

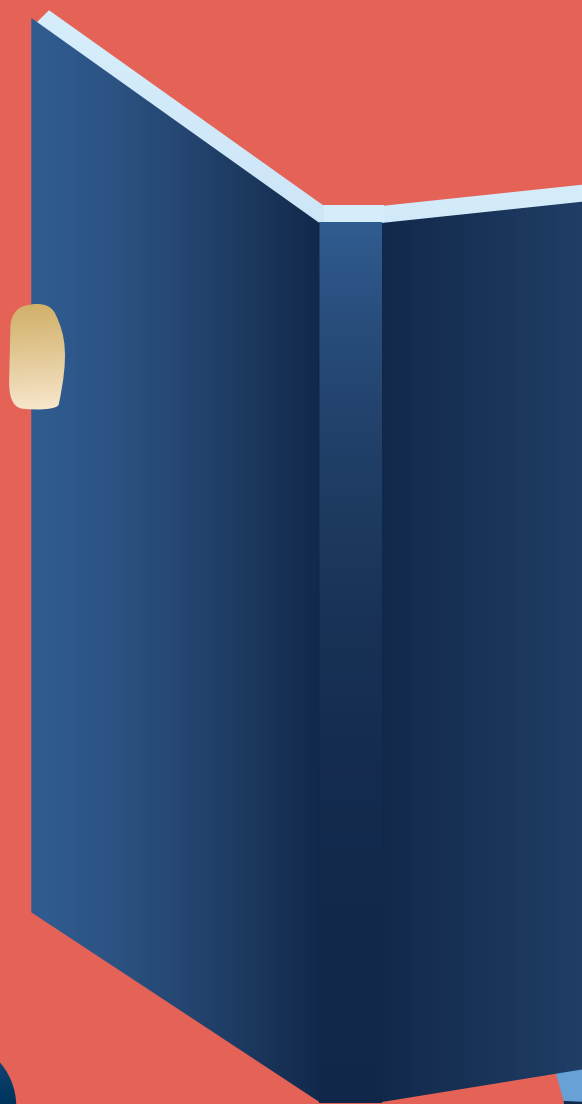
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# Collective Investment Trusts:

## What ERISA Plan Fiduciaries Need to Know

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Collective investment trusts (CITs) have become increasingly popular ERISA plan investment options as fiduciaries seek to lower investment management fees. What are CITs, and what should fiduciaries know before investing in them?

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**T**he rise in litigation against ERISA plan fiduciaries has driven employee benefit plan fiduciaries to look more critically at investment management fees. In this process, fiduciaries may be offered the option to move plan assets from a mutual fund to a collective investment trust (CIT).<sup>1</sup>

CITs are investment vehicles like mutual funds; however, unlike mutual funds, they are available only to institutional investors (e.g., retirement plans). Investment firms often offer CITs that hold the same underlying assets as the firm's mutual funds. But the investment management fees for CITs are usually lower than those of the sibling mutual fund. CITs are often marketed as being effectively the same as mutual funds, at a lower cost. This has led many fiduciaries to choose CIT investments over mutual funds. For instance, the share of defined contribution (DC) plan assets invested in CITs more than doubled—from 13% to 30%—over the past decade.<sup>2</sup>

Plan fiduciaries should be aware that CITs are not the same as mutual funds—even if they hold the same or similar underlying assets.<sup>3</sup> Because they are limited to institutional investors, CITs are regulated based on the assumption that the investors have the knowledge and bargaining power to safeguard their own interests. As such, CITs are much less regulated than mutual funds. This can be seen as a benefit because of lower cost but also can lead to less favorable legal terms in the areas of transparency, accountability and liquidity when compared with mutual funds.

The duty of prudence under the Employee Retirement Income Security Act (ERISA) requires employee benefit plan fiduciaries to evaluate the risks of an investment, including the legal risk.<sup>4,5</sup> When trustees are presented the opportunity to move assets from a mutual fund to a sibling CIT, they should evaluate whether less regulation for lower fees is a worthwhile trade, and they must understand the legal risks. This article will examine the background of CITs, explore the differences between mutual funds and CITs, and present strategies for evaluating potential investments in CITs.

