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Collective Investment Trusts: An Important Piece in the Retirement Planning Puzzle

Benefits for advisors, consultants, and plan sponsors

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Introduction: CITs 101

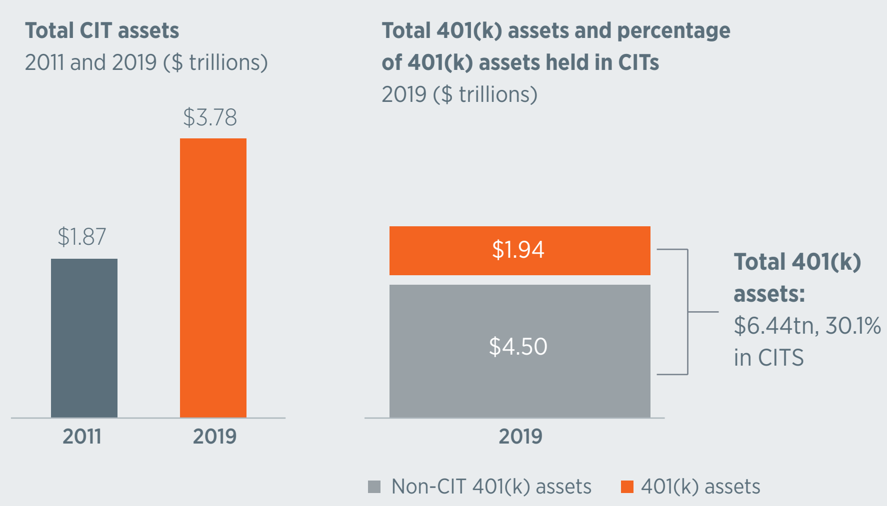
The collective investment trust (CIT) is no longer the retirement industry's best-kept secret.

While incorporating CITs in defined contribution (DC) plans, primarily 401(k) plans, is hardly a new idea, it has started to gather momentum recently. CIT proponents have long forecasted CITs would increase their DC market share, while the cynics claimed that CITs have been touted as "the next big thing" for years.

In 2019, total CIT assets exceeded $3.78 trillion.[1] Moreover, during the same period, their share of 401(k) assets reached 30.1%, or approximately $1.94 trillion, primarily at the expense of mutual funds, which saw their share of 401(k) assets decline to represent less than half of total 401(k) assets (48.2%).[2]

Figure 1

From 2011 to 2019, total assets in CITs grew by approximately 102%



Note: RHS exhibit represents total 401(k) assets and percentage (%) of 401(k) assets held in CITs; Non-CIT 401(k) assets include 401(k) assets held in mutual funds, institutional separate accounts, group annuity, company stock, self-directed brokerage and ETFs.

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There is no assurance that any investment strategy will be successful. See important disclosures on page 9.

Sources applicable to footnotes and figure 1

[1] LHS exhibit Cerulli Associates, The Cerulli Report U.S. Defined Contribution Distribution 2020: Adapting to Changes in the Regulatory Environment

[2] RHS exhibit Cerulli Associates, The Cerulli Report-U.S. Retirement Markets 2020: Exploring Opportunities in the Small Plan Market

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For retirement plan advisors, CITs should be a key consideration. In this paper, we will discuss what a CIT is (and what it isn't), the benefits of CITs, the factors that are driving their adoption, the myths and realities of CITs, and some important considerations that could further increase adoption.

What are CITs?

CITs are pooled, tax-exempt investment vehicles sponsored and administered by a bank or trust company that also acts as the trustee. CITs comingle assets from eligible investors into one private investment portfolio with a specific strategy. Currently, CITs are available for DC and defined benefit (DB) plans, excluding most 403(b), 457(b), and 457(f) plans. They are not currently permissible investment vehicles for individual retirement accounts (IRAs). Today, much of the exciting growth and potential for greater CIT implementation is occurring in the DC market.

History of collective investment trusts

As the retirement plan industry has evolved, so has the structure of investment vehicles used in 401(k) plans. CITs have been available for decades (first launched in 1927) and were offered in very early 401(k) plans.

