Investment Company Bond Insurance

A Guide for Insureds

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Abbreviations used in this study:

1934 Act	Securities Exchange Act of 1934
ERISA	Employee Retirement Income Security Act of 1974
FINRA	Financial Industry Regulatory Authority
ICA	Investment Company Act of 1940
SEC	U.S. Securities and Exchange Commission
SFAA	Surety & Fidelity Association of America

Introduction

Registered investment companies, like many regulated financial institutions, are required by applicable law to meet certain "fidelity" bonding requirements. In the investment company context, these requirements focus on insuring against certain specified forms of employee dishonesty. A registered investment company typically maintains a fidelity bond that provides broader coverage than what is legally required.

While fidelity bonds originally insured against employee dishonesty, their scope of coverage has been expanded over time such that they now typically encompass not only traditional employee dishonesty but also multiple other crime risks, including shareholder imposter fraud, that are related to *intent*-based wrongdoing. These fidelity bonds are commonly referred to as "financial institution bonds."

Financial institution bonds developed exclusively for investment companies are designed to protect insured entities against the financial impact of a direct actual loss of certain assets—either the insured's own assets or a third-party's assets held by the insured. Such investment company bonds typically insure registered investment companies (i.e., funds) themselves and are frequently structured to extend coverage to the funds' investment advisers and/or other affiliated service providers.

This guide is structured as follows:

- ***Part I*** focuses on the fundamentals of financial institution bonds, with an emphasis on the subset of financial institution bonds known as investment company bonds.
- ***Part II*** reviews the scope of coverage typically found in investment company bonds, including the insuring agreements and riders common to such bonds in the commercial market.
- ***Part III*** explores the various ways such bonds can be structured to meet the needs of investment companies, their advisers, and affiliated service providers.

Notes

By necessity, this guide generalizes as to the insurance issues discussed, is designed simply to be informative, and should not be construed or relied upon as legal advice (for which interested parties should look to their own counsel). The terms and conditions of individual bonds themselves will govern any coverage questions arising in a particular matter. Also, while insurers have designed investment company bond forms specifically for investment management insureds, the case law discussing investment company bond insurance is relatively limited. As a result, resolution of disputed coverage provisions under an investment company bond form would likely be informed by case law from other bond insurance contexts. Accordingly, this guide cites such cases to aid consideration of the issues discussed.

Primer on Terminology

Bonds may be described, often interchangeably, using a variety of terms—e.g., “fidelity” bonds, “17g-1” bonds, “investment company” bonds, “statutory” bonds, and “financial institution” bonds, among others.

Unless additional explanation is needed for clarity, this guide generally uses the terms “investment company bond” and simply “bond” interchangeably to refer to a financial institution bond maintained by a fund group to satisfy its legal requirements.

Fidelity Bond—In its narrowest sense, this term is used to refer to a bond that provides coverage for “fidelity” loss (i.e., a loss resulting from employee dishonesty). But the term is often used more broadly to refer to a bond that covers loss resulting from employee dishonesty but also covers other types of loss as well.

Investment Company Bond—This term is used for a bond that is tailored for registered investment companies. This type of bond covers loss resulting from employee dishonesty but also covers other types of loss as well.

17g-1 or **Rule 17g-1 Bond**—This term narrowly refers to a bond that satisfies the fidelity bonding requirements (specifically, coverage for employee larceny or embezzlement) of rule 17g-1 under the ICA. This term is sometimes used more broadly to refer to a bond that satisfies the fidelity bonding requirements but also provides other coverages as well.

Statutory Bond—This term is used to refer to a bond that satisfies certain legal requirements. For registered investment companies, for example, a 17g-1 bond is a statutory bond. Other types of financial institutions (e.g., employee benefit plans or broker-dealers) may be required by their governing legal framework to satisfy certain bonding requirements.

Financial Institution Bond—This term is used for bonds that are commonly purchased by various financial institutions, including banks, broker-dealers, trust companies, credit unions, insurance companies, mortgage companies, and, as particularly relevant here, registered investment companies.

Form 14 Bond—This term (based on a standard form number used by the SFAA) describes a financial institution bond designed for investment companies, stockbrokers, stock exchanges, commodity brokers, and investment bankers. Other form numbers are used for bonds for other types of financial institutions, including mortgage bankers and finance companies (Form 15), credit unions (Form 23), commercial banks, savings banks, and savings and loan associations (Form 24), and insurance companies (Form 25).

ERISA Bond—This term is used to describe a bond that satisfies the bonding requirements imposed by ERISA on employee benefit plans.

FINRA Bond—This term is used to describe a bond that satisfies the bonding requirements imposed by FINRA on its member securities dealers.

Non-US Bond—This term is used to describe a bond that a domestic fund group may, for a variety of practical and/or legal reasons, purchase for investment companies and other entities domiciled outside the United States.

Fundamentals

Financial Institution Bonds

ORIGIN AND GENERAL PURPOSE

The investment company bond is a descendant of a series of bonds once known as "banker's blanket bonds." The history of these instruments spans over a century.[1] First marketed by Lloyd's of London in 1911, the blanket bond combined in a single instrument various types of unrelated coverage that were previously the subject of separate policies. The first American banker's blanket bond, developed by the Surety Association of America (now known as the SFAA) in cooperation with the American Bankers Association in 1916, covered employee dishonesty, loss of property on premises or in transit through robbery or theft, as well as other risks. The bond achieved its present general form in 1941 when Standard Form 24 was released.

The "financial institution bond" is designed to "insure[s] against the dishonesty of a financial institution's employees and provide[s] coverage for other crime risks."[2] As its name suggests, the product is commonly purchased by banks, stockbrokers, trust companies, and other types of financial institutions. The product also frequently serves as a "statutory bond" for such financial institutions—i.e., as an insurance product whose primary purpose is to permit regulated entities to meet the bonding requirements imposed on them by law.[3]

There are various "standard forms" of financial institutions bonds. For the fund industry, the SFAA's Form 14 (for investment companies, stock exchanges, and certain broker/dealers) is of particular relevance to the discussion of investment company bonds. SFAA's other forms are intended for other types of financial institutions, including mortgage bankers and finance companies (Form 15), credit unions (Form 23), commercial banks, savings banks, and savings and loan associations (Form 24), and insurance companies (Form 25). A full discussion of these various forms is beyond the scope of this guide.

Financial Institution Bonds vs. D&O/E&O and Other Liability Policies

It is useful to consider certain traditional differences between financial institution bonds and third-party liability policies, such as directors and officers/errors and omissions liability (D&O/E&O) insurance and independent directors liability (IDL) insurance.

One difference is the nature of the risks insured. As noted above, financial institution bonds typically encompass employee dishonesty and multiple other crime risks that are related to *intent*-based wrongdoing. By contrast, D&O/E&O insurance and other third-party liability insurance policies are generally designed to cover only *unintentional* acts, like errors and negligence.

Another difference concerns the scope of coverage that is potentially available for an insured's liability to third parties. Bonds customarily cover only an insured's *direct actual* loss of certain assets in the insured's possession—either the insured's own assets or the assets of a third party held by the insured. Bond coverage is typically limited to "direct compensatory damages" only, and excludes any other items of recovery (e.g., indirect or consequential damages, as well as taxes, fines, and penalties). By contrast, liability insurance policies may not be so limited, and generally *do* broadly indemnify insureds for their liability to third parties. It is worth noting that, in the context of investment companies (which rely for their day-to-day management and operations upon external investment advisory entities and other external entities), some investment company bonds effectively provide some measure of third-party liability coverage.

Investment Company Bonds

IN GENERAL

An “investment company bond” (commonly referred to in the fund industry as a “fidelity bond” or a “rule 17g-1 bond”) is simply a financial institution bond that is tailored for use by registered investment companies and certain of their affiliates. Indeed, the so-called “Form 14”—one of the “standard forms” of financial institution bond developed by the SFAA[4]—is specifically designed for use by registered investment companies, among certain other financial institutions.[5]

The remainder of this guide uses the terms “investment company bond” and “bond” interchangeably to refer to a financial institution bond maintained by a fund group to satisfy its legal requirements.

The basic forms and wordings of financial institution bonds tend to be more standardized than for certain other insurance products (e.g., directors and officers/errors and omissions liability insurance products). Nonetheless, individual bond insurers may utilize their own proprietary bond forms and “riders”[6] (i.e., separate addenda that add, delete, and/or modify certain bond terms or conditions), which can, and often do, differ in various respects from the standard forms.

STATUTORY REQUIREMENTS (RULE 17G-1)

Investment company bonds serve as “statutory bonds,” in that their primary purpose is to permit registered investment companies to meet the specified “fidelity” (i.e., employee dishonesty) bonding requirements imposed on them by rule 17g-1 under the ICA. More specifically, under rule 17g-1, a registered investment company is required to maintain a bond against “larceny and embezzlement” (as defined in section 37 of the ICA) by “each officer and employee” having access to securities or funds of the investment company. As most investment companies do not have “employees” of their own, investment company bonds typically define the term “employee” broadly, so as to include numerous categories of individuals who may be involved in fund group operations.

As discussed below (see Scope of Coverage: Insuring Agreements and Riders – Fidelity (Employee Dishonesty) Coverage), however, investment company bonds typically provide broader fidelity coverage than is required by the rule, by, for example, covering dishonest employee acts other than “larceny and embezzlement” or covering entities, such as fund advisers, other than the funds themselves.

