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Proposed Legislation Authorizing CIT Investments May Provide 403(b) Plans with an Opportunity to Lower Fees and Increase Flexibility

Public schools and certain tax-exempt entities (entities established, e.g., for religious, charitable, scientific or educational purposes) may establish a Tax Code section 403(b) plan for their employees. These plans have (in some respects) less restrictive contribution rules than 401(k) plans.

Currently, under 403(b) plans, investments are limited to insurance company annuity contracts and mutual funds.

Legislation currently being considered by Congress would expand permitted 403(b) investments to include collective investment trusts ("CITs"). This legislation has broad bipartisan support, and there is a reasonable chance that it will pass this year.

For some 403(b) plans, the inclusion of CITs in the plan's portfolio or investment fund menu may reduce costs and increase choice—a clear gain both for employer-sponsors and their employees.

What are CITs?

CITs are tax-exempt, pooled investment vehicles maintained by a bank or trust company exclusively for certain investors, such as tax-qualified ("401(a)") retirement plans like 401(k) plans, defined benefit plans and Taft-Hartley plans, and for certain government plans.

They operate very much like mutual funds, with an investment portfolio managed by professionals, with a defined objective, but with significantly reduced regulatory overhead.

Advantages

CITs generally have lower fees than comparable mutual fund strategies, because of the reduced regulatory burden. In addition—and unlike mutual funds that are locked into explicit management fees by share class—CIT fees may be negotiable.

In addition, CITs allow a wide variety of investment strategies, and the combination of strategies. Thus, e.g., a CIT may include mutual funds and separate accounts in one vehicle.

Finally, CITs may simplify the investment oversight process for plan sponsors by allowing them to utilize one investment vehicle across multiple plan types. For instance, a university might use the same CIT for its defined benefit plan, its 401(k) plan, and (if this legislation passes) its 403(b) plan. In the past they could use the CIT for the pension and the 401(k) plan but if they wanted the same investment strategy in the 403(b) plan they would need to use a mutual fund vehicle. Combining assets this way allows fiduciaries to focus on one vehicle/one set of strategies which may reduce costs.

Increasing movement toward mutual fund-like transparency

While in the past, CITs have lacked some of the popular features of mutual funds, many of the bigger CITs/CIT providers have implemented daily valuation/daily pricing, daily trading, ticker symbols, "fact sheets," and many CITs now report information to Morningstar.

Not just for mega-plans

CITs have historically been a practical alternative only for mid-size or larger plans able to meet CIT investment minimums of $10 million or more. The CIT market is, however, changing, with innovations that open up investment in them to a broader range of plans.

For example, platforms have been developed in partnership with multiple asset managers that allow plan advisors to seamlessly onboard multiple plan clients. Such arrangements not only reduce the minimums for individual plans but enable advisors to access their preferred investment managers and thus to reinforce the consistency and quality of their offerings.

Improved participant outcomes, with a fiduciary kicker…

Given the expanded opportunities—reduced cost and increased flexibility—that CIT investments present, the proposed legislation, if adopted, will give employers with 403(b) programs significant new opportunities to improve participant outcomes and respond to participant demand for lower-cost alternatives and broader investment diversification.

One feature of the proposal should, however, be noted: it would impose fiduciary liability in some cases.

Under the proposal, to qualify for participation in a CIT under the securities laws (1) the 403(b) program must either be a governmental plan or be subject to ERISA title I (including ERISA's fiduciary rules), or (2) the employer must "agree to serve as a fiduciary for the plan with respect to the selection of the plan's investments among which participants can choose."

For non-governmental plans, thus, implementing a 403(b) CIT program will necessarily involve some fiduciary responsibility. In this regard we would simply observe that, given the recent focus of plaintiffs lawyers on 403(b) plans, and 403(b) fee litigation, the ability to use lower-fee CITs in these programs may be a feature and not a bug.

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Takeaways for sponsors

This proposal—part of broader, bipartisan retirement policy legislation—is currently being considered both by the House of Representatives and the Senate. As we noted at the top, there is a reasonable chance of it passing in this Congress, although much will depend on the politics of the next several months.

In anticipation of possible passage, sponsors may want to consider reviewing their 403(b) plan fund menu to determine which asset/fund choices may be appropriate in a CIT vehicle.

Sponsors thinking of moving to a 403(b) CIT strategy will want to review the issues such a change may present with their financial advisor, with their recordkeeper and other service providers, and with counsel.

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