- **1927** The first CIT launches
- **1936** Congress amends the Internal Revenue Service Code to allow DB plans to use CITs
- **1950s** Banks permitted to combine assets from stock bonus plans, pensions, and corporate profit-sharing plans
- **1974** Employee Retirement Income Security Act of 1974 (ERISA) becomes law
- **1978** Revenue Act of 1978 passes allowing employees to avoid taxes on deferred compensation, creating the 401(k) plan structure
- **2000** National Securities Clearing Corporation (NSCC) adds CITs to its mutual fund trading platform
- **2006** The Pension Protection Act of 2006 becomes law
- **2012** DOL issues a final regulation under Section 408(b)(2) of ERISA creating greater fiduciary focus on fees
- **2016** DOL publishes the Fiduciary Rule; while ultimately vacated in 2018, it raises awareness around fees
- **2019** Wilmington Trust partners with Nasdaq to register the first CIT tickers on the Nasdaq Fund Network
- **2020** The Public Service Retirement Fairness Act introduced

DB: Defined benefit | DOL: Department of Labor

CITs are heavily regulated. Although they are not registered under the Securities Act of 1933 or the Investment Company Act of 1940, they are overseen by the Office of the Comptroller of the Currency or state banking regulators. Additionally, the sponsoring trustee of a CIT, a bank or trust company, is committed to acting in the best interest of unit holders because it is bound by the fiduciary standard under the Employee Retirement Income Security Act of 1974 (ERISA).

CITs are not newcomers to the retirement landscape. Although first launched in 1927, they did not become broadly used until the 1950s when Congress first allowed banks to combine assets from stock bonus plans, pensions, and corporate profit-sharing plans.[3] CITs are not necessarily new vehicles to plan sponsors either as they have long been used by DB plans and large DC plans.

[3] https://www.ctfcoalition.com/portalresource/AM-WP-CollectiveInvestmentTrustsAPerfectStorm-030317.pdf

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Myth:

Performance for a strategy will be the same regardless of the investment vehicle.

Reality:

If the strategy holds all the same securities, how can there be discrepancies when comparing the performance of the strategy in a mutual fund relative to the strategy in a CIT? In fixed income strategies, certain securities may not be available to a CIT manager as they were to a mutual fund manager when it launched its fund, prompting the CIT manager to choose different options.

When the National Securities Clearing Corporation (NSCC) added CITs to its mutual fund trading platform in 2000 they became quickly and widely transacted. They received another boost in 2006 when the Pension Protection Act was signed into law, requiring DC plan sponsors to invest unallocated 401(k) assets into qualified default investment alternatives (QDIAs), most commonly target-date funds (TDFs).

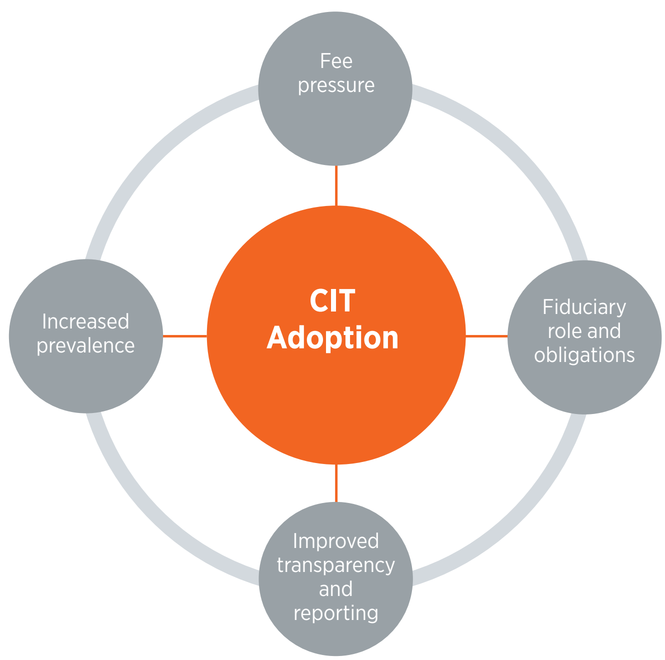
TDFs are one obvious example where CITs have experienced an increase in the amount of assets under management. In 2018, assets in target-date CITs increased by approximately $300 billion from 2019 to 2020 to $1.2 trillion.[4] This growth reflected the DC market's willingness to embrace a less familiar investment vehicle, relative to a mutual fund, to access lower pricing. Robust growth in target-date CITs has spilled over into single-asset-class options on the core menu, with advisors realizing that if they are comfortable with a target-date CIT, they also can consider the vehicle in other investment categories.

What are the advantages of CITs in regard to fees?

In recent years, several forces have combined to create an environment in which CITs offer meaningful benefits to advisors and consultants, plan sponsors, and participants.