### The History of CITs

In response to the stock market crash of 1929 and the Great Depression, Congress passed the Securities Act of 1933 and the Investment Company Act of 1940. These laws separated the banking industry from the investment industry and established a robust regulatory apparatus for investments offered to the public, such as mutual funds. In the 1950s, however, the Federal Reserve Board ruled that banks could pool retirement plan assets held in trust for investment purposes. And

the Securities and Exchange Commission (SEC) determined that these pooled investment trusts were mostly exempt from the Investment Company Act. This put banks back in the business of offering pooled investment vehicles to retirement plans. Today, most people call these bank industry investment vehicles CITs.<sup>6</sup>

For half a century, CITs have competed against mutual funds for employee benefit plan dollars. Because they escaped the regulation of the Investment Company Act, CITs had a built-in competitive advantage.<sup>7</sup> The investment industry spent decades lobbying for Congress to regulate CITs to the same standard as mutual funds. By the 1990s, those efforts appeared to have gained traction. The SEC issued a report recommending an even regulatory playing field for CITs and mutual funds.<sup>8</sup> But the SEC recommendation went nowhere, and investment companies eventually pivoted. Instead of continuing to champion mutual funds, they began collaborating with independent banks and trust companies, or establishing their own affiliated banks or trust companies, so they too could offer CITs to the retirement plan industry.

Through the 1990s, mutual funds were far more popular than CITs. It was easier to invest in and divest from mutual funds, and information about mutual funds was more readily available. Following the end of hostilities over the disparity in regulation, the investment industry embraced CITs. In the 2000s, CITs were allowed to trade on the National Securities Clearing Corporation platform, and investment industry research publications began covering CITs. As barriers to the adop-

tion of CITs fell, employee benefit plan investment in CITs rose.

The 2010s saw a proliferation of fiduciary breach claims under ERISA based on allegedly imprudent investment fees. Because CITs are less regulated, they cost less to administer. Investment firms pass some of those savings on to CIT investors—usually around five basis points or 0.05%. But the savings can be as much as 25 basis points or 0.25%. With CITs being billed as “the same as a mutual fund, but cheaper,” employee benefit plan fiduciaries began to wonder whether their fiduciary duties obligated them to select CITs over mutual funds.<sup>9</sup> Fiduciaries began investing in CITs en masse.

CITs now hold more than \$4 trillion in assets—almost ten times more than in 2000 when they held less than \$500 billion.<sup>10</sup> Over the same period, mutual fund assets grew by a relatively paltry factor of four. According to Morningstar, in 2024 CITs overtook mutual funds in the critical category of target-date funds (TDFs), holding more than 50% of employee benefit plan assets in the category.<sup>11</sup>

### Differences Between CITs and Mutual Funds

Owing to looser regulation, CITs are more flexible than mutual funds. They are not subject to some of the investment protections applied to mutual funds. The table on page 34 illustrates some of the major differences between mutual funds and CITs.

From the investor point of view, the differences in CIT regulation are neither all positive, nor all negative. For instance, it is positive that the trustee of a CIT is an ERISA fiduciary. This means that if an investment is mismanaged,

#### Collective Investment Trusts at a Glance

- Collective investment trusts (CITs) are pooled investments that are similar to mutual funds, but available only to institutional investors.
- 30% of defined contribution retirement plan assets are invested in CITs.
- CITs now hold more than \$4 trillion in assets.

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the plan sponsor could file a breach of fiduciary duty claim against the trustee of a CIT. Technically, the trustee of a CIT must have “exclusive management” of the CIT.<sup>12</sup> In practice, however, CIT trustees typically delegate complete investment management authority to an investment management firm, which is often unaffiliated with the trustee bank. This ambiguous dual authority is essentially unexplored by the courts, complicating and thereby deterring potential claims—particularly where the investment management firm offering a CIT is not affiliated with the trustee bank.

In addition, the trustee of a CIT is always a bank or trust company. The most common CIT trustees are very large banks, which have greater resources for defense compared with those of a plan fiduciary. Plans must factor the potential for success into the decision to expend plan assets to bring a claim. A plan fiduciary may have a greater chance of bringing a successful claim against a smaller investment firm—even if that investment firm is not an ERISA fiduciary. Fiduciary breach claims against CIT trustees are very rare.<sup>13</sup> Plan fiduciaries should be aware of the potential limitations of the fiduciary protections offered by CITs.

The different regulatory status for CITs also has pros and cons. Mutual funds are regulated by the SEC, which is a large federal organization with the stated mission “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” CITs trusted by national banks are regulated by the Office of the Comptroller of the Currency (OCC)—also a large federal organization—with the mission to ensure “that national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.” Investors should be aware that the OCC mission statement doesn’t specifically mention investors or an intent to protect investors.

Most of the largest CIT trustees, which together have more than half of all CIT assets under management, are state banks headquartered in states such as Massachusetts, Pennsylvania, New Hampshire and Maryland, so they are not

regulated by the OCC. For instance, the Massachusetts Division of Banks (DOB) is the regulator of Massachusetts state banks, under a mission “to ensure a sound, competitive, and accessible financial services environment throughout the Commonwealth.” As with the OCC, there is no mention of protecting investors. The investor protections offered by the state banking regulators vary by state, and banking authorities generally have fewer resources than an organization like the SEC.

