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Governance of Collective Investment Trusts: Benefits To Plan Investors

The Benefits of Collective Investment Trusts as Compared to Mutual Funds in Serving as Retirement Plan Investment Options

Both mutual funds and collective investment trusts ("CITs") are commonly used as investment options in participant-directed retirement plans, such as 401(k) plans. While both are highly regulated, they are subject to different regulatory regimes that reflect the nature and qualifications of their investor base. While each has its advantages, the differences in regulation and governance provide a number of benefits to retirement investors who use CITs rather than mutual funds. This article explores the benefits of using CITs.

Background – Overview of Mutual Fund and CIT Regulation

The term "mutual fund" is generally used (and is used for purposes of this article) to describe open-end investment companies that are registered with, and subject to regulation by, the U.S. Securities and Exchange Commission (the "SEC") under the Investment Company Act of 1940 (the "Investment Company Act"). The Investment Company Act, in combination with the Securities Act of 1933 and the Securities Exchange Act of 1934 (together with the Investment Company Act and the Investment Advisers Act of 1940 (the "Advisers Act"), the "Securities Laws"), regulates all aspects of the management, operation, offering and trading of mutual funds, from limitations on certain investments to conflicts of interest to fund governance to disclosures and regulatory reporting. There is generally no restriction on the types or qualifications of investors that are permitted to invest in mutual funds. They can be sold directly to the public and institutions as well as through various distribution channels, such as wire houses, brokers, investment advisors or other financial advisors. The only true limitation is they must be sold by or through a licensed and registered broker.

CITs, by contrast, are specifically exempted from the Securities Laws (other than the Advisers Act, which would not apply directly to the CIT itself), so long as they are operated in accordance with the conditions of each law's applicable exemption. Because the trustee of a CIT is required under these exemptions to be a U.S. bank or trust company, a CIT is subject to regulation and oversight under the banking law governing its trustee, such as the National Bank Act and the rules and regulations of the Office of the Comptroller of the Currency (the "OCC") for national banks and federal savings associations, a state's banking law for banks and trust companies established under state law, and general common law principles of fiduciary duties. In addition, because CITs by definition serve as investment vehicles exclusively for retirement assets (pursuant to one of the conditions of the Securities Law exemptions), they are subject to the fiduciary responsibility and prohibited transaction rules under the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which is interpreted and enforced by the U.S. Department of Labor (the "DOL"). (The only exception would be CITs that limit their investors to governmental plans and church plans that are not subject to ERISA, but these are unusual.)

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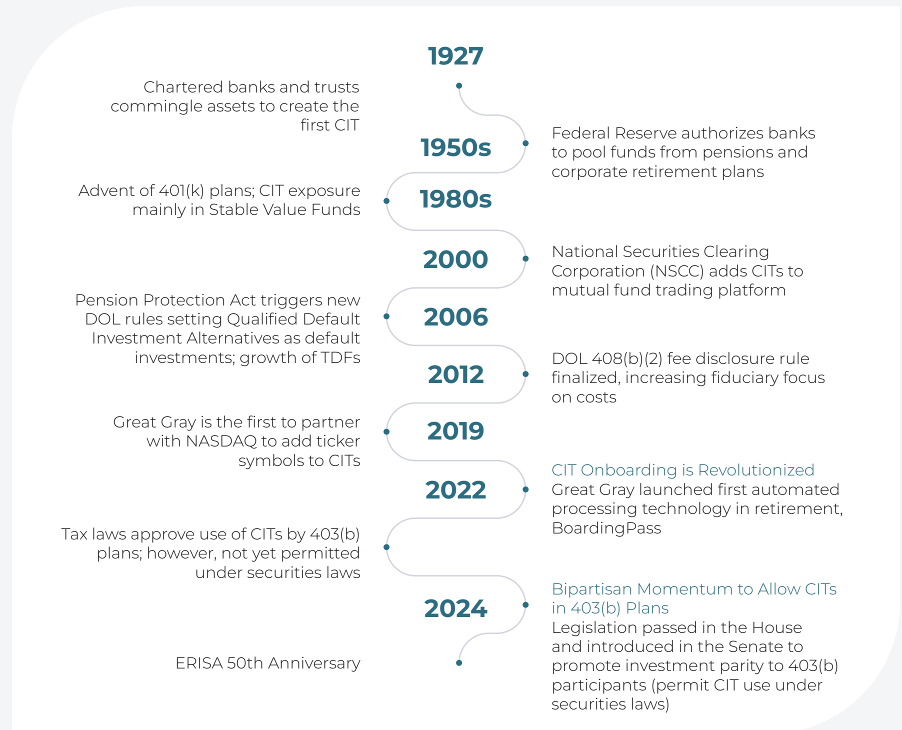
History of collective investment trusts (CITs)

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.