One of the most influential forces in the DC market is acute fee pressure. This proverbial "race to the bottom" is reflected in the downward trend of both plan investment fees and administration costs. The current focus on reducing fees assessed to participants aligns with an increased emphasis on the obligations of a fiduciary, including assessing "fee reasonableness." This is relevant to an investment vehicle discussion because plan fiduciaries have a responsibility to be aware of their purchasing power. Pricing inefficiencies across investment vehicles and share classes can be material.

Figure 2
DC market forces supporting CIT adoption



[4] 2021 Target-Date Strategy Landscape, Morningstar

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Myth:

CITs lack transparency and periodic reporting. Participants want a ticker, so CITs aren't suitable for DC plans.

Reality:

Today, as more advisors see the potential benefits of implementing CITs, this misconception is being debunked. Most fund managers create quarterly fact sheets for their CITs and provide a data feed to aggregators, such as Morningstar. One important milestone was reached last year when Wilmington Trust partnered with Nasdaq to register the first CIT tickers on the Nasdaq Fund Network. As of April 2021, there were more than 467 tickers available on the network.

The initial wave of CIT adoption has been primarily motivated by the fee advantage CITs can present relative to mutual funds and exchange-traded funds (ETFs). In general, CITs have lower administrative, marketing, and distribution costs versus mutual funds with similar investment strategies. They also have simpler disclosure statements and investors are not required to receive a prospectus as with mutual funds.

CITs still have reporting requirements that are addressed via quarterly factsheets (see Myth vs. Reality sidebar). Additionally, given the tax-exempt status of the trust, portfolio managers are able to manage the portfolios by taking advantage of benefits that are similar to those that participants gain in a 401(k) plan. As an example, the sale of a low-cost-basis stock would not trigger a pass-through of long-term capital gains to the investor.

Share class structures inside CITs allow for trustees and asset managers to take into consideration the size of plans' investments in a fund(s), and the size of consultants' or advisors' assets in a fund(s) when the fee structure is created.

What else should advisors and plan sponsors consider regarding fees?

The fees charged for CITs vary according to the service provided and are based on the assets in trust. It is important to understand how fees are assessed.

Costs may include:

- Custodial fees
- Investment advisor's fees
- Transactional fees related to the investment platform or investment vehicle being used
- Trustee's fees

The participation agreement, offering circular and quarterly fact sheets for the CIT, contain important fee and expense disclosures.

The participation agreement is the contract you enter into for services performed by the CIT. It will provide the requisite disclosure of compensation, acknowledgment of fiduciary status under ERISA, and description of termination terms. This agreement also serves as an acknowledgement of the terms and conditions that may be placed on the investments, so it should be carefully reviewed by you and your advisor, and the analysis documented.

Investing in CITs may be subject to certain terms and conditions, and may even restrict a plan's ability to freely surrender its interests under certain market conditions. Therefore, your advisor should become familiar with the details contained in the participation agreement.

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Myth:

CITs are only for big plans.

Reality:

While this might have been an accurate statement a decade ago, it no longer reflects the marketplace. Many asset managers have recognized CITs as a distribution opportunity, given the benefits they can potentially offer advisors and their plan sponsor clients, and have proactively lowered or even eliminated required asset minimums. Furthermore, as more advisors see the value of CITs, they will become more commonplace among the traditional advisor-sold segments of the DC market by plan asset size.

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How can CITs enhance an advisor's business?

As previously noted, CITs can benefit an advisor's business in many ways. Their value is most notable through:

- **Lower fees.** Many plan sponsors do not know to ask about lower-cost investment vehicles. By ensuring access to CITs, advisors can support plan sponsors and participants by maximizing every dollar the participant puts aside for retirement.
- **A streamlined process.** By employing CITs as part of the solution, advisors can use their buying power to streamline their work with clients and select a single manager for a strategy.
- **Active management options.**With their built-in fee advantages, CITs can bring relatively low-cost alpha to investors. Keep in mind that participants may be reluctant to pay higher fees associated with active management. However, simply matching a benchmark does not help many participants achieve long-term retirement goals.
- **Creation of white-labeled products.** By creating their own white-labeled products, advisors and plan sponsors can change subadvisors and underlying investments without the need to distribute Sarbanes-Oxley blackout notices, which can impede the process, and transfer cost to plan participants.
- **Fund manager relationships.** In an increasingly competitive environment, advisors are looking for additional ways to demonstrate their value-add to clients. Through strong fund manager relationships, advisors can support plan sponsors that might not otherwise be able to invest in lower-cost CITs.
- **Addressing potential fiduciary risk.** Lawsuits have been brought that allege a plan fiduciary failed to fulfill its fiduciary obligations by not investigating lower-cost investment vehicle options, including CITs, when they were available. Advisors can help plan sponsors avoid such allegations by conducting thorough due diligence on the types of investment vehicles that are potentially available to the plan and ensuring that the plan has documented why they chose a particular vehicle.

