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POLICY RESEARCH

CITs: A Welcome Addition to 403(b) Plans

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Introduction

Recently, a bipartisan bill introduced by Congressmembers Jimmy Panetta, Ron Estes, Brendan Boyle, Darin LaHood, Madeleine Dean, and Andy Barr in the House would allow 403(b) plans to invest in collective investment trusts. Such a change would introduce low-cost options to plans that have to-date been riddled with high-cost options and conflicts of interest. While the regulation of CITs is not as uniform as that of 1940 Act funds and their transparency is limited, we believe that permitting 403(b) plans to invest in CITs would generally be beneficial to plan recipients. We also recommend that the CITs made available in 403(b) plans be limited to those already available to investors in 401(k) plans. Such a change to the proposed legislation would afford 403(b) plan participants greater protections in relation to CITs introduced into their plans.

In this paper, we provide evidence of the low cost and attractiveness of CITs for 403(b) plans and provide the regulatory context for our recommended change to the proposed legislation.

Key Takeaways

- Collective investment trusts are generally pooled investment vehicles organized as trusts and maintained by a bank or trust company and are managed in accordance with a common investment strategy.

- Retirement plans that offer CITs generally charge lower investment fees to workers saving for retirement, but these investment types are not available to public-sector or nonprofit workers covered by 403(b) plans.

- A proposed bill would allow more workers to benefit from the lower costs of CITs by allowing them in 403(b) plans.

- The bill could be further improved by requiring the CITs to be offered in a plan covered by the Employee Retirement Income Security Act of 1974 to be eligible to be offered by a 403(b) plan, which would add additional protections for 403(b) plan participants.

- This requirement would ensure that the CIT offered basic participant protections and would also ensure there was data collected by the federal government on these CITs.

What Are CITs?

Collective investment trusts are generally pooled investment vehicles organized as trusts and maintained by a bank or trust company and are managed in accordance with a common investment strategy. Generally speaking, only certain retirement plans—such as 401(k) plans, other defined-contribution or defined-benefit retirement plans that are qualified under Internal Revenue Code Section 401(a), and government 457(b) plans—may invest in CITs.

CITs (as used in this article) generally fall into two types:

- A1 funds, which are also referred to as common trust funds
- A2 funds, which are also referred to as collective investment funds

A1 funds involve the pooling of assets of various trust accounts held by a bank in its capacity as trustee, executor, administrator, or guardian. Typical investors (or grantors) in A1 funds include foundations, corporations, endowments, trusts, and other entities that are exempt from federal income tax. Some A1 funds accept investment from certain taxable investors, including high-net-worth individuals and asset aggregators.

A2 funds are also pooled investment vehicles organized as trusts and maintained by a bank or trust company. Typical investors are certain retirement plans, such as 401(k) plans, other defined-contribution or defined-benefit retirement plans that are qualified under Internal Revenue Code Section 401(a), and government 457(b) plans. Under certain circumstances, CITs may permit investment by qualified plans that include self employed persons (often referred to as HR10 plans) and church plans. Generally, CITs may not be held in 403(b) plans, individual retirement accounts, or health savings accounts.[1]

1. "Collective Investment Trusts." Coalition of Collective Investment Trusts. 2015. P. 3. https://www.ctfcoalition.com/portalresource/CollectiveInvestmentTrustsWhitePaper.pdf (Collective Investment Trusts).

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Retirement Plans That Offer CITs Generally Charge Lower Investment Fees to Workers Saving for Retirement

CITs can offer a significant benefit to workers saving for retirement through reduced expenses. Morningstar's analysis demonstrates that CITs are often more-affordable investment options for retirement investors. Because CITs are not marketed and regulated in the way that mutual funds are, the administrative and regulatory costs are generally lower than those of mutual funds, allowing for lower expense ratios to be charged to end investors. In many cases, firms offer CITs and mutual funds for the same investment strategy. When comparing the net expense ratio of CIT tiers and mutual fund share classes of the same strategy, CITs are cheaper 91% of the time,[2] and even when considering only the least expensive CIT tier and mutual fund share class, CITs are cheaper 82% of the time. The asset-weighted average expense ratios of both active and passive CITs are roughly half those of their mutual fund counterparts. Table 1 demonstrates that across all investment strategies, as of year-end 2019, the average passive CIT costs fewer basis points than the average passive mutual fund. Similarly, the average active CIT costs less in basis points than the average active mutual fund.[3]

Exhibit 1 Average Asset-Weighted Expense Ratio by Investment Vehicle and Management Style

	Active, %	Passive, %
Mutual Fund	0.647	0.077
Collective Investment Trust	0.369	0.048

Source: Morningstar data.