MYTH

CITs are not regulated.

REALITY

CITs are regulated by State or Federal Banking Laws, the Internal Revenue Service's laws and regulations, and the Department of Labor's Employee Retirement Income Security Act of 1974 (ERISA). Each of these sources of regulation help ensure that CITs are governed by well-designed policies and procedures, and that the CIT trustee acts in the best financial interest of the plan participants.

Comparison of Specific Areas of Regulation and Governance

› General Regulatory Considerations in the Offer and Sale of Fund Interests, Including Disclosure

Both mutual funds and CITs are "open end" investment funds, meaning that they create new units of beneficial interest in the fund when an investor makes a new investment, and extinguish those units when an investor redeems out, with no fixed number of units. These units are purchased and redeemed at the net asset value per unit of the fund, determined as of the close of trading on each business day. But beyond these commonalities, there are a number of differences in the purchase and redemption process.

Mutual fund shares are permitted to be publicly offered to both institutional and retail investors, including possibly unsophisticated individuals. To govern the process for offering mutual fund shares to investors, SEC rules require the mutual fund to sell shares only pursuant to an effective, up-to-date detailed disclosure document (the fund prospectus) that is required to include specific information and be on file with the SEC (which is also required to be supplemented by a statement of additional information that is filed with the SEC). The sales are made through distributors that are typically SEC-registered broker-dealers, although investors may buy and redeem shares directly from some mutual funds. In order to ensure equitable treatment of investors, there are limits on the differences in the share classes a mutual fund may offer, with the primary permitted differences relating to the costs of distribution and shareholder servicing. Mutual fund shareholders must receive semi-annual reports containing financial statements and other required information and the mutual fund's financial statements must be audited annually by an independent auditor.

Unlike mutual funds, CITs cannot be sold directly to the general public or any institution. They can only be sold to qualified retirement plans

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MYTH

CITs lack fee transparency.

REALITY

Since 2011, the Department of Labor has mandated that certain plan administrators provide uniform performance, fee and other disclosures to plan participants regarding all investment options offered in 401(k) retirement plans. This mandate promoted greater transparency about CITs, and in turn, many CITs issue quarterly fact sheets and fund data is readily available.

managed by persons who are subject to various fiduciary duties in their selection of a CIT (or mutual fund or other offering) as a plan investment or investment option (with a very limited exception for owner-only plans, subject to the requirement that the plan be represented by a sophisticated person). Where the CIT is to be used as a plan investment option for participant-directed investment, among the obligations of the responsible plan fiduciary are to select a sufficiently diverse set of investment options that are reasonably designed to maximize risk adjusted returns, so that individual plan participants can select investment portfolios with appropriate risk and return characteristics. Thus, a CIT can be offered as an investment to an individual employee only after being selected as an investment option in a qualified retirement plan.

In view of CITs being available exclusively to qualified retirement plans that are institutional investors (or represented by sophisticated persons), there are no specific disclosure, distribution or registration requirements, other than (1) general fiduciary considerations that require accurate disclosures to investors and no misleading statements (more on that below) and (2) streamlined disclosure requirements under ERISA tailored to be provided to participants and beneficiaries of a retirement plan sufficient for them to direct investments of their individual plan accounts into the CIT. These disclosure requirements, under DOL Regulation 404a-5, include a table identifying the name and type of fund (i.e., large-cap fund, fixed income, balanced, etc.), including investment performance over standardized periods compared to a designated benchmark that is an appropriate broad-based securities market index, and a fund's annual expense ratio. Regulation 404a-5 also requires that investors have access to a website that contains a description of the fund's investment objective, principal strategies and principal risks, and performance that is updated at least quarterly. It is important to note that Regulation 404a-5 has been in effect since 2011, its disclosure requirements were modeled on the elements of a mutual fund summary prospectus, and its purpose was to create a more fulsome and uniform source of information about all investment options in a retirement plan so that investors were better equipped to make an informed investment decisions. This was a significant step in improving transparency about all offerings in a retirement plan.

