Regulation of CIFs

The advantages of collective investment funds

IN MY last column, I addressed the structural aspects of collective investment funds (CIFs) and the Employee Retirement Income Security Act (ERISA) implications of offering them under a qualified plan. Here, I cover the regulation of CIFs and compare them with mutual funds.

Under the Department of Labor (DOL)'s participant-level disclosure rules, a CIF held in a participant-directed individual account plan would be treated as a "designated investment alternative" subject to disclosure. As a result of these rules, advisers may be called on to assist plan sponsors in providing participants with standardized performance information for each such investment alternative, measured against its benchmark index, in the format of a comparative chart. In addition, plan sponsors must also post online the CIF's investment objectives and strategies, portfolio turnover ratio and quarterly updates on performance data and fees. Because the Investment Company Act of 1940 has long required mutual funds to disclose information similar to the DOL-mandated disclosures, and because banks competing with mutual funds have instituted comparable communications with respect to their products over the years, advisers who want to offer CIFs can easily partner with a bank trustee that has already developed the capacity to produce the new DOL disclosures.

CIFs as QDIAs

ERISA Section 404(c)(5) offers fiduciaries protection against liability for investment losses when participants are "defaulted" into a qualified default investment alternative (QDIA). The QDIA provisions generally contemplate an investment fund product or model portfolio that has a balanced strategy or target-date retirement investment strategy; customized CIFs can fit under either approach.

CIFs can be structured to meet the QDIA requirements so that plan fiduciaries will be protected when a participant is defaulted into such a CIF. While the CIF adviser does have fiduciary responsibility, prudence is a matter of following an appropriate investment process and does not require a guarantee of favorable results. As with any prospective investment, ERISA's prudence standard requires fiduciaries to follow an objective and thoroughly documented process for obtaining information about a CIF being considered for inclusion on a plan investment menu. Information such as the nature of the investment, its performance history and expense will enable the fund to be evaluated and periodically reviewed to ensure its continuing suitability.

Mutual Funds and CIFs

Compared with a QDIA composed of a tiered group of affiliated mutual funds—which is how TDFs made up of mutual funds are typically structured—CIFs may be positioned as superior investment vehicles because they enhance the diversification of investment managers. CIFs also eliminate conflicts of interest inherent in tiered mutual fund structures that could potentially result in excessive fees. Accordingly, CIFs are potentially more cost-effective investments that eliminate barriers to the best possible investment performance. In fact, CIFs are one of the investment alternatives the DOL had in mind when it recently called on plan sponsors to ask about customized target-date funds.

Moreover, CIFs offer certain flexibility unavailable through mutual funds, as the latter are subject to heavy regulation under the Investment Company Act. Mutual funds initially gained market share at the expense of CIFs, due in part to certain administrative weaknesses in CIF operations, primarily the lack of daily valuation. Mutual funds at that point offered more investment strategies, could be valued and traded on a daily basis, and had broader reach under the securities laws in terms of marketing to institutional or non-institutional investors.

However, in 2000, when the National Securities Clearing Corporation added CIFs to its trading platform, CIFs began to trade daily and provide daily valuations, with liquidity available on a daily, monthly or quarterly basis. Bank trustees can readily calculate CIF performance on a single pricing basis and track the ownership of interests in a CIF through unitized accounting.

CIFs also offer a greater range of investment objectives with either passive or active investment management styles, and are arguably less expensive than mutual funds. Mutual funds generally have higher marketing and distribution costs due to the broad reach of potential investors, whereas CIFs are limited to retirement plans. The Securities and Exchange Commission (SEC) registration exemption results in significantly lower compliance costs than are found with a mutual fund, and the elimination of board meetings, shareholder meetings, proxy and prospectus requirements, and a statement of additional information results in even greater savings.

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