefit of their own employees.[20]

Conclusions.

We understand that NAPLIA has taken the position that a plan advisor must be bonded if he or she has the ability to be paid directly by plan funds. NAPLIA believes that this gives the advisor discretionary authority over plan assets, as distinguished from situations where the advisor submits a quarterly invoice or payment of the advisor's fee is otherwise subject to the approval of a third party.

We conclude, like NAPLIA, that bonding is required where an advisor has the authority to direct the plan trustee to pay the advisor's fee. A potential source for this authority is that such payments are hardwired into the plan document. Alternatively, the plan's named fiduciary could have issued a directive to the trustee that the advisor's invoices are to be paid on presentation. (We note that the DOL takes the position that a determination whether to pay a particular expense out of plan assets is a fiduciary act.[21])

As noted above, on the issue of handling, the primary standard to determine whether a person should be bonded is whether plan funds could be lost as a result of that person's dishonesty. Subject to this standard, the regulations indicate that the necessary handling of plan assets occurs if the person has the power to transfer funds or other property from the plan to himself or a third party. This could happen through actual or apparent authority. If the advisor has unlimited discretion to direct payments to himself from the plan, then the plan is clearly exposed to the risk that the advisor could act dishonestly and bonding is necessary. On the other hand, to the extent that there are financial controls or supervision of such payments, the risk of loss might be reduced to a level where bonding might not be required.[22] Thus, while we think that it is likely that bonding of NAPLIA advisors would be required, the ultimate answer depends on an evaluation of the controls and their impact on the level of risk. However, unless there has been a formal assessment that this risk is minimal, the prudent course would be compliance with the bonding requirement.

[18] ERISA Regulation Section 2580.412-27 & -28.
[19] ERISA Regulation Section 2580.412-31 & -32. The insurance company exemption does not apply to plans benefitting the insurance company's own employees.
[20] ERISA Regulation Section 2580.412-29 and -30.
[21] DOL Advisory Opinions 2001-01A and 97-03A.
[22] Field Assistance Bulletin No. 2008-4 , Q-13.

I trust that this discussion has been responsive to your concerns. Please do not hesitate to call or email if you have questions or would like to discuss these matters.

Best wishes.

Sincerely,

Marcia S. Wagner