



DIVISION OF
INVESTMENT MANAGEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

February 28, 1994

Ms. Natalie Shirley
Vice President and General Counsel
ICI Mutual Insurance Company
1401 H Street
Washington, D.C. 20005-2148

ACT ICA-40
SECTION _____
RULE 17g-1
PUBLIC _____
AVAILABILITY 2/28/96

Dear Ms. Shirley:

Your letter dated November 1, 1993, seeks our concurrence with your view that a proposed revision to the fidelity insurance bond provided by ICI Mutual Insurance Company ("ICM") to investment companies does not violate paragraphs (a) and (c) of Rule 17g-1 under the Investment Company Act of 1940. 1/

The provision in question, Section 12A of ICM's standard fidelity bond, formerly provided for the automatic termination of the bond as to any employee where any partner, officer, or supervisory employee of the insured learns that such employee committed any dishonest or fraudulent act or theft. The Commission's inspection staff questioned whether this termination clause violated paragraphs (a) and (c) of Rule 17g-1. In response, ICM proposes to delete this clause and instead require in its bond that an insured that learns of a dishonest or fraudulent act or theft by an employee immediately remove the employee from a position that would enable the employee to cause the insured to suffer a loss by such conduct. The insured also will be required to notify ICM of the particulars of the employee's conduct within 48 hours of learning of such

1/ Paragraph (a) of Rule 17g-1 requires each registered management investment company to provide and maintain a fidelity insurance bond against larceny and embezzlement, covering each officer and employee of the investment company who may have access to the securities or funds of the investment company. Paragraph (c) of the rule further requires that the bond provide that it shall not be cancelled, terminated, or modified except after written notice by the acting party to the affected party and to the Commission (and, in the case of joint bonds, by the fidelity insurance company to all registered investment companies named as insureds and to the Commission) not less than sixty days prior to the effective date of cancellation, termination, or modification.

conduct. 2/ You state that the revised provision does not operate as a termination provision as to the employee, and, therefore, does not violate Rule 17g-1. You further state that this provision benefits the insured and its shareholders by removing dishonest employees from a position of access to an investment company's assets.

We agree that the proposed provision, standing alone, does not violate Rule paragraphs (a) and (c) of Rule 17g-1. We also agree that, because the change is not intended for the benefit of the fidelity insurance company and does not adversely affect the rights of registered investment companies, the modification may take effect immediately upon notifying the Commission and the insureds, without regard to the 60-day waiting period prescribed by Rule 17g-1(c). 3/

Sincerely,


Barbara Chretien-Dar
Attorney

2/ Provided that the insured complies with the removal and notification requirements of Section 12A, claims arising from an employee's conduct will continue to be covered under the bond. ICM will not terminate the bond as to that employee except in compliance with the notice and effectiveness provisions of paragraph (c) of Rule 17g-1. Telephone conversation with Natalie Shirley on February 28, 1994.

3/ We understand that, with respect to each investment company affected, the change will be initiated by the investment company and will be approved by a majority of the investment company's disinterested directors. See ICI Mutual Insurance Company (pub. avail. Jul. 28, 1988); Federal Insurance Company (pub. avail. Aug. 15, 1978).



November 1, 1993

Mr. Thomas S. Harmon
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 6th Street, N.W., M/S 10-6
Washington, DC 20549

Re: Investment Company Blanket Bonds

Dear Mr. Harmon:

As you know, several regional offices of the Securities and Exchange Commission ("SEC") have stated, in the course of their investment company inspection program, that the fidelity bonds issued by ICI Mutual Insurance Company ("ICI Mutual") are not in compliance with Rule 17g-1 under the Investment Company Act of 1940. Specifically, these regional offices have taken the position that Section 12(A) of ICI Mutual's standard form of Investment Company Blanket Bond ("Bond") violates the requirements of Rule 17g-1(a) and (c).