Rule 17g-1

This ICA rule requires a registered investment company to maintain a bond against “**larceny and embezzlement**.”

PARTICULAR FUND INDUSTRY RISK ISSUES

While originally modeled on a banker's blanket bond, the investment company bond's present form reflects years of customization to meet both the specific requirements of the ICA and the specific needs of the fund industry. Today, as with most other financial institution bonds, investment company bond forms typically have a number of separate insuring agreements in addition to the fidelity coverage described above. Each of these additional insuring agreements sets forth an independent coverage grant to the insured for other types of direct loss or other expense to the insured.

> Bond losses in the fund industry typically result from **employee dishonesty** or **shareholder impostor fraud**.

Broadly speaking, the fidelity insuring agreement affords coverage for the risk of loss resulting from the fraud or dishonesty of an entity's employees or other designated "insiders"; the other insuring agreements afford coverage for certain designated types of "outsider" crime risks. As a practical matter, in ICI Mutual's experience, the two key types of losses most frequently covered under such bonds are those resulting from the fraud or dishonesty of employees and those resulting from shareholder impostor fraud committed by outsiders. (See examples on next page.)

- ***Employee Dishonesty:*** While employee dishonesty may assume a variety of forms, employee dishonesty claims submitted to ICI Mutual tend to arise from (1) theft or other actions (e.g., fraudulent expense reports) to enrich the employee or (2) misappropriation of client assets (whether conducted in writing or electronically).

- ***Shareholder Impostor Fraud:*** A number of the claims submitted to ICI Mutual involve losses from fraudulent redemptions or other fraudulent transactions in fund shares that are effected by "impostors"—i.e., by fraudsters posing as legitimate fund shareholders. In some instances, fraudulent transactions might be requested through traditional writings (e.g., mailed redemption requests containing forged shareholder signatures); in other instances, fraudulent transaction requests might be submitted via the phone, online, or through other technologies (e.g., facsimile or automated phone systems).

THE ROLE OF AN INDUSTRY MUTUAL INSURER

ICI Mutual is an "industry mutual" insurer—i.e., an insurer that is owned and governed by its member-insureds, which themselves operate within a specific industry. In this regard, ICI Mutual differs fundamentally from the commercial insurance companies (generally organized as stock companies) with which it competes. As an industry mutual insurer, ICI Mutual is dedicated solely to serving the insurance and risk management needs of registered funds, fund directors and officers, and fund advisers and their affiliates, providing them with an expert and reliable long-term alternative to the uncertainties and cyclicality to which commercial insurance markets have historically been subject.

Like similar industry mutual insurers operating in other industries (e.g., legal services, health care, higher education), ICI Mutual is structured to provide enduring value to its member-insureds and to its industry.

Indeed, it is precisely because of its structure as an industry mutual insurer that ICI Mutual is able to provide its member-insureds, and the fund industry as a whole, with numerous tangible protections and benefits that either are unavailable from commercial insurers or cannot be counted on to be available from commercial insurers on a consistent, long-term basis.

Over the years, ICI Mutual has continued to introduce new coverages, or expand existing coverages, to meet the evolving needs of the fund industry. For example, ICI Mutual was a leader in developing phone/electronic transactions coverage (for "impostor"-type risks such as fraudulent online or telephone redemptions in fund shares), as well as computer security coverage (for "hacker"-type risks such as unauthorized data changes resulting in the fraudulent transfer of shareholder funds). A list and description of these and other tailored coverages is provided in Appendix A.

Examples of Bond Claims

Employee Dishonesty

- Fraudulent reimbursement requests – An employee charged personal expenses on his corporate credit card and submitted fraudulent expenses for reimbursement.
- Misappropriation of funds – An employee diverted funds from clients by making payments from their accounts into fictitious entities that he had created.
- Theft of office supplies – An employee stole printer cartridges and other office supplies, then sold and shipped them (at the fund complex's expense) to third parties.
- Trading for personal benefit – A portfolio manager arranged the purchases and sales of options from the mutual funds he managed to his own account at favorable prices.
- Theft from abandoned shareholder accounts – One or more employees effected redemptions out of three abandoned shareholder accounts, with the proceeds deposited into personal checking accounts.
- Unauthorized redemptions – An employee of a transfer agent engaged in unauthorized redemptions from shareholder accounts.

Shareholder Impostor Fraud

- Fraudulent account closing – A 401(k) account was fraudulently closed, and the proceeds were sent to an unauthorized third party.
- Forged redemption requests – An independent financial advisor forged client signatures on accounts, then forged redemption requests, with the proceeds sent to his address.
- Fraudulent trading activity – An unauthorized person placed a series of online orders in a client's mutual fund account.
- Fraudulent addition of bank account – An unauthorized person added a new bank account to a mutual fund shareholder's account, and the proceeds from the sale of mutual fund shares were sent to the new bank account.
- Telephone fraud – An unauthorized individual redeemed fund shares over the telephone and received the proceeds by wire transfer.

Miscellaneous

- Account opening fraud – A fraudster used a forged or altered U.S. Treasury check to open a mutual fund account, then emptied the account; months later, the U.S. Treasury flagged the check as fraudulent.
- Uncollectible item of deposit – A fund incurred a loss as a result of checks deposited in a shareholder's account, which checks were uncollectible because the payee's name had been altered.
- Third-party check fraud – A broker misappropriated third-party checks, then altered them and deposited them into his personal advisory account.
- On-premises loss – An insured reported that stock certificates of trust company clients had apparently been lost on premises and could not be located.

Key Concepts

Although they differ in their specific wording, investment company bond forms used by different insurers tend to have a similar overall structure, and there are certain key concepts that are common to most of these bonds.

NATURE OF LOSS

As a general matter, investment company bonds do not expressly define the term "loss." Broadly speaking, a loss is understood to be financial in nature.[7]

"Loss": While this term is typically undefined in investment company bonds, loss is understood to be **financial in nature**.

A loss is also understood to be causally linked to the wrongful act in question. In this regard, many financial institution bonds, including many investment company bonds, limit coverage to loss that results directly from the wrongful act.[8]

Other terms of bonds may provide further clarity to the undefined term of loss. For example, exclusions in many bonds may preclude coverage for certain losses including (1) damages of any type (other than direct compensatory damages) for which an insured might legally be liable, (2) taxes, fines, or penalties (including two-thirds of treble damages awards), and (3) potential income not realized because of a covered loss. Under this provision, the bond covers "direct compensatory damages" as opposed to any other types of "damages." The distinction between "direct compensatory damages" and other liabilities to third parties goes to the heart of the difference between a fidelity bond and liability insurance.

Other Bonds of Potential Relevance to the Fund Industry

ERISA Bonds: These bonds are designed to protect against losses caused by fraud or dishonesty by persons who manage or handle funds or property of employee benefit plans ("plans"). Under ERISA, plan fiduciaries and other designated "plan officials" of employee benefit plans, as well as investment advisers to in-house and third-party plans, generally must be bonded against such fraud or dishonesty.

FINRA Bonds: FINRA is a self-regulatory organization for securities dealers. FINRA generally requires each member to maintain a fidelity bond ("FINRA bond"), in an amount based on the member's net capital requirements under the 1934 Act. This rule applies to all broker/dealers regardless of the type of business they conduct and therefore many affiliated broker-dealers of fund groups require this coverage. FINRA bonds are designed to protect the insured against certain types of losses, including losses caused by fraud committed by its officers and employees, and the effect of such losses on the broker/dealer's capital.

Non-US Bonds: Domestic fund groups may seek, for a variety of practical and/or legal reasons, to purchase separate "Non-US" bond coverage for investment companies and other entities domiciled outside the United States.

LIMIT OF LIABILITY

Per-Occurrence Coverage

As with other insurance products, investment company bonds have limits of liability, which may differ between and among the various insuring agreements. Unlike the *aggregate* limits of liability offered under many insurance products which cap the total amount of coverage available to an insured during the coverage period regardless of the number of claims under the relevant insurance product, investment company bonds typically have limits of liability offered on an "each and every occurrence" basis (often referred to as "*per-occurrence*" coverage) under most insuring agreements.[9] This means that the full stated limit of liability is available for each and every covered "single loss," even if there have been other prior "single losses" during the bond period.

> "Per-Occurrence" Coverage: Investment company bonds typically make the **full stated limit of liability** available for *each and every* covered "**single loss**" during the bond period under most insuring agreements.

By contrast, an aggregate limit of liability caps the total amount of coverage available to an insured during the coverage period regardless of the number of claims under the relevant insurance product. Some investment company bonds may specify an aggregate limit of liability for certain insuring agreements. For example, grants of ancillary coverage, such as for social engineering fraud, may be subject to an aggregate limit of liability.

Single Loss

Under most investment company bonds, the term "single loss" is defined to include, among other things, all loss caused by or involving the same person, whether the result of a single act or a series of acts, such that the ongoing acts of that person is treated as a single cause of loss. Such loss would be subject to a single deductible (if applicable to the insuring agreement) and have access to a single limit of liability.

