

Plan Investments in Bank Collective Investment Funds

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The AICPA Employee Benefit Plan Audit Quality Center has developed this primer to provide Center members with a general understanding of defined benefit and defined contribution pension plan investments in bank collective investment funds (CIFs). Health and welfare plan investments in common trust funds are not addressed in this document.

Included in this primer are discussions of the unique characteristics and structure of CIFs, how they are regulated, valuation methods, fees commonly charged and methods for determining them, disclosures made to plan sponsors, and references to the relevant accounting and auditing professional literature.

Introduction

Bank collective investment funds are specifically designed under banking and tax laws for qualified tax-exempt retirement plans and certain trusts. CIFs are regulated under several regulatory and statutory rules, including federal or state banking laws and regulations, and the Employee Retirement Income Security Act of 1974 (ERISA). CIFs must also comply with federal tax laws that limit the eligible investors to U.S. tax-qualified retirement plans and U.S. governmental retirement plans. In addition, CIFs must meet specific bank management standards and investor eligibility restrictions to qualify for securities law exemptions under the Securities Act of 1933, Securities Exchange Act of 1934, and the Investment Company Act of 1940 (40 Act).

Types of CIFs

CIFs may be established for various purposes.

Many banks establish CIFs as investment vehicles for their smaller personal trusts or for employee benefit plan clients. The Office of the Comptroller of the Currency (OCC) establishes rules for CIFs offered by federally chartered (national) banks. While state chartered banks and other institutions offering CIFs are not subject to these regulations, many of them rely on or follow the OCC rules. Therefore, this document addresses only OCC regulations. However, other regulations may apply, depending on the issuing institution's charter (see *CIF Regulation* section below).

Regulations issued by the OCC under 12 CFR 9.18 authorize two general types of CIFs, type A1 and type A2. An A1 fund is established under 12 CFR 9.18(a)(1) and is maintained "exclusively for the collective investment and reinvestment of money contributed to the fund by the bank, or by one or more affiliated banks, in its capacity as trustee, executor, administrator, guardian, or custodian under a Uniform Gifts to Minors Act." The banking industry generally refers to A1 funds as "common trust funds." Thus, you will typically see common trust funds held within health and welfare benefit plan trusts, including those structured as Voluntary Employee Beneficiary Associations (VEBA) exempt from federal income taxes under IRC Section 501(c)9. An A2 fund is established under 12 CFR 9.18(a)(2) and is "a fund consisting solely of assets of retirement, pension, profit sharing, stock bonus or other trusts that are exempt from federal income tax under IRC Section 401(a)." The banking industry generally refers to A2 funds as "collective investment funds." The remainder of this primer will focus on type A2 collective investment funds.

What is a CIF?

A CIF is a trust created for qualified tax-exempt plans and certain trusts.

A CIF is a trust created and administrated by a trust company or a bank with trust powers that combines and collectively invests the assets of multiple qualified tax-exempt retirement plans. These pooled funds look like mutual funds, but they are exempt from registration with the Securities and Exchange Commission (SEC). Congress created exemptions for CIFs from the SEC's registration and reporting requirements if the funds are maintained by a bank and participation in the fund is restricted to only those customers covered by the exemption (e.g., qualified tax-exempt retirement plans).

Many banks offer CIFs in a wide range of asset classes and types, including domestic equity, international equity, domestic fixed income, international fixed income, stock/bond blend, target date funds, and short term investment funds. CIFs may have investment guidelines under which funds can invest in derivatives and alternative investments, such as hedge funds, private equity funds, or similar investments, and engage in other investment activities, such as securities lending or hedging.

Similar to mutual funds, banks may offer CIFs as passively managed (indexed) or actively managed funds. The portfolio manager of an actively managed fund tries to outperform the market index (such as the S&P 500) by performing an in-depth analysis of investments and selecting the ones they believe will perform best. In a passively managed fund, the manager tries to mimic the returns of the index it follows. An "enhanced fund" may employ a strategy that makes it a hybrid of the passive and active style.

Because of the investor eligibility restrictions discussed in the *Introduction* section above, banks market CIFs to a focused segment of institutional investors (i.e., employers, plan sponsors and fiduciaries, and their record keepers) rather than to the retail public, foundations, endowments, and other investors. The relationship between the participating entity and the trust fund is a fiduciary one, in which the plan must first appoint the bank as trustee or investment adviser of the assets that will be invested in the CIF. Unlike the relationship between mutual fund participants and the 40 Act funds, the CIFs are held to the higher fiduciary standard as they are subject to ERISA. Because CIFs are not open to the general public, the regulatory oversight of fund offerings to the general public is not relevant to CIFs.