CITs also offer far more flexibility, subject to general fiduciary considerations, in creating different share classes to meet the needs of different retirement plan investors, such as to accommodate lower fees for investments by multiple or larger plans due to efficiencies of scale. For these reasons, the costs involved in the offer and sale of fund units can, depending on the circumstances, be considerably less for a CIT than for a mutual fund.

As a general matter, mutual fund disclosure and marketing rules do not apply to CITs because CITs are exempt under the securities laws, in deference to CITs being subject to banking and ERISA regulation. However, CIT trustees and any SEC-registered investment adviser engaged as a sub-advisor to help manage the CIT assets may follow various aspects of the rules under general anti-fraud principles and/or because the OCC's CIT handbook recommends following such antifraud rules to avoid potential securities law fraud violations.

› Redemption of Investments

Mutual funds are prohibited, with very limited exceptions, from suspending the right of redemption or postponing payment of proceeds beyond seven days. As a result, the SEC continues to impose more requirements on mutual funds to have sufficient liquidity to meet investor redemptions, including recently proposing the imposition of various liquidity risk programs and

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anti-shareholder dilution measures (redemption fees) that could have an adverse effect on the timing and cost of mutual fund investments. In particular, such changes could place retail investors at a disadvantage relative to institutional investors by requiring mutual fund investor redemptions to be placed earlier in the day.

In comparison, CITs and their trustees have greater flexibility and more tools in their toolbox to achieve the goal of ensuring that all participating accounts are treated fairly. For example, the trustee may generally not permit some accounts to withdraw while restricting others, and if the CIT invests primarily in assets that are not readily marketable, the trustee may require advance notice for withdrawals of up to a year, or possibly longer, depending on the requirements of applicable law and the fund documents. These rules permit a CIT trustee to use its authority, if needed, to suspend or delay withdrawals if, in its capacity as a fiduciary to the CIT, it views such steps as necessary to protect the non-withdrawing investors from adverse impacts of large withdrawals on the fund. In practice, this authority would not be expected to be invoked other than for CITs that invest in relatively illiquid assets, such as real estate, or under unusually adverse market conditions.

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› General Fiduciary and Investment Governance

Mutual funds are required to operate under a very specific governance structure. A mutual fund typically is governed by a board of directors or trustees, a certain percentage of whose members must satisfy independence requirements. The board, including a majority of the independent directors, must approve the investment advisory agreement with an Advisers Act-registered investment adviser, which the mutual fund enters into to provide for the management of fund investments. The board also usually retains a fund administrator, transfer agent, distributor, and custodian, each of whom may or may not be affiliated with the fund’s investment adviser. The audit committee of the board controls the engagement of the mutual fund’s independent auditor.

Mutual funds are further subject to fairly detailed rules that impose certain limits on fund investments. Among other things, a mutual fund that is classified as “diversified” is not permitted to invest more than 5% of its assets in any one issuer nor own more than 10% of the outstanding voting securities of an issuer. There are restrictions on investments in other mutual funds and on leveraged investments. In addition, to maintain favorable tax treatment, mutual funds must distribute nearly all their taxable income and gains on an annual basis and meet certain investment restrictions under Subchapter M of the Internal Revenue Code. This often creates artificial year-end trading to ensure there is sufficient cash to make these distributions.

The Investment Company Act requires mutual funds to adopt policies on a variety of matters, including borrowing, lending, industry concentration

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and the issuance of senior securities, which are changeable only with shareholder approval. The Investment Company Act further requires that mutual fund shareholders approve a material change to the agreement with the fund's investment adviser, such as an increase in advisory fees or an agreement with a new adviser. This requires a proxy solicitation with all of the associated legal, operational and mailing costs.

CITs, by contrast, are generally not subject to specific, detailed rules in regard to governance and investments but rather to general fiduciary duties of prudence and loyalty, under applicable banking laws and ERISA. The CIT trustee can manage and operate the CIT on its own, or can retain third parties to assist as sub-advisors or in other capacities, as the trustee determines to be appropriate consistent with its fiduciary duties for the management of the particular CIT. In addition, as "group trusts" for pooling investments of tax-exempt retirement plans, CITs are exempt from income tax (other than on unrelated business taxable income). These differences provide more flexibility while preserving protections for the CIT investors.