As an example, if an insured fund suffers a $2 million single loss that is otherwise covered under a per-occurrence insuring agreement of an investment company bond, and the bond's limit of liability is $1 million, the fund may have coverage for up to $1 million. If, within the same bond period, the same fund (or a different fund insured on the same bond) suffers another, unrelated $2 million single loss otherwise covered under a per-occurrence insuring agreement of the bond, that fund may also receive up to $1 million of coverage.[10]

DEDUCTIBLES

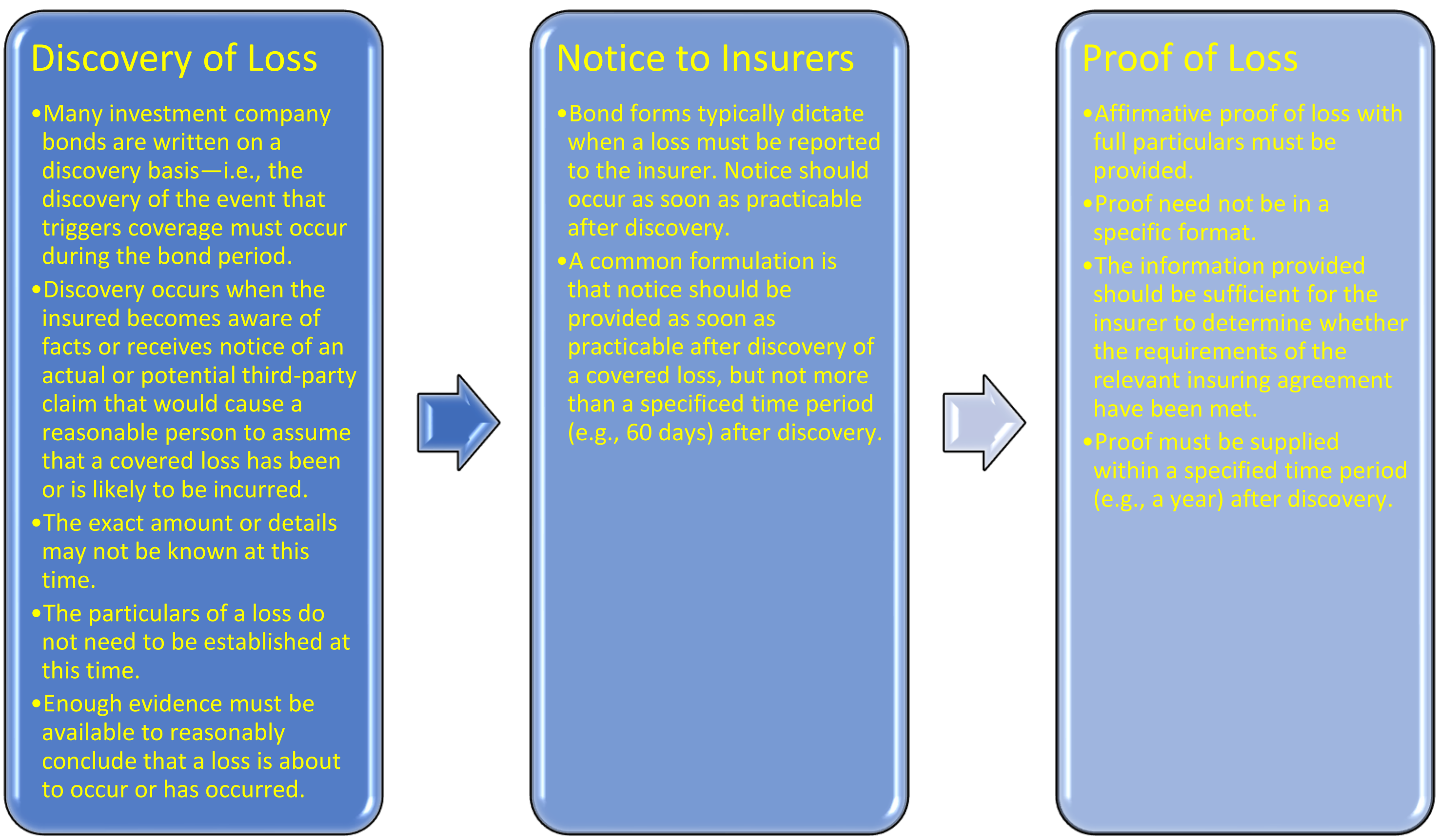
Deductibles

A deductible, also known as a "retention," is the point at which the risk transfers from the insured to the insurer for a given covered loss. Most insurance products contain deductibles, including the bond, with one exception. To comply with rule 17g-1 under the ICA, no deductible applies to losses sustained by registered investment companies under the fidelity (or "employee") insuring agreement.[11] Other losses under the fidelity insuring agreement (i.e., losses sustained by insured entities other than registered investment companies), as well as losses under other insuring agreements, are typically subject to deductibles.

DISCOVERY, NOTICE, AND PROOF OF LOSS

Discovery of Loss

Many investment company bonds, including ICI Mutual's bond, are written on a discovery basis, which means the event that triggers coverage under the bond must be discovered during the bond period. "Discovery" is defined in ICI Mutual's bond as the time when the insured becomes aware of facts or receives notice of an actual or potential third-party claim "which would cause a reasonable person to assume that loss covered by this bond has been or is likely to be incurred even though the exact amount or details of the loss may not be known." The particulars of a loss do not need to be established to make a claim; however, enough evidence must be available to reasonably conclude that a loss is about to



occur or has occurred.[12] The failure to provide an insurer with timely notice of a loss under a bond may result in the unavailability of coverage.

Notice to Insurer

Bond forms typically dictate when an insured must report a loss to the insurer. A common formulation is to require an insured to provide notice "as soon as practicable" after discovery of a covered loss, but not more than a specified time period (e.g., sixty days) after the discovery.

Proof of Loss

Bond forms typically require insureds to "prove" that they suffered a loss. In this regard, a bond may require an insured to provide "affirmative proof of loss with full particulars" within a certain period (often, six months to a year) after discovery.[13] The "proof of loss" requirement does not require an insured to adhere to any specific format. Rather, a proof of loss is adequate if it satisfies the purpose it is intended to serve.[14] An insured submitting proof of loss should provide information sufficient for an insurer to determine whether the requirements of the relevant insuring agreement have been met.[15] In the instance of a fidelity loss, for example, an insured should be prepared to show that it has suffered a loss, that the loss resulted from a covered act committed by an "employee" (as defined in the bond), and the amount of the loss.

SUBROGATION

Subrogation is the process by which an insurer may be reimbursed for amounts paid to its insureds. In theory, subrogation allows the insurer to "step into the shoes" of the insured and pursue a claim against an alleged wrongful actor with the same rights as the insured.[16] Should an insurer seek to pursue its right of subrogation, the bond would typically require the insured to provide appropriate cooperation to the insurer. In this regard, the insured would, for example, provide the insurer with all documents, information, and authority necessary to pursue the claim.

SALVAGE

Salvage refers to the recovery of funds or assets following a covered loss, which may be obtained by either the insured or the insurer. If an insurer has covered a loss under a bond's terms, any subsequent recovery of the loss—whether through legal action, asset liquidation, or other means—would be allocated between the insurer and the insured. For example, if the recovered amount were to exceed the bond's limit of liability plus the deductible, the recovery would first be used to compensate the insured for the portion of the loss over the bond's limit of liability, then to reimburse the insurer for the loss covered under the bond, and finally to cover the insured's deductible. This allocation methodology is intended to ensure equitable distribution of recovered amounts.

Scope of Coverage: Insuring Agreements and Riders

Like financial institution bonds in general, investment company bonds insure against various types of crime risks. The core coverage afforded is for "fidelity" risk—i.e., the risk to the institution of a loss resulting from the fraud or dishonesty of the institution's employees or other designated "insiders." In addition to fidelity coverage, investment company bonds also commonly provide additional ancillary coverages for certain designated types of "outsider" crime risks. These ancillary coverages take the form of separate "insuring agreements." Some of these ancillary coverages are so common and well-established as to have long since been incorporated directly into insurers' basic bond forms.[17] Other ancillary insuring agreements may be provided, if at all, only through separate riders to insurers' basic bond forms.

Broadly stated, it can be helpful to categorize these ancillary "outsider crime" coverages into "brick-and-mortar" crime coverages, on the one hand, and "technology-oriented" crime coverages, on the other. Most of the ancillary insuring agreements included in financial institution bonds predate the digital age and are generally designed to address only designated brick-and-mortar crimes perpetrated by outsiders—i.e., frauds or thefts that are perpetrated face-to-face or via paper transactions. But over the past several decades, bond insurers have also introduced several ancillary insuring agreements that may be characterized as more technology-oriented in nature, in the sense that they are designed to respond to certain "outsider" crime risks that are more closely associated with developments in technology, including the rise of the internet.

Typical Structure of Investment Company Bonds

Nature of Perpetrator	"Brick-and-Mortar" Crimes	"Technology-Oriented" Crimes
Insider Crimes	Fidelity (Employee Dishonesty)	
Outsider Crimes	On Premises In Transit Forgery or Alteration Securities Counterfeit Currency Uncollectible Items of Deposit	Computer Security Fraudulent Transactions ("Phone/Electronic")

Fidelity (Employee Dishonesty) Coverage

As described above, the primary purpose of investment company bonds is to permit registered investment companies to meet the specified "fidelity" (i.e., larceny and embezzlement) bonding requirements imposed on them by rule 17g-1 under the ICA. The bonds, however, typically provide a broader scope of fidelity coverage than is required by the rule in two respects—(1) with respect to the covered acts of employees (see Definition of "Dishonest or Fraudulent Act" below) and (2) with respect to coverage for non-fund entities (see Structuring a Program – Funds-Only Bond Versus Joint Bond below).