CIF Structure

Plans are beneficial owners of the CIF's and do not own the underlying fund assets.

The bank, as trustee of the fund, holds legal title to the assets within the trust. The participating retirement plans are the beneficial owners of the CIF, holding an undivided interest in the total assets of the CIF (represented by units in the CIF) rather than in the underlying assets themselves.

OCC banking regulations require CIFs to be established through a written plan that must include provisions on the bank's operation of the fund, including the bank's investment powers and policies, fee and expense information, the fund's allocation of income, profits and losses, and the terms and conditions governing admission and withdrawal of participating accounts, among other things. A bank must make this information available to CIF participating accounts or trusts, the CIF's beneficial owners, upon request.

CIF Regulation

CIFs are subject to various regulations.

Banks and their CIFs are subject to examination and oversight by federal and state banking regulators. Depending on the institution's charter (federal or state, bank or thrift), the regulator could be one or more

of the following: the OCC; the Federal Reserve Board; the Office of Thrift Supervision; the Federal Deposit Insurance Corporation; or a state banking regulator. CIFs in which plans invest also are subject to ERISA and Department of Labor (DOL) regulations.

OCC bank regulators conduct periodic on-site examinations, during which they review and test bank policies, procedures, systems, and risk management, as well as an institution's compliance with the applicable banking and other regulations and laws governing its trust activities, including the management of its CIFs.

OCC banking regulations require that CIFs be audited at least once every 12 months by auditors responsible only to the bank's board of directors. The regulations do not specify that a financial statement audit performed in accordance with generally accepted auditing standards (GAAS) is required. However, a bank must prepare a financial report, based on the annual audit, at least once during each 12-month period for each CIF it administers which, at a minimum, must contain a list of investments in the fund showing the cost and current market value of each investment; and a statement covering the period after the previous report showing (organized by type of investment) a summary of purchases (with costs), a summary of sales (with profit or loss and any other investment changes), income and disbursements, and an appropriate notation of any investments in default. In most cases, the bank will engage an independent public accounting firm to perform a GAAS audit to meet these requirements. A bank must provide either a copy of the financial report, or must provide notice that a copy of the report is available without charge, to each person who ordinarily would receive a regular periodic accounting with respect to each participating account.

In the CIF, the bank acts as both trustee/fiduciary and fund manager. Fiduciary standards are established by federal and state banking law and ERISA (the assets in CIFs in which plans invest are considered retirement plan assets, and therefore are subject to the requirements of ERISA). The bank, as trustee of the CIF, is a fiduciary under ERISA and subject to ERISA's fiduciary requirements including the prohibitions on self-dealing and conflicts of interest. Bank regulators examine CIFs for compliance with ERISA and other fiduciary rules.

The DOL may also conduct reviews of banks and their CIFs for ERISA compliance. A CIF may, but is not required to, file a Form 5500 as a direct filing entity (DFE). Plans that participate in CIFs that file as DFEs generally are eligible for certain annual reporting relief. For reporting purposes, a CIF is not considered a DFE unless a Form 5500 and all required attachments are filed for it in accordance with the *Direct Filing Entity (DFE) Filing Requirements*.

CIF Valuation

Unit prices of the fund are based on the market value of the underlying assets.

CIFs may trade on a daily, monthly, or less frequent basis (i.e., quarterly), and are valued accordingly. However, banks that offer CIFs to 401(k) plans or participate in the National Securities Clearing Corporation's (NSCC) trading system typically perform valuations on a daily basis to allow for daily purchases and sales. The NSCC is a subsidiary of the Depository Trust and Clearing Corporation (DTCC) that was established in 1976 and is regulated by the SEC. NSCC typically nets batches of participant purchases and redemption orders among the participating firms (which includes brokers, investment managers and others) and directs payments and security transfers appropriate to each firm participating in the system.

Audited financial statements are largely available for CIFs. These financial statements provide useful information in assessing fair value measurements. FASB ASC 820-10-35-59 permits a reporting entity (including a CIF), as a practical expedient, to estimate the fair value of an investment using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment as of the reporting entity's

measurement date, based on certain criteria. See FASB ASC 820-10-35-59 to 62 for guidance in estimating fair value using the practical expedient. In rare situations, depending on the investment structure, the investment's financial statements may not be valued at fair value, but on some other basis, which would be disclosed in the notes to the audited financial statements.

