Introduction to Common and Collective Funds

Funds used for the collective investment of assets are referred to both as common trust funds and collective investment funds. The Internal Revenue Code (IRC) refers to "common trust funds" in §584 while the Office of the Comptroller of the Currency uses the term "collective investment fund" in 12 CFR §9.18. The trust world generally uses the term "common trust fund" to describe funds used for the collective investment of fiduciary accounts. These generally include accounts held by a savings association as trustee, executor, administrator or guardian. Common trust funds are tax-exempt under §584 of the IRC if operated in accordance with the rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency (12 CFR §9.18(a)(1)). The term "collective investment fund" is used primarily to describe the collective investment of tax-qualified retirement plans. Collective investment funds (CIFs) are tax-exempt under Revenue Ruling 81-100. Collective investment funds are also referred to as group trusts and as (a)(2) funds, which references §9.18(a)(2).

The benefit to trust customers of using a common or collective fund as an investment vehicle is the generally favorable investment performance of the funds and a reduction in fees charged to trusts and retirement plan accounts invested in the fund. Another important advantage to participants in a fund is the automatic diversification of investments. The fund is much larger than any of the individual participants investing in the fund. This allows each of the individual trusts or qualified plans to participate in a fully diversified and broadly based investment portfolio. A potential disadvantage is that capital gains (long and short term), and losses are passed through to participants proportionally. Therefore, participants may incur a tax liability resulting from investment transactions within the fund. This, of course, may not be a concern for employee benefit plan accounts or other accounts that are tax-exempt in nature.

Savings associations will be permitted for the first time to offer common and collective funds to its trust customers without having to register them with the Securities and Exchange Commission. This result was achieved by the language in Section 223 of the Gramm-Leach-Bliley Act that amended Section 2(a)(5) of the Investment Company Act of 1940.

OTS Regulation §550.260(a) authorizes savings associations to invest fiduciary funds in CIFs established and administered in accordance with the Comptroller of the Currency's (OCC) §9.18. There are a number of requirements contained in §9.18. Some of them are described below.

Written Plan

A CIF must be established and maintained in accordance with a written plan. The plan should be approved by a resolution of the bank's board of directors. The board may assign authority for approving the establishment of a CIF to a designated committee. A plan must contain provisions regarding the operation of the fund, including provisions related to:

- investment powers and policies with respect to the fund;
- allocation of income, profits and losses;
- fees and expenses that will be charged to the fund and to participating accounts;
- terms and conditions governing the admission and withdrawal of participating accounts;

- audits of participating accounts;
- basis and method of valuing assets in the fund;
- expected frequency for income distribution to participating accounts;
- minimum frequency for valuation of fund assets;
- amount of time following a valuation date during which the valuation must be made;
- bases upon which the bank may terminate the fund; and
- any other matters necessary to clearly define the rights of participating accounts.

Fund Management

A savings association administering a CIF shall have exclusive management of the fund. An exception is where a prudent person might delegate responsibilities to others. A savings association should always seek an opinion of counsel as to the securities law consequences of a delegation.

Proportionate Interests

Each participating account in a CIF must have a proportionate interest in all the fund's assets. The accounts investing in the fund are called participants and each participating account shares proportionally in the investment results of the fund. Neither the fiduciary nor any beneficiary of a participating account has ownership of any particular asset or investment of the fund. The interests held in the fund by participating accounts are called units.

Valuation

A savings association administering a CIF shall determine the value of the fund's assets at least once every three months. An exception is made for (a)(2) funds that are primarily invested in real estate or other assets that are not readily marketable. In these cases a savings association shall determine the value of the fund's assets at least once each year. Each fund asset shall be valued at market value as of the date set for valuation, unless the savings association cannot readily ascertain market value, in which case the savings association shall use a fair value determined in good faith. An exception is made for short-term investment funds. A savings association may value a fund's assets on a cost, rather than market value basis for purposes of admissions and withdrawals if the plan requires the savings association to: 1) maintain a dollar-weighted average portfolio maturity of 90 days or less; 2) accrue on a straight-line basis the difference between the costs and anticipated principal receipt on maturity; and 3) hold the fund's assets until maturity under usual circumstances.