In response, ICI Mutual took temporary steps to alleviate the regional offices' concerns by revising Section 12(A) to provide that if an officer, partner or supervisory employee ("supervisory person") learns that an employee committed a dishonest or fraudulent act or theft ("bad act"), such employee must be removed from a position of access to the securities or funds of the investment company.

During a recent conversation with Larry Stadulis, he noted that while he recognized the important policy reasons for encouraging the removal of an employee who has committed a bad act from access to fund assets, he wanted to be certain that the investment company is not in violation of Rule 17g-1 if ICI Mutual denied coverage for losses resulting from the dishonest or fraudulent act or theft of an employee where a supervisory person knew the employee had previously committed a bad act and failed to remove such employee from an access position.

The following is a brief background of the termination section of the Bond and a discussion of the reasons the proposed revision complies with Rule 17g-1.

I. Background

A. Present Section 12(A)

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Currently, Section 12(A) of the standard form of the Bond provides:

This Bond shall terminate

- A. as to any Employee as soon as any partner, officer or supervisory employee of the Insured, who is not in collusion with such Employee, learns that such Employee committed any Dishonest or Fraudulent Act(s) or Theft, but such coverage shall not terminate with respect to Property then in transit in the custody of such Employee . . .

As set forth in our letter dated May 20, 1993 to Thomas S. Harman, Associate Director, Division of Investment Management, ICI Mutual believes that Section 12(A) of the standard form of Bond is in technical compliance with Rule 17g-1(a) and (c). In addition to the provision's technical compliance with the Rule, the policy reasons for including it in the Bond are compelling. If a bond did not contain the substance of Section 12(A), an employer, such as an investment adviser, would have no incentive to carefully check the background of prospective employees. As stated in Newhard, Cook & Company v. Insurance Company of North America, 929 F.2nd 1355 (8th Cir. 1991), "This incentive minimizes fraud which benefits both the investment industry and its customers." A failure to minimize fraud could result in a loss of public confidence and higher premiums. In addition, it is unrealistic for an insurance company to be expected to cover the dishonest or fraudulent acts or thefts of an employee who has previously committed bad acts, particularly at an affordable price.

Notwithstanding our arguments to the contrary, you have indicated that the staff continues to believe that Section 12(A) of the ICI Mutual standard form of Bond, violates Rule 17g-1(a) and (c).

Section 12(A), or language similar to Section 12(A), has been, for many years, a standard provision in fidelity bonds. ICI Mutual (and likely most insurers offering this type of coverage) is, for commercial reasons, unable to delete this provision and take the risk of continuing to offer coverage for the acts of an employee who is known to have previously committed bad acts and now has access to fund assets. An obvious alternative, is to require the insured to immediately dismiss any

employee who has previously committed a bad act.¹ However, this solution may be unacceptable to insureds.

B. Revised Section 12(A)

To avoid either of the above Draconian results, and in response to the comments of the regional offices, ICI Mutual amended Section 12(A) to provide as follows:

- A. Any Insured who learns that an Employee has committed any Dishonest or Fraudulent Act(s) or Theft shall immediately remove such Employee from a position that will enable such Employee to cause the Insured to suffer a loss by any Dishonest or Fraudulent Act(s) or Theft. The Insured, within forty-eight hours of learning that an Employee has committed any Dishonest or Fraudulent Act(s) or Theft shall notify the Underwriter [ICI Mutual], with full and complete particulars of such Dishonest or Fraudulent Act(s) or Theft.

For the purposes of this subsection, knowledge that an Employee has committed any Dishonest or Fraudulent Act(s) or Theft which is possessed or discovered by any officer, partner or supervisory employee of any Insured, who is not in collusion with such Employee, shall constitute knowledge or discovery by such Insured.²

¹Insureds frequently dismiss employees once they learn that such employee has committed a bad act. Under current Section 12(A) it is not unusual for insureds to request that the Bond be reinstated as to a particular employee who has committed a bad act, if the bad act was of a trivial nature or occurred many years ago.

