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Congress Should Expand Investment Options For 403(b)s

By **Jason Levy** (December 9, 2024, 6:56 PM EST)


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The time is now to finish the job of providing 403(b) retirement plans with access to collective investment trusts, or CITs, by passing the Retirement Fairness for Charities and Educational Institutions Act, or S. 4917.

Currently, employees of hospitals, public schools and charities, and other participants in 403(b) retirement plans, do not have the same access to CITs that has been afforded to those who invest in private sector retirement plans, like 401(k) plans, for decades.

This lack of access harms participants in 403(b) plans.

CITs are strictly regulated and often cost less than other pooled investment products like mutual funds. According to an April 2023 study by Morningstar Inc., CITs are cheaper than mutual funds 88% of the time, with the average actively managed CIT costing 60% less than the average actively managed mutual fund.[1]

For retirement investors, these fee reductions can add up to tens of thousands or hundreds of thousands of additional retirement savings over the course of a career. Under current law, 403(b) plans do not have the opportunity to utilize this often lower-cost investment vehicle.

Congress has already expressed its intent to level the playing field. In 2022, the Secure 2.0 Act changed the tax laws to allow 403(b) plans to invest in CITs. But still, additional legislation is needed to amend the securities laws to provide 403(b) plans access to CITs.

A bill passed by the U.S. House of Representatives in March — Division F of the Expanding Access to Capital Act, or H.R. 2799 — and bills pending in the Senate — including S. 4917 and the Empowering Main Street in America Act, or S. 5139 — have received bipartisan support and would do just that by amending relevant provisions in the Securities Act, the Securities Exchange Act and the Investment Company Act.

This article explains why legislation should be passed to provide 403(b) plans with the same access to an investment vehicle that has been available to 401(k) plans for decades.

CITs are a strictly regulated investment product appropriate for 403(b) plans.

CITs are subject to regulation and legal oversight under federal and state banking law, and under general common law principles of fiduciary duty. In addition, CITs offer retirement investors protections not present in mutual funds or other investment vehicles.

CITs have been subject to regulation by the Employee Retirement Income Security Act since ERISA's enactment 50 years ago — providing retirement investors with additional protections. Unlike mutual funds, the investment managers of CITs must adhere to ERISA's fiduciary obligations, which require CITs to be managed with undivided loyalty for the exclusive benefit of the plan's participants and beneficiaries.

These fiduciary obligations were described in 1982 by the U.S. Court of Appeals for the Second Circuit in Donovan v. Bierwirth, and by subsequent federal appeals courts, as "the highest known to the law."[2] CIT investment managers must follow the stringent prohibited-transaction rules under ERISA and the U.S. tax code, which provide important protections to plan investors.

Both ERISA and non-ERISA 403(b) plans would benefit from the protections afforded by CITs.

Pending legislation will provide CIT access to both ERISA and non-ERISA 403(b) plans. When a non-ERISA 403(b) plan invests in a CIT, it will benefit from ERISA protections. As long as one of the investors in the CIT is an ERISA plan, all of the plan assets will be managed in accordance with the ERISA standard.

Under ERISA look-though rules, the investment managers for a CIT containing ERISA plan investors must manage the CIT and its underlying assets in accordance with ERISA and its fiduciary standards.

As practical matter, CIT trustees can be expected to use the same CIT vehicles for ERISA and non-ERISA plans to avoid the additional expense and administrative complexity of operating separate vehicles. Accordingly, non-ERISA 403(b) plans that invest in a CIT would benefit from the ERISA protections.

By contrast, mutual funds themselves are not subject to ERISA standards even if ERISA investors invest in them.

The pending legislation would give 403(b) plans access to a lower-cost investment vehicle.

As noted above, CITs often cost less than mutual funds utilizing the same investment strategy. Regulatory differences with mutual funds are the primary reason why CITs often produce these cost savings.

Mutual funds are designed for a broad investor base, including retail and institutional investors. Therefore, the U.S. Securities and Exchange Commission rules that governing them are focused on protecting the least sophisticated investors by requiring extensive disclosures for all potential investors, whether retail or institutional.

And because mutual funds must be sold by SEC-registered broker-dealers, they are subject to the Financial Industry Regulatory Authority's additional costly and burdensome conduct and marketing rules.

In sum, because mutual funds are available directly to retail investors, they are subject to stringent and

costly SEC and FINRA registration and marketing rules, specifically geared to provide extra protection to individual retail investors.

By contrast, CIT sales are more restricted. CITs are available only to institutional, tax-qualified investors like retirement plans. CITs are subject to a stringent regulatory regime designed to protect retirement investors — but aren't required to meet the more onerous obligations that apply to funds sold directly to retail investors.

Instead, there are tailored disclosure requirements applicable to retirement plan options, including CITs. As a result, CITs experience lower regulatory expenses, leading to reduced overall costs for retirement plan investors — which provides better prospects for higher performance outcomes than the same mutual fund product.

403(b) plan decision-makers may access fulsome information about CITs.

Just as private sector fiduciaries have fulsome access to information about CIT investment options, 403(b) plan decision-makers will benefit if legislation is passed to provide 403(b) plans access to CITs.

CITs are subject to a disclosure regime that is tailored to the needs of retirement plan investors. Under ERISA, CITs must follow (1) general fiduciary considerations that require accurate disclosures to investors and no misleading statements, and (2) streamlined disclosure requirements under ERISA that are tailored to provide participants and beneficiaries of a retirement plan appropriate information for them to direct investments of their individual plan accounts into the CIT.

These disclosure requirements include a table identifying the name and type of fund, e.g., large-cap, fixed income, balanced etc., specifying investment performance over standardized periods compared to a designated benchmark — an appropriate broad-based securities market index — and disclosing a fund's annual expense ratio.

Because CIT trustees have an obligation to treat all investors the same with respect to access to information, CITs can be expected to provide the information described above for both ERISA and non-ERISA plans.

These disclosures, combined with Morningstar tracking and reporting on CITs, provide private sector retirement plan fiduciaries with equal information about CITs and other investment vehicles — allowing fiduciaries to be investment vehicle agnostic when creating a plan investment lineup. One can expect the same result for 403(b) plan decision-makers if legislation is passed to provide 403(b) plans with access to CITs.

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[1] See Morningstar's 2023 Retirement Plan Landscape Report, https://www.morningstar.com/lp/retirement-plan-landscape-2023, at page 25.

[2] See, e.g., Donovan v. Bierwirth, 680 F.2d 263, 272 n.8 (2d Cir. 1982); Chao v. Hall Holding Co. Inc. , 285 F.3d 415, 426 (6th Cir. 2002); SEC v. Capital Consultants, LLC, 397 F.3d 733, 751(9th Cir. 2005).