Admission and Withdrawal of Accounts

A savings association administering a CIF shall admit an account to or withdraw an account from the fund only on the basis of the valuation described above. An exception would be for (a)(2) funds that are invested primarily in real estate or other assets that are not readily marketable. These funds may require a prior notice period for withdrawals that may not exceed one year.

Method of Distribution

A savings association administering a CIF shall make distributions to accounts withdrawing from the fund in cash, ratably in-kind, a combination of cash and ratably in-kind or in any other manner consistent with applicable law in the state in which the savings association maintains the fund.

Segregation of Investments

If an investment is withdrawn in-kind from a CIF for the benefit of all participants in the fund at the time of the withdrawal but the investment is not distributed ratably in-kind, the savings association shall segregate and administer it for the benefit, ratably, of all participants in the CIF at the time of withdrawal.

Audits and Financial Reports

At least once during each 12 month period, a savings association administering a CIF shall arrange for an audit of the CIF by auditors responsible only to the board of directors of the savings association. At least once during each 12 month period, a savings association administering a CIF shall prepare a financial report of the fund. The report must disclose the fund's fees and expenses in a manner consistent with applicable law in the state in which the savings association maintains the fund. This report 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 the following (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.

A savings association may include in the financial report a description of the fund's value on previous dates, as well as its income and disbursements during previous accounting periods. A savings association may not publish in the financial report any predictions or representations as to future performance. In addition, with respect to (a)(1) funds, a savings association may not publish the performance of individual funds other than those administered by the savings association or its affiliates. A savings association administering a CIF shall provide a copy of the financial report or shall provide notice that a copy of the report is available upon request without charge to each person who ordinarily would receive a regular periodic accounting with respect to each participating account. The savings association may provide a copy of the financial report to prospective customers. In addition, the savings association shall provide a copy of the report upon request to any person for a reasonable charge.

Advertising Restriction

A savings association may not advertise or publicize any (a)(1) fund except in connection with the advertisement of the general fiduciary service of the savings association.

Self-dealing and Conflicts of Interest

A savings association administering a CIF must comply with the following:

- ***Bank Interests***. A savings association administering a CIF may not have an interest in that fund other than in its fiduciary capacity. If, because of a creditor relationship or otherwise, the savings association acquires an interest in a participating account, the participating account must be withdrawn on the next withdrawal date. However, a savings association may invest assets that it holds as fiduciary for its own employees in a CIF.
- ***Loans to participating accounts***. A savings association administering a collective investment fund may not make any loan on the security of a participant's interest in the fund. An unsecured advance to a fiduciary account participating in the fund until the time of the next valuation date does not constitute the acquisition of an interest in a participating account by the savings association.
- ***Purchases of defaulted investments***. A savings association administering a collective investment fund may purchase for its own account any defaulted investment held by the fund (in lieu of segregating the investment) if, in the judgment of the savings association, the cost of segregating the investment is excessive in light of the market value of the investment. If a savings association elects to purchase a defaulted investment, it shall do so at the greater of market value or the sum of cost and accrued unpaid interest.

Management Fees

A savings association administering a CIF may charge a reasonable fund management fee only if:

- The fee is permitted under applicable law (and complies with fee disclosure requirements, if any) in the state in which the savings association maintains the fund.
- The amount of the fee does not exceed an amount commensurate with the value of legitimate services of tangible benefit to the participating fiduciary accounts that would not have been provided to the accounts were they not invested in the fund.

Expenses

A savings association administering a CIF may charge reasonable expenses incurred in operating the CIF, to the extent not prohibited by applicable law in the state in which the savings association maintains the fund. However, a savings association shall absorb the expenses of establishing or reorganizing a CIF.