## Fiduciary Responsibilities and Investing in CITs

ERISA requires plan fiduciaries to:

- Employ appropriate methods to investigate the merits of an investment and to structure the investment
- Engage in a reasoned decision-making process, consistent with that of a prudent person acting in a like capacity
- Monitor the prudence of their investment decisions to ensure that they remain in the best interest of plan participants.

In discharging these duties, employee benefit plan fiduciaries have a duty to take legal risks into account.<sup>14</sup>

Plans that are interested in investing in CITs should take the following steps to ensure that they are fulfilling their fiduciary duties.

### *Determine That the Investment Is a CIT*

Investment advisors do not always appreciate the differences between CITs, mutual funds and other investment

## takeaways

- Collective investment trusts (CITs) are investment vehicles that are similar to mutual funds but available only to institutional investors, such as retirement plans.
- Because CIT investment management fees are usually lower than those for mutual funds, many employee benefit plan fiduciaries have chosen CITs over mutual funds for plan assets.
- When considering moving assets to a CIT, employee benefit plan trustees should evaluate whether less regulation for lower fees is a worthwhile trade, and they must understand the legal risks.
- State and federal regulators that oversee CITs also are not specifically charged with protecting investors.
- Fiduciaries considering investing in CITs can fulfill their fiduciary duties by carefully reviewing and negotiating the terms.

TABLE

**Comparing Mutual Funds and Collective Investment Trusts (CITs)**

| Mutual Fund                                                                                                                    | CIT                                                                                                                                                                                           |
|--------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Available to the public                                                                                                        | Available only to retirement plans and similar institutional investors                                                                                                                        |
| Regulated by the U.S. Securities and Exchange Commission (SEC)                                                                 | Regulated by the U.S. Office of the Comptroller of the Currency (OCC) if the bank/trust is a national entity or by the applicable state banking regulator if the bank/trust is a state entity |
| Fees are all-inclusive, generally nonnegotiable.                                                                               | Fees are usually not all-inclusive, fund administrative expenses are paid from the fund assets before fees.                                                                                   |
| Liquidity minimum                                                                                                              | No minimum liquidity                                                                                                                                                                          |
| Leverage maximum                                                                                                               | No maximum leverage                                                                                                                                                                           |
| Daily valuation                                                                                                                | Daily valuation is not required.                                                                                                                                                              |
| Underlying investments limited to stated investment policy; cannot be changed without investor approval                        | Underlying investments can generally be altered at bank/trust discretion                                                                                                                      |
| No restrictions on transfer or assignment                                                                                      | Transfer and assignment are often prohibited.                                                                                                                                                 |
| Shares can be redeemed at any time, with settlement usually in seven days.                                                     | Withdrawal is subject to any restrictions in the trust agreement, which usually allow the bank/trust to suspend withdrawals in its discretion.                                                |
| Investment terms are effectively nonnegotiable.                                                                                | Terms can sometimes be negotiated, especially with large investments.                                                                                                                         |
| Annual and semiannual reports of holdings and other disclosures                                                                | Annual report of holdings (Form 5500)                                                                                                                                                         |
| Governed by board of directors; one of the directors must be independent from the investment firm that offers the mutual fund. | Governed by bank or trust company, no independence requirement                                                                                                                                |
| Boards of directors are not fiduciaries under the Employee Retirement Income Security Act (ERISA).                             | Bank or trust company is a fiduciary under ERISA.                                                                                                                                             |

vehicles. As such, an advisor may not offer up the fact that a recommended investment is a CIT. Plan fiduciaries should ask.

**Review the Terms**

Plan fiduciaries should recognize that CIT terms can vary quite dramatically, and some terms can be unfavorable. If the investment under consideration is sufficiently large, fiduciaries

should retain counsel with expertise in negotiating institutional investment agreements to review the trust and participation agreements; advise on any risks; and, if necessary, negotiate concessions. For smaller investments where the cost of retaining appropriately experienced counsel could materially affect the return on the investment, plan fiduciaries should consider whether a CIT is the appropriate vehi-

cle for the investment. A mutual fund or an exchange-traded fund (ETF) may be more appropriate under the circumstances.<sup>15</sup>

In cases where fiduciaries evaluate a potential investment that is offered both through a CIT and through a mutual fund or ETF, and the fiduciaries select the mutual fund or ETF even though the CIT costs more, the fiduciaries should record in minutes or other

documents their reasoning (e.g., that the indirect costs of the CIT, such as legal expenses, outweigh the difference in fees).