CIFs generally invest in marketable securities (but also may invest in other CIFs or mutual funds), and the unit price generally will be based on the fair value of the underlying securities or holdings, which may include cash for liquidity purposes, less any accrual of fees and expenses that are borne by the funds (see further discussion of fees in the *CIF Fees* section below). In other words, the unit value of a CIF is calculated as the value of the underlying assets, less fees and expenses, divided by the number of outstanding units.

CIF Fees

CIF fees may be charged at the plan or participant level.

CIF fees typically bear operational and administrative expenses and investment management fees. In the case of CIFs that trade on the NSCC platform, the expenses and fees are typically borne internally at the fund level so that the daily accruals are reflected in the daily unit value calculation of the CIFs. However, banking regulations and tax rules allow CIFs to vary the advisory and other fees charged to different retirement plans in the same CIF so long as the fee is reasonable based on the services provided. Thus, banks may individually negotiate fees and then charge them externally to the plan or may create multiple classes of units with varying fee structures to allow for different levels of services, such as recordkeeping, to be charged at the CIF level or by plan at the plan account level. When fees are charged at the plan level, the plan sponsor may decide whether to subsidize some or all of the costs or charge plan participants.

Because they are not sold to the retail public, CIFs do not incur costs such as retail distribution and advertising.

CIF Information Available to Plan Sponsors

Plan sponsors have access to certain information about the CIF.

Information about CIFs that is made available to retirement plan sponsors includes the CIF written plan and any material updates to it; the declaration of trust; the annual audited financial statements for the CIF (if available); the Form 5500 if the CIF files as DFE; and any other reports as agreed between the bank and the sponsor. In addition, the CIF manager often provides plan sponsors with information about the particular investment strategy, including investment guidelines, information on fees and expenses, and investment performance.

The plan sponsor, administrator, or record keeper typically uses this information to prepare disclosures it makes to defined contribution plan participants. For example, this information may be delivered in the form of "fund fact sheets," as part of quarterly plan participant statements, or on a website hosted or maintained by any of the plan's service providers. Accordingly, this information can be specific to each plan, reflecting the actual costs to the plan participants (and not just the internal fees and expenses of the CIF).

References to Auditing and Accounting Professional Literature

OCC Comptroller's Handbook, **Collective Investment Funds**, provides an overview of collective investment funds administered by a national bank pursuant to 12 CFR 9.18, outlines their associated risks, and establishes a framework for managing those risks, <http://www.occ.gov/static/publications/handbook/CIFfinal.pdf>.

FASB ASC 820, Fair Value Measurements and Disclosures, establishes a framework for measuring fair value, and prescribes disclosures about fair value measurements.

AICPA Audit and Accounting Guide, **Employee Benefit Plans**, provides guidance on auditing plan investments, including CIFs.

AICPA's **Alternative Investments – Audit Considerations, A Practice Aid for Auditors** is a resource useful to plan auditors relating to the audit testing of these investments. This Practice Aid includes an example confirmation for alternative investments, illustrative examples of due diligence, ongoing monitoring, and financial reporting controls as well as practical advice in auditing these investments.

PCAOB Staff Audit Practice Alert No. 2, **Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists**, issued December 10, 2007, highlights certain requirements in the PCAOB auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of GAAP that are particularly relevant to the current economic environment.

EBPAQC's **Plan Advisory: Valuing and Reporting Plan Investments**, is a guide to assist plan sponsors in understanding their responsibilities for valuing and reporting their plan investments. It is a comprehensive document that contains information about their responsibility for reporting plan investments, how plan investments are reported, investment valuation and related disclosures, their responsibility for valuing investments and establishing internal controls, special considerations for alternative investments, investment information they should request from the plan trustee or custodian, how their independent auditor can assist them, and where to obtain additional information.

EBPAQC's **Investment Resource Center**, provides general information about investments, and links to authoritative literature, primers and past center calls related to those investments.

AICPA annual Audit Risk Alert, **Employee Benefit Plans Industry Developments**, highlights the hot topics in the employee benefit plan industry. This alert will include current issues with various employee benefit plan investments.

75 Federal Register 64910, **Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans** (October 20, 2010), <http://edocket.access.gpo.gov/2010/pdf/2010-25725.pdf>, and 75 Federal Register 41600, **Reasonable Contract or Arrangement under 406(b)(2)** (July 16, 2010), <http://edocket.access.gpo.gov/2010/pdf/2010-16768.pdf>, provide guidance regarding the disclosure of fee information to plan sponsors and plan participants.