Other key features and requirements of fidelity coverage are described below.

DEFINITION OF "EMPLOYEE"

Under the "fidelity" insuring agreement of investment company bonds, coverage applies only to certain losses (e.g., those caused by larceny or embezzlement) committed by an "employee" of an insured.[18] The intent is clear that the term "employee" refers to a natural person only.

Bonds typically provide a broad definition of "employee" that encompasses certain natural persons that may not be considered employees in the normal course; this is particularly true for investment company bonds, given the unique structure of fund complexes (particularly, that virtually all funds are externally managed and that funds have limited, if any, operations or employees of their own). With respect to investment company bonds, the officers, directors, trustees, partners, or employees of a fund's affiliated investment adviser, underwriter, transfer agent, shareholder accounting recordkeeper, or administrator (as well as certain other people, including the fund's attorneys) are often included in the bond's definition of "employee" of the fund, subject to certain conditions and other limitations.[19]

Under certain circumstances, however, the determination of an individual's status as an "employee" of a business entity may be less clear-cut. This determination might involve, for example, an examination of whether the insured can direct or control the individual.[20] Questions tend to arise in and around the use of temporary workers or independent contractors.[21]

DEFINITION OF "DISHONEST OR FRAUDULENT ACT"

As described above (in Investment Company Bonds – Statutory Requirements (Rule 17g-1)), the "fidelity" insuring agreement is required to cover "larceny and embezzlement" by employees to satisfy the requirements of rule 17g-1 with respect to registered investment companies. Typically, however, the "fidelity" insuring agreement in investment company bonds afford broader coverage. For example, ICI Mutual's bond's fidelity insuring agreement affords coverage to insured funds and other insured entities for loss caused by any "Dishonest or Fraudulent Act" committed by an "Employee" (see discussion above). In accord with virtually all financial institution bonds (including other investment company bonds), this fidelity coverage requires that the employee-perpetrator act with a specified objective, or "intent." In this regard, bond forms typically require that the employee-perpetrator act with the intent (1) to cause an insured to sustain the loss *and* (2) to obtain an improper financial benefit for himself or another person (sometimes referred to as a "dual intent" requirement).[22]

> "Dishonest or Fraudulent Act"
> Most investment company bonds broaden the scope of coverage under the fidelity insuring agreement by providing coverage for "**dishonest or fraudulent acts**" of employees (as compared to the narrower rule 17g-1 requirement that a registered investment company maintain a bond against "larceny and embezzlement" by employees).

ADDITIONAL STATUTORY REQUIREMENTS

Rule 17g-1 imposes certain specific requirements on investment company bonds:

- ***Approval by Fund Independent Directors:*** The form of the bond and the amount of coverage must be approved on at least an annual basis by a majority of the independent directors of a fund's board "with due consideration to all relevant factors" (including fund assets at potential risk, custody arrangements, and the nature of the fund's portfolio securities).

- ***Amount of Coverage:*** The rule specifies minimum levels of coverage, based on the assets of the covered fund or funds.

- ***Per-Occurrence Coverage:*** Rule 17g-1 can also be read to require investment companies to maintain the specified amount of fidelity coverage throughout the year, notwithstanding payments of any losses. To address this issue, the fidelity insuring agreement in investment company bonds (as well as certain other insuring agreements) is typically designed to provide per-occurrence coverage (instead of aggregate coverage), meaning that the bond covers each and every "single loss" to the full limit of the insurer's stated liability notwithstanding prior payments.

- ***Termination Provisions:*** Investment company bonds may provide for termination as to any employee who had committed a dishonest or fraudulent act as soon as the insured had learned of such conduct. To address concerns that this termination might be viewed as violating rule 17g-1's bonding requirement, ICI Mutual obtained no-action relief from the SEC to permit termination subject to notice to the insured (and, in certain circumstances, to the SEC).[23]

- ***EDGAR Filing Requirements:*** Investment companies are required to file electronic copies of their fidelity bonds with the SEC.

“Brick-and-Mortar” Outsider Crime Coverages

As noted above, investment company bonds (and financial institution bonds generally) developed over many decades, and many of the insuring agreements arose well before the digital age. As a result, these insuring agreements tend to focus on the physical world—e.g., on written documents, security certificates, checks and money orders, property taken from offices or other premises, and paper currency and coins.

FORGERY OR ALTERATION

Financial institution bonds for a long time did not contain a definition of forgery, causing courts to apply various interpretations of definitions under criminal law. In the mid-1980s, forgery was defined under such bonds to be the signature by a person of a name other than his own, who was doing so with an intent to deceive.[24] Alteration refers to the changing, in a material manner, the terms or legal effect of a document, also executed with the intent to deceive.

The insuring agreement covering losses due to forgery or alteration under the bond typically requires that a loss result directly from the forgery or alteration of specific categories of covered documents. Moreover, this insuring agreement often includes other conditions that must be met for coverage to be available. For example, this insuring agreement typically requires: (1) that the document that is the subject of the forgery is itself a written, original document; (2) that the insured have actual possession of the forged document at issue; (3) that the insured actually relied on such document in good faith; and (4) that coverage may not be claimed based on forgery of a document not covered by a bond merely by virtue of the forged document’s being “bundled” with a covered document.

Over its history, ICI Mutual has seen a number of bond claims involving this “brick-and-mortar” insuring agreement. By contrast, ICI Mutual’s claims experience suggests that the remaining “brick-and-mortar” insuring agreements discussed in this section are rarely, if ever, implicated in fund industry bond claims.

SECURITIES

Investment company bonds typically include protection against securities-related loss that might result from securities that are counterfeit, are lost or stolen, or contain a forgery or alteration. This insuring agreement typically requires an insured to show, in order for coverage to be available, that a loss resulted directly from a counterfeit, forged, or altered security and that the security itself be genuine and original in order for coverage to be available.

As with the forgery and alteration insuring agreement described above, the securities insuring agreement typically requires that (1) the insured actually relied on the counterfeit, forged, or altered security in good faith and (2) coverage may not be claimed based on the counterfeit, forgery, or alteration of a document not covered by a bond merely by virtue of such document’s being “bundled” with a covered counterfeit, forged, or altered security.

OTHER INSURING AGREEMENTS

A number of other "brick-and-mortar" insuring agreements are standard in investment company bonds, although the language employed in different bonds may vary. Each of these insuring agreements has only rarely, if ever, been invoked in any claim situation in ICI Mutual's experience. These insuring agreements may be summarized as follows:

- ***Audit Expense:*** Expense of audits or examinations required by any governmental regulator due to fidelity loss.

- ***On Premises:*** Loss of financial assets from an insured's offices due to such acts as robbery, larceny, theft, fraud, or the mysterious disappearance of property not committed by an "employee." The term "property" tends to encompass the vast majority of financial assets,[25] but the property at issue must be located within an insured's offices or premises to qualify for potential coverage under this insuring agreement.

- ***In Transit:*** Loss of financial assets while in transit due to such acts as robbery, larceny, theft, fraud, or the mysterious disappearance of property. This insuring agreement would, for example, cover loss from property that is the object of a dishonest or fraudulent act, or mysterious disappearance outside of the offices or premises of the insured, while the property is in the custody of any person authorized to act as a messenger, except while in the mail or with a carrier for hire.

- ***Counterfeit Currency:*** Loss suffered by the insured resulting directly from the good faith receipt of counterfeit currency.

- ***Uncollectible Items of Deposit:*** Loss resulting directly from payment of dividend, issuance of shares, or withdrawals based upon uncollectible items of deposit (such as uncollectible checks) of a shareholder. To reduce the potential for these types of losses, fund groups have

Mutual Fund Transactions: A Relatively "Closed" System

In considering the appropriate scope of third-party fraud coverages for insureds under the bond, ICI Mutual has historically derived comfort from the traditional "closed" nature of mutual fund shareholder transactions. Redemptions and other transactions in fund shares tend to be made to the shareholder of record at the address of record or to pre-designated persons or bank accounts. The potential for successful fraud is reduced where redemption proceeds must remain within such a "closed" environment. In contrast, the potential for successful fraud is likely to increase where proceeds may be sent to other persons or bank accounts.

In such instances, ICI Mutual, in underwriting its bond coverage, has traditionally expected fund groups to take additional steps to mitigate the potential for fraud. For example, for coverage to be potentially available under the bond's phone/electronic transactions insuring agreement, a shareholder who seeks to send redemption proceeds to a different person or bank account (i.e., not a pre-designated person or bank account) must generally provide a written, non-electronic request accompanied by a signature guarantee. Similarly, a shareholder request to send redemption proceeds to a different address must generally be subject to a time delay before any such proceeds will be sent to the new address. These additional steps are broadly intended to ensure that such requests were, in fact, made by the shareholder and not by a fraudster (i.e., that the shareholder's identity has been properly authenticated).

implemented check-hold policies (i.e., the number of days a check to purchase shares of an investment company must be in the possession of the transfer agent before a shareholder can redeem the value of the shares purchased with that check). This control is in place to prevent an individual from submitting a check that is not backed by sufficient funds and immediately withdrawing cash from the account, thus causing a loss to the fund.