Does a plan sponsor receive additional fiduciary coverage when using CITs?

The CIT trustee will always be an ERISA 3(38) investment manager to the fund. This provides the plan sponsor with additional protection regarding specific investment selection in CITs. Section 402(c)(3) of ERISA allows plan sponsors to delegate responsibility for selecting, monitoring, and replacing plan assets to an investment manager that meets the requirements of Section 3(38) of ERISA. According to Section 405(d)(1) of ERISA, if an investment manager is properly appointed, "no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager."

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Myth:

CITs are always cheaper than a mutual fund equivalent.

Reality:

CITs are not always the cheapest share class. For example, if an R-6 mutual fund share class is at scale, it may be more cost effective. Navigating across a multitude of share classes and investment vehicles can be confusing and offers advisors an opportunity to help their clients identify the best vehicle to fit a plan sponsor's goals.

The CIT trustee is a regulated financial institution responsible for managing and monitoring the CIT's investment advisors; approving and monitoring compliance with the CIT's investment policy; and making sure the investments meet the CIT guidelines. Equally important is that the plan sponsor's fiduciary obligations are minimized, limiting responsibility to appropriately monitoring the CIT trustee.

How is investing in a CIT different from investing in a mutual fund?

The logistics of investing in CITs are quite different from investing mutual funds. In addition to the usual requirements (understanding the investment characteristics, the role it will play in the plan's overall portfolio, and the anticipated value it provides compared to the fees charged) CIT selection requires the plan sponsor to enter into a trust agreement and sign a participation agreement.

Investments managed within CITs, unlike mutual funds, are governed by ERISA fiduciary rules, including the duties of prudence and loyalty. Meaning, the CIT trustee has direct fiduciary accountability to each plan sponsor and their fiduciaries with respect to the plan assets invested by the CITs.

How can advisors assist plan sponsors with the selection of CITs?

The role of an advisor or consultant when working with clients is to help in selecting and monitoring CITs. Since this arena is still an emerging environment, not all asset managers have access to CITs. By working with plan sponsors, advisors can add value by detailing the benefits of CITs for all investment options, which includes the cost structure differences between CITs and mutual funds.

Hiring a service provider to hold and manage plan assets, whose fees are paid with plan assets, is a fiduciary decision and should be made prudently. Prudence requires fiduciaries to consider relevant information (or that which they should know to be relevant) in order to make a well-informed decision.[5]

For a meaningful comparison, the Department of Labor (DOL) urges plan sponsors (with the help of a knowledgeable advisor) to survey service providers by providing them with complete and identical plan information as well as the services they are seeking.[6]

Plan sponsors should "ask service providers about their services, experience with employee benefit plans, fees and expenses, customer references or other information relating to the quality of their services and customer satisfaction with such services."[7]

The DOL also recommends gathering:

- **Information about the firm itself:** The financial condition and experience with retirement plans of similar size and complexity
- **Information about the quality of the firm's services:** The identity, experience, and qualifications of professionals who will be handling the plan's account, any recent litigation or enforcement action that has been taken against the firm, and the firm's experience or performance record

[5] 29 C.F.R. §2550.404a-1(b)(1)(A)(i).

[6] See, DOL Tips for Selecting and Monitoring Services Providers for Your Employee Benefit Plan. Available at www.dol.gov

[7] DOL Meeting Your Fiduciary Responsibilities. Available at www.dol.gov

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When selecting CITs, advisors should help plan sponsors understand:

- **The depth of the sponsoring organization:** Is the CIT sponsored by an asset manager's special purpose trust company or a third-party trust company? What is the internal expertise of the group sponsoring the CIT?
- **The CIT sponsor's corporate structure:** Is the bank or trust company a wholly owned subsidiary of a larger conglomerate where the parent may be shielded from liability associated with the CITs?
- **The risk and compliance structures of the CIT sponsor:** Are the CITs susceptible to mismanagement?
- **The governance structure of the CITs:** How does the sponsor monitor investment subadvisors?
- **The regulatory framework:** Is the CIT overseen by a state agency or the Office of the Comptroller of the Currency?
- **The disciplinary history of the CIT trustee:** Has the CIT trustee been subject to regulatory violations or litigation in a way that should be a red flag for plan sponsors?