²Upon further consideration, ICI Mutual believes that it is more appropriate to delete Section 12(A) of the standard form Bond and use the revised language of Section 12(A) as a separate condition of the Bond. As the revised language is no longer functionally a termination provision of the Bond it would be confusing to include it under the section in the Bond that is entitled "Termination".

II. Revised Provision is in Compliance with Rule 17g-1(a) and (c)

Rule 17g-1(a) requires that fidelity coverage be provided to cover "each officer and employee...who may...have access to securities or funds of the investment company..." By its terms, this provision requires only that coverage be provided; it does not dictate the terms and provisions of such coverage. Nor does it suggest that payment must be made for a loss regardless of the acts or omissions of the Insured.

The revised provision complies with Rule 17g-1(a) in that the provision does not automatically terminate coverage for each officer and employee who may have access to the assets of the insureds, provided the terms of the provision have been followed.

Similarly, Rule 17g-1(c) is not violated by inclusion of the new provision in the Bond. In relevant part, Rule 17g-1(c) requires bonds described in paragraph (b) of the Rule to contain a provision prohibiting the bond's cancellation, termination or modification without sixty days prior written notice from the "acting party" to the "affected party" and to the Commission and, where the bond is a joint insured bond, by the fidelity insurer to all registered investment companies named as insureds and to the Commission.

The revised provision fully complies with Rule 17g-1(c) in that it does not operate to cancel, terminate or modify the Bond as to any employee. The provision merely places a requirement to perform an act, i.e., remove an employee who has committed a bad act from a position of access to the securities or funds of a company. This act, which is required only upon knowledge by the insured of the fact that an employee has committed a bad act, is fully within the control of the insured.

The requirement of the revised provision to remove the employee from a position of access to the insured's assets is not unlike other requirements or conditions of the Bond. For example, the Bond includes a requirement to notify ICI Mutual of a merger or consolidation of an investment company, to give notice of discovery of loss within sixty days of discovery of a loss and to give ICI Mutual notice if there has been a change in control of an insured. Obviously, failure on the part of an insured to take the required action could jeopardize coverage under the Bond. However, the insured is easily able to take the required action and thus avoid an issue as to coverage.

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Although these provisions are beneficial to protect the insurer, they are also necessary to provide the insured with a reasonably priced product. These provisions allow the insurer to offer a product at a reasonable price with only minimal obligations on the part of the insured. Moreover, the obligation or requirement to remove an employee from an access position has the positive attribute of encouraging the protection of the insured and its shareholders and is reasonable for the insurer to insist upon.

III. Independent Directors Must Approve the Form of the Bond

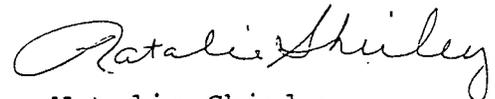
Rule 17g-1(d) requires, in pertinent part, that the bond shall be in "such reasonable form and amount" as a majority of the disinterested directors of the fund shall approve. Accordingly, the funds directors must review and approve the terms and conditions of the Bond, including any obligations or requirements imposed on the insured to maintain coverage. It is fully within the province of the independent directors to review the Bond and establish procedures to accommodate its provisions, including the removal of an employee who has previously committed a bad act from a position of access to the company's assets.

* * *

As stated above, striking Section 12(A) from the standard form of the Bond and including a provision that requires the insured to remove an employee that has committed a bad act from a position of access to the funds and securities of the company does not violate Rule 17g-1. Accordingly, the modification should be acceptable to the staff. On a related issue, we believe that the modification suggested above does not adversely affect the investment companies named to the bonds and thus, would not require 60 days notice to the Commission and each investment company named to the Bond, provided of course, that the change is initiated by the investment company and is approved by a majority of such company's disinterested directors.

I would be happy to discuss this matter further at your convenience. Please let me know if you have any questions or comments.

Very truly yours,



Natalie Shirley
Vice President and
General Counsel