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Re: ERISA Bonding Requirements

Jon:

Section 412 of the Employee Retirement Income Security Act ("ERISA") requires bonding of the persons "handling" the funds within employee benefit plans. Failure to maintain proper bonding is considered a violation of ERISA. This letter summarizes Section 412 and explains which parties must be bonded, required bonding amounts, and the types of plans subject to Section 412.

The bonding requirements under Section 412 are intended to protect employee benefit plan participants from risk of loss due to fraud or dishonesty (e.g., larceny, theft, embezzlement, forgery, misappropriation). Every fiduciary and person who handles funds or other property within said plan must be bonded. These parties are referred to as "plan officials" under ERISA. While the individuals handling plan assets must be bonded, the plan itself must be the insured party. It is important to note that these bonding requirements are not the same as fiduciary liability insurance. All bonds must be purchased through the Department of the Treasury's Listing of Approved Sureties.

Plan officials who receive, safeguard, and/or disburse funds, as well as service providers who have access to funds or who can make decisions regarding the funds are all required to be bonded. Where an entity acts as the plan administrator, the individuals handling funds within that entity require bonding. The term "handling" includes activities such as:

1. physical contact with cash or checks;
2. authority to transfer funds;
3. disbursement authority;
4. authority to sign checks;
5. supervisory/decision making authority over activities that require bonding.

This applies to investment advisors and to those who have the authority to handle plan assets even if they don't actually exercise such authority to handle assets. Fiduciaries that are trust companies, insurance companies, banks, or registered broker-dealers are exempt from the bonding requirements.

Each plan official must be bonded for at least 10% of the funds that they handle, with a minimum bond amount of $1,000 per plan. There is a $500,000 maximum bond amount under ERISA for any plan official unless the plan includes employer securities, in which case the maximum jumps to $1,000,000. Employer securities are considered equities or debts of the employer issued to employees. There is an exception for such employer equities or debts that happen to be part of a broadly diversified investment within the plan (e.g., mutual fund) – this will not result in the increased $1,000,000 maximum.

Bond amounts are set at the beginning of each fiscal year based on the value of the plan and are not adjusted throughout the year. Required bonds may be purchased using plan assets and service providers may be bonded by the plans, however neither is required. Deductibles cannot be utilized when it comes to ERISA-required bond amounts but can if the plan elects to purchase excess bond. Plan administrators may name more than one plan as the insured on the same bond so long as the required minimum bond amounts are met for each plan.

All plans subject to Title I of ERISA are **required** to be bonded. These include the following types of plans that are employer or union-sponsored:

- Retirement plans that are exempt from Federal Income Tax (as defined under the §401(a) and §501(a) of the Internal Revenue Code "IRC"):
  - **401(k)** plans,
  - Employee stock ownership plans (**"ESOPs"**),
  - **Stock bonus plans,**
  - **Keogh plans,**
  - **Defined benefit plans,**
  - **Profit sharing plans**, and
  - Voluntary employees' beneficiary associations (**"VEBAs"** - IRC 501(c)(9)), among others;
- **Deferred compensation plans that do not qualify for Federal Income Tax exemption (such as secular trusts)** (IRC §402(b));
- Group or annuity individual retirement accounts (**"IRAs"** - IRC §408(c));
- **403(b) annuity or custodial account plans subject to ERISA**

- Simplified Employee Pension plans **("SEP" -** IRC §408(k)**);**
- **Pension trusts** established prior to June 25, 1959 and funded by employee contributions (IRC §501 (c)(18));
- **SIMPLE IRAs** (IRC §408(p)) **and 401(k)s**;
- **Church plans** subject to ERISA

Other entities, such as hedge funds, may also be subject to ERISA bonding requirements if they are determined to hold plan assets.

In certain situations, plans that would otherwise be regulated by ERISA and therefore be subject to these bonding requirements are not due to the makeup of their participants and beneficiaries. These situations typically involve the participants/beneficiaries being the owners (or owners' spouses) of the "employer" (e.g., sole shareholder or a Limited Liability Company).

Plans not subject to Title I of ERISA and plans that are "completely unfunded" are exempt from these bonding requirements. Unfunded plans pay employee benefits directly from the employer's or union's general assets and not from any separate fund. Exempt plans include the following types even when sponsored by an employer or employee association:

- Deferred compensation plans for government employees (**457 Plans**)
- **Traditional** and **Roth IRAs** that are not SEP, SIMPLE, or group IRAs;
- **Church plans** not subjected to ERISA
- **Railroad Retirement Act plans**
- Plans under some **tax-exempt international organizations**
- Plans utilized entirely for compliance with **workers' compensation, unemployment compensation, or disability insurance** legislation
- **403(b)** annuity or custodial account plans subject to ERISA where employees may elect for reduced compensation and where the employer's plays a limited role in administering the plan
- **Unfunded excess benefit plans**
- Deferred compensation plans for management or highly compensated employees – **"Top Hat" plans** (such plans must pay benefits from the general assets of the employer);
    - **Rabbi trusts** that hold the assets of these plans
- Plans outside of the United States for **nonresident aliens**

- **Unfunded welfare plans** that include no employee contributions (or with some employee contribution subject to IRC §125)

These bonding requirements also apply to "small plans" under the small plan audit waiver regulation. If plans of under 100 participants (up to 120 participants in some situations) elect not to file an independent audit with their yearly report to the Department of Labor, they may be subject to additional bonding amounts if 5% or more the assets are not invested in "qualifying plan assets." In this situation, the plan must be bonded for at least 100% of the value of non-qualifying plan assets.

Section 412 of ERISA is extremely technical and each individual situation requires professional evaluation in order to determine whether these bonding requirements apply and if so, to what extent. This letter is intended to provide general information about ERISA's bonding requirements and does not constitute legal advice or a legal opinion.

We will continue to monitor for amendments to Section 412 and notify any parties that may be affected.

Sincerely,

Mark P. Laird