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Revisiting collective investment funds

RETIREMENT plan advisers are seeing continued growth and acceptance of an investment structure from the past: the collective investment fund (CIF). This appears to be due to improved operational tracking arising from technological advances, along with competitive fee and expense characteristics that are highly valued in the current era of financial transparency and disclosure.

In this column, I will address the structural aspects of a CIF and the Employee Retirement Income Security Act (ERISA) implications of offering these funds to qualified plans. In my next column, I'll summarize the key regulatory aspects of CIFs and compare them to managed accounts.

CIFs are designed either for common trust funds or for investment by tax-exempt retirement plans under regulation of the Office of the Comptroller of the Currency (OCC). A CIF, then, is a trust created and administered by a trust company or bank with trust powers to jointly invest retirement plan assets. If properly structured, the CIF is exempt from Securities and Exchange Commission (SEC) registration and reporting requirements.

A CIF is created by a declaration of trust, with each investing retirement plan holding a proportionate interest in the underlying assets. Investment adviser firms typically work with the sponsoring financial institution, which must "maintain" the CIF, as well as offer a specific investment style in a subadvisory capacity.

Participation in the CIF trust is limited to tax-qualified retirement plans and individual retirement accounts (IRAs), with certain exceptions and limitations. The CIF is exempt from taxation under Internal Revenue Service (IRS) Revenue Ruling 2011-1, provided certain conditions are satisfied. For example, the group trust governing documentation must expressly prohibit any part of its income that equitably belongs to any retiree benefit plan from being used for any purpose other than the exclusive benefit of the participants and the beneficiaries of that particular plan.

Every CIF in which an ERISA plan invests is subject to ERISA regulation. Only government plans are exempt from ERISA. This means that plan assets must be invested in every underlying asset of the CIF trust.

The CIF trustee and any trust company personnel who perform fiduciary functions on behalf of the trustees are considered ERISA fiduciaries. Their fiduciary responsibilities include providing investment advice to ERISA plans, as well as discretionary authority and control over CIF assets. Similarly, a retirement plan adviser who supplies advice with respect to the investment of CIF assets is also considered an ERISA fiduciary. All of these fiduciaries are subject to ERISA's standard of care in their dealings with the underlying CIF investments. The CIF itself is also subject to ERISA's reporting and disclosure rules.

CIF transactions with ERISA fiduciaries are subject to ERISA's prohibited transaction rules. Among other things, this may mean that investing in proprietary mutual funds or other proprietary investment products is prohibited. It also means that a registered investment adviser (RIA) who is paid for advising a plan—making the adviser a fiduciary—cannot advise the plan to invest in a CIF managed by the RIA, thereby doubling his fee.

Every collective investment fund in which an ERISA plan invests is subject to ERISA regulation.

Section 408(b)(8) of ERISA provides a statutory exemption from the prohibited transaction rules so that a plan may purchase a CIF interest from the bank that maintains the CIF, provided that the bank receives no more than reasonable compensation and the transaction is expressly permitted by the plan or by an independent plan fiduciary with authority to manage and control plan assets. This allows the bank to charge additional fees for asset management without the need for fee leveling, as would be required of a mutual fund.

Assuming a plan qualifies as a Section 404(c) plan, the fiduciary protection against personal liability for an individual participant's losses would extend to all investment alternatives available under the plan. CIFs by nature are investment products, and in this regard, they are similar to any other investment alternative offered to plan participants. Thus, the fiduciary protection afforded to a Section 404(c) plan would clearly extend to CIFs as well as any other investment funds that participants select from the plan's menu.

However, this fiduciary protection is not absolute. The plan sponsor would remain responsible for prudently selecting and maintaining the various investment alternatives for the plan's menu. In addition, any investment adviser to the CIF, along with the bank trustee, would be viewed as a fiduciary for ERISA purposes and would be responsible for prudently investing the CIF's assets. Thus, even though the plan sponsor and adviser would be subject to certain ongoing fiduciary duties, they would be able to draw comfort from the fact that the adviser and bank trustee also serve as co-fiduciaries.

Marcia S. Wagner is an expert in a variety of employee benefits issues and executive compensation matters, including qualified and nonqualified retirement plans, and welfare benefit arrangements. A summa sum laude graduate of Cornell University and Harvard Law School, she has practiced for 26 years. Wagner is a frequent lecturer and has authored several books and numerous articles.

 Illustration by Dadu Shin