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.

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Self-dealing and Conflicts of Interest

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

- ***Bank Interest.*** 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.

Common and Collective Funds Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of common and collective investment funds. Consider whether:

- adequate policies, procedures and internal controls have been established for the administration of common and collective investment funds;
- the funds are operated in accordance with applicable law and the terms of the governing instrument; and
- deficiencies are identified and corrective action promptly initiated.

Examination Procedures

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Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping; the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to common and collective investment funds (CIFs). Scoping material should include:
   - Risk profile
   - Relevant PERK documents
   - The fund(s) annual audit(s).
   - Previous trust and asset management examination report
   - Workpapers from the previous examination
   - Plan documentation for each CIF and amendments thereto

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- Board and committee minutes
- Examples of CIF marketing material

2. Evaluate the adequacy of administrative and operational policies and procedures, as appropriate to the size and character of CIF operations. Note any particular changes. Consider whether the policies address:

   - a review of any new CIF plan document by bank counsel;
   - plan approval by the board or a board designated committee;
   - compliance with applicable law and standards of fiduciary conduct; and
   - compliance with the fund's written plan.

3. Review the CIF investment policies and procedures for adequacy and appropriateness.

4. If an outside investment manager or other portfolio management responsibilities are delegated to a third party, ensure that appropriate documentation is maintained and that compliance with the investment policy is being monitored. Assess the due diligence efforts with respect to the selection of the third party. Assure compliance with OCC regulation 9.18(b)(2), and assess whether any SEC registration issues have been raised as a result of the delegation.

5. Determine whether management and staff have the expertise necessary to administer CIF's. Identify and evaluate any personnel and/or organizational changes.

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6. Review procedures for admissions and withdrawals from the CIF. Determine whether anyone has been authorized to review and approve the admissions and withdrawals.

7. Review the annual report and audit of each CIF. Determine that the information contained in the financial report meets the requirements of 12 CFR §9.18(b)(6).

8. Determine if a copy or notice of the financial report availability is furnished to each person to whom a regular periodic accounting would ordinarily be rendered.

9. Determine if the savings association files an informational tax return for the common trust fund with the IRS in accordance with IRC §6032. Determine if the common or collective fund is filing directly with the Department of Labor as a direct filing entity using Form 5500 or whether the CIF is providing participating employee benefit plans with information regarding the underlying assets of the CIF so that the plan may include this information on its Form 5500.

10. Consider whether the following risk contributors (if applicable) have been addressed:

- the accuracy and credibility of management reports;
- the thoroughness of the compliance program;
- the effectiveness of the supervision and audit function;
- the quality of the written policies and procedures;
- the effectiveness of management; and

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- the adequacy of policies and procedures governing the management of CIFs.

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of a Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification.

1. Determine that the savings association maintains exclusive management control of the CIF and that procedures are in place to maintain records relating to investment, administrative and operational decisions in order to document compliance.

2. Determine if sound portfolio diversification principals are followed.

3. If proprietary mutual funds were funded through conversions from the savings association's CIFs, determine whether the savings association considered all pertinent issues before the conversion took place and whether applicable law and fiduciary principles were followed.

4. If there are unresolved exceptions present from internal or external audit reports, compliance reports or examination findings, discuss corrective action with management.

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5. Review the promotional and advertising publications for the CIF to ensure that funds are marketed only in connection with the advertisement of the general fiduciary service of the savings association.

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6. Review the returns of the CIF's and compare the returns to comparable indices for one, three and five year returns. Determine if the returns are reported in accordance with AIMR reporting guidelines. Note any significant differences and discuss with management.

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7. Determine if the savings association receives only reasonable compensation for investing ERISA accounts in the collective investment fund. Also determine if the plan document, trust agreement or a fiduciary (other than the savings association or an affiliate) that has authority to manage and control plan assets, expressly permits investment in the fund.

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8. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts or funds need to be reviewed to arrive at a well-founded conclusion.

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If the examiner cannot rely on the trust and asset management Level I and Level II procedures, or data contained in department records or internal or external audit reports, proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

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1. Review the management and administration of the CIFs. Determine if management is following internal procedures and is in compliance with the terms of the written plan governing each of the CIFs.

2. If the CIF obtains its tax-exempt status under IRC §584, determine that it is operated in conformity with 12 CFR §9.18.

3. For any defaulted securities (equity or fixed) held by a CIF, determine if the security(s) have been segregated in a separate account on the annual report.

4. Review expenses and charges to the CIF. Ensure that all charges to the funds are appropriate and authorized by applicable law.

5. Review a sample of portfolio valuations. Determine that the valuations are:

   - completed at least quarterly (except funds invested primarily in real estate or other not readily marketable assets) and in accordance with the frequency set forth in the plan; and
   - in conformance with the express methodology provisions of the plan.