While there can be a number of governance benefits to the board oversight structure required for mutual funds, banking law effectively imposes analogous requirements for a governance structure within the trustee itself. The OCC's Comptroller's Handbook for Collective Investment Funds (May 2014), which even non-OCC regulated banks and trust companies generally use as a guide to best practices in managing a CIT, requires the trustee's board of directors to manage or direct a CIT's administration, with the obligations of ensuring that a written plan, policies and procedures are in place to comply with applicable law and of supervising the trustee's responsibilities as a fiduciary. This is typically handled through establishing oversight committees within the bank or trust company to oversee the establishment of a new CIT (or a new fund within an existing CIT), evaluate investment performance on an ongoing basis, oversee valuation of both marketable and hard-to-value assets, and evaluate and address risks that arise in the management and operation of the CIT. Like mutual funds, CITs are required to have an annual independent audit, the results of which are reported to investors, and the CIT trustee will typically have in place a rigorous internal audit and compliance program to meet general banking law requirements.

› Conflicts of Interest/Prohibited Transactions

Both mutual funds and CITs are subject to specific rules on conflicts of interest, including restrictions on dealings with the fund's investment manager/advisor and its affiliates. The mutual fund rules are a function of the Investment Company Act, and the rules for CITs are mainly based on ERISA on account of the ERISA prohibited transaction rules but also come from applicable banking and common law, as a bank, acting in a fiduciary capacity, is subject to conflict of interest restrictions that govern any fiduciary relationship. In each case, there are exceptions or exemptions to enable the fund's manager to engage in transactions that are beneficial for the fund subject to conditions limiting the manager's ability to use the fund's assets for its own benefit, including an ERISA exemption specifically for CITs that provides relief from a number of the more technical issues that can arise in trying to navigate ERISA's prohibited transaction rules. While ERISA's prohibited transaction rules strictly prohibit conflicts of interest, available exemptions approved by Congress and the Department of Labor help ease the management of CITs without altering ERISA's fiduciary obligations to manage a CIT prudently and with undivided loyalty to the plans' participants and beneficiaries.

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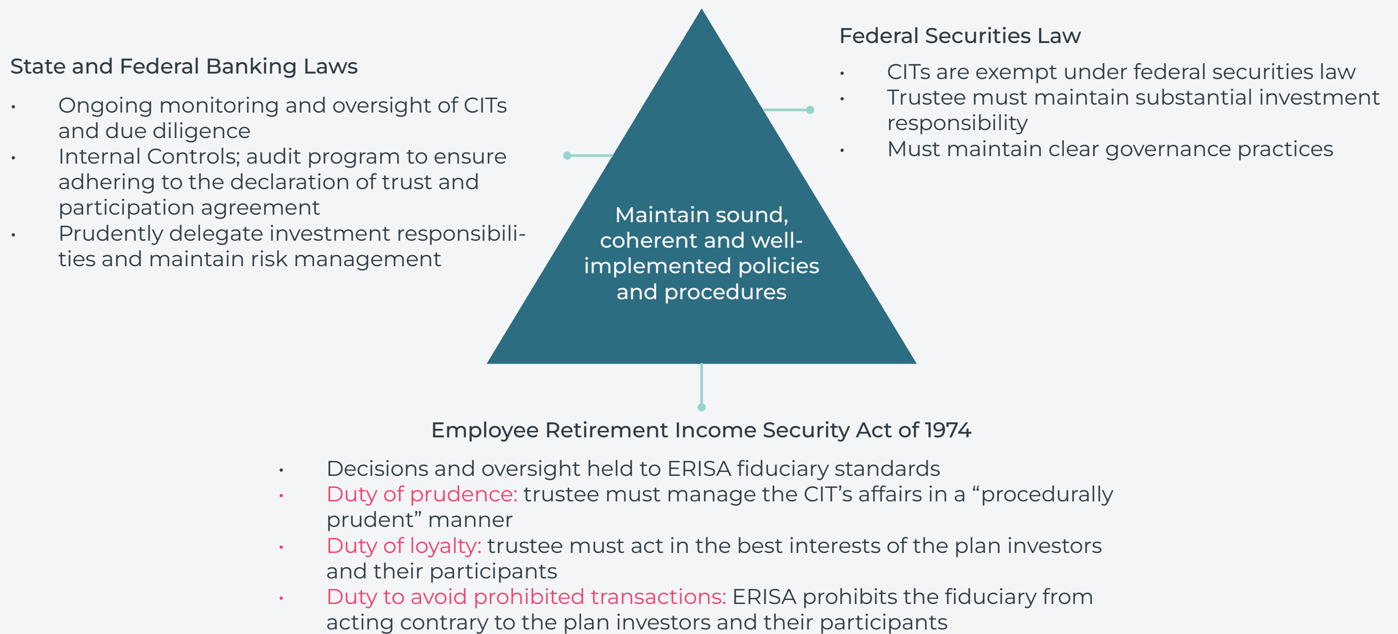

