SULLIVAN & WORCESTER

Sullivan & Worcester LLP
One Post Office Square
Boston, MA 02109

T 617 338 2800
F 617 338 2880
www.sandw.com

November 9, 2016

Mr. Mark S. Liftman, President
Theodore Liftman Insurance, Inc.
101 Federal Street
Boston, Massachusetts 02110-1827

Re: Bonding Requirements for ERISA Plans

Dear Mark:

This letter discusses the situations in which Section 412 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), requires fraud or dishonesty bonds.

The bonding requirements of Section 412(a) generally apply to a fiduciary of plans covered by ERISA and apply also to a non-fiduciary who "handles" plan assets. A failure to have the necessary coverage results in a violation of ERISA.

A person is subject to the bonding requirements if he or she has the right or power to exercise discretionary authority over purchases and sales of plan assets or has discretionary authority in the administration of the plan. Thus, a plan administrator will be subject to these requirements. (If the plan administrator is an entity, the bond is required with respect to natural persons who perform the necessary "handling" functions.) Additionally, each investment advisor who has discretionary authority with respect to purchasing or selling plan assets will be subject to the requirements. The bonding requirement may also apply to a person who provides investment management services with respect to a brokerage account of an ERISA plan participant. In other words, several persons may need to be covered with respect to a single plan.

Bonding is required regardless of whether the fiduciary has custody of or otherwise actually handles assets of the plan, because the bonding rules apply to all plan fiduciaries who have these rights or powers (other than certain trust and insurance companies, banks and registered broker-dealers) if there is a risk that funds or property of the plan could be lost as a result of fraud or dishonesty. Moreover, in the view of the Department of Labor, one or more fiduciaries may be responsible for ensuring that the bonding rules are satisfied. A statement that the plan has the required level of coverage is part of the annual Form 5500 filing of certain plans, and evidence of appropriate coverage is a routine request in Department of Labor plan audits.

The amount of the required bond is generally the greater of $1,000 or 10% of the amount involved that constitutes assets of an "employee benefit plan" governed by Title I, Subtitle B, Part 4 of ERISA and valued as of the beginning of the fiscal year of the employee benefit plan. The amount of the bond need not exceed $500,000. No deductible can be applied with respect to

the mandatory coverage, although a deductible is permitted with respect to coverage that exceeds the statutory mandate.

However, if the plan holds "employer securities," the $500,000 cap in the preceding paragraph is increased to $1,000,000. This applies regardless of the extent of the plan's holding of such securities or which fiduciary (or non-fiduciary who handles plan assets) actually holds the securities and whether the securities are publicly or privately held. Employer securities are equity or debt issued by an employer of employees participating in the plan, or by an affiliate of such employer. The term does not, however, include broadly diversified funds like mutual or index funds that happen to hold also some securities of the employer.

The amount of the bond must be set as of the beginning of the fiscal year for the employee benefit plan; thus, if assets handled by a person increase during the year, or a plan first acquires employer securities mid-year, coverage will not need to be increased until the beginning of the next plan fiscal year.

Plans with fewer than 100 participants (up to 120 participants in certain situations) that choose not to include an independent audit with their annual report may be required to have a bond in an amount greater than the limits set forth in earlier paragraphs. Specifically, if such a plan invests more than 5% of its assets in assets that are not "qualifying plan assets," and the plan does not want to be required to have an independent audit, the plan must maintain a bond in the amount of 10% of the amount of assets involved (subject to the $500,000 or $1,000,000, as applicable, caps discussed earlier) or 100% of the amount of assets not invested in qualifying plan assets, whichever is greater. Qualifying plan assets include the following: employer securities; plan loans to participants; assets held by banks, insurance companies, broker-dealers or other organizations authorized to act as trustee for IRAs; mutual funds; investment and annuity contracts issued by an insurance company; and, for an individual account plan, assets in the participant's individual account over which the participant exercises control and with respect to which the participant gets a statement at least once a year from the institution holding the funds.

In determining who must be covered, the Department of Labor is of the view that generally each member of a committee serving as the plan administrator or making investment decisions for the plan must have the required coverage, up to the applicable limit. The Department's guidance, however, is not always as clear as it could be and so questions may arise as to whom exactly is "handling" plan assets and whether coverage is required. At a minimum, however, each person serving as a fiduciary, including a fiduciary under ERISA § 3(21) and an investment manager under ERISA § 3(38), must have the required coverage, or satisfy the requirements for an exemption from coverage. Moreover, the fact that assets of more than one plan may be pooled for investment purposes (through a Rev. Rul. 81-100 group trust for example), does not mean that each plan can avoid the necessary coverage requirements.

Employee benefit plans governed by Title I, Subtitle B, Part 4 of ERISA generally include all plans of the types in List 1 below ("Types of Plans Included") and exclude all plans of the types in List 2 below ("Types of Plan Excluded"). Nevertheless, a particular plan of a type in List 1 may be excluded if it does not benefit anyone who is an "employee," as described below immediately following List 2.