"Technology-Oriented" Outsider Crime Coverages

The advent of the digital age has brought new crime risks for fund groups. While investment company bonds were neither designed nor intended to provide broad cyber liability coverage, many insurers have developed new technology-related coverages over time. In this regard, many insurers provide limited coverage for certain technology-related direct losses of insured entities, under one or more insuring agreements. The fidelity insuring agreement, for example, provides coverage for technology-related direct losses committed by employees. Other technology-related insuring agreements may provide (1) protection against third-party fraud in redemptions and other transactions in fund shares that are requested by voice over the telephone or through electronic transactions; (2) protection of insureds' internal computer systems against unauthorized access and hacker attacks; and (3) protection against social engineering fraud.

PHONE/ELECTRONIC TRANSACTIONS

As described above, bonds have historically provided coverage for third-party fraud effected by certain written means, such as the forgery or alteration of transaction requests. As technology has evolved and as fund groups have changed their operations over time, other means of requesting transactions (by voice over the telephone, via facsimile, using an automated phone system, or online) have become more prevalent. ICI Mutual's bonds, as well as bonds of other insurance companies, have evolved to provide coverage for these "phone/electronic" transactions.

In such instances, ICI Mutual has traditionally expected fund groups to take additional steps to mitigate the potential for fraud. For example, for coverage to be potentially available under the phone/electronic transactions insuring agreement, a shareholder who seeks to send redemption proceeds to a different person or bank account (i.e., not a pre-designated person or bank account) must generally provide a written, non-electronic request accompanied by a signature guarantee. Similarly, a shareholder request to send redemption proceeds to a different address must generally be subject to a time delay before any such proceeds will be sent to the new address. These additional steps are broadly intended to ensure that such requests were, in fact, made by the shareholder and not by a fraudster (i.e., that the shareholder's identity has been properly authenticated).

COMPUTER SECURITY

Broadly stated and as discussed above, an investment company bond's fidelity insuring agreement can provide coverage for, among other things, technology-related losses resulting directly from the dishonesty of "employees." Many investment company bonds may also include a separate computer security insuring agreement designed to provide limited coverage for direct financial losses resulting from technology-related crimes committed by outside "hackers" (e.g., a hacker's transfer of funds from the insured's bank account to the hacker's bank account).

The "hacker-oriented" nature of a computer security insuring agreement is underscored by long-standing language that expressly precludes coverage under the insuring agreement for technology-related crimes committed by authorized users—i.e., by persons or entities who are not themselves employees, but to whom the insured has nevertheless granted access to its internal computer systems. Thus, as a practical matter, so-called "hacker" coverage may be available under some investment company bonds for attacks that are committed by either (1) "employees," as that term is broadly defined (whether they are acting alone or in collusion with others, including persons who are not "employees"), under the fidelity insuring agreement or (2) "unauthorized" third parties—i.e., persons or entities who have not been authorized by the insured to use its computer systems (unless, as noted above, such third parties are acting in collusion with the insured entity's "employees")—under a computer security insuring agreement.

It is important to note that a computer security insuring agreement in an investment company bond does not provide coverage for all cyber-related risks. The computer security coverage expressly precludes indirect losses and/or non-financial losses from hacks, such as business disruption expenses, remediation expenses, notification expenses associated with data loss, and ransom payments. Further, the computer security insuring agreement only provides coverage for hacks of the computer systems in the insured's possession, custody, and control. While this insuring agreement does typically provide coverage for certain enumerated technology-related losses, it is not intended to, and does not, replace separate standalone cyber coverages.

ANCILLARY COVERAGES (E.G., SOCIAL ENGINEERING)

Recent years have seen an increase in "social engineering" fraud against financial institutions and other entities. Such frauds often involve fraudsters who pose as officers, employees, or service providers of the targeted entity and who seek to trick or mislead an employee of the entity into sending money, securities, or other property to the fraudsters.

Shareholder Authentication

Recent large-scale data breaches have heightened concerns among regulators, businesses, and the public over the risk of identity theft and the resulting potential for fraudulent financial transactions. Other developments associated with the digital age—i.e., advances in computing power, the rise of social media, and growth in online commerce—have also fueled these concerns. The concerns are well founded. Fraudulent customer transactions reportedly cost financial institutions and their customers billions of dollars each year. To date, most fraudulent transactions have occurred outside the mutual fund context. Yet the fund industry has not been immune, and the ongoing risk to the industry and to fund shareholders cannot be discounted.

Fund groups have long sought to protect the integrity of transactions effected by fund shareholders, whether effected by traditional means (e.g., in writing, by telephone) or by newer means (e.g., online, via mobile apps). But the digital age has added to the challenges, and for many fund groups, these challenges have underscored the importance of robust "shareholder authentication"—that is, of having appropriate mechanisms and processes in place (1) to confirm the identities of shareholders who seek to conduct redemptions or other transactions involving fund shares and (2) to ensure the integrity of the transactions that are effected by those fund shareholders.

Under standard form financial institution bonds, coverage is not generally available for such "social engineering" fraud. In light of interest from insureds, ICI Mutual (like some other insurers) has added a "social engineering" insuring agreement to its investment company bond, which is available as an addition by rider. ICI Mutual's social engineering fraud insuring agreement potentially provides coverage for loss resulting directly from the insured, in good faith, transferring, paying, or delivering money as a direct result of the intentional misleading of an employee through the use of a communication that purports to be from an "employee" or from the officer or employee of a vendor that has a pre-existing, written agreement with the insured. Social engineering fraud insuring agreements typically have sublimits for this coverage, which are much lower than those for most other insuring agreements and are often subject to an aggregate limit for social engineering losses.

Structuring a Bond Program

The Appropriate Amount of Bond Limits

Investment company bonds are issued with specified limits. This means that each individual bond is subject to a maximum dollar limit on the amount that the insurer may be required to pay, individually or collectively, to any and all insureds for each and every insurance claim under that bond. This maximum dollar limit is referred to as the bond's "limit of liability," and may range from hundreds of thousands to hundreds of millions of dollars, depending upon statutory requirements, limits that individual insurers are prepared to offer, and limits that insureds deem appropriate for their own protection.

As discussed above, investment companies are required to purchase fidelity insurance. While the minimum coverage limits for investment companies are set forth in rule 17g-1 under the ICA, the question of "how much" coverage to purchase becomes a business judgment that may be influenced by a number of factors. As for the funds' own coverage, the ultimate responsibility for this judgment necessarily rests with fund boards.[26]

In reaching such a business judgment, fund boards frequently consult with representatives of other joint insureds, with their insurers, and with their insurance consultants (e.g., risk managers, counsel, brokers). Among the factors that may be useful for boards to consider are the following:

- ***Assets Under Management:*** Some fund boards find it useful to know the limits purchased by fund groups of comparable size. Upon request, some insurers and insurance brokers are willing to provide information (on a no-name basis) regarding amounts of limits purchased by an insurance applicant's peer fund groups. This information can also sometimes be found through the review of fund bonds (i.e., rule 17g-1 bonds) filed with the SEC, as required by the ICA.

- ***Scope of Coverage:*** Another factor that may be relevant is the scope of coverage afforded under the bond being purchased. For example, is the bond funds-only or is it a joint bond that also covers advisers and other affiliated service providers? If the bond is joint, do the insured service providers have coverage only for the services that they render to insured funds, or do they also have coverage for services rendered to others (e.g., private advisory accounts)? Generally, a broader scope of coverage may warrant higher limits, inasmuch as the bond limit will be exposed to a greater number of risks. (See Structuring a Program – Funds-Only Bond Versus Joint Bond, below.)

- ***Availability of Other Coverage:*** Advisers and other non-fund entities that are part of a larger financial holding company may have coverage under a separate bond issued to the ultimate parent company, possibly suggesting a need for lower limits in any joint bond that may be under consideration by the fund board.[27]

Funds-Only Bond Versus Joint Bond

It is uncommon for funds within a single fund complex to purchase a separate investment company bond for each individual fund. Rather, a single bond typically covers all funds within the complex (or certain groupings of funds, as when a single complex has multiple "cluster boards") together with the directors and officers of those funds. Where a bond insures only the foregoing, it is commonly known as a "funds-only" bond.

Where a bond is structured to extend beyond the foregoing, to also include as insureds one or more affiliated advisers and/or other affiliated service providers (together with the providers' own directors and officers), the bond is commonly known as a "joint" bond.[28] Under a joint bond, coverage for the service providers may be limited to services provided only to investment companies, or the coverage may also extend to services provided to others (e.g., private advisory accounts).[29]

As with other options involving investment company bonds, the selection between a funds-only bond and a joint bond is a business judgment for the affected funds' directors.

While this section discusses two of the most commonly used options for structuring an investment company bond insurance program—"funds-only" and "joint"—other options and variations exist. For fund groups seeking additional information regarding these other options and variations, consultation with counsel or other insurance consultants may be appropriate.

FUNDS-ONLY BOND

Funds-only bonds eliminate most of the issues associated with joint bonds discussed below. Also, a funds-only bond may make sense when the adviser and other non-fund entities already have coverage through a parent company's insurance program (as may be the case when the fund complex is just one of several business units in a larger organization).