There are limitations to comparing CIT and mutual fund costs via net expense ratios alone because of the types of expenses each investment type does and does not incorporate into this ratio. The mutual fund expense ratios often include subtransfer agency fees, and the management fee of the mutual fund may be elevated because of revenue-sharing arrangements that support the distribution of the fund. These fees generally offset the direct administrative costs plans pay to recordkeepers, while plans offering CITs would be billed separately for the services. Since subtransfer agency and revenue-sharing expenses are not reported explicitly, they cannot be deducted from the mutual fund net expense ratio to allow for an apples-to-apples comparison with CIT expense ratios. Instead, it can be beneficial to consider total cost of plans that offer each type of investment, bringing together the plan administrative fees and investment expenses.

The overall cost of 401(k) plans that offer CITs shows further support that the presence of CITs in a retirement plan reduces average expenses. By matching the investments reported by defined-contribution plans with managed investments (mutual funds, exchange-traded funds, CITs, and so on) in the Morningstar retirement plan database, based on the distribution of the plan's assets across

2. This estimate incorporates some double counting as multiple tiers and share classes can be from the same strategy.
3. While the Morningstar CIT database is comprehensive, covering over 6,700 CIT tiers, the most competitive CIT fees are negotiated on a client-by-client basis and therefore not reported to public databases.

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the investment options, we can calculate an asset-weighted expense ratio for each plan. For the purposes of comparing plans, it is often easier to consider the average plan for plans of a certain size. By bucketing plans into asset ranges (for example, $1 million in assets, $1 million-$5 million, $5 million-$10 million, $10 million-$25 million, and so on), we can capture a benchmark of investment expenses, plan expenses, and overall costs for plans of that size. We find that the median asset-weighted investment expense ratio of plans with at least one CIT is at least 10 basis points cheaper than the median cost of plans without CITs for all ranges over $25 million in assets. CITs often have higher minimum investment amounts than mutual funds and are therefore less common in plans with smaller asset bases. Plans under $25 million in assets with a CIT are more likely to include a limited number of CITs, such as a stable value CIT, rather than using CITs for the full investment lineup. As expected, the benchmark plan administrative fee for 401(k)s with CITs is slightly higher than for those without; however, the overall cost is consistently lower. The higher administrative expenses reflect that plan administrative fees are directly billed to participants rather than embedded in the expense ratio of a mutual fund, as previously discussed. With the reduced overall cost, this analysis demonstrates that plans with CITs are, on average, less expensive than those without, while potentially offering more transparency into the types of fees the participant is paying.

Proposed Legislation Would Allow More Workers to Benefit From the Lower Costs of CITs and Could Be Further Improved

We support new legislation that would allow 403(b) plans to offer CITs to their participants. The bipartisan bill—the Public Service Retirement Fairness Act—introduced by Congressmembers Jimmy Panetta, Ron Estes, Brendan Boyle, Darin LaHood, Madeleine Dean, and Andy Barr, on March 12, 2020—would make lower-cost options available to potentially millions of public-service workers saving for retirement. Currently, 403(b) plans, which serve government workers, cannot invest in CITs.

We believe that the proposed legislation could be enhanced by adding additional participant safeguards. Specifically, we believe that the CITs permitted in 403(b) plans should be limited to those already included in plans covered by the Employee Retirement Income Security Act of 1974, such as 401(k) plans.[4] The reason for such a requirement is that CITs in 401(k) plans have a nexus with ERISA, allowing ERISA plan participants to bring an action against the trustee if the trustee has violated its fiduciary duty. While CITs are generally considered low-cost products and we are unaware of any actions in recent history alleging wrongdoing in the CIT marketplace, we think it is possible that new CITs could be created separately for the 403(b) marketplace and want to protect against such possible gaming of the law. That being said, such a concern is unlikely to be relevant on day one of the Public Service Retirement Fairness Act going into law. Consequently, the proposed legislation would be beneficial at this time with or without our enhancement, and efforts should be made to include such a change in the near term.

4. Note that about 9,000 403(b) plans are covered by ERISA. These plans also are generally prohibited from offering CITs, although a smattering of plans have used novel mechanisms to offer modified CITs.

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Workers in 403(b) plans deserve access to the same best-in-class investments as workers in other plans, and CITs can often provide the best value compared with the mutual funds and annuities available in most 403(b) plans.

The Patchwork of Regulations for CITs Lends Importance to Requiring a Nexus With ERISA
Unlike the case of registered funds being regulated by the SEC, CITs are governed by a patchwork of regulations and not a consistent framework. As mentioned above, CITs consist of A1 and A2 funds. A1 funds are predominately governed by the Office of the Comptroller of the Currency or state law. No one entity regulates A2 funds, but rather these funds are subject to various statutes, related regulations, and rulings under banking, securities, and tax law.