### Negotiate

If the plan counsel identifies concerns with the agreements for a potential CIT investment, the counsel can help plan fiduciaries negotiate with the investment management firm and bank that, together, offer the CIT.

Negotiating CIT terms involves unique challenges. Many other investment vehicles are effectively offered by one party. CITs, on the other hand, are often jointly offered by an investment management firm and an independent bank. The investment management firm's interests are not the same as those of the bank, and their respective interests may conflict.<sup>16</sup> This complicates negotiations. Having counsel with prior experience negotiating CIT terms can improve the odds of a successful negotiation.

Another way to improve the odds of attaining satisfactory terms is to select CIT investments from firms that focus on managing Taft-Hartley plan assets. Taft-Hartley plans are among the largest in the country and have the resources to drive a shrewd bargain. Firms that cater to Taft-Hartley plans often offer CITs that require little or no negotiation, because the negotiation was already done by earlier Taft-Hartley investors. In any negotiation, plan fiduciaries should keep in mind that the strength of their bargaining position derives from the fiduciaries' ability to walk away. Plan fiduciaries that are willing to walk away will likely achieve the best terms and establish a reputation for demanding favorable terms.

### Conclusion

CITs are on the rise. What was once the exclusive domain of the largest employee benefit plans is fast becoming a part of plans across the spectrum. Plan fiduciaries should be aware that CITs are different from mutual funds and prudently evaluate the impact of those differences. Plan fiduciaries should generally consult legal counsel with appropriate expertise when considering a CIT investment. ●

### Endnotes

1. Collective investment trusts (CITs) are not available to 403(b) plans. See, 26 USC § 403(b)(1) and (7). References in this article to Employee Retirement Income Security Act (ERISA) fiduciaries do not include fiduciaries of 403(b) plans.

bio



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2. Lia Mitchell, *2023 Retirement Plan Landscape Report: An In-Depth Look at the Trends And Forces Reshaping U.S. Retirement Plans* (2023), page 24. Morningstar Center for Retirement and Policy Studies.

3. *Parmer v. Land O'Lakes, Inc.*, 518 F. Supp. 3d 1293, 1305–06 (D.Minn. 2021).

4. 29 CFR §2550.404a-1(b)(2).

5. Department of Labor (DOL) Information Letter 1996-03-21.

6. They are also sometimes referred to as collective investment funds, CITs or commingled trusts. See, also, 12 CFR §9.18(c)(a)(ii). (This establishes authority for national banks to establish "collective investment funds," which are the vehicles under discussion in this article. It is unclear why the CIT terminology has prevailed over alternatives.)

7. See, 15 U.S.C. § 77c (exempting CITs from SEC regulations but not exempting mutual funds).

8. See, U.S. Department of Treasury Report, *Modernizing the Financial Industry*, page 59 (1991).

9. Some plaintiffs' firms have, in fact, asserted that ERISA fiduciaries are obliged to select CITs over mutual fund versions of the same investment. Courts, however, have generally rejected that argument. *Parmer v. Land O'Lakes, Inc.*, 518 F. Supp. 3d 1293, 1305–06 (D.Minn. 2021).

10. See, Coalition of Collective Investment Trusts, white paper: *Collective Investment Trusts* (2015); T. Godbout, "CITs Dominant as Target Date Asset Holders," American Society of Pension Professionals and Actuaries (ASPPA).

11. M. Pacholok, "CITs Dethrone Mutual Funds as the Most Popular Target-Date Vehicle," Morningstar.

12. See, e.g., 12 CFR §9.18.

13. Fiduciary breach claims are most commonly brought by plan participants against plan sponsors, such as a plan's board of trustees. For an example of a claim brought by plan participants against a CIT trustee, see *Nelsen v. Principal Global Investors Trust Company*, 362 F.Supp.3d 627 (2019).

14. *Tatum v. RJR Pension Inv. Comm.*, 2014 U.S. App. LEXIS 14924 (4th Cir. Aug. 4, 2014).

15. Although every CIT is unique, in the author's experience the providers of a CIT are usually unwilling to allocate resources to negotiating with a potential investor unless the contemplated investment is at least in the range of \$10 million to \$50 million. There can, of course, be exceptions, such as where a single investment is small but the plan or its affiliates have other investment relationships with the CIT providers that, in aggregate, are large.

16. For example, in the author's experience, investment managers are usually willing to negotiate, but the bank may begin discussions by asserting that the terms of the CIT are not negotiable. Fiduciaries should recognize that most things are negotiable when there is enough money at stake.