JOINT BOND

Joint bonds are often the most cost-effective approach to purchasing insurance and frequently permit individual funds (and their affiliates) to secure more aggregate coverage at lower overall premiums than would otherwise be feasible for them.[30] Also, where funds and service providers are insured under separate bonds issued by different insurers, there may be some dispute between and among the insureds and the various insurers as to which bond should respond to a loss within the fund complex. In contrast, a joint bond lessens that risk.

Rule 17g-1 does impose certain restrictions on the coverage amounts and allocation among registered investment companies and other named insureds, but it is important to remember that these restrictions apply only to the portion of the bond that protects against larceny and embezzlement—that is, the fidelity portion of the investment company bond. For example, joint bonds must have a level of coverage at least equal to the sum of total coverage that each individual investment company would have otherwise been required to carry. Further, if insureds other than registered investment companies are named on a joint bond, the bond's limit must be sufficient to provide each named insured with the amount of coverage that it would have been required under the securities laws to maintain individually. In addition, a registered investment company that is bonded with other named insureds must enter into an agreement with all of the other named insureds providing that the investment company would receive an equitable and proportionate share of recovery under the bond for fidelity losses and would, in no case, receive less than the investment company would receive had it been individually bonded. Lastly, the majority of the board of directors who are not "interested persons" of such investment company (i.e., independent directors) must approve the premium to be paid by the investment company.

Premium Allocation Under a Joint Bond

When multiple entities (e.g., more than one fund, or a combination of funds and non-funds) are insured under an investment company bond, fund boards typically consider what portion of the joint bond's premium should be allocated to each of the funds, as well as to the non-funds.

Under rule 17g-1, the majority of the independent directors of a fund insured under a bond must approve the premium to be paid by the fund.[31] The rule also sets forth certain regulatory requirements for boards to consider in arriving at appropriate premium allocations with respect to registered funds. Specifically, the board must consider "all relevant factors," which would include "the number of the other parties named as insureds, the nature of the business activities of such other parties, the amount of the joint insured bond, and the amount of the premium for such bond, the ratable allocation of the premium among all parties named as insureds, and the extent to which the share of the premium allocated to the investment company is less than the premium such company would have had to pay if it had provided and maintained a single insured bond."

Other factors that may be relevant for boards to consider in arriving at premium allocations in a joint bond may include the following:

- ***Prior losses attributable to service providers:*** A fund group may wish to consider its actual loss history and, in particular, whether any prior losses were attributable to advisers or non-funds.

- ***Prior premium allocations:*** Premium allocations used by a fund group in prior years can be an additional guide, unless a rational basis for departure from prior practice is identified (such as acquisitions, mergers, and other material changes to the relative risks of funds and non-funds).

- ***Separate premium quotations:*** Some fund groups take the extra step of requesting separate premium quotations for, respectively, a funds-only and provider-only bond. The proportionate share of the total represented by each quotation may provide an additional factor to consider.

Insurers and insurance consultants are sometimes asked to provide their views with regard to an appropriate premium allocation. While they are often willing to do so, it is important to recognize that their views are just one of multiple factors that may be relevant for fund boards to take into consideration when arriving at business judgments regarding appropriate premium allocations. Indeed, different fund groups may have different preferences regarding allocation methodologies, resulting in premium allocations that may vary from one group to the next.

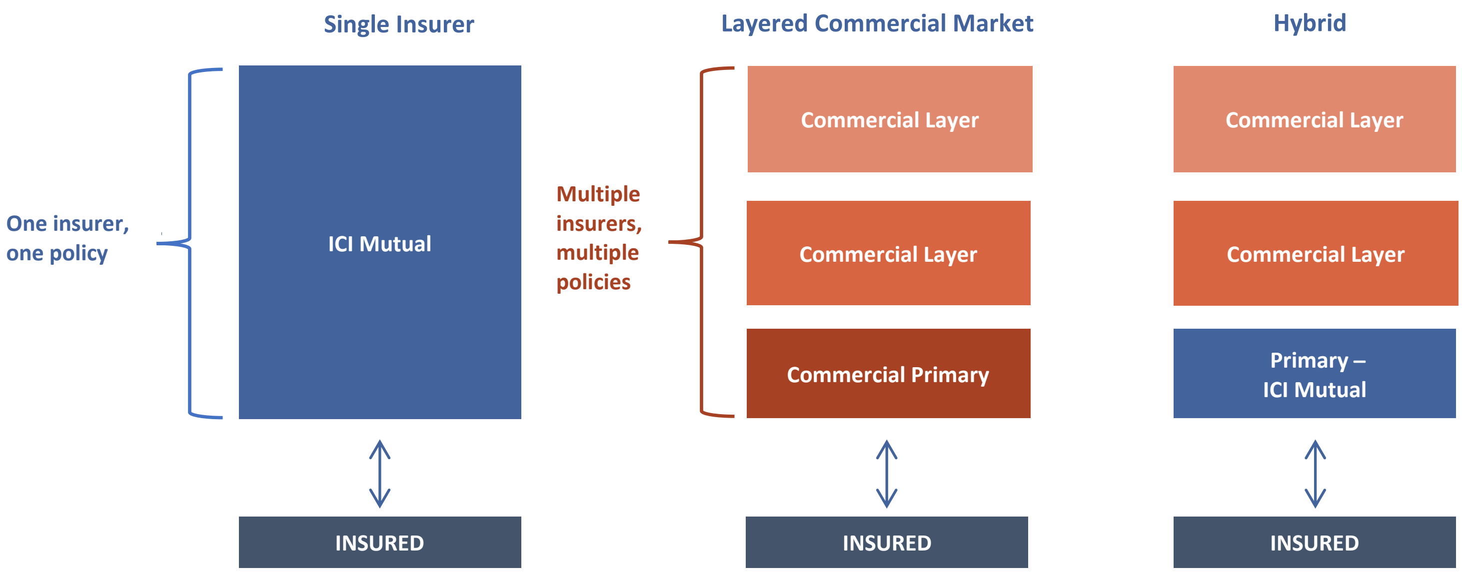
Single-Insurer Program Versus Multiple-Insurer Program

One basic insurance choice faced by many fund groups is whether to purchase their investment company bond from a single insurer, or rather to place it with multiple insurers in a “layered” insurance program. (See box, below.) As with other options involving the structuring of investment company bonds, the decision between a single-insurer program or a layered program is a business judgment for the relevant funds’ board of directors.

For example, one fund group may decide to purchase $40 million in bond coverage from a single insurer in a single bond. By contrast, another fund group might instead opt for a “layered” $40 million program, under which the first $10 million of loss is contracted to one insurer (known as the “primary” insurer), the next $10 million to another insurer (known as the “first-level excess” insurer), and so on. In layered programs, excess carriers often “follow form” (i.e., incorporate the terms and conditions) of the primary bond.

Options for Structuring Bond Programs

Fund groups have three basic options in structuring their bond programs. Some fund groups choose a “single insurer” or “hybrid” structure utilizing ICI Mutual, whereas others choose a “layered commercial market” structure utilizing only commercial insurers. These choices ultimately involve business judgments. Discussions of factors that fund groups may wish to consider in reaching such judgments are described in the text.



The risk of insurer insolvency may be a pertinent consideration for many insureds. Splitting a program among multiple insurers may mitigate this risk. The risk of insurer insolvency may also be mitigated, whether in a single-insurer or a multiple-insurer program, by selecting only highly rated, well-capitalized insurer(s).[32] Moreover, the risk of catastrophic losses bankrupting an insurer may be smaller than it appears, because many insurers themselves purchase insurance from other insurers (known as "reinsurers") for all or part of the original risk.[33] A catastrophic loss will thus often be shared among the original insurer(s) *and* a number of reinsurers. ICI Mutual, for example, has historically retained only a portion of the risk on the investment company bonds that it issues.

Convenience of the claims adjustment process may be another pertinent consideration for many insureds. In a layered program, the insured must seek recovery separately from its primary insurer and from each excess insurer whose coverage may be implicated. If the primary insurer *denies* coverage, the "follow form" excess carriers are likely to adopt that same position with respect to their own layers. However, if the primary insurer affords coverage, that determination is not necessarily binding on the excess insurers. Also, a negotiated insurance settlement with the primary insurer for less than the primary bond's limits may itself generate a coverage dispute with an excess insurer.[34]

In a single-insurer program, by contrast, the insured need interface with only the insurer (and not with any reinsurers of the insurer), and the insured may seek full coverage from its single insurer up to the stated bond limits in the event of a covered loss. In these ways, single-insurer programs can lessen the administrative burden on the fund group of a very large insurance claim and reduce the risk of coverage disputes with excess layers.

Finally, a given insurer's willingness to write large limits may be another factor that affects an insured's choice between a single-insurer or a layered program. In recent years, many investment company bond providers—in order to manage their overall "aggregation" risk—have reduced the overall limits they are willing to write for individual fund groups, even as the insurance requirements of many fund groups have increased. Indeed, few investment company bond providers remain willing to write very large insurance limits; most insurers now restrict the capacity that they are prepared to provide on individual fund group insurance programs.

Appendix A: Tailored Coverages

Over the years, ICI Mutual has continued to introduce new coverages, or expand existing coverages, to meet the evolving needs of the fund industry. These coverages are described below.