In terms of federal banking laws, the OCC's regulations apply to CITs sponsored by national banks and trust companies. The terms *A1 funds and A2 funds* refer to the specific sections of the OCC regulations that established these two types of vehicles.[5]

On a state level, many states apply the OCC's rules either by statute, rule, other guidance, or as best practices to regulate A1 and A2 funds sponsored by state chartered institutions.

Additional Regulation: Special Cases
Different agencies have oversight of certain aspects of CITs under certain conditions.

The Department of Labor regulates CITs with ERISA plan assets. Specifically, the trustee and any subadvisor of a CIT generally serve as ERISA fiduciaries and must comply with ERISA fiduciary standards in managing the CIT. ERISA's prohibited transaction rules also control all transactions, including those between the CIT and any "parties of interest," as well as the CIT's fiduciaries.

Most CITs qualify as exempt from U.S. tax because they are "group trusts." Certain requirements apply to qualify for this treatment, including that each investing plan must adopt the terms of the group trust as part of its own trust.

The U.S. Securities and Exchange Commission may regulate CITs under the Securities Act of 1933 and the Investment Company Act of 1940. Under Section 3(a)(2) of the Securities Act, interests in CITs typically qualify as "exempt securities" and therefore are exempt from registration under the Securities Act so long as the CIT is "maintained by a bank." Under the 1940 Act, most CITs avoid registration as investment companies by relying on an exclusion from the definition of an investment company found in Section 3(c)(11) of the 1940 Act, which is substantially similar to the Securities Act exemption described above. Under Section 3(a)(12) of the Securities Exchange Act of 1934, CIT interests also typically qualify as "exempted securities" and therefore enjoy broad exemptions from the requirements of that act.

5. Kirsch, C. & Smith, M. 2015."An Overview of the Regulatory Framework Applying to Collective Trusts." Eversheds Sutherland. https://us.eversheds-sutherland.com/Events/172998/Webcast-CIT-Regulatory-Framework

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To the extent that a CIT sponsor uses the services of a broker/dealer with respect to the sale of its CITs, the broker/dealer's representatives must comply with Financial Industry Regulatory Authority rules applying to member firm sales of exempt securities.

To the extent that a CIT invests in commodity interests, the CIT's sponsor and subadvisor (if any) would have to comply with applicable Commodity Futures Trading Commission rules and regulations.[6]

A Nexus With ERISA Would Allow for More-Consistent Data

The lack of consistent data on CITs further supports our recommendation that CITs made available in 403(b) plans be limited to those already in 401(k) plans, so the information available to 401(k) plan recipients is also available to 403(b) plan recipients. The lack of comprehensive reporting on CITs can sometimes lead to a lack of consistent, reliable, and comparable public data on CITs, a stark contrast to the wealth of information available for mutual funds. The primary regulatory filing with CIT data is the Form 5500. This filing is governed by the IRS, DOL, and Pension Benefit Guaranty Corporation and primarily focused on monitoring ERISA-compliant defined-benefit and -contribution plans. Since CITs are not the emphasis of the filing, Form 5500 is deficient in collecting necessary data to evaluate CITs fully, and it is filed on a significant lag. Reduced paperwork and regulatory compliance work are what allows CITs to generally be cheaper than publicly registered products. Participants in plans with CITs are nonetheless guaranteed access to certain information regarding the CIT by ERISA.[7] Such information includes basic fee and performance data, as well as a benchmark comparison. Furthermore, many CIT providers voluntarily report their data to third-party databases such as Morningstar. While there are several simple improvements to the Form 5500 that could further enhance CIT data access[8], the lack of required public disclosure in place today should not represent a significant barrier.

Conclusion

The Public Service Retirement Fairness Act seeks to make the benefits of CITs available to those who have not had access to these investments in the past. We agree with its objective and believe that introducing CITs to 403(b) plans is a net improvement for investors. Given the regulatory status of CITs and their limited data availability, we believe that the benefits to 403(b) investors could be enhanced if their investments are limited to those CITs already available in 401(k) plans. In this way, a 401(k) plan recipient who has the protections and rights afforded by ERISA is offered the same product, providing a quality check on the CITs offered to 403(b) plan recipients who lack such protections. M

6. Collective Investment Trusts, P. 11 – 12.
7. 29 C.F.R. § 2550.404a-5 2015
8. Mitchell, L. & Szapiro, A. 2018. Morningstar White Paper. "Retirement Plan Transparency: Opaque Data Hinders Best-Interest Advice." https://www.morningstar.com/lp/retirement-plan-transparency.

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