Collective Investment Funds

Collective investment funds ("CIFs") are not new to the retirement plan industry. In fact, they have been available for decades as an investment alternative offered to both defined benefit and defined contribution plans. When 401(k) plans became popular in the 1980s, CIFs remained as an investment option in many of the early plans. However, mutual funds became the more popular retirement investment choice due in part to their transparency, daily pricing and more frequent performance and holdings reporting. Now, CIFs are making a comeback and re-emerging as a mainstream investment option for tax-exempt qualified retirement plans.

Collective Investment Funds Timeline and the Road to ERISA

1927 First CIF offered pre-dating the first public offering of a mutual fund by a year or more

1936 Congress amended Internal Revenue Code which provided tax-exempt status to certain bank CIFs

1955 FED authorizes banks to pool funds from pension, profit sharing, and stock bonus plans and the IRS subsequently ruled that such funds could be tax-exempt resulting in CIFs becoming the dominant retirement vehicle at the time and in the decades that followed

1963 100-year-old Studebaker closes automotive plant in South Bend, Indiana, and defaults on defined benefit retirements to 11,000 employees—the Studebaker default is generally regarded as a pivotal event in starting the enactment of the Employee Retirement Income Security Act (ERISA)

1974 President Ford signs ERISA† into federal law on Labor Day, September 2, 1974—ERISA subsequently influences future legislation that creates 401(k) plans

1978-1981 The Revenue Act of 1978 included a provision that became Internal Revenue Code Sec. 401(k) (for which plans are named), sanctioning the use of salary reductions under which employees are not taxed on elected deferred compensation income as a source of plan contributions—the law went into effect January 1, 1980, regulations were issued in November of 1981

2000 National Securities Clearing Corporation (NSCC) allows CIFs onto its Fund/SERV® settlement platform allowing CIFs to be traded and tracked the same way as mutual funds

2006 Pension Plan Protection Act of 2006 triggers a comeback for CIFs

2010 Pension Plan Protection Act of 2006 triggers a comeback for CIFs

†The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for retirement and health benefit plans in private industry. Before ERISA was enacted by Congress, employees were not protected under any law and many of them retired or were discharged without benefits. There were many years of different questionable practices by certain pension plans prior to the passing of ERISA in 1974. (The Teamsters Union Pension Fund was one of the largest, well known entities for unethical practices, including a rather colorful history involving questionable loans to certain Las Vegas casinos.)

The Comeback

Technology advances, CIF regulatory status and public policy have been major catalysts for CIFs. The Pension Plan Protection Act of 2006 outlined automatic enrollment of plan participants into tax-qualified plans while identifying CIFs as potential qualified default investment alternatives ("QDIA") for some defined contribution plans. The growing popularity of CIFs is also driven by an increased focus on plan expenses. Under ERISA, one of the fundamental responsibilities of fiduciaries is “defraying reasonable expenses of administering the plan” and CIFs generally may deliver significant cost advantages over mutual funds.

You should consider a fund’s investment objectives, risks, and charges and expenses carefully before investing. Contact your financial advisor or call First Trust Portfolios L.P. at 1.877.937.4015 to request an Information Statement, which contains this and other information about a fund. Read it carefully before you invest. This paper was prepared by First Trust Portfolios L.P. It is based upon sources and data believed to be accurate and reliable.

Continued on back page.
Collective Investment Funds | Adhering to ERISA's Fiduciary Standards

How do Collective Investment Funds differ from Mutual Funds?

While CIFs are similar in nature to mutual funds in that they are pooled investment vehicles with a specific philosophy and strategy, there are several factors that differentiate CIFs from mutual funds. CIFs are not registered with the SEC and are exempt from the Investment Company Act of 1940 (“ICA”). Mutual funds are regulated by the SEC and must comply with the ICA and the Securities Exchange Acts of 1933 and 1934, whereas CIFs are regulated by either the Office of the Comptroller of the Currency or individual state banking regulators. Because of the different regulatory environment in which mutual funds and CIFs operate, CIFs are not required to have boards of directors or provide prospectuses, and they are limited in their marketing activity. CIFs may have lower fees and simpler structures, although expense ratios vary widely among both mutual funds and collective investment funds. Because CIFs are used in defined contribution plans, fund trustees are held to the fiduciary requirements of the Employee Retirement Income Security Act (“ERISA”), an important consideration for plan sponsors. Mutual fund managers avoid the ERISA fiduciary duty due to an exemption given to registered investment companies. Since mutual funds are already regulated under the ICA, the thinking was that dual regulation was unnecessary.

Collective Investment Funds | ERISA Fiduciary Standards Further Explained

CIFs must adhere to ERISA’s Look Through Rule
Plans assets are deemed to include an undivided interest in every underlying asset of a CIF in which a plan holds an interest. [ERISA Look-Though Rule, Consideration & Exemptions]

CIFs Trustees are held to the Standard of Care according to ERISA’s Prudent Man Rule
A fiduciary must act “with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity” would act. This rule is derived from the common law of trusts. This is an objective standard based upon how a person with experience and knowledge of a certain area would act in a given situation. If a fiduciary lacks the expertise for a certain area then the fiduciary must obtain expert help. [29 U.S.C. §1104 (a) (1) (B)]

CIFs are held to the ERISA Standard of Diversification Rule
A fiduciary must diversify investments in order to minimize risk of loss unless it would be considered prudent to not diversify investments. [29 U.S.C. §1104 (a) (1) (C)]

CIFs are held to ERISA’s General Duty of Loyalty
ERISA section 404(a) (1) is commonly refered to as the exclusive benefit rule and is considered to command a fiduciary’s duty of undivided loyalty. A fiduciary shall discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries.

CIFs are subject to ERISA’s Reporting and Disclosure (i.e. Form 5500)
This rule is intended to assure that employee benefit plans are operated and managed in accordance with certain prescribed standards and that participants and beneficiaries, as well as regulators, are provided or have access to sufficient information to protect the rights and benefits of participants and beneficiaries under employee benefit plans.

GOING FORWARD
Every retirement plan’s investment policy is different. Therefore, it is imperative that plan sponsors carefully evaluate the CIF structure before offering these investments in their plan. However, we believe that given the momentum of the current CIF market, asset managers will need to evaluate CIF options to compete in the 401(k) market going forward.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA and the Internal Revenue Code. First Trust has no knowledge of and has not been provided any information regarding any investor. Financial advisors must determine whether particular investments are appropriate for their clients. First Trust believes the financial advisor is a fiduciary, is capable of evaluating investment risks independently and is responsible for exercising independent judgment with respect to its retirement plan clients.