Shareholder Transaction Coverages (Technology-Oriented *and* Brick-and-Mortar)

- ***Voice-Initiated Transactions (1990) –*** This coverage, in the form of a standard insuring agreement, protects insured entities against losses resulting from fraudulent redemptions or other fraudulent transactions in fund shares that are effected by third-party imposters by phone.
- ***Automated Phone Transactions (1991) –*** Similar to the voice-initiated transactions coverage, this coverage protects insured entities against losses resulting from fraudulent redemptions or other fraudulent transactions in fund shares that are effected by third-party imposters using automated phone systems.
- ***On-Line Transactions (1996) –*** This coverage, originally in the form of a standard insuring agreement, protects insured entities against losses resulting from fraudulent redemptions or other fraudulent transactions in fund shares that are effected by third-party imposters via the Internet.
- ***Phone-Electronic Transactions (2001) –*** This coverage, in the form of a standard insuring agreement, protects insured entities against losses resulting from fraudulent redemptions or other fraudulent transactions in fund shares that are effected by third-party imposters by phone, Internet, or certain other technologies.
- ***Wireless Transactions (2012) –*** This coverage expands the phone/electronic transactions insuring agreement by permitting coverage for fraudulent transactions transmitted using wireless devices.
- ***Phone/Electronic Transactions for Investment Advisory Clients (2018) –*** This coverage expands the standard phone/electronic transactions insuring agreement to protect insured entities against losses resulting from fraudulent redemptions or other fraudulent transactions in private accounts.

Other Technology-Oriented Coverages

- ***Computer Security (1991) –*** This optional insuring agreement provides coverage for certain computer frauds effected by unauthorized third parties.
- ***Social Engineering (2018) –*** This coverage protects against losses resulting directly from fraudsters who pose as employees of insured entities (or of officers or employees of vendors) and who seek to trick or mislead legitimate employees of insured entities into sending money, securities, or other property to the fraudsters.

Foreign Coverages

- ***Foreign Funds (1992) –*** ICI Mutual extended bond coverage (by optional rider) to non-SEC registered funds and related entities.
- ***Bond Form for Foreign Funds (1994) –*** ICI Mutual developed a standalone bond form for non-SEC registered funds and related entities that are domiciled outside the United States.

Appendix B: Questions to Consider

When evaluating and selecting investment company bonds, fund boards and other stakeholders may wish to consider a number of questions as they seek to achieve an appropriate scope, level, and cost of coverage and as they assess the various options that may be available in the insurance marketplace. This appendix sets forth some of these questions. Please note that these questions are illustrative only. Not all questions may be of relevance to every fund group, nor may the various questions have the same importance to different fund groups. Where particular questions are discussed in the guide, cross-references to relevant page numbers of the guide are provided.

Which Bond is Appropriate for My Fund Group?

- What bond options are available to my fund group? How do these options differ with regard to the basic coverages they provide? How do these options differ with regard to other terms? From the perspective of our funds and other insureds, which of these differences in basic coverages and terms are important to us and which are not? [See pages 11–18.]

- How important to my fund group are the following additional factors: (1) price, (2) type of insurer (commercial versus industry mutual), (3) reputation of insurer (e.g., for service, claims handling, and claims payments), (4) financial strength of insurer, (5) insurer's knowledge of the fund industry, and (6) long-term commitment of the insurer to the fund industry? [See pages 22–23.]

- What factors should my fund group consider when determining how much coverage to purchase? Are peer data available on these factors? [See page 19.]

What Type of Bond Structure is Appropriate for My Fund Group?

- What are the advantages and disadvantages of funds-only bonds versus joint bonds (which cover funds, but may also cover affiliated advisers and/or other service providers)? [See pages 20–21.]

- Who should pay the premiums for a "joint" bond? How should these premiums be allocated? [See pages 21–22.]

- What are the relative advantages and disadvantages of single-insurer programs versus "layered" multiple-insurer programs? [See pages 22–23.]

Other Questions

- Whom can my fund group consult on insurance issues (e.g., risk managers, counsel, brokers)? [See page 19.]

Endnotes

[1] *See generally* THE FINANCIAL INSTITUTION BOND AND COMMERCIAL CRIME POLICY: PRINCIPLES AND ANNOTATIONS 1 *et seq*. (Michael Keeley et al., eds. 2023) (noting that fidelity bonds cover "certain losses [e.g., those caused by employee dishonesty] that are difficult for banks to protect against."); Private Bank & Trust Co. v. Progressive Cas. Ins. Co., 409 F.3d 814, 816 (7th Cir. 2005) (citations omitted).

[2] *See* Robert J. Duke, *A Brief History of the Financial Institution Bond* in FINANCIAL INSTITUTION BONDS 1 (Michael Keeley, ed., 4th ed., 2016).

[3] *See generally* Michael Keeley and Sean W. Duffy, HANDLING FIDELITY BOND CLAIMS 410 (A.B.A. 2nd ed. 2005) ("Financial institutions and other businesses in regulated industries often are required by statute to maintain a certain level of fidelity coverage. Such requirements are imposed to protect the public or the state or federal government from losses resulting from employee fraud or other risks typically faced by those regulated industries."); *see also* William E. Heinbokel & Robert Olausen, HANDLING FIDELITY BOND CLAIMS 1 (Michael Keeley et al., eds., 3d ed. 2019) ("Practically all financial institutions are required by federal agencies with supervisory oversight to maintain such coverage.").

[4] The SFAA's membership includes more than 450 insurance companies that write fidelity and surety insurance in the United States. SFAA members represent over 90% of the market premium for surety and fidelity insurance. For over a hundred years, the SFAA—often with input and assistance from outside groups representing financial institution insureds (e.g., the American Bankers Association)—has developed and periodically revised its set of "standard" financial institution bond forms and riders. While SFAA-promulgated bond forms and riders continue to be broadly used by insurers offering financial institutions bonds, not all bond forms and riders mirror SFAA-promulgated wordings. *See* SFAA, Who We Are (last visited June 12, 2025), https://surety.org/about-sfaa/#what-we-do. A second insurance industry organization, the Insurance Services Office ("ISO"), has introduced its own set of "standard" financial institution bond forms and riders. While the scope of coverage provided under the ISO's set of forms and riders "is similar in many ways" to the coverage provided under the SFAA's set, differences can and do exist. *See generally* JEFFREY E. THOMAS, 1 NEW APPLEMAN ON INSURANCE LAW LIBRARY ED. § 111.01[5][c] (LexisNexis). As noted in the text, some individual insurers, including ICI Mutual, utilize their own proprietary bond forms and riders (which may frequently be patterned after analogous standard forms and riders promulgated by the SFAA and/or the ISO, but which may differ in various respects).

[5] *See* SFAA, Financial Institution Bond, Standard Form No. 14 (revised to May 2011), https://cdn.ymaws.com/www.surety.org/resource/resmgr/about/StandardForm14.pdf (noting that among the "institutions eligible for [the] Form 14" are [registered investment companies], stock exchanges, stockbrokers, and certain commodity brokers).

[6] Broadly stated, "riders" can be defined as separate addenda that an insurer attaches to its "standard" form of bond in order to add, delete, and/or modify certain bond terms or conditions. Such riders may be standardized, semi-standardized, or custom-crafted.

[7] *See generally* FINANCIAL INSTITUTION BONDS 265 *et seq.* (Michael Keeley, ed., 4th ed., 2016) (noting that "'Loss' refers to economic harm sustained by the Insured.").

[8] This loss causation language was added, for example, to the SFAA's standard financial institution bond in 1980, which "underscored the bond underwriters' intent that the bond provide coverage only where there is a direct link between the loss and the covered conduct." The industry added the new language to the bond "[i]n response to expansive judicial interpretations of the Bond's causation requirement." William T. Bogaert,

Causation: The Direct Loss Requirement in FINANCIAL INSTITUTION BONDS 947–48 (Michael Keeley, ed., 4th ed., 2016).

[9] As discussed herein, some readings of rule 17g-1 appear to prohibit an aggregate limit of liability on "fidelity" coverage in bonds subject to rule 17g-1. However, these readings would apply only to the "larceny and embezzlement" requirement of rule 17g-1 and not to any other insuring agreements in such bonds.

[10] If the investment company bond also has an aggregate limit of liability, such aggregate limit of liability may further limit the insured fund's recovery under the bond.

[11] While rule 17g-1 generally does not address deductibles for fidelity bonds, the SEC staff had long held the position that fidelity bonds could not be subject to a deductible. Beginning in 1978, a bond with a deductible was permitted if the entity responsible for placing the bond maintained an escrow account in an amount not less than the deductible amount of the fidelity bond and indemnification by that entity (or another, agreed-upon entity) for any loss that such a fidelity bond would have covered but for its deductible provision. *See* 1978 SEC No-Act. LEXIS 1402 (Jun. 7, 1978).

[12] Mere suspicion of a covered loss by an insured is not sufficient to trigger the notice requirement. *See*, *e.g.*, NCUA Bd. v. Cumis Ins. Soc'y, 2015 U.S. Dist. LEXIS 45281, at *82 (N.D. Ohio Apr. 7, 2015) (citing FDIC v. Aetna Casualty & Surety Co., 903 F.2d 1073, 1079 (6th Cir. 1990) (noting that "suspicion of loss is not enough").

[13] All of these deadlines may be extended if the insured requests an extension and shows good cause for such extension.