6. Review a list of participants in each CIF to ensure that only eligible accountholders are allowed to participate. Ensure that IRA and Keogh accounts are not invested in common trust funds per SEC no-action letters.

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7. Review a sample of investment portfolios to determine compliance with terms of the saving association's investment policy. Identify any significant changes in holdings, credit quality or risk profile.

8. Ensure that current plan documentation for each CIF operated by the trust department is on file. Review documents for each new CIF and amendments to existing CIF's for compliance with 12 CFR §9.18(b)(1). For new CIFs, review the IRS determination letter for tax- exempt status if one has been issued.

9. Ensure that admissions and withdrawals are performed according to policy and are posted in a timely manner.

10. If the savings association converted an ERISA collective investment fund into a proprietary mutual fund, determine if the conditions of prohibited transaction class exemption PTE 97-41 were met.

11. Determine if the following conditions of PTE 91-38 have been met:

- The plans interest in a CTF does not exceed 10 percent of the total assets unless it is a STIF
- The terms of purchases and sales (or any other transactions) by the CTF are at least as favorable to the CTF as those obtainable in an arm's length transaction with an unrelated party
- The savings association is maintaining CTF records for six years from the date of any of the above referenced transactions

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12. Select a sample of short-term investment funds (STIF's) and determine whether such funds are operated in accordance with the provisions of 12 CFR §9.18.

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 880P

Laws

Internal Revenue Code	Section 584

Code of Federal Regulations

12 CFR 550.240	Trust Powers
12 CFR 550.260(b)	Investment in Collective Investment Funds
12 CFR 550.40	Investment Authority
12 CFR 9.18	Collective Investment Fund Regulation

Office of Thrift Supervision Publications

Other

Revenue Ruling 81-100

Workpaper Attachments - 880P

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Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Plan Documentation

▪ Does the plan set forth written provisions addressing the following: • Investment powers and policies? • Fees and expenses to be charged to the fund? • Terms and conditions governing the admission and withdrawal of participating accounts? • Audits of the fund? • Bases upon which the savings association may terminate the fund? • Any other matters necessary to clearly define the rights of participating accounts?
▪ Is a copy of the plan available to any person for inspection at the offices of the savings association during business hours and is a copy provided to any person who requests it?

Annual Report

▪ Does the annual report list the fund's investments, showing both book value and market value?
▪ Does the annual report list purchases and sales, showing any profits and losses for the period?
▪ Does the annual report provide a statement of income and disbursements for the period?
▪ Does the annual report provide a notation of any investments in default?
▪ Does the financial report only include representation regarding the fund's value on previous dates and income and disbursements during previous accounting periods and make no predictions or representations as to future performance?
▪ Does the financial report only reference the performance of funds administered by the savings association or affiliates?
▪ If the financial report includes any comparative performance statistics, are they made in conformance with AIMR guidelines?

Investment Portfolio

▪ Do the investments held by the fund correspond with the investment objectives of the participating accounts and the authorized investments for each participating account?
▪ For any defaulted securities, is the purchase by the savings association undertaken in conformance with the guidelines noted in 12 CFR §9.18(b)(8)(ii)?
▪ Are brokerage transactions for CIFs placed on the basis of best execution?

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▪ Are decisions to purchase, sell or retain investments for the CIF fully documented?

Portfolio Diversification

▪ Do any participating accounts hold a substantial percentage of the units of the CIF?
▪ Does any single holding of stocks, bonds or other obligations, not guaranteed by the U.S. government, of any one entity constitute a significant percentage of the entire holdings of the CIF?
▪ Does the savings association maintain, in cash and/or readily marketable securities, a sufficient percentage of the assets of the fund as necessary to provide for liquidity needs and to prevent inequities among withdrawing participants?

Admissions and Withdrawals

▪ Are admissions and withdrawals permitted only if a written request or notice of intention is entered in the CIFs records on or before the valuation date?
▪ Are admissions and withdrawals permitted only in the manner prescribed by written plan of the CIF?
▪ Are distributions to withdrawing participants made in cash or ratably in kind, or partly in each or in any other manner consistent with applicable state law?

Prohibited Transactions

▪ Did the savings association sell assets to or purchase assets from a CIF (excluding defaulted securities)?
▪ Did the CIF invest in stock or other obligations of the savings association or its affiliates?
▪ Did the savings association make loans on the security of a participation in a CIF?
▪ Did the CIF borrow funds from any source?

Advertising

▪ Did the savings association refrain from advertising or publicizing the CIFs except in connection with the advertisement of the general fiduciary services of the bank.

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