List 1 – Types of Plans Included

Fiduciaries (or nonfiduciaries handling plan assets) of the following types of plans generally are required to be bonded –

- Retirement plans exempt from federal income tax under Sections 401(a) and 501(a) of the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code"), including defined benefit pension plans, money purchase pension plans, profit sharing plans, so-called Section 401(k) plans, stock bonus plans, employee stock ownership plans ("ESOPs") and so-called Keogh or H.R. 10 plans that have employee participants

- Employer-sponsored welfare plan trust funds exempt from federal income tax under Internal Revenue Code Section 501(c)(9) ("VEBAs")

- Employer-sponsored Simplified Employee Pension ("SEP") plans under Internal Revenue Code Section 408(k), or group individual retirement accounts or annuities ("IRAs") under Internal Revenue Code Section 408(c) that are sponsored by an employer or an employee association[1]

- SIMPLE IRAs under Internal Revenue Code Section 408(p)[1] or SIMPLE 401(k) arrangements under Internal Revenue Code Section 401(k)(11)

- Union-sponsored plans of the types listed above

- Employer-sponsored deferred compensation plans not qualified for federal income tax exemption, including so-called "secular" trusts, Internal Revenue Code Section 402(b) trusts and funded excess benefit plans

- Pension trusts that are established under Internal Revenue Code Section 501(c)(18) before June 25, 1959 as part of a plan providing for payment of pension benefits funded only by contributions of the employees

[1] The arrangement may, however, be structured in a way that any person "handling" funds will typically satisfy another bonding exemption.

- Annuity arrangements or custodial accounts established under Internal Revenue Code Section 403(b) that are employee benefit plans subject to ERISA either because the employer contributes to the program or because the employer has more than limited involvement in administration of the program

- Church plans (maintained by tax-exempt churches, church associations or church conventions) that elect to be subject to ERISA

<u>List 2</u> – <u>Types of Plans Excluded</u>

Fiduciaries of the following types of plans generally are <u>not</u> required to be bonded –

- Traditional and Roth IRAs not related to a SEP, a SIMPLE plan or a group IRA sponsored by an employer or an employee association

- Employer (for profit or tax-exempt) sponsored deferred compensation plans for select groups of management or highly compensated employees that pay benefits solely from the general assets of the employer (so-called "top hat" plans)

- "Rabbi" trusts, which hold the assets of top hat plans

- Plans established under Internal Revenue Code Section 457 that provide deferred compensation arrangements for employees of federal, state or local governments

- Certain other governmental plans (plans to which the Railroad Retirement Act applies) or plans maintained by certain tax-exempt international organizations

- Annuity arrangements or custodial accounts established under Internal Revenue Code Section 403(b) and not otherwise subject to ERISA because they provide only for voluntary employee salary reduction contributions and the employer's role in administering the program is limited

- Church plans that have not elected to be subject to ERISA

- Plans maintained outside the United States primarily for nonresident aliens

- Unfunded excess benefit plans

- Unfunded welfare plans to which no employee contributes (or to which employees contribute pursuant to an Internal Revenue Code Section 125 plan if the arrangement otherwise meets the reporting and trust exemption requirements of applicable Department Labor guidance)

- Plans maintained solely to comply with workers' compensation laws, unemployment compensation laws or disability insurance laws

- Plans that do not benefit "employees" (as described in the following paragraph)

Particular plans of the types in List 1 are not subject to ERISA and are therefore not subject to the bonding requirements, if all of the participants and beneficiaries are in the following categories –

- 100% owner of the sponsoring corporation, limited liability company or unincorporated sole proprietorship

- The spouse of a 100% owner of the sponsoring corporation, limited liability company or unincorporated sole proprietorship

- Either or both spouses if together they own 100% of the sponsoring corporation

- A partner of the sponsoring partnership

- The spouse of a partner of the sponsoring partnership

If, however, one or more common law employees participate in the arrangement, the bonding requirements apply.

Of course, an investment advisor should observe the ERISA bonding requirements not only for its client plans but also for any in-house plan it maintains for its own employees.

Application of Bonding Requirements to Hedge Funds and Other Investment Vehicles.

Private equity investments by "benefit plan investors" are subject to Department of Labor regulations that impose ERISA fiduciary and prohibited transaction consequences with respect to the assets of an entity, such as a hedge fund, if benefit plan investors own 25% or more of any class of equity interests of the entity and the entity is not an operating company, a venture capital operating company ("VCOC") or a real estate operating company ("REOC"), each as defined in the Department Labor regulations, or the entity is not a publicly held company or a registered investment company (a mutual fund). The term benefit plan investor for this purpose excludes foreign, governmental and church plans. The managers of an entity treated as holding plan assets are ERISA fiduciaries subject to the bonding requirement.

An entity not otherwise exempted will be deemed to hold ERISA plan assets only to the extent benefit plan investors are invested in the entity. Thus, if assets of an investment fund are owned 30% by plans subject to ERISA, only 30% of that fund's investment in a second fund would be counted toward the 25% limit for the second fund.

Of course the investing plan in a fund that is not treated as holding plan assets (for whatever reason) are still subject to the bonding requirements.

Scope of Letter

This letter is intended to provide a general overview of the bonding requirements under ERISA for persons or companies providing investment advice to client plans covered by ERISA for a fee or other remuneration. Because sound legal advice must necessarily take into account all relevant facts and circumstances and developments in the law, the information you will find in this letter is not intended to constitute legal advice or a legal opinion as to any particular matter.

Very truly yours,

David A. Guadagnoli

© Sullivan & Worcester LLP