[14] "The purpose of a provision for proof of loss is to afford the insurer an adequate opportunity for investigation, to prevent fraud …, and to enable it to form an intelligent estimate of its rights and liabilities before it is obligated to pay. Its object is to furnish the insurer with the particulars of the loss and all data necessary to determine its liability and amount thereof." Sutton v. Fire Ins. Exch., 265 Ore. 322, 325, 509 P.2d 418, 419 (1973) (*citing* 14 Couch, Cyclopedia of Insurance Law (2d ed) § 49:373, at 15).

[15] As a practical matter, insureds are likely to prefer not to submit final proofs of loss until after any underlying litigation has been resolved. This reluctance will be justified by both the insured's reluctance to fully and finally value the "loss" until the resolution of the litigation and by the insured's desire not to be forced to make admissions that might be harmful to its position in that litigation. Under such circumstances, many insurers will accede to an insured's request for an extension.

[16] "[Subrogation] is a term of art describing a legal fiction that allows an insurer to step into the shoes of its insured after making payment for the insured's damages." 13 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 158.01 (2018). ICI Mutual's bond provides for such subrogation, except in the case of a bond claim by one insured against another.

[17] *See generally* JEFFREY E. THOMAS, 1 NEW APPLEMAN ON INSURANCE LAW LIBRARY ED. § 111.01[1] (LexisNexis) ("While employee dishonesty remains the primary insuring agreement in fidelity bonds today, the coverage provided by fidelity bonds has been expanded over time, and [such bonds] now also provide coverage for other types of losses, including losses of property resulting directly from robbery, burglary, and theft while such property is lodged on an insured's premises, 'in-transit' losses, and losses from forgeries and alterations of certain types of instruments and security-type documents"); SFAA, Financial Institution Bond, Standard Form No. 14 (revised to May 2011), https://cdn.ymaws.com/www.surety.org/resource/resmgr/about/StandardForm14.pdf (explaining that "the basic bond coverage" provided under Form 14 consists of "fidelity," "on premises," "in transit," and "counterfeit currency" insuring agreements, and identifying certain "optional" coverages contained in the form itself).

[18] Under ICI Mutual's bond, for example, "employee" includes nine separate categories of individuals, including, among others: (1) each officer, director, trustee, partner, or employee of any named insured entity, (2) each officer, director, trustee, partner, or employee of an insured investment company's adviser,

underwriter, transfer agent, or administrator (under conditions specified in the definition), (3) each individual assigned, by contract or by any agency furnishing temporary personnel, to perform the usual duties of an employee in any office of any named insured entity, and (4) each officer, partner, or employee of certain securities depositories and national securities exchanges while performing certain services. The definition also provides that, except as otherwise included within certain of the nine enumerated categories, brokers, agents, independent contractors, or "representatives of the same general character" shall not be considered "employees."

[19] The definition of "employee" might also be revised to reflect the bond's scope of coverage. For example, in a bond that names in-house employee benefit plans as insureds, individuals associated with such plans might be deemed "employees" of such plans.

[20] *See, e.g.*, IRS, Independent Contractor (Self Employed) or Employee?, https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee; Charles L. Muhl, Goldberg, Kohn, Bell, Black, Rosenbloom & Moritz, Ltd., *What is an Employee? The Answer Depends on the Federal Law*, MONTHLY LABOR REVIEW, (Jan. 2002); RESTATEMENT (THIRD) AGENCY, § 7.07(3) cmt. F (2006).

[21] Investment company bonds typically expressly exclude brokers, agents, independent contractors, or other persons of the same general character from the definition of "employee," unless such persons fall directly into a category of persons otherwise included in the definition. However, sometimes it may be unclear whether a person is an employee or a person of the same general character as a broker, agent, or independent contractor. In those instances, a number of tests may be applied to determine whether the arrangement more closely resembles employment or simply an agency relationship. These tests are often multifactor in nature, with the factors tending to fall into three broad categories: (1) the scope of behavioral control that the business exercises over the individual, (2) the nature of the relationship between the business and the individual, and (3) the financial control that the business exercises over the work being performed.

[22] Indeed, some commercial bond forms have historically used a narrower coverage formulation for the "financial benefit" requirement, under which the employee-perpetrator must act to obtain financial benefit for *himself/herself*, rather than for himself/herself *or another person*. The ICI Mutual bond uses the broader formulation.

[23] ICI Mutual's bond obliges an insured, once it learns that an employee had committed a dishonest or fraudulent act or theft, to remove such employee from a position of access within forty-eight hours and give ICI Mutual notice of such event. Based on the notice received from the insured, ICI Mutual may then give sixty-days' notice of termination of the bond to the insured and the SEC as to that particular employee. *See* SEC No-Act. Ltr. (Feb. 28, 1994), https://www.sec.gov/divisions/investment/noaction/1994/icimutualinsurance022894.pdf.

[24] *See, e.g.*, SFAA Financial Institution Bond (1986); *see also* SFAA Financial Institution Bond (2011). However, if a signature is genuine but the person signing does not have the authority to sign, then a forgery, as covered by the bond, has not occurred.

[25] Under ICI Mutual's bond, for example, "property" is generally limited to money, securities, checks, and other "valuable papers" (excluding all data processing records) and does not encompass furnishings, premises, and other types of physical items.

[26] *See* SEC No-Act. Ltr., 1995 SEC No-Act. LEXIS 838 (Nov. 7, 1995).

[27] Typically, an investment company bond contains an "Other Insurance" provision, which provides that coverage under the bond is excess to any other existing insurance coverage or suretyship.

[28] While "funds-only" and "joint" policies have the commonly understood meanings discussed above, the SEC, as a technical matter, views *any* policy in which one registered investment company shares coverage with another entity as a "joint" policy. Under this more technical meaning, a policy that insures multiple

investment companies is thus a "joint" policy, even if the policy does not insure the funds' advisers or other service providers. Both types of "joint" policy are permissible under rule 17d-1(d)(7) of the ICA provided that certain conditions are met (e.g., a majority of the independent directors must determine that the joint policy is in the best interest of the fund). 17 C.F.R. § 270.17d-1(d)(7).

[29] It should be noted that rule 17g-1(d)(2) under the ICA stipulates that "… (2) A joint insured bond shall be in an amount at least equal to the sum of (i) the total amount of coverage which each registered management investment company named as an insured would have been required to provide and maintain individually pursuant to the schedule hereinabove had each such registered management investment company not been named under a joint insured bond, plus (ii) the amount of each bond which each named insured other than a registered management investment company would have been required to provide and maintain pursuant to federal statutes or regulations had it not been named as an insured under a joint insured bond."

[30] *See, e.g.,* Exemption of Certain Joint Purchases of Liability Insurance Policies, ICA Rel. No. 10,700 (May 16, 1979), 1979 SEC LEXIS 1544 ("This arrangement … may induce individual insurance companies to underwrite more extensive coverage, and may result in lower aggregate premiums.").

[31] 17 C.F.R. § 270.17g-1(e).

[32] In this regard, many policyholders refer to ratings and analysis provided by AM Best Company in order to assess the financial strength and creditworthiness of insurers and other risk-bearing entities. *See generally* About AM Best, https://web.ambest.com/about/ (last visited Aug. 12, 2025).

[33] *See generally* P.T. O'NEILL & J.W. WOLONIECKI, THE LAW OF REINSURANCE IN ENGLAND AND BERMUDA 4 (1998) ("The laying off of risk by means of reinsurance traditionally serves three basic purposes. First, reinsurance can increase the capacity of the insurer to accept risk. The insurer may be enabled to take on larger individual risks, or a large number of smaller risks, or a combination of both…. Secondly, reinsurance can promote financial stability by ameliorating the adverse consequences of an unexpected accumulation of losses or of single catastrophic losses, because these will, at least in part, be absorbed by reinsurers. Thirdly, reinsurance can strengthen the solvency of an insurer from the point of view of any regulations under which the insurer must operate which provide for a minimum 'solvency margin,' generally expressed as a ratio of net premium income over capital and free reserves.").

[34] *Cf.* Comerica Inc. v. Zurich Am. Ins. Co., 498 F. Supp. 2d 1019, 1034 (E.D. Mich. 2007) (holding that primary policy's $20 million liability limit was not exhausted by the primary insurer's negotiated insurance payment of $14 million); Eric S. Connuck, *Excess D&O Insurance*, BUS. L. TODAY, Sept./Oct. 2008, at 45 ("[T]he risk of a possible forfeiture of excess coverage must be factored into any compromise of a coverage dispute that includes less than all of the involved insurers."); Susanne Sclafane, *"Workouts" Leave Buyers Battling Up D&O Coverage Towers*, NAT'L UNDERWRITER, July 7/14, 2008, at 21 ("Buyers of directors and officers liability coverage who have settled claims with their primary insurers may find disgruntled excess carriers unwilling to pay out on their layers for large claims—even when excess policies contain 'follow-form' language.").

ICI Mutual is the predominant provider of D&O/E&O liability insurance and fidelity bonding for the U.S. mutual fund industry. Its insureds represent more than 70% of the industry's managed assets. As the mutual fund industry's dedicated insurance company, ICI Mutual is owned and operated by and for its insureds. ICI Mutual's services assist insureds with identifying and managing risk and defending regulatory enforcement proceedings and civil litigation.

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