› Enforcement – By Regulators and Private Rights of Action

Another important consideration in comparing mutual funds and CITs is the ability to enforce the applicable rules and restrictions, whether under the Securities Laws for mutual funds or under ERISA and banking laws for CITs.

The Securities Laws are generally enforceable only by the SEC. While there are private rights of action provided under certain sections of the Securities Law statutes, they are relatively limited. For example, Section 36(b) of the Investment Company Act permits a mutual fund investor to bring a lawsuit for breach of fiduciary duty with respect to a mutual fund investment adviser's compensation, but there is no mention of a right of action for imprudence or disloyalty in managing fund investments. To make such a claim, the investor would be left with bringing a state law action for breach of fiduciary duty, where the state law may not have concepts of prudence and loyalty intended to address the nature and circumstances of mutual fund investment management, and it may be unclear which court has jurisdiction over the claim. As a practical matter, if investors are dissatisfied with how the mutual fund is being managed, they "vote with their feet" (in other words, they redeem out of the fund and bear any corrollary market value and tax consequences).

Like the SEC, applicable federal and state banking regulators are authorized to take remedial action, including imposing an enforcement action, against a bank acting as a CIT trustee if the bank violates applicable banking laws or regulations, or does not act in accordance with its fiduciary obligations. While the banking laws, though, similarly may not be privately enforceable other than through a state law breach of fiduciary duty action, that is not the case with ERISA. In addition to authorizing the DOL to bring investigations and take enforcement action, ERISA specifically provides a right of action in federal court for plan fiduciaries, participants and beneficiaries to bring claims for breach of the fiduciary duties of prudence and loyalty, for engaging in non-exempt prohibited transactions, and for other violations of ERISA's strict fiduciary standards. There is a developed

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body of case law interpreting how ERISA's fiduciary requirements apply to the management of investments. Thus, CIT investors are not solely dependent on the regulators to enforce applicable legal requirements.

	COLLECTIVE INVESTMENT TRUST	MUTUAL FUND
Principally Regulated By	OCC or state bank/trust regulator, DOL, IRS	SEC
Fees	Greater flexibility and generally lower fees relative to comparable mutual funds	Generally higher expense ratios with limited availability to customize fees (can only vary distribution and shareholder servicing fees among share classes)
Offering and Disclosure Documents	Declaration of Trust and Participation Agreement; fact sheets and other disclosures	SEC Registration Statement, which includes a Prospectus, Summary Prospectus. Statement of Additional Information
Trustee or Board of Directors	Trustee; ERISA Fiduciary for investment decisions	Board of Directors; Responsible for overseeing fund services in compliance with federal securities laws
Availability	Limited to tax-qualified corporate retirement plans and certain state and local government plans; they are not available to IRAs and cannot be sold directly to individual investors	General public

Cost Considerations

The differences in regulation impact the costs of investing. Because mutual funds are required to be registered with the SEC and are subject to much more extensive and specific rules on governance, disclosure, distribution and taxation, they tend to be subject to higher fees and costs than comparable CITs.

Conclusion

Mutual funds and CITs are highly regulated entities designed to serve particular purposes. Because CITs are specifically intended for retirement plans, they are not subject to a number of requirements applicable to mutual funds whose purpose is largely focused on a different market segment. But even absent these Securities Law requirements, investors in CITs remain well protected by banking law and ERISA, including ERISA's far-reaching fiduciary responsibility and prohibited transaction rules that are enforceable, unlike many of the Securities Law provisions, through a private right of action. CITs may also have investment flexibility and cost advantages over mutual funds. For these reasons, CITs should be considered a viable alternative to mutual funds for retirement plan investment.

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