When evaluating the service providers' responses, advisors and plan sponsors should consider the nature and scope of the proposed services to ensure the arrangement is necessary and reasonable. Advisors can assist plan sponsors with reviewing the CIT documents to help ensure they meet the requirements of ERISA Sec. 408(b)(2).[8]

According to the DOL, "Fees and expenses are one of several factors to consider when you select and monitor plan service providers…The level and quality of service…will also affect your decisions."[9] Fiduciary decisions are evaluated based upon the process used to determine whether or not the services are necessary and reasonable in light of the value delivered to the plan (and its participants) by the provider.

In addition to ensuring the plan sponsor has the proper information for 408(b)(2) purposes, another critical aspect to evaluate is the degree to which the CIT sponsor is able to assist plan sponsors with meeting their duties to disclose investment- and fee-related information to plan participants under DOL Reg. 404a-5 (the Participant Fee Disclosures). This regulation requires plan sponsors to disclose specific information concerning performance and expenses associated with the plan's designated investment alternatives (DIAs) at least annually, as well as the location of a website where participants can get more current information updated at least quarterly.

To assist plan sponsors in meeting their requirements to provide the Participant Fee Disclosures, DOL Reg. 408b-2 requires services providers, to offer identifying information such as the name and type or category of the alternative, performance data, benchmarks, and fee and expense information with respect to which the return is fixed. The CIT will also need to disclose the annual operating expenses of the fund and all compensation charged against the fund. The CIT already is required to

[8] 29 C.F.R. §2550.408b-2.

[9] Department of Labor, Understanding Retirement Plan Fees and Expenses. Available at www.dol.gov

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disclose to the plan sponsor the fee and expense.[10] Advisors should be prepared to gauge the extent to which the CIT sponsor is capable of providing such information in a timely and accurate fashion.

As a technical matter, an advisor should be prepared to verify whether the CIT in which the plan is investing has a CUSIP number. This number typically means that the CIT units can be easily traded on a daily basis between other non-CIT investments in the plan.

The future of CITs

While CITs have a decades-long track record, there is still much to be done to help raise awareness of their benefits to further increase adoption. This starts with current stakeholders. Remember, experience is the best education. Sharing successes and expertise can guide advisors and consultants, plan sponsors and participants, asset managers, the media, and other influencers along the path from awareness to consideration to engagement.

Ongoing efforts to enhance technology will also go a long way in streamlining CIT-related operations. To date, tremendous progress has been made in developing systems to automate the participation process allowing for easier onboarding with plan sponsors and advisors. However, more can still be done.

Finally, changes on the legal and regulatory front can provide more people access to CITs. The federal government currently prohibits almost all 403(b) plans from accessing CITs. This should change. There is general support for new legislation that would allow 403(b) plans to invest in CITs. In 2020, bipartisan legislation was introduced in the House of Representatives that seeks to address this specific issue. The Public Service Retirement Fairness Act aims to "ensure public sector and nonprofit retirement savings programs have the same access to low-cost investments as for-profit plans do." At the time of writing this paper, there is hope that this bill will be reintroduced.

Similarly, it should be easier for participants in Keogh retirement plans to access CITs. This would necessitate changing SEC Rule 180, which requires participants to be "sophisticated" or advised by a "sophisticated" advisor to invest in CITs. Maintaining the status quo negatively impacts thousands of professionals who are working as independent contractors.

For many years, CITs have proven to be a valuable arrow in the quiver for advisors who provide holistic, goals-based solutions to plan sponsors and participants. CITs are gaining market share because stakeholders are becoming more cognizant of the potential benefits they can provide. But the work of raising awareness needs to continue until all working Americans have the opportunity to take advantage of this important investment vehicle.

[10] See, 29 C.F.R. §2550.408b-2(c)(1)(iv)(E)(3). This includes the following additional investment information about a the CIT investment funds which are designated as an investment alternative (an "alternative"): provide identifying information such as the name and type or category of the alternative (29 CFR 2550.404a-5(d)(1)(i)); performance data (29 CFR 2550.404a-5(d)(1)(ii)); benchmarks (29 CFR 2550.404a-5(d)(1)(iii)); and fee and expense information for alternatives with respect to which the return is fixed (29 CFR 2550.404a-5(d)(1)(iv)(B)). The CIT will also need to disclose the annual operating expenses of the fund; and all compensation charged against the fund. The CIT already is required to disclose to the plan sponsor the fee and expense information described in 29 CFR 2550.404a-5(d)(1)(iv)(A)(1) and (2) pursuant to paragraphs (c)(1)(iv)(E)(1) and (2) of the 408